Review of New York City's Financial Plan For Fiscal Years 2006 Through 2009

July 2005

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I. Executive Summary

On July 6, 2005, the City of New York submitted to the Financial Control Board a modification to its financial plan for FY 2005 and a new four-year financial plan for fiscal years 2006 through 2009 (the "July Plan"). Although the City ended FY 2005 with an estimated surplus of $3.5 billion and projects a balanced budget for FY 2006, the July Plan shows budget gaps of $4.5 billion for each of fiscal years 2007 and 2008 (see Table 1). The FY 2007 budget gap represents 13.3 percent of City fund revenues, and results from the use of nonrecurring resources to balance the FY 2006 budget, the expiration of temporary taxes, and growth in nondiscretionary expenses.

The City's economy continues to recover from the recession that began in March 2001 and the terrorist attack on the World Trade Center. Wall Street profits rebounded in calendar year 2003 to reach $16.8 billion—the second-highest level on record. Elevated activity in underwriting and mergers and acquisitions is expected to yield profits of $14.4 billion in calendar year 2005, but the first quarter was disappointing. Since the end of the recession, private sector employment has grown by 63,300 jobs, including 10,000 jobs in the high-paying securities industry.

The FY 2005 surplus is the largest on record, although as a percent of City fund revenues it is smaller than the peak level reached in FY 2000. Tax revenues were $3.5 billion higher than the City's conservative forecasts for FY 2005, and these account for virtually the entire surplus. Personal income and business tax revenues were higher by $1.8 billion, and tax revenue from real estate transactions was higher by $1.4 billion, or 93.6 percent, which reflects a booming real estate market.

After the growth in spending was held down to the local inflation rate during fiscal years 2002 and 2003, spending grew by almost 10 percent during each of fiscal years 2004 and 2005, and is projected to grow by another 7.5 percent in FY 2006. Recurring revenues are not keeping pace, however, and the City has balanced the FY 2006 budget with $4.6 billion in nonrecurring resources, which includes the entire FY 2005 surplus—leaving nothing for future years.

Much of the growth in spending has been fueled by nondiscretionary spending. Even though the City will benefit by $1 billion annually by FY 2009 from actions taken by the State to hold down the cost of Medicaid for localities, the City will nevertheless devote an increasing share of revenues to nondiscretionary expenses. City-funded spending for debt service, pension contributions, Medicaid, and health insurance for municipal employees is projected to consume more than half of City fund revenues in FY 2009, compared with 37 percent in FY 2003.

While our review has identified areas that could generate net resources of $770 million in FY 2006, the City faces a number of potentially costly budget risks (see Table 2). For example, the July Plan does not consider the possibility that an arbitration panel will make a nonbinding recommendation that the City's teachers, who have been without a contract since May 2003, should receive wage increases similar to the two-year retroactive wage increase of 10.25 percent awarded to police officers.

The July Plan also assumes that all employees will self-fund wage increases retroactive to FY 2005 with productivity or other savings, and that they will accept annual wage increases of 1.25 percent beginning in FY 2006. Although retroactive productivity savings will be difficult to obtain, one possible source of funding could come from changes in actuarial methods proposed by the City Actuary that could reduce pension contributions by $1.1 billion during fiscal years 2006 and 2007.

The City faces additional budget risks, including whether it will be required to increase education funding by substantial amounts as part of any resolution of the Campaign for Fiscal Equity lawsuit, and whether the current economic recovery will be sustained throughout the financial plan period.

A number of City-related public authorities also face fiscal challenges. The Off-Track Betting Corporation projects increasing losses during the financial plan period, and while the Metropolitan Transportation Authority is on track to balance its budget during calendar years 2006 and 2007, it still faces long-term fiscal challenges. The Health and Hospitals Corporation is making progress balancing this year's budget on a cash basis, but it continues to operate in a difficult financial environment.

The City's finances have stabilized in the aftermath of the terrorist attack on the World Trade Center, the economy continues to improve, and the City's credit rating is at its highest level since the 1975 fiscal crisis. Given the size of the budget gaps and budget risks facing the City, however, the City should begin the process of identifying actions that will help balance the FY 2007 budget and narrow the out-year budget gaps. While the FY 2007 budget gap is formidable, the City has demonstrated the ability to manage gaps of this magnitude in the past.

Table 1
Four-Year Financial Plan
(in millions)

	FY 2006	FY 2007	FY 2008	FY 2009
REVENUES				
Taxes				
General Property Tax	$12,452	$ 13,136	$ 14,067	$ 14,722
Other Taxes	16,644	16,749	16,697	17,646
Discretionary Transfers[1]	947	---	---	---
Tax Audit Revenue	512	509	509	509
Tax Program	(221)	(233)	(92)	(141)
Miscellaneous Revenues	4,826	4,486	4,506	4,528
Unrestricted Intergovernmental Aid	562	562	562	562
Anticipated State & Federal Actions	50	---	---	---
Less: Intra-City Revenues	(1,289)	(1,271)	(1,270)	(1,271)
Categorical Grant Disallowances	(15)	(15)	(15)	(15)
Subtotal: City Funds	$ 34,468	$ 33,923	$ 34,964	$ 36,540
Other Categorical Grants	927	923	928	934
Inter-Fund Revenues	364	355	344	343
Total City & Inter-Fund Revenues	$ 35,759	$ 35,201	$ 36,236	$ 37,817
Federal Categorical Grants	5,109	4,860	4,850	4,850
State Categorical Grants	9,320	9,372	9,432	9,475
Total Revenues	$ 50,188	$ 49,433	$ 50,518	$ 52,142
EXPENDITURES				
Personal Service				
Salaries and Wages	$ 18,151	$ 18,260	$ 18,437	$ 18,651
Pensions	4,735	5,086	4,979	4,851
Fringe Benefits	5,549	5,804	6,145	6,467
Subtotal – Personal Service	$ 28,435	$ 29,150	$ 29,561	$ 29,969
Other Than Personal Service				
Medical Assistance	$ 5,024	$ 5,172	$ 5,319	$ 5,458
Public Assistance	2,516	2,504	2,504	2,504
Pay-As-You-Go Capital	200	200	200	200
All Other	14,246	13,769	13,886	14,066
Subtotal – Other Than Personal Service	$ 21,986	$ 21,645	$ 21,909	$ 22,228
Debt Service	3,337	4,116	4,488	4,841
Budget Stabilization-Discretionary Transfers[1]	(2,581)	- - -	- - -	- - -
General Reserve	300	300	300	300
Subtotal – Expenditures	$ 51,477	$ 55,211	$ 56,258	$ 57,338
Less: Intra-City Expenses	(1,289)	(1,271)	(1,270)	(1,271)
Total Expenditures	$ 50,188	$ 53,940	$ 54,988	$ 56,067
Gaps To Be Closed	**$ - - -**	**$ (4,507)**	**$ (4,470)**	**$ (3,925)**

Source: NYC Office of Management and Budget

[1] FY 2006 includes the benefit of FY 2005 discretionary transfers and prepayments of $3.528 billion. These 2005 discretionary transfers include prepayments of subsidies of $645 million, lease debt service of $88 million, and budget stabilization of $1.848 billion, to total $2.581 billion; and a TFA grant of $947 million, which increased FY 2006 revenue by $947 million.

Table 2
OSDC Risk Assessment of NYC Financial Plan

(in millions)

	Better/(Worse)			
	FY 2006	**FY 2007**	**FY 2008**	**FY 2009**
Gaps per July Plan	**$ - - -**	**$ (4,507)**	**$ (4,470)**	**$ (3,925)**
Tax Revenues	$ 450	$ 200	- - -	- - -
Savings from Prior Years' Expenses	200	- - -	- - -	- - -
Battery Park City Asset Sale	150	- - -	- - -	- - -
Delayed Hiring	50	- - -	- - -	- - -
FY 2005 Pension Fund Investment Earnings	10	25	50	75
Federal Assistance	(50)	- - -	- - -	- - -
Uniformed Agency Overtime	(40)	(25)	(25)	(25)
OSDC Risk Assessment	**770**	**200**	**25**	**50**
Surplus/Gaps to be Closed	**$ 770**	**$ (4,307)**	**$ (4,445)**	**$ (3,875)**
Other Risks and Potential Offsets[2]				
Current Round of Collective Bargaining[3]	(1,050)	(500)	(500)	(500)
Next Round of Collective Bargaining[4]	(750)	(950)	(1,200)	(1,500)
Campaign for Fiscal Equity Settlement	- - -	(575)	(1,100)	(1,600)
Change in Pension Methodologies[5]	640	490	(20)	(200)

[2] The July Plan includes a general reserve of $300 million annually. The July Plan also includes $200 million annually for pay-as-you-go capital financing, which the City has used on occasion in the past to help fund operating costs. We also note that extension of the temporary personal income tax surcharge on high-income earners, which is scheduled to expire on December 31, 2005, would generate about $300 million in FY 2006 and about $600 million annually thereafter.

[3] The July Plan assumes that all uniformed employees will agree to economic terms similar to those awarded to the Police Benevolent Association, which included a two-year retroactive wage increase of 10.25 percent covering fiscal years 2003 and 2004, and productivity improvements to help fund the recurring cost. The estimates in the table assume that the City and the United Federation of Teachers (UFT) will agree to similar economic terms for the same liability period. The costs shown in the table could be reduced if the City and the UFT agree to productivity improvements.

[4] The July Plan assumes that all employees will self-fund their wage increases in FY 2005 with productivity or other savings. The July Plan includes a reserve for collective bargaining sufficient to fund annual wage increases of 1.25 percent for all employees beginning in FY 2006. Wage increases at the projected rate of inflation for all employees who have yet to reach new agreements covering FY 2005, and for all employees beginning in FY 2006, would increase the projected gaps by the amounts shown in the table. The potential liabilities could be reduced to the extent that the City and the municipal unions reach agreements on productivity savings.

[5] The City's contribution to its pension funds was $185 million higher in FY 2005 than would have been required if the City Actuary's proposed changes in actuarial methods had been implemented. The estimated savings shown in the table could be higher by $185 million if the Actuary's recommendations are adopted in FY 2006 and the City recoups the overpayment.

II. Economic Outlook

New York City's economy has improved considerably since the recession and the terrorist attack on the World Trade Center. The Wall Street rebound in calendar year 2003 boosted incomes and spending, which gave the local economy a needed lift. The economy is now producing jobs at a modest rate. Tourism has recently surged, aided by a lowered value of the dollar, while commercial and residential real estate markets remain energetic as property values climb. Yet the current economic performance falls well short of the boom seen in the late 1990s.

In general, modest economic growth is expected to continue in the coming years, although the City's economic expectations have softened since February 2005. Inflation and interest rates are now projected to be higher throughout the Financial Plan period than previously projected, while economic growth is projected to be lower, most notably in calendar years 2006 and 2007. The outlook for Wall Street profits was also reduced for calendar year 2007.

The July Plan assumes a modest slowdown in the national economy during the second half of calendar year 2005. The City anticipates that growth in business spending will buoy the economy as consumer spending slows in response to high energy prices and rising interest rates. The Federal Reserve is expected to slowly and steadily raise the Fed Funds rate to 4 percent by the end of 2005 and to 4.5 percent by the end of 2006. As a result, national inflation is projected to increase by 2.6 percent in 2005 but then slow to 2 percent in 2006. The City projects that the national economy will grow by 3.7 percent in 2005, but that rising interest rates will then dampen growth to around 3 percent annually from 2006 through 2009. The July Plan assumes that national employment will grow by 1.7 percent in 2005, but then slow to 1.2 percent in 2006 and to about 0.8 percent annually from 2007 to 2009.

The City's economy began to improve when Wall Street profits rebounded in 2003 to $16.8 billion—the second-highest level on record. Although profits eased to $13.7 billion in 2004, the City expects that improved activity in underwriting and mergers and acquisitions will help Wall Street profits increase to $14.4 billion in 2005. Profits in the first quarter of 2005, however, totaled $2.6 billion—about half the level of one year earlier—as rapid growth in interest expenses eroded revenue gains. Wall Street has resumed hiring, with 3,200 jobs added in 2004 and 3,400 new jobs expected in 2005. The recovery in employment and year-end Wall Street bonuses also helped wage growth in the City rebound, to 6.8 percent in 2004, but the softer economy and lower profits are expected to dampen wage growth to about 6.1 percent in 2005. The July Plan assumes that Wall Street profits will remain near $14 billion in

2006, but it also assumes that higher interest rates will reduce profits to $10 billion in 2007. Lower profits are expected to hold down wage growth to 4.5 percent in 2006 and 3.3 percent in 2007.

After three years of decline, the City's economy added 10,000 jobs in 2004, with much of the increase coming in the second half of the year. Tourism-related industries (leisure and hospitality services, and retail trade), health care industries, and Wall Street accounted for most of the job gains. Monthly data for early 2005 shows job growth in most industries, although total gains have slowed since January. The City projects that job growth will rise to nearly 40,000 jobs in 2005, primarily in professional and business services, leisure and hospitality, health care, and retail trade. Overall growth is expected to slow to 25,000 jobs in 2007 before a modest rebound to a 31,000-job gain in 2009.

Because inflation erodes the purchasing power of consumers and businesses—effectively reducing their incomes and profits—it can lower economic activity. Since 2002, inflation has increased in the New York metropolitan area by nearly one percentage point more than the national rate, and inflation in the City has risen to annualized rates not seen since the early 1990s, reaching 3.7 percent in the first half 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 one percentage point higher in the City (at 3.2 percent) than in the nation in the first half of 2005. Much of this difference can be traced to higher local housing costs. Despite the high inflation rate so far this year, the July Plan assumes that local inflation will slow down during the second half of calendar year 2005, as rising interest rates begin to have an effect on the economy, and that inflation will average 3 percent for the year before falling to 2.4 percent in 2006.

The June forecast from Global Insight anticipates a somewhat weaker short-term national economic outlook. Some anemic economic reports, including the slowdown of the Gross Domestic Product (GDP) in the first quarter of 2005, have caused Global Insight to lower its GDP forecast and raise its inflation forecast. Compared to the City, Global Insight now projects slightly less GDP growth and slightly higher inflation in 2005, but similar national employment growth. The forecasts converge in the later years of the Financial Plan period.

The economic risks to the City's Financial Plan have not changed much since February 2005. High oil prices and interest rates are two major factors that will continue to determine economic growth. Other risks include high debt levels for consumers and businesses, widening budget and trade deficits, the effects of the revaluation of the Chinese yuan, and sluggish economic growth overseas.

III. Fiscal Year 2005

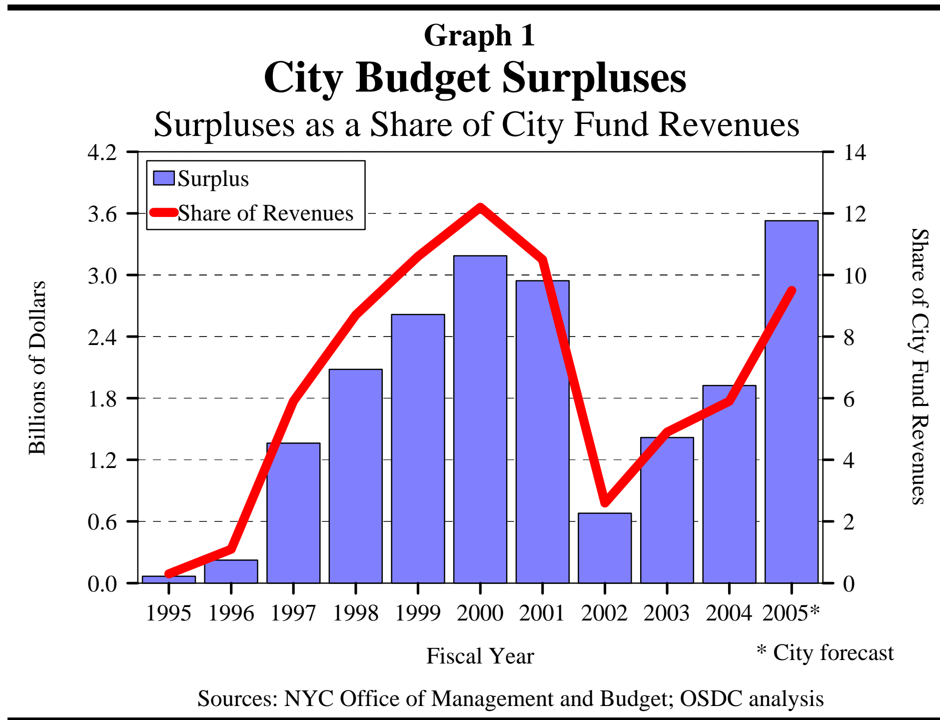
For a second consecutive year, New York City's budget has benefited from an unexpected surge in tax revenues. In FY 2004, the budget benefited from a rebound on Wall Street and increased real estate transaction activity. In FY 2005, the driving forces were revenues from real estate transaction activity—which were $1.4 billion or 93.6 percent higher than at the beginning of the fiscal year—and personal income and business tax revenues, which were higher by $1.8 billion. In total, tax revenues were higher by almost $3.5 billion, accounting for virtually the entire $3.5 billion surplus projected for FY 2005 (see Table 3).

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 peak level reached in FY 2000 (9.5 percent in FY 2005 compared to 12.2 percent in FY 2000). The July 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. The budget gaps projected for fiscal years 2006 and 2007 have risen moderately since the June 2004 forecast, but the gap for FY 2008 is substantially larger.

Graph 1

City Budget Surpluses

Surpluses as a Share of City Fund Revenues



Sources: NYC Office of Management and Budget; OSDC analysis

Table 3
Financial Plan Reconciliation
June 2004 Plan vs. July 2005 Plan

(in millions)

Better/(Worse)

	FY 2005	FY 2006	FY 2007	FY 2008
Surplus/(Gaps) per June 2004 Plan	**$ 220**	**$ (3,894)**	**$ (4,522)**	**$ (3,681)**
Revenues				
Tax Revenues				
Real Estate–Related Taxes	$ 1,359	$ 488	$ 166	$ 74
Personal Income Tax	1,060	507	354	134
Business Taxes	770	392	411	281
Real Property Tax	(54)	439	579	693
All Other Taxes	350	179	181	109
Subtotal	**3,485**	**2,005**	**1,691**	**1,291**
Other				
Anticipated State Aid	(201)	(196)	(94)	(77)
Anticipated Federal Aid	(50)	- - -	- - -	- - -
TSASC	(120)	120	(2)	(2)
Battery Park City Authority	(150)	- - -	- - -	- - -
Other	424	121	51	45
Total	**3,388**	**2,050**	**1,646**	**1,257**
Expenditures				
Collective Bargaining	(873)	(544)	(719)	(943)
Medicaid*	(184)	(334)	(508)	(699)
Uniformed Agency Overtime**	(160)	12	(9)	(9)
Department of Education	(110)	(142)	(110)	(110)
Energy Costs	(55)	(113)	(127)	(110)
Hudson Yards Debt Service	(6)	(46)	(95)	(139)
City Debt Service	169	145	7	(46)
Agency Needs	115	(449)	(131)	(159)
Fringe Benefits	34	(69)	(29)	(32)
Pension Contributions	9	(622)	(564)	(468)
Budget Adoption	- - -	(229)	- - -	- - -
TFA Debt Service	- - -	- - -	193	- - -
Total	**(1,061)**	**(2,391)**	**(2,092)**	**(2,715)**
Reserves				
General Reserve	260	- - -	- - -	- - -
Prior Years' Expenses	200	- - -	- - -	- - -
Total	**460**	**- - -**	**- - -**	**- - -**
Agency Actions	521	- - -	- - -	- - -
Net Change During FY 2005	**$ 3,308**	**$ (341)**	**$ (446)**	**$ (1,458)**
Surplus/(Gaps) per July 2005 Plan	**$ 3,528**	**$ (4,235)**	**$ (4,968)**	**$ (5,139)**

* State actions to slow the growth in Medicaid are reflected in the City's gap-closing program.

** The Police Department funded an increase in its overtime costs of $85 million from internal reserves.

Sources: NYC Office of Management and Budget; OSDC analysis

A. Revenue Reestimates

Tax revenues are projected to exceed the June 2004 estimates by nearly $3.5 billion in FY 2005 (see Table 3). The City also raised its revenue forecasts for fiscal years 2006 through 2008 by between $1.3 billion and $2 billion annually. Almost 40 percent ($1.4 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 a year, long-term rates have not responded—the rate on the ten-year Treasury bond has actually fallen since June 2004—and mortgage rates are now below last year's levels. Refinancings had tapered off but have recently surged again, and purchase activity remains strong, so the expected sharp drop in transaction activity did not occur.

While tax collections from real estate transactions are now expected to drop sharply in FY 2006, an 11 percent increase in assessed values 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 $1.1 billion. The additional revenue comes mostly from higher-than-expected wage growth and from a surge in year-end final and extension payments. Improved economic performance lifted business tax collections by $770 million above the levels expected in June 2004.

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 (excluding an increase in education aid), 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 $120 million lower 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 still-unspecified actions. Finally, the receipt of $150 million from the sale of property to the Battery Park City Authority (BPCA) was removed from the May 2005 Plan. Although a new date for its completion has not been set, BPCA's financial plan makes provision for the transfer of these resources to the City.

B. Expenditure Reestimates

Expenditures are projected to exceed the estimates in the June 2004 Plan by $1.1 billion in FY 2005, $2.4 billion in FY 2006, $2.1 billion in FY 2007, and $2.7 billion in FY 2008. Although the impact in FY 2006 should be mostly offset by higher-than-anticipated revenues, the unexpected spending has caused budget gaps to widen by $446 million in FY 2007 and by $1.5 billion in FY 2008 (see Table 3).

The City increased its reserves for collective bargaining by $873 million in FY 2005, mostly to fund retroactive wage increases for uniformed employees, consistent with the June 2005 police arbitration award. The amounts added in subsequent years reflect the recurring cost of wage increases for uniformed employees, offset by anticipated productivity improvements, and a reserve to help fund the next round of collective bargaining.

Medicaid will cost $1.7 billion more during fiscal years 2005 through 2008 than the projections made in June 2004. These estimates did not anticipate the cost-containment and other actions taken by the State in March 2005 that will reduce costs (for further discussion, see "State Actions" in Section IV of this report). Pension contributions are essentially unchanged for FY 2005, but the City's projections grew by $622 million for FY 2006, $564 million for FY 2007, and $468 million for FY 2008. These estimates reflect the recommendations of an independent actuarial consultant that assessed the pension funds pursuant to a biennial review mandated by the City Charter.

Spending for education exceeded the June 2004 estimates by more than $100 million annually, largely because of unexpected year-end overspending in FY 2004. Overtime in the uniformed agencies was $143 million higher than expected in FY 2005, and other agency spending is projected to be higher by $449 million in FY 2006.

Debt service will be lower in FY 2005 because there was no need for short-term borrowing given the City's large cash balance. It will also be lower in FY 2006 because of savings from bond refundings. In fiscal years 2007 and 2008, however, debt service costs will be higher than previously forecast because of increased capital spending and interest costs related to development of the far West Side of Manhattan. Debt service on bonds issued by the Transitional Finance Authority will be lower by $193 million in FY 2007 because the City paid down $200 million of high coupon debt in FY 2005.

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 similar savings during the Financial Plan period, although such savings are not reflected in the July 2005 Plan.

IV. Balancing the FY 2006 Budget

In the absence of the FY 2006 gap-closing program and the transfer of the FY 2005 surplus, the July Plan would have shown a budget gap of $4.2 billion in FY 2006 and about $5 billion in each of fiscal years 2007 through 2009. The City narrowed the FY 2006 budget gap to $700 million by transferring the FY 2005 surplus into FY 2006, and closed the remaining gap through a combination of federal, State, and City agency actions (see Table 4).

The FY 2006 gap-closing program will have only a minimal effect on the out-year budget gaps, however, 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 gap-closing program, the July Plan projects gaps of $4.5 billion in fiscal years 2007 and 2008, and $3.9 billion in FY 2009. Most of the recurring benefit of the gap-closing program comes from State actions, most notably those intended to hold down the growth in Medicaid.

Table 4
Gap-Closing Program
(in millions)

	Better/(Worse)			
	FY 2006	**FY 2007**	**FY 2008**	**FY 2009**
Gaps to be Closed	**$ (4,235)**	**$ (4,968)**	**$ (5,139)**	**$(4,836)**
FY 2005 Surplus	3,528	- - -	- - -	- - -
Agency Actions	476	318	317	318
State Actions	317	375	443	733
Federal Actions	50	- - -	- - -	- - -
Debt Service	85	1	1	1
Tax Reductions	(221)	(233)	(92)	(141)
Total	**$ 4,235**	**$ 461**	**$ 669**	**$ 911**
Remaining Gaps	**$ - - -**	**$ (4,507)**	**$ (4,470)**	**($3,925)**

Sources: NYC Office of Management and Budget; OSDC analysis

A. Agency Actions

Agency actions are expected to generate $476 million in FY 2006, but the recurring value declines to slightly more than $300 million. The largest contribution is expected from the Police Department ($146 million in FY 2006), with most of the savings to come from reducing personal service reserves and from federal homeland security grants.

B. 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 based on that budget the July Plan estimates that the City's FY 2006 budget will benefit by $317 million in State gap-closing assistance (see Table 5) and another $323 million in State education aid.

Table 5
State Gap-Closing Assistance
(in millions)

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

Sources: NYC Office of Management and Budget; OSDC analysis

The value of the State's 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 it assumed in the February 2005 Plan. The availability of these resources, however, may depend on the State's own financial condition in those years because most of the future assistance—discussed below—would come from a State assumption of local Medicaid costs.

- The State was credited with extending the City's sales tax on clothing purchases under $110 until March 31, 2007, which was expected to 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 City, however, subsequently successfully petitioned the State to reinstate the sales tax exemption.
- Medicaid cost-containment initiatives are expected to 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, reducing benefits, requiring prior authorization for certain drug prescriptions, and implementing a preferred drug list.

- 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.

C. Federal Actions

The July 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. Congress, however, has 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. Moreover, a recent federal audit of Medicaid claims filed by the Department of Education found lax record-keeping that resulted in $435 million in questionable federal reimbursements, and this could lead to a disallowance.

D. Tax Reduction Program

In addition to the real property tax rebate program, which began in FY 2005 and is scheduled to expire after FY 2007, the FY 2006 adopted budget includes additional tax reductions. These reductions, which are valued at $221 million in FY 2006 but decline in value to $141 million by FY 2009, are comprised of the following components.

- The State reinstated the City's sales tax on clothing purchases under $110 until April 1, 2007, as part of the State budget process, but the City successfully petitioned the State to roll back the tax effective September 1, 2005. Reinstating the exemption earlier will reduce City tax revenues by $184 million in FY 2006 and by $166 million in FY 2007.

- Incentives for Lower Manhattan will provide additional commercial rent tax exemptions for commercial and retail space, sales tax exemptions, industrial business zones relocation credits, and enhancements to the relocation and employment assistance program. These incentives are valued at about $17 million in FY 2006 and grow to $42 million by FY 2009.

- Other tax reduction initiatives will provide real property tax relief for senior citizens, the disabled, and owners who renovate small rental buildings, and will provide J-51 benefits for repairs to Mitchell-Lama properties and for lead paint abatement. Finally, the unincorporated business tax will be phased out for out-of-city small business transactions. Collectively, these items are valued at $20 million in FY 2006, rising to $99 million in FY 2009.

E. Debt Service Initiatives

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

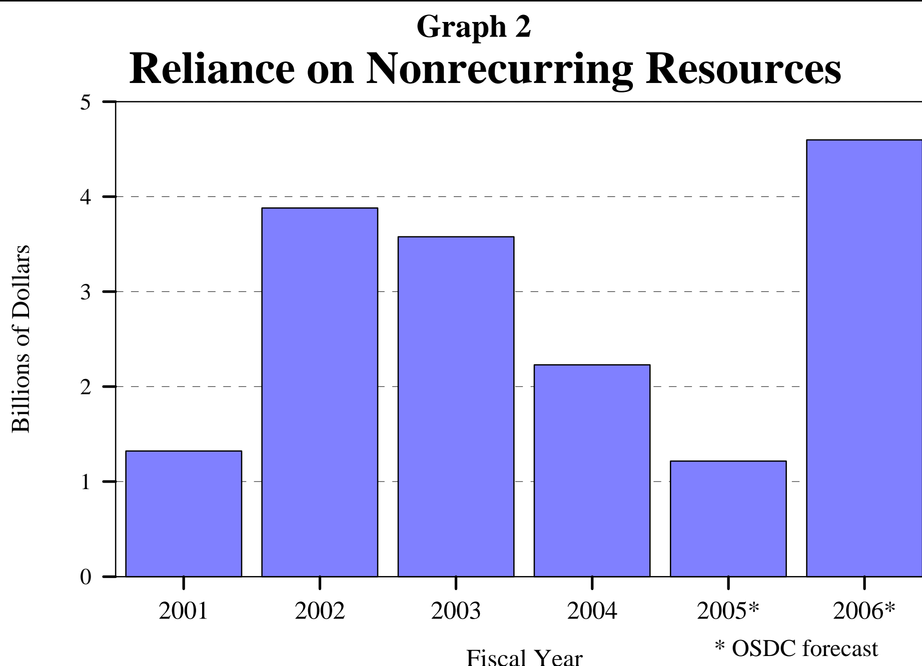
V. The Out-Year Budget Gaps

The July Plan successfully closes a budget gap of $4.2 billion for FY 2006, but leaves out-year budget gaps of $4.5 billion in each of fiscal years 2007 and 2008 and $3.9 billion in FY 2009. Large gaps remain because the City has relied so heavily on nonrecurring resources to balance the FY 2006 budget rather than on actions that would produce recurring benefits.

Since FY 2001 the City has relied heavily on nonrecurring resources to balance the budget and to support a level of spending that it could not otherwise afford. While the reliance on nonrecurring resources during times of fiscal stress is understandable, it becomes questionable at a time when the economy is growing at a modest rate, Wall Street is experiencing record years, and the real estate industry is booming (see Graph 2). The FY 2005 budget included $879 million in temporary tax increases approved by the State to help the City weather its latest fiscal crisis, $744 million from retroactive airport lease payments from the Port Authority of New York and New Jersey, and an additional $502 million from the MAC refinancing initiative. In FY 2006, we estimate that the budget was balanced with $4.6 billion in nonrecurring resources, which includes the FY 2005 surplus of $3.5 billion (see Appendix).

Graph 2

Reliance on Nonrecurring Resources



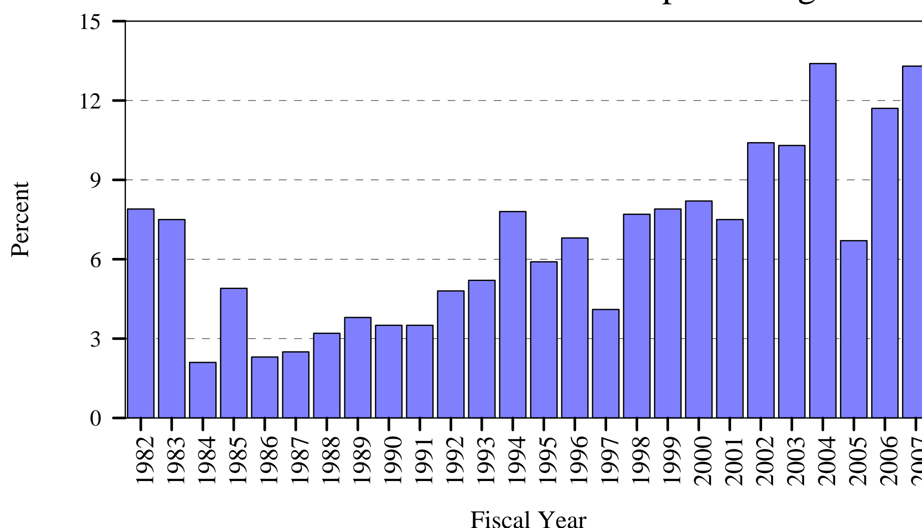
Sources: NYC Office of Managment and Budget; NYC Comptroller; OSDC analysis

The out-year budget gaps are large, both in absolute dollars and as a percent of City fund revenues. The FY 2007 budget gap represents 13.3 percent of City fund revenues and is the second-largest gap as a percent of City fund revenues to be projected at this point in the financial planning process (see Graph 3). Moreover, this gap estimate does not include the risk that wage settlements could be higher than assumed in the July Plan to complete the current round of collective bargaining. (For further discussion on collective bargaining risks, see "Collective Bargaining" in Section VII of this report.)

Graph 3

Budget Gap as a Percent of City Fund Revenues

As Forecast in the Prior Year's Adopted Budget



Sources: NYC Office of Management & Budget; OSDC analysis

To its credit, the City created a reserve to help fund the next round of collective bargaining, which covers fiscal years 2006 through 2009. The reserve, however, is only sufficient to fund annual wage increases of 1.25 percent—less than half the projected local inflation rate—and this leaves a significant potential liability. Similarly, any resolution of the Campaign for Fiscal Equity lawsuit could require an increase in City funding for education.

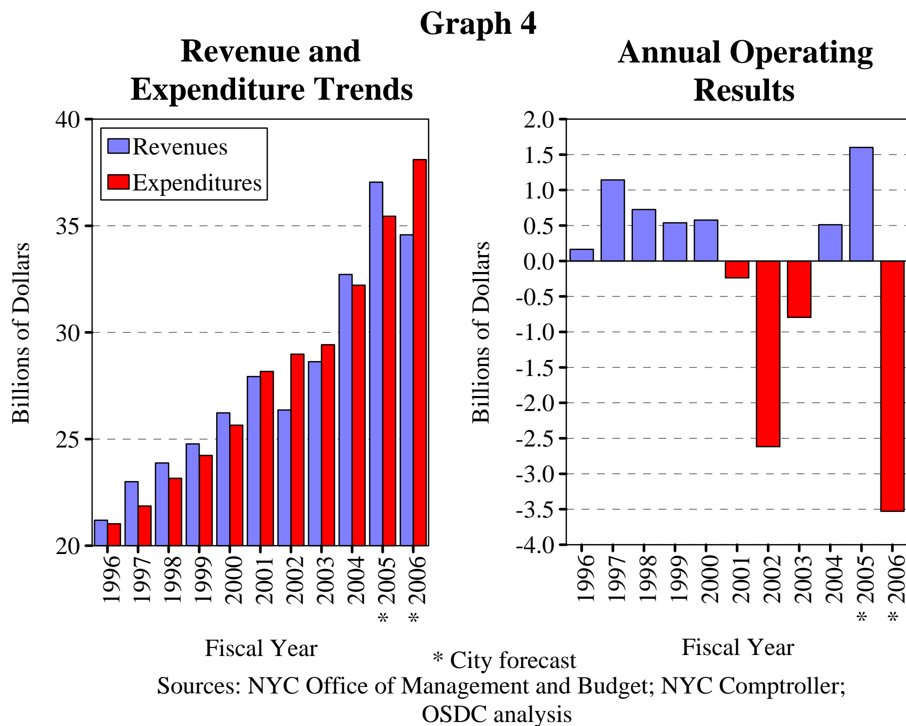
Given the size of the out-year budget gaps, the City should move expeditiously to prepare a gap-closing program for FY 2007. The extent to which the FY 2007 gap-closing program relies on actions that produce recurring benefits will determine the City's progress in narrowing the budget gaps projected for fiscal years 2008 and 2009.

VI. Results of Current-Year Operations

The City projects a surplus of $3.5 billion for FY 2005, but this estimate includes resources transferred from prior years. While the surplus is certainly a favorable development, the transfer of resources from prior years masks the results of operations in the current year. We believe a more accurate picture of the City's fiscal condition can be obtained by examining the results of current-year operations—the difference between revenues received and expenditures incurred in the current year.

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. Even though City-funded expenditures (adjusted for surplus transfers) grew by 22 percent in that period—far faster than the local inflation rate—revenues fueled by the Wall Street boom grew even faster (see Graph 4). This pattern changed, however, beginning in FY 2001. While expenditures continued their rapid growth that year—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 4), which was masked by the City's practice of transferring the prior year's surplus to the following year.

Graph 4



* City forecast

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 terrorist attack on the World Trade Center 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 (i.e., deficit financing) 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 an additional $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 a sharp rebound on Wall Street. Budget balance in FY 2004 was also aided through the use of $1.7 billion in nonrecurring resources.

We estimate that the City ended FY 2005 with a current-year surplus of $1.6 billion, an estimate that excludes some $1.9 billion in resources that were transferred from prior years. The City, however, could have incurred a current-year 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.

Moreover, the City is on track to end FY 2006 with a current-year operating deficit of $3.5 billion. The deficit largely reflects the expiration of temporary taxes that helped the City through its latest fiscal crisis, and continued rapid growth in nondiscretionary spending. While the deficit will undoubtedly narrow as the City takes actions to help balance the FY 2007 budget, the City may not generate a current-year surplus in FY 2006—a clear sign of fiscal stress.

VII. Revenue and Expenditure Trends

The City's practice of transferring prior years' surpluses—usually by prepaying certain expenses—can obscure underlying expenditure trends. Similarly, the City excludes TFA debt service from the Financial Plan. Adjusting for these actions provides a more accurate picture of City spending.

City-funded expenditures, adjusted for surplus transfers and TFA debt service, are projected to grow by 7.4 percent in FY 2006. While expenditure growth is projected to slow to 2.8 percent, on average, during fiscal years 2007 through 2009 (only slightly higher than the projected inflation rate for that period), the City has yet to complete the current round of collective bargaining. Also, the July Plan assumes that employees will accept annual wage increases of 1.25 percent during fiscal years 2006 through 2009. In addition, the City could be called upon to increase its contribution to the Department of Education as part of any resolution of the Campaign for Fiscal Equity litigation.

Over the entire Financial Plan period, City fund revenues rise at an average annual rate of just 0.4 percent, with growth held down by the expiration of temporary tax increases and only modest increases in the City's economy.

A. Revenue Forecasts

City fund revenues[6] are projected to total $34.6 billion in FY 2006—a reduction of $2.5 billion, or 6.7 percent, compared to the FY 2005 forecast (see Graph 5). More than one third of the reduction is due to tax revenues, which are projected to decline by $952 million, or 3 percent. Tax revenues will decline, despite sizable gains in the real property tax, because the expiration of temporary taxes authorized by the State to help the City balance its budget during the recent fiscal crisis reduces collections by $525 million. Revenues generated by real estate transactions are projected to decline by $875 million. Miscellaneous revenues are projected to fall by $1.6 billion in FY 2006, which reflects the decline in the level of nonrecurring resources that boosted collections in FY 2005.

The July Plan assumes that City fund revenues will grow slightly in FY 2007 and then average 4 percent during fiscal years 2008 and 2009. The absence of sizable nonrecurring revenues during fiscal years 2007 through 2009 results in greater

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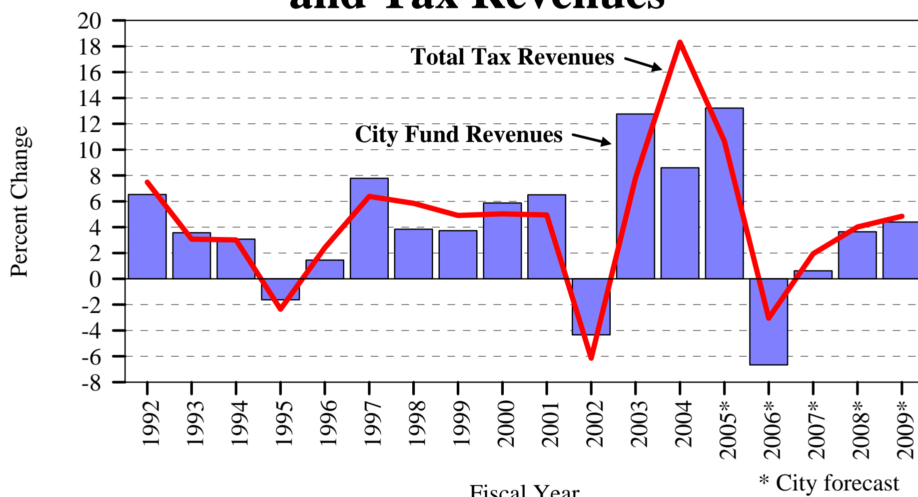
[6] Our estimates of City fund revenues include the portion of personal income tax revenues dedicated to pay debt service on bonds issued by the TFA, and tobacco settlement revenues dedicated to pay debt service on tobacco bonds.

stability in miscellaneous revenues, which are projected to decline at an average annual rate of 2.6 percent during this period.

Graph 5

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

Table 6
City Fund Revenues
(in millions)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	Four-Yr Avg Growth Rate
Taxes						
Property Tax	$ 11,495	$ 12,432	$ 13,095	$ 14,008	$ 14,672	6.3%
Personal Income Tax	6,518	6,017	5,875	6,058	6,478	-0.2%
Sales Tax	4,402	4,165	4,308	4,424	4,656	1.4%
Business Taxes	4,100	3,911	4,089	4,113	4,300	1.2%
Real Estate Transaction Taxes	2,336	1,460	1,193	1,144	1,151	-16.2%
Other Taxes	2,434	2,349	2,363	2,417	2,467	0.3%
Subtotal	**31,285**	**30,334**	**30,923**	**32,164**	**33,724**	**1.9%**
Miscellaneous Revenues	5,200	3,629	3,306	3,335	3,357	-10.4%
Unrestricted Intergovernmental Aid	562	562	562	562	562	0.0%
Anticipated Federal Aid	0	50	0	0	0	0.0%
Total City Fund Revenues	**$ 37,047**	**$ 34,575**	**$ 34,791**	**$ 36,061**	**$ 37,643**	**0.4%**

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

The major factors behind the decline in revenues are described below and shown in Table 6.

- Property tax revenues are projected to increase by $937 million in FY 2006, reflecting the strong growth in property values in the City in recent years. The continuation of the real property tax rebate program, however, again lowers real property tax revenues by about $250 million.

- Personal income taxes are expected to decline by $501 million in FY 2006, with $230 million of that decline due to the continued phaseout of the high-income surcharge. An expected decline in capital gains realizations will also reduce collections.

- Sales tax revenues are forecast to decline by $237 million in FY 2006. While underlying collections continue to be boosted by tourist spending, receipts are reduced by over $300 million because of the expiration of the one-eighth-point rate increase, the restoration of the exemption for clothing purchases of items costing less than $110, and a new tax exemption for Lower Manhattan.

- Collections from the real estate transaction taxes, which surged over the last two years and contributed to the sizable surpluses the City realized in this period, are projected to drop by $875 million in FY 2006 as rising interest rates reduce real estate activity.

- Miscellaneous revenues are expected to decline by almost $1.6 billion in FY 2006, which reflects a reduction in the level of nonrecurring resources that had benefited FY 2005, including $631 million from the refinancing of outstanding MAC debt and $744 million from a retroactive airport lease settlement reached with the Port Authority of New York and New Jersey.

Our review finds that year-to-date strength in nonproperty tax collections will continue into FY 2006 and will boost sales, personal income, and business tax collections. The real estate transaction taxes also appear likely to remain strong in the short run. Overall, we expect tax collections to be higher than the City's forecast by $450 million in FY 2006 and $200 million in FY 2007.

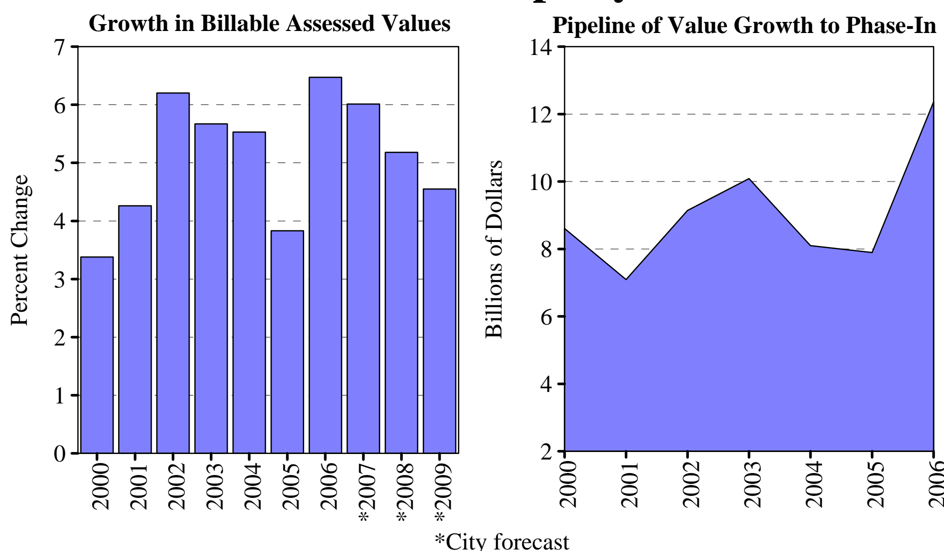
1. Real Property Taxes

Real property taxes are the single-largest source of the taxes collected by the City, and are projected to increase by $937 million in FY 2006 (see Table 6). The growth results from increasing assessed values, because the average real property tax

rate, which the City increased by 18.5 percent in January 2003, is expected to remain unchanged during the Financial Plan period. The real property tax rebate program, which required State approval, allowed the City to effectively roll back the FY 2003 rate increase for homeowners during fiscal years 2005 through 2007 in the form of a rebate, at an annual cost of $256 million.

Graph 6

Factors Supporting Projected Growth in the Real Property Tax



*City forecast
Sources: NYC Department of Finance; NYC Office of Managment and Budget

Throughout the entire Financial Plan period, real property tax revenues are projected to increase at an average annual rate of 6.3 percent, accounting for all of the net tax revenue growth during this period. The higher revenues are largely due to increasing assessed values (see Graph 6, left side).[7] The revenue growth is also supported by provisions of State law that require increases in assessments for income-producing properties to be phased in, thereby creating a pipeline of future increases (see Graph 6, right side). This pipeline has reached its highest level since FY 1991. As these assessment increases are phased in and the pipeline is drawn down, the pace of property tax revenue growth can be maintained despite a slight slowdown in the rate of growth for property values. Finally, property tax revenues are boosted in fiscal years 2008 and 2009 because of the scheduled expiration of the tax rebate program for homeowners.

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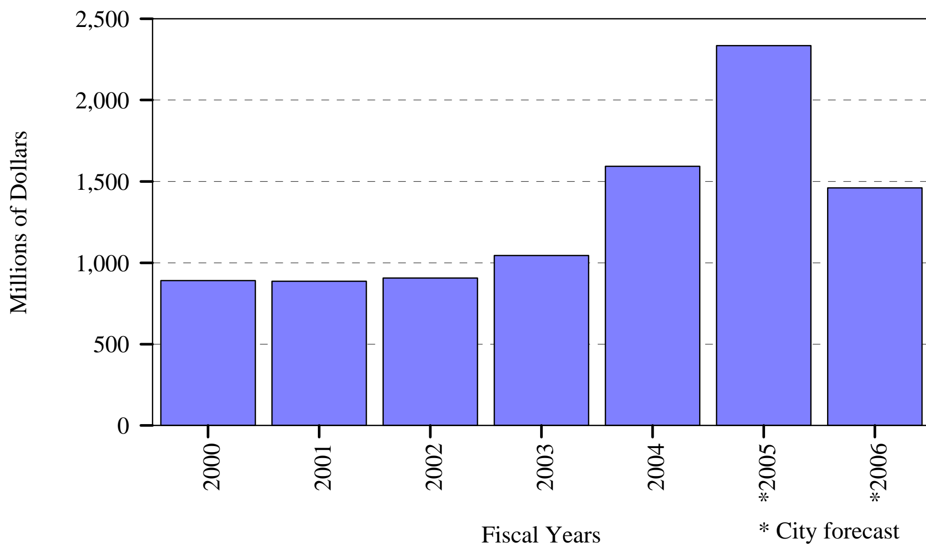
[7] Not all growth in market values results in increased assessed values, as State law limits assessment increases for certain types of properties.

2. Real Estate Transaction Taxes

The strong demand for property, the growth in property values, and continued low mortgage interest rates have combined to cause tax collections related to real estate transactions (the mortgage-recording and real property transfer taxes) to reach $2.3 billion in FY 2005, or nearly twice the City's forecast at the beginning of the fiscal year. This surpassed the amount collected in FY 2004 by $742 million, and is more than double the amount collected in FY 2003 (see Graph 7).

Graph 7

Tax Revenues from Real Estate Transactions



Note: Collections are for the mortgage recording and real property transfer taxes.
Source: NYC Office of Management and Budget

Despite the steady short-term interest rate increases begun by the Federal Reserve in June 2004, collections have surged to record levels as long-term interest rates—including mortgage rates—have actually fallen slightly since last year, helping to support the continued growth in the commercial and residential real estate markets. The City is expecting that long-term interest rates will soon begin to rise, resulting in a dramatic 38 percent falloff in real estate transaction tax collections during FY 2006.

While we agree with the City that collections from the real estate transaction taxes are likely to decline in FY 2006, we expect the falloff to be less steep and to begin later than the City forecasts. A sharp decline of the magnitude the City forecasts implies a sizable drop in both the number of transactions and the price levels in order to bring collections below the level of two years ago. Thus, our analysis indicates that

the City could realize additional revenues of $250 million in FY 2006 and $150 million in FY 2007 from the transaction taxes.[8]

Current residential real estate sales in the City remain strong, and local home prices are continuing to rise. Given the continuation of low mortgage rates, the July national forecasts for calendar year 2005 from the Mortgage Bankers Association (MBA) are now much stronger than those of a few months ago, showing continued increases in mortgage originations, property prices, and home sales. Likewise, the MBA forecasts for 2006, while still showing a downturn in the housing market, are projecting a much milder slowdown than the drop projected a few months ago. In addition, data through the end of June 2005 from the MBA show that the level of national mortgage originations—both for purchases and refinancings—remains high.

The National Association of Realtors has also recently revised its forecast for the real estate markets. Given the persistence of low mortgage rates so far this year, the group now expects no decline in either home sales or prices in 2005. Both groups forecast only a modest decline in the national housing markets in calendar year 2006. Likewise, commercial markets remain strong in the City, with several large transactions announced in recent months. Cushman & Wakefield recently reported that commercial property sales in the City will set a new record in 2005—sales totaled $12.7 billion through mid-June, compared to about $15 billion for all of 2004.

3. Personal and Business Income Taxes

Revenues from the personal income tax are expected to decline in FY 2006 by $501 million, or 7.7 percent, in response to the continued phaseout of the high-income surcharge and expectations of lower capital gains realizations and wage growth. The projected easing in the pace of economic growth is also expected to affect the business taxes, which are projected to decrease by $189 million in FY 2006.

The July Plan assumes that the temporary surcharge on high-income earners, which was enacted by the State at the City's request to help deal with the City's most recent fiscal crisis, will expire on December 31, 2005 as scheduled. In the past, the City has received State approval to extend temporary tax increases to help deal with fiscal pressures. For example, the State recently extended the 14 percent personal income tax surcharge, which was originally enacted in FY 1992 by the State at the City's request during the early 1990s recession, until December 31, 2008. If the City were to seek State approval to extend the high-income surcharge, the City could

[8] If the market continues to defy expectations for a third consecutive year, receipts would exceed the estimates in the July Plan by $875 million in FY 2006.

realize additional revenues of about $300 million in FY 2006 and about $600 million annually thereafter.

Personal income tax revenues are forecast to decline again in FY 2007 as the benefit from the high-income surcharge is completely eliminated. In addition, collections are dampened by an anticipated drop in Wall Street profits in calendar year 2007, which, when combined with a slowing in overall job growth, results in a lower rate of wage growth. Modest growth in personal income tax collections is expected to resume in FY 2008—at a rate of 3.1 percent—as Wall Street and the local economy improve, and personal income tax growth is expected to rise to 6.9 percent in FY 2009. Business tax collections likewise show improved growth in the later part of the Financial Plan period, with projected average annual gains of 3.5 percent in fiscal years 2007 through 2009.

4. Sales Tax

Sales tax collections were very strong in FY 2005, boosted not only by income growth for local residents, but by spending from record numbers of tourists, who are responding to the weak value of the dollar relative to other currencies. While this pattern is likely to continue in the short term, the expiration of the one-eighth-point increase in the sales tax will reduce collections by $118 million in FY 2006.[9] Although the State budget extended the suspension of the State's sales tax exemption for clothing items costing less than $110, the City has received approval from the State Legislature to reinstate the local sales tax exemption as of September 1, 2005, at a cost of $184 million. In addition, the sales tax exemption for Lower Manhattan reduces collections by another $16 million. These three changes contribute to a projected decline in sales tax collections of $237 million, or 5.4 percent. Sales tax revenues are projected to increase by an average of 3.8 percent annually in fiscal years 2007 through 2009, although growth is higher at the end of this period than at the beginning, when economic growth is projected to be somewhat lower.

B. Expenditure Forecasts

City-funded expenditures, adjusted for surplus transfers and TFA debt service, grew at almost three times the rate of inflation during fiscal years 2004 and 2005. Spending is projected to continue that trend in FY 2006, with an expected growth rate of 7.5 percent, which would increase expenditures to $38.1 billion (see Graph 8). While expenditure growth is projected to slow during fiscal years 2007 through 2009

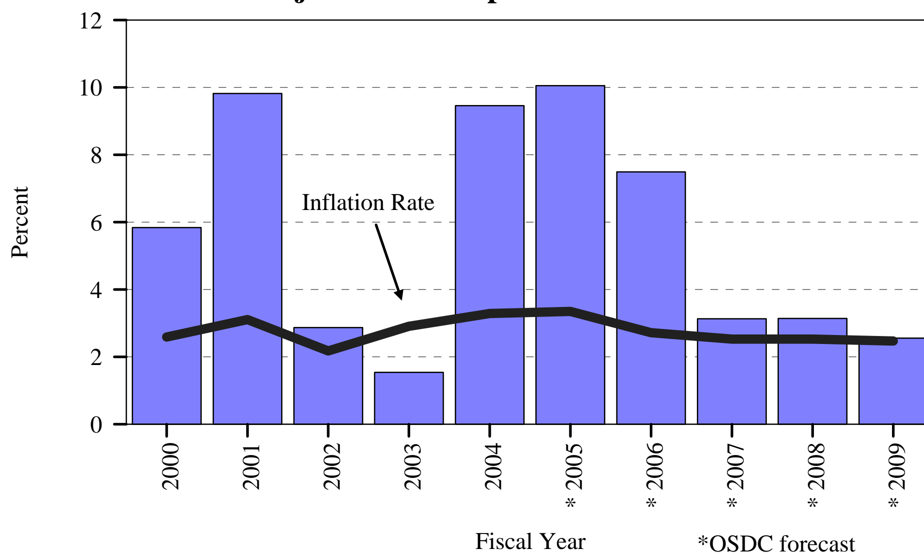
[9] The one-eighth-point decrease in the City sales tax rate was offset by a one-eighth-point increase in the MTA sales tax rate. City taxpayers still experienced an overall reduction in the sales tax rate because a Statewide one-quarter-point sales tax surcharge expired on May 31, 2005.

to an average of 2.8 percent, which is only slightly higher than the projected inflation rate, the City has yet to complete the current round of collective bargaining. Also, the July Plan assumes that employees will accept annual wage increases of 1.25 percent during fiscal years 2006 through 2009. In addition, the City could be called upon to increase its contribution to the Department of Education as part of any resolution of the Campaign for Fiscal Equity litigation.

Graph 8

Changes in City-Funded Expenditures

Adjusted for Surplus Transfers



Sources: NYC Comptroller's Office; 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 17 percent during fiscal years 2004 and 2005. These costs are projected to consume 47 percent of City fund revenues in FY 2006, compared with 37 percent in FY 2003. Even though pension contributions are projected to level off and the rate of Medicaid growth is expected to slow to a rate slightly higher than the inflation rate as a result of enactment of the State Medicaid cap, spending in these four categories is still projected to account for 51 percent of City fund revenues by FY 2009.

Table 7
City-Funded Expenditures
(Adjusted for Surplus Transfers and Includes TFA Debt Service)
(in millions)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	Four-Year Avg. Growth Rate
Salaries and Wages[1]	$10,661	$10,310	$10,315	$10,239	$10,183	-1.1%
Debt Service	4,170	4,231	4,825	5,426	5,787	8.5%
Medicaid	4,770	4,864	5,020	5,167	5,306	2.7%
Pension Contributions	3,195	4,557	4,905	4,797	4,668	9.9%
Health Insurance	2,322	2,602	2,832	3,107	3,412	10.1%
Public Assistance	528	534	534	534	534	0.3%
Judgments and Claims[2]	410	411	457	500	553	7.8%
Pay-As-You-Go Capital[3]	200	200	200	200	200	0.0%
Collective Bargaining Reserve[4]	0	100	350	625	900	N/A
Other	9,191	10,294	9,860	9,936	10,025	2.2%
Total	$35,447	$38,103	$39,298	$40,531	$41,568	4.1%

[1] Salaries and wages include the reserve for the current round of collective bargaining.
[2] Excludes costs of $160 million in FY 2005 and $190 million annually thereafter, which are paid by the City but reimbursed by the New York City Health and Hospitals Corporation.
[3] In FY 2005, the City used these resources to pay down high-coupon TFA debt, which generated savings of $193 million in FY 2007.
[4] Reserves for the next round of collective bargaining starting in 2005.
Note: Totals may not add up due to rounding.
Sources: NYC Office of Management and Budget; OSDC analysis

The primary factors behind the projected growth in City-funded expenditures are described below and shown in Table 7.

- Salary and wage costs, excluding the reserve for the next round of collective bargaining, are projected to decline in FY 2006 from the FY 2005 level and then remain stable during the balance of the Financial Plan period. Salary and wage costs for FY 2005 are unusually high because they include the retroactive cost of funding a two-year 10.25 percent wage increase for all uniformed employees, retroactive to fiscal years 2003 and 2004. The July Plan does not reflect the potential cost of completing the current round of collective bargaining.

- Debt service is projected to hold steady at $4.2 billion during fiscal years 2005 and 2006, but these costs are projected to jump by 14 percent to reach $4.8 billion in FY 2007, and then to grow at an average annual rate of 9.5 percent to reach $5.8 billion in 2009.

- Medicaid is projected to reach $4.9 billion in FY 2006, and then grow at an average annual rate of 2.9 percent to reach $5.3 billion by FY 2009. The current estimated rate of growth is less than half of the 7.1 percent average annual growth that would have occurred in the absence of actions taken by the State to slow the growth in Medicaid costs. These actions 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.

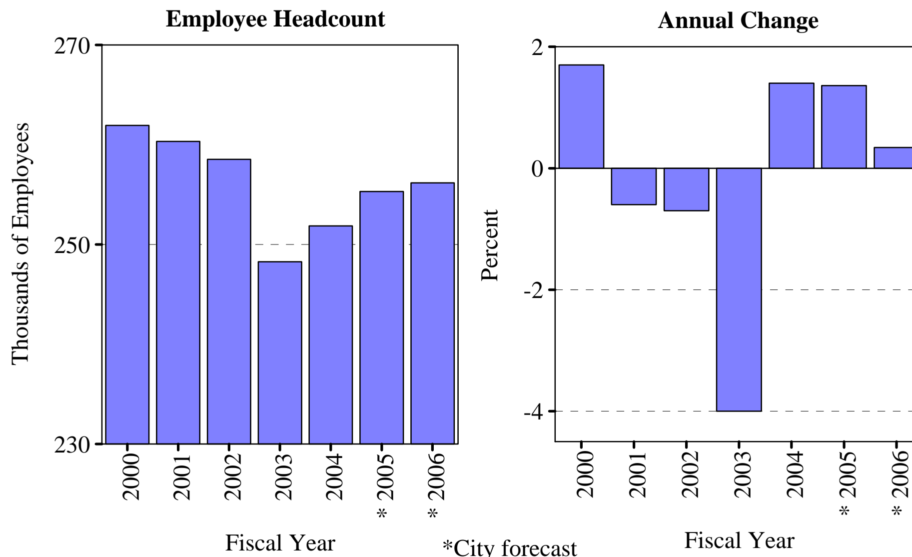
- Pension contributions are projected to total nearly $4.6 billion in FY 2006, an increase of $1.4 billion over the actual FY 2005 contribution. Contributions are projected to peak in FY 2007 at $4.9 billion, and then decline slightly to $4.7 billion by FY 2009. These estimates reflect the recommendations of an independent actuarial consultant to revise certain assumptions and other technical changes, but they do not reflect the impact of the City Actuary's proposed changes in methods used to calculate City pension contributions that could reduce planned contributions by $1.1 billion during fiscal years 2006 and 2007.

- Health insurance costs for municipal employees are projected to reach $2.6 billion in FY 2006, which is an increase of $280 million or 12 percent over the FY 2005 level. These costs are expected to grow at an average annual rate of 10 percent annually during the Financial Plan period, reflecting rapidly anticipated increases in health insurance premiums.

- The City established a reserve for collective bargaining that would provide wage increases of 1.25 percent each year, which is less than half the projected inflation rate. Although the reserve reduces the City's potential future liability, the City still faces the significant risk that employees will receive larger wage increases in future agreements.

The July Plan assumes that City-funded staffing levels (both full-time and full-time-equivalents) will increase by 877 employees in FY 2006, to reach a total of 256,179 employees by June 30, 2006 (see Graph 9). After reducing the workforce by more than 12,000 employees during fiscal years 2001 through 2003, the City added 3,616 employees in FY 2004 and planned to add another 2,899 employees in FY 2005, excluding Department of Education employees. The City, however, fell far short of that goal in FY 2005. Since the City is likely to remain below July Plan levels in FY 2006, the City could realize savings of $50 million.

Graph 9
City-Funded Workforce
(Full-Time and Full-Time-Equivalent Employees)



1. Collective Bargaining

The City has reached new labor agreements with the unions that represent most civilian employees for the three-year contract period covering fiscal years 2003 through 2005, but it has not been able to negotiate new agreements with the unions that represent uniformed employees or teachers. The New York State Public Employees Relations Board (PERB) previously declared impasses in negotiations with the Police Benevolent Association (PBA), the Uniformed Firefighters Association, the Detectives' Endowment Association, the Sergeants Benevolent Association, and the United Federation of Teachers (UFT).

The May 2005 Plan assumed that uniformed employees and teachers would reach agreements with the City that were consistent with the economic terms of the agreement negotiated with District Council 37, which represents most civilian employees. The District Council 37 agreement provided employees with a $1,000 lump sum payment, effective upon signing; a 3 percent wage increase in the second year of the contract period; and a 2 percent wage increase that would be fully funded by productivity and other savings in the third year. The agreement also called for the creation of a joint City-union committee to identify productivity savings to fund an additional 1 percent wage increase in FY 2005. On June 28, 2005, the City and District Council 37 reached agreement on such productivity improvements, which

include increasing civilianization in the Police Department, replacing outside contractors with City employees in many clerical and computer positions, and making mutual efforts to reduce the use of paid sick leave.

A PERB-appointed arbitration panel recently awarded the members of the PBA, which represents 23,000 police officers, a two-year retroactive wage increase of 5 percent in the first year and another 5 percent (compounded) in the second year. In making the award, the chairman of the arbitration panel recognized the practice of the City and the municipal unions to negotiate wage and benefit increases above a budgeted amount in exchange for productivity and internal savings. Thus, the award includes productivity and other cost savings that will help fund the recurring cost of the award beginning in FY 2006. These savings include a reduction in starting salaries of police cadets from $40,658 to $25,100 during their six months in the academy, a reduction in salary and a six-month elongation of the salary progression schedule for new employees, the elimination of a personal leave day, and an increase in the number of tours that can be rescheduled without overtime, from 10 to 15. The City estimates that these productivity improvements will fund 45 percent of the recurring cost during the Financial Plan period of the wage increases awarded to police officers.

The City now assumes that the PBA award will set the pattern for agreements with all uniformed employees, but it also continues to assume that the City's teachers will reach an agreement with economic terms similar to those of the District Council 37 agreement. The UFT, which has been without a contract since May 2003, is seeking annual wage increases of 6 percent over a three-year period to make teachers' salaries more competitive with surrounding communities in order to better attract and retain high-quality teachers. The PERB has appointed a fact-finding panel, which may release its recommendations by the start of the new school year. While the panel's recommendations are nonbinding, they are likely to be influenced by the PBA award and to have a significant impact on negotiations. A UFT agreement with economic terms similar to those of the PBA award would exceed the amounts set aside in the July Plan by $1.1 billion in FY 2006 (including the retroactive component) and by $500 million in subsequent years. The cost would be reduced to the extent that the City and the UFT agree to productivity improvements.

As PERB awards cannot exceed two years, the PBA award covered only two of the three years of the expired agreement with police officers. The chair of the arbitration panel stated that if he were not so constrained he would have recommended—subject to the City's ability to pay—a wage increase of at least 20 percent over four years, based on comparisons of police officer salaries in other jurisdictions. The City assumes that uniformed employees and teachers will self-fund their wage increases in FY 2005 through productivity improvements and other offsets,

which will be difficult to achieve retroactively. Wage increases at the projected inflation rate, without offsetting productivity savings, would exceed budgeted levels by $600 million in FY 2006 and $500 million annually thereafter.

The July Plan includes a reserve for the next round of collective bargaining, but it is funded at about half the projected local inflation rate for fiscal years 2006 through 2009.[10] If wages were to increase at the projected inflation rate without any offsetting productivity savings, costs would exceed the reserve by $150 million in FY 2006, $450 million in FY 2007, $700 million in FY 2008, and $1 billion in 2009.

2. Pension Fund Contributions

Between fiscal years 2000 and 2005, pension contributions grew at an average annual rate of 40 percent—from $597 million to $3.2 billion (see Graph 10). The sharp increase in pension contributions was primarily due to pension fund investment shortfalls experienced during fiscal years 2001 through 2003, which are currently being phased in over a five-year period;[11] and to benefit enhancements. Contributions are projected to increase by another $1.3 billion in FY 2006 and then peak at $4.9 billion in FY 2007 before declining slightly in subsequent years. The City Actuary, however, has recommended changes in the methodologies used to calculate pension contributions that could reduce planned contributions during fiscal years 2006 and 2007.

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 that would reduce planned City-funded contributions by a net of $325 million in FY 2006 and $200 million in FY 2007. The anticipated changes 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 July Plan, however, only recognizes the recommendations of the actuarial consultant and other technical reestimates, which increased planned pension

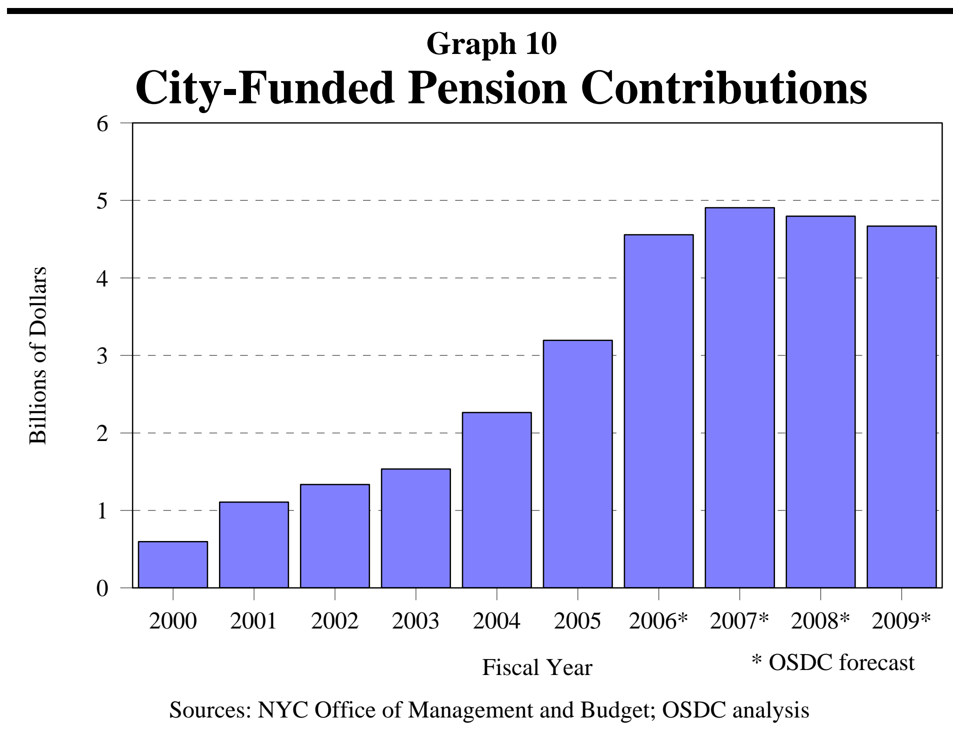
[10] The reserve for collective bargaining is sufficient to fund annual wage increases of 1.25 percent for all employees during fiscal years 2006 through 2009, while local inflation is projected to average 2.5 percent during this period.

[11] The pension funds lost about 8 percent on their investments in each of fiscal years 2001 and 2002, and gained only 3.8 percent in FY 2003, whereas the actuarial assumption was a gain of 8 percent for each of those years.

contributions by $862 million in FY 2006, $718 million in FY 2007, and by about $450 million annually thereafter.

Graph 10

City-Funded Pension Contributions



Sources: NYC Office of Management and Budget; OSDC analysis

In May 2005, the Actuary submitted to the boards of the five actuarial pension funds a proposal that included both revised actuarial assumptions and methodologies. However, the pension boards did not approve the proposed revisions, and as a result, the current actuarial assumptions and methodology used to calculate pension contributions remain in effect.

The Actuary expects to resubmit his proposals to the trustees for their approval during FY 2006. The proposal requires approval by the pension boards, and elements of the proposal require approval by the State. If the proposal is approved, pension contributions could be lower than anticipated in the July Plan by $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. These estimates are based on the Actuary's projections at the time he submitted his proposals to the pension funds in May 2005. Because the FY 2005 contribution was based on current methodologies, the City contributed $185 million more in FY 2005 than would have been required if the Actuary's proposals had been adopted. If the Actuary's proposals are adopted in FY 2006, the City could recoup the overpayment.

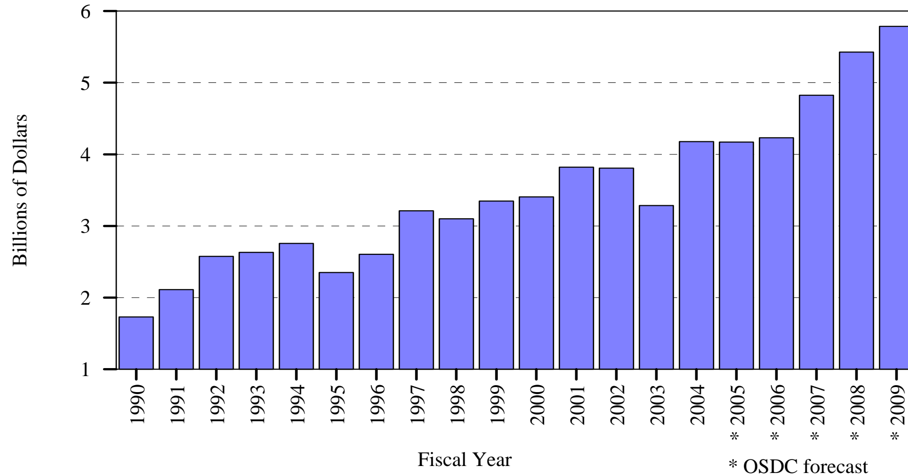
In addition, the pension funds earned about 9.4 percent on their investments during FY 2005, somewhat more than the anticipated return of 8 percent. As a result of these unexpected gains, planned pension contributions could be lower by approximately $10 million in FY 2006, $25 million in FY 2007, $50 million in FY 2008, and $75 million in 2009.

3. Debt Service

City-funded debt service costs are expected to remain flat at $4.2 billion in FY 2006, with little change over fiscal years 2004 and 2005. In FY 2007 debt service costs are projected to jump 14 percent, to $4.8 billion, and then increase at an average annual rate of 9.5 percent (nearly four times the rate of inflation) in fiscal years 2008 and 2009, reaching $5.8 billion by FY 2009 (see Graph 11). Consequently, after averaging 12.2 percent during fiscal years 2004 through 2006, the City's debt burden[12] is projected to swell to 15.4 percent in FY 2009. (For further information regarding the City's debt burden, outstanding debt, or growing capital plan, please see our report 4-2006, *New York City's Growing Debt Burden*, issued July 2005.)

Graph 11

Debt Service



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

4. Medical Assistance

Medicaid expenditures are projected to total $4.9 billion in FY 2006—$94 million more than in FY 2005—and then to grow at an average annual rate of

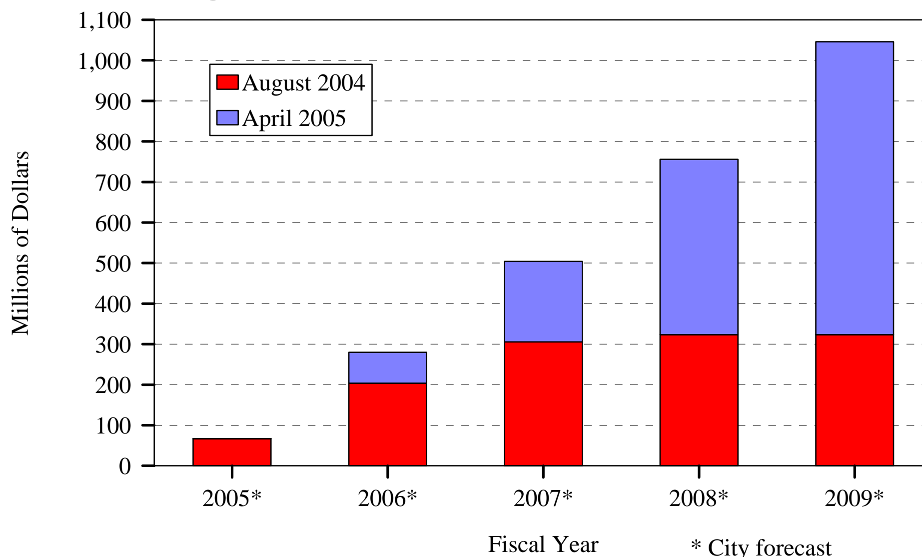
[12] The debt service burden is defined as City-funded debt service as a percent of City fund revenues, including amounts to support TFA and TSASC debt service.

2.9 percent through FY 2009. By contrast, the federal government's forecast assumes that Medicaid expenditures will grow at about 8 percent annually starting in calendar year 2006. The July Plan projects a much slower growth rate, largely because the State has taken steps to help localities reduce Medicaid expenditures. In the absence of this State support, the City's Medicaid expenditures would have grown at an average rate of 7.1 percent annually between fiscal years 2006 and 2009.

New York State is one of 23 states that require localities to contribute to the cost of Medicaid, and New York State's statutory local share is the highest in the nation. Despite the mandated local contribution, projected growth in City-funded Medicaid expenditures has decelerated because of increased State financial participation. In August 2004, the State enacted a three-year State takeover of the local costs of Family Health Plus, a program that provides health insurance to adults whose incomes exceed limits allowed in Medicaid. Since FY 2002, Family Health Plus has been one of the fastest-growing components of medical assistance. In April 2005, the State provided localities with additional Medicaid budget relief by implementing cost-containment measures and a cap on growth in the local share of Medicaid. In total, State actions are expected to provide the City with 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 12).

Graph 12

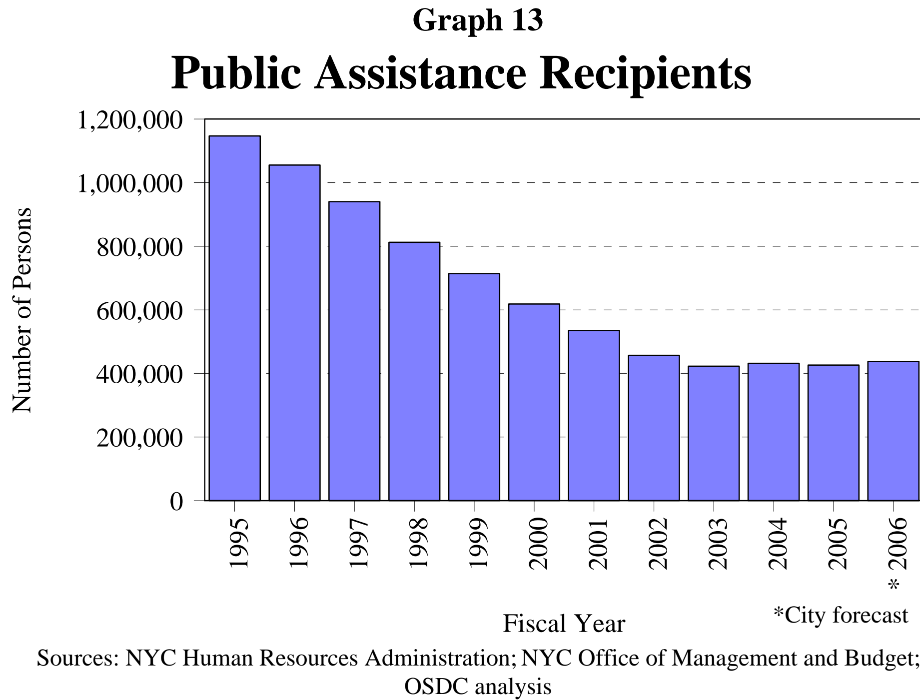
Savings from State Medicaid Initiatives



Sources: NYC Office of Management and Budget; OSDC analysis

5. Public Assistance

New York City’s public assistance caseload has declined by more than 700,000 persons since FY 1995, but this steady decline ended in FY 2004, when the average monthly caseload increased by 2 percent to 431,959 persons (see Graph 13). The July Plan assumes that the monthly public assistance caseload will increase slightly to 437,371 persons during FY 2006. The City-funded cost of this program is projected to remain stable during the Financial Plan period, at about $530 million annually.



Graph 13

Public Assistance Recipients

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

The federal law creating the Temporary Assistance to Needy Families program (TANF), which provides aid to 45 percent of New York City’s public assistance recipients, expired in 2002. Since then, Congress has approved extensions of TANF funding and regulations without major policy changes. The current extension will expire on September 30, 2005. In ongoing TANF reauthorization debates, Congress has considered increasing the work participation rate from 50 percent to 70 percent. The proposed change could be difficult for the City to meet, and could potentially subject the City and welfare recipients to financial penalties. State and City officials have requested that Congress increase the range of activities that can count as work in the TANF program to accommodate the needs of the City’s welfare recipients. Since FY 2000, the percentage of federal welfare cases meeting federal work requirements

has declined, reflecting a growing proportion of adults who receive federal assistance but are unable to work.

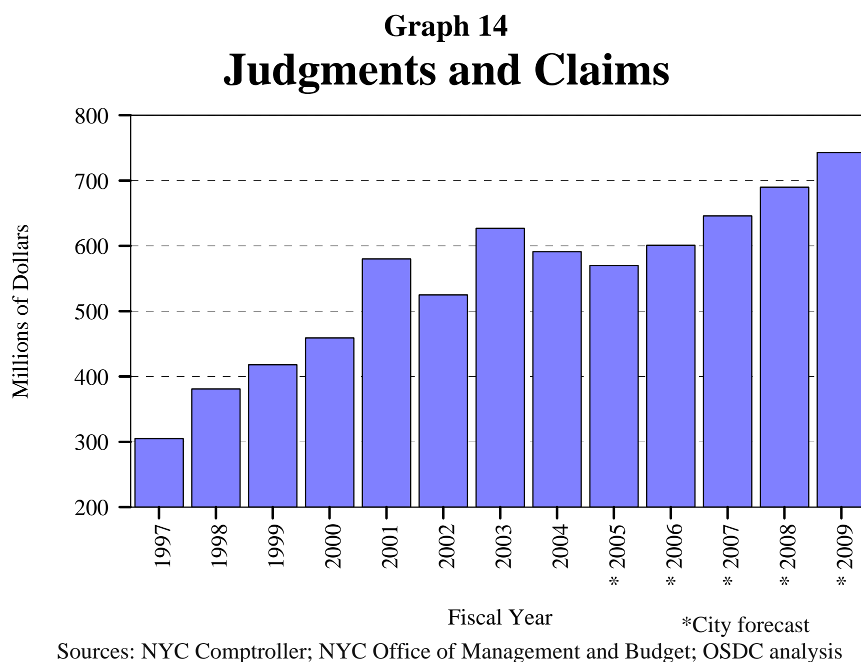
To help recipients meet the current work requirements, New York City created the Wellness Comprehensive Assessment Rehabilitation and Employment program (WeCare) in April 2005. WeCare is expected to provide services to 46,000 individuals annually that will include case management, medical treatment, skills training, education programs, and job placement and job retention services. WeCare will also assist eligible public assistance recipients in obtaining federal disability assistance. The City has hired contractors to implement the program.

6. Judgments and Claims

After declining in fiscal years 2004 and 2005, expenditures for judgments and claims are projected to increase by 5.4 percent in FY 2006 to reach $601 million, and then grow at an average annual rate of 7.3 percent to reach $743 million by FY 2009 (see Graph 14).[13] The projected growth in FY 2006 is due largely to settlements with values of more than $1 million. The growth in the out-years is due to settlements with values of less than $1 million, which are projected to grow by 8.5 percent annually from $351 million in FY 2006 to $448 million in FY 2009.

Graph 14

Judgments and Claims



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

[13] Includes costs paid by the City for the New York City Health and Hospitals Corporation, for which the City receives reimbursement.

The City's estimates do not reflect any potential liability arising from the Staten Island ferry accident of October 15, 2003, or the World Trade Center (WTC) attack on September 11, 2001. Regarding the Staten Island ferry, the claims filed against the City total more than $3 billion, but the City contends that its liability is limited to $14.4 million, the value of the ferry under Federal Maritime law. Regarding the WTC attack, there are some $500 million in claims against the City and its contractors arising from debris removal work at the WTC site. The City expects these claims to be covered by the WTC Captive Insurance Company, Inc., which is funded by a $1 billion grant from the Federal Emergency Management Agency. The City also faces a $314 million property damage claim made by Con Edison and its insurers due to the loss of an electrical substation when 7 WTC collapsed.

7. Uniformed Agency Overtime

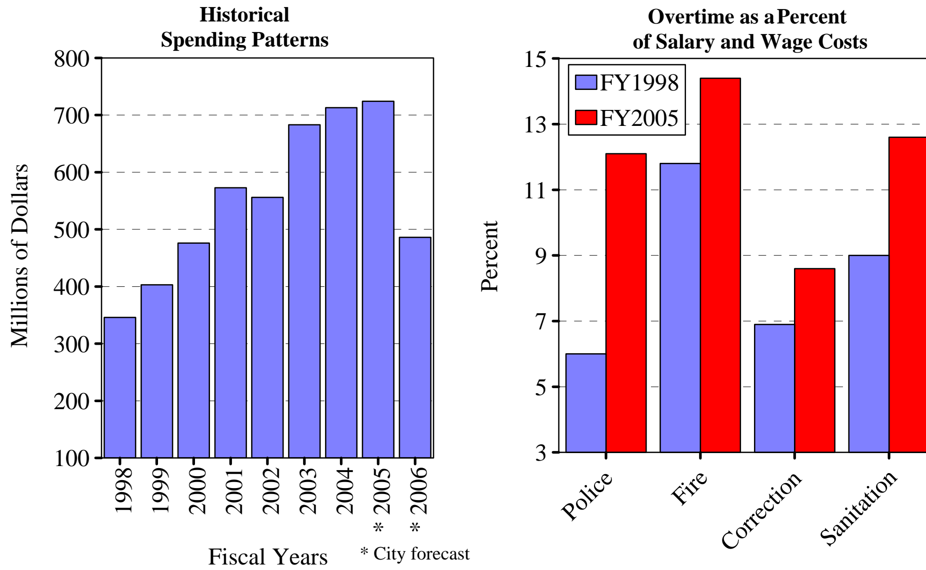
Overtime costs in the uniformed agencies are projected to decline from $724 million in FY 2005 to $486 million in FY 2006, and then to rise to $498 million during fiscal years 2007 through 2009. The uniformed agencies have relied increasingly on overtime in recent years to meet programmatic objectives, and overtime as a percent of salary and wage costs rose from 7.6 percent in FY 1998 to 12.1 percent in FY 2005. The Police Department shows the most rapid increase—going from 6 percent of salary and wage costs in FY 1998 to 12.1 percent in FY 2005 (see Graph 15).

The July Plan assumes that overtime costs in the Police Department will decline from $424 million in FY 2005 to $261 million in FY 2006, and then remain essentially at that level during the balance of the Financial Plan period. In fact, overtime costs are likely to remain at the FY 2005 level, and the difference will have to be funded by reserves maintained by the Police Department and the receipt of federal grants. In response to the July 2005 terrorist bombings in London, the Police Department has increased patrols on City subways and buses, but expects the Metropolitan Transportation Authority to reimburse the City for these additional costs.

Overtime costs in the Fire Department are projected to decline in FY 2006 to $112 million, from $160 million in FY 2005. Similarly, overtime costs in the Department of Correction are projected to decline, to $43 million in FY 2006 from an average of $60 million during the last three fiscal years. We believe, however, that overtime costs in the two departments are likely to be higher by $40 million in FY 2006 and by $25 million annually thereafter.

Graph 15

Trends in Uniformed Agency Overtime



Sources: NYC Office of Management and Budget; OSDC analysis

VIII. Semi-Autonomous Agencies

Covered organizations are semi-autonomous agencies subject to the Financial Emergency Act (FEA) and include but are not limited to the Department of Education,[14] the Health and Hospitals Corporation, the New York City Transit Authority (a component agency of the Metropolitan Transportation Authority), and the Off-Track Betting Corporation. The City has a financial relationship with these agencies and may be called upon to provide additional funding to help balance their budgets. In addition, a number of other entities, mostly public authorities, are not subject to the FEA but have a financial relationship with the City. These include the Municipal Assistance Corporation, the Transitional Finance Authority, and TSASC Inc. In addition, the City recently created a new local benefit corporation, the Hudson Yards Infrastructure Corporation, to finance development of the far West Side of Manhattan.

A. Termination of the Financial Emergency Act

In the years leading up to the 1975 fiscal crisis, New York City spent more than it could afford, and funded the shortfall by issuing large amounts of short-term debt and by capitalizing operating expenses. These practices and inadequate financial controls led to a loss of access to the credit markets, which precipitated a fiscal crisis in March 1975.

New York State took a number of actions to help New York City restore fiscal stability. The State created the Municipal Assistance Corporation (MAC), which issued long-term bonds, backed by sales tax and stock transfer tax revenues, to refinance the City's short-term debt and later to fund the City's capital program. The State also enacted the Financial Emergency Act (FEA), which improved financial planning, enhanced oversight, and increased transparency and accountability.

The FEA requires the City and its related public authorities to balance their budgets each year in accordance with generally accepted accounting principles (GAAP), and to prepare rolling four-year financial plans based on reasonable assumptions and methods of estimation; forbids practices that led to the 1975 fiscal crisis, such as capitalizing operating expenses and rolling over short-term debt from one year to another; and authorizes the State Comptroller to intercept certain City revenues and to deposit them in a debt service fund to guarantee that debt service payments are made on time.

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

The FEA also established the Financial Control Board ("the Control Board"), which is chaired by the Governor and includes the Mayor, the State Comptroller, the City Comptroller, and three members of the private sector.[15] The Control Board sets the form of the City's four-year financial plan, issues quarterly reports on the City's finances, and, if the FEA is violated, can impose a "control period" during which financial plans, financial plan modifications, contracts, and borrowings would be subject to Control Board approval before implementation.[16]

At the City's request, in August 2003 the State Legislature agreed to effectively assume (subject to annual appropriation) outstanding MAC bonds that date back to the 1975 fiscal crisis in order to help the City overcome the fiscal crisis precipitated by the attack on the World Trade Center. The MAC refinancing initiative is expected to save the City $2.5 billion through FY 2008, but at a cost of $5.1 billion to the State over a 30-year period.

When the MAC refinancing initiative was enacted, the State Legislature modified the FEA termination language from the "earlier" to the "later" of July 2008 or until all the bonds with the State bond covenant are refunded, redeemed, discharged, or otherwise defeased.[17] Because most City bond issuances have included the State bond covenant, the FEA was effectively extended for nearly 30 years.[18] Some have suggested that the change in the termination language was unintentional, and State legislation was recently introduced that would terminate the FEA on July 1, 2008, as originally scheduled.

The Mayor has appointed a charter revision commission, which is considering a number of proposals that could appear on the November ballot. One proposal under consideration would incorporate some of the provisions of the FEA into the City Charter in the event that the FEA terminates on July 1, 2008. However, the commission's authority is limited, and extending some features of the FEA would still

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15 The Control Board is assisted in the exercise of its responsibilities and powers under the FEA by the Office of the State Deputy Comptroller for the City of New York, which became a permanent part of the Office of the State Comptroller in August 1985.

16 Prior to July 1, 1986, all financial plans, financial plan modifications, and borrowings, together with certain contracts, were subject to the approval of the Control Board prior to implementation. However, on June 30, 1986, the Control Board determined and ordered that the control period terminate, at which time the Control Board's approval powers entered a "sunset" period.

17 The State bond covenant assures bondholders that the State will not take any action that might impair the ability of the Control Board to fulfill its responsibilities under the FEA.

18 The Control Board's authority to impose a control period would still terminate on July 1, 2008. If the City were to violate the FEA after that date, the Control Board could recommend the imposition of a control period, but it would take an act of the State Legislature and the Governor's approval to implement it. MAC, which also has oversight responsibilities, is still scheduled to terminate on July 1, 2008.

require State action. For example, the Mayor has proposed State legislation that would make permanent the FEA provision that the State Comptroller maintain a debt service fund on behalf of the City to reassure the financial market that the City's debt obligations will be paid on time. Moreover, the City does not have the authority to require the Health and Hospitals Corporation and other City-related public authorities to prepare four-year financial plans and comply with other fiscal standards established under the FEA. The commission also cannot extend the Control Board's authority to impose a control period if the FEA were violated.

New York City deserves credit for balancing its budget in both good times and bad in accordance with GAAP over the past 24 years. Nevertheless, the City is always under pressure to spend beyond its means, and the possibility always exists that outside events can trigger a fiscal crisis. The City encountered fiscal difficulties in FY 1991, triggered by the national recession, and again in FY 1995 when the bond market collapsed. The attack on the World Trade Center precipitated a fiscal crisis that necessitated the use of $2 billion in bond proceeds (i.e., deficit financing) from the Transitional Finance Authority to help balance the City's budget.

Even though the City expects to end FY 2005 with a surplus of $3.5 billion, there still exists a large imbalance between recurring revenues and expenditures that has been masked through the use of nonrecurring resources and prior years' surpluses. In fact, the City is on course to end FY 2006 with a current-year deficit of $3.5 billion, excluding discretionary surplus transfers from prior years. Furthermore, the City projects a budget gap of $4.5 billion in FY 2007, which represents about 13 percent of City fund revenues—and is the second-largest budget gap as a percent of City fund revenues to be projected at this point in the financial planning process since the City first balanced its budget in accordance with GAAP in FY 1981.

The State Comptroller supports the charter revision commission's efforts to incorporate features of the FEA into the City Charter, but believes that the FEA has served the City well over the past 30 years and should remain in effect indefinitely, or at least as long as the State is responsible for paying off the City's fiscal crisis debt. The prospect of a control period provides the City with an added incentive to adopt its budget on time and to maintain fiscal discipline. In its absence, the City would be permitted to roll over a deficit into the following fiscal year, without penalty, by issuing short-term borrowings—a practice similar to one that led to the 1975 fiscal crisis. The annual meeting of the Control Board is also a useful venue to discuss the City's finances, and the presence of the Governor and the State Comptroller reinforces the notion that the State and City are partners.

The State Comptroller is also concerned that a future mayor would be free to unilaterally modify the form of the financial plan, and that over time there could be erosion in the free flow of timely information about the City's finances.[19] The FEA requires the City to promptly furnish the Control Board with any requested information to assist in the quarterly review of the City's finances. The oversight community, financial markets, media, and the public have come to depend on this information to independently assess the City's finances.

History clearly demonstrates that whenever the City experiences periods of fiscal stress, the State is called upon to provide financial assistance. Furthermore, the economies of the City and the State are closely intertwined, and a failure of the City to meet its debt obligations would also affect the State's ability to raise funds in the public credit markets. Thirty years ago, the State Legislature concluded that the FEA was a "necessary, proper, reasonable and appropriate means by which the state can and should implement its overriding concern with respect to the financial condition of the city and can and should exercise its duty under section twelve of article eight of the constitution to prevent abuses by the City in taxation and in the contracting of indebtedness..." The State Comptroller believes that the original legislative findings behind the FEA remain applicable today.

B. Department of Education

The July Plan allocates $14.1 billion to the Department of Education in FY 2006, excluding pensions and debt service. Of this amount, the City would fund 41 percent, the State would fund 46 percent, and the federal government and private grants would fund the remainder. Including pensions and debt service—these have grown rapidly in recent years, and are mandatory education-related expenditures—raises the City's share to 50 percent and reduces the State's share to 39 percent (see Graph 16).

State law prohibits the City from reducing its funding for education (excluding pensions and debt service) from one year to the next, unless there is a reduction in City revenues. The July Plan includes $5.8 billion in City funding for operations in FY 2006, which exceeds the State's minimum requirement by $223 million and which establishes a new base level for FY 2007.

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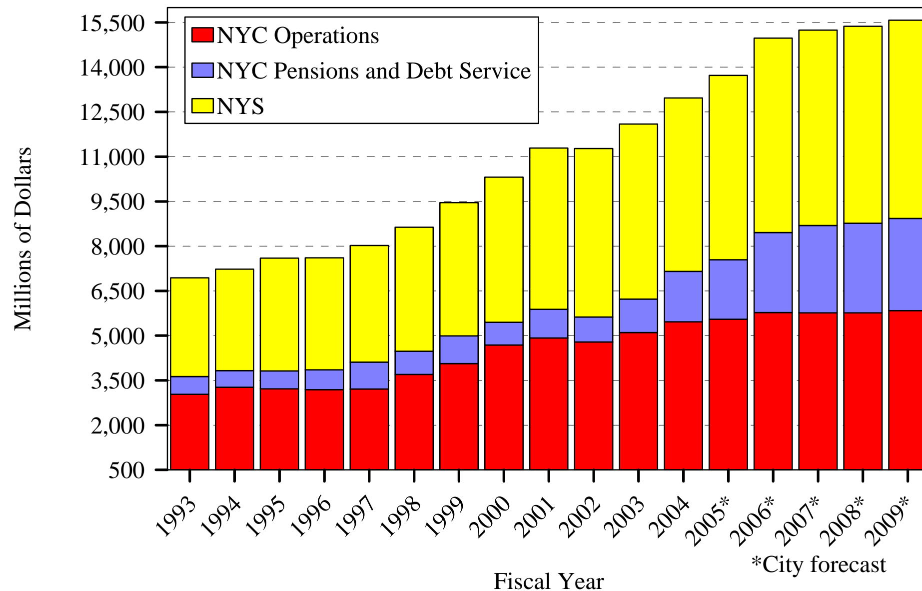
[19] This concern is not without precedent. In 1997, then-Mayor Giuliani instructed the mayoral agencies not to comply with a subpoena issued by the State Comptroller, who was conducting performance audits of City operations. The New York State Court of Appeals subsequently ordered the Mayor to comply with the subpoena, but the Mayor succeeded in delaying the transfer of information for more than two years while this issue was being litigated.

The City projects that the department will end FY 2005 with a surplus of $36.8 million, which will be allocated to schools in FY 2006. Last year, the department was found to have unexpectedly developed a $236 million shortfall when its accounting system was reconciled with the City's. To avoid such overspending in the future, reconciliations will be performed monthly until the department's accounting system is merged with the City's.

Graph 16

State and City Contributions to City Schools



Sources: NYC Office of Management and Budget; OSDC analysis

The City's contribution to education has been the subject of debate as the State attempts to fulfill a court order in a case regarding the level of State support for City schools, *Campaign for Fiscal Equity v. State of New York*. 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, and the Assembly Speaker, the Senate Majority Leader, and the plaintiffs have each suggested that the City should fund part of any 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 as recommended by the Governor, it would need to increase its contribution by as much as $575 million in FY 2007, $1.1 billion in FY 2008, $1.6 billion in FY 2009, and $2.3 billion in FY 2010.

C. Health and Hospitals Corporation

The New York City Health and Hospitals Corporation (HHC) continues to make progress toward balancing its FY 2006 budget on a cash basis, while operating in a difficult financial environment. HHC projects operating deficits that average $600 million annually during fiscal years 2006 through 2009.

HHC expects to ends FY 2005 with a closing cash balance of $449 million—the largest year-end balance since FY 2000. To balance the FY 2006 budget, HHC plans to draw upon its cash balance; generate $260 million in receipts, primarily by obtaining State and federal approval for appeals of old insurance claims; and implement other measures to produce savings of $185 million annually.

Despite its large cash reserves, HHC still forecasts large annual operating deficits. The projected deficits are attributable to HHC's conservative revenue forecasts; loss of market share; reimbursement for the care it provides that does not fully cover its cost, especially for ambulatory care; declining third-party receipts; and rising costs for pensions, affiliation contracts, and other-than-personal-service expenditures.

In a March 2005 report, the State Comptroller recommended that HHC also prepare its budget and financial plan on an accrual basis, starting with the FY 2006 executive budget.[20] In response, HHC has prepared accrual-basis financial plans that, like the cash-basis plans, project large budget gaps.

[20] See our report 13-2005, *The Financial Outlook for the Health and Hospitals Corporation*, March 2005.

The Commission on Health Care Facilities in the 21st Century was created by the State to examine its health care system and identify areas where hospitals and nursing homes should be closed, resized, consolidated, or converted. The commission is also reviewing formulas used by public and private insurance programs to reimburse hospitals, and is looking for areas in which the State's health care technology and capital plan can be improved. The commission begins its work at a time when there is excess hospital capacity in the State and many New York State hospitals and nursing homes face financial difficulties. The commission's recommendations are scheduled to be presented to the Governor and the Legislature in December 2006, with implementation expected in 2008.

D. Metropolitan Transportation Authority

A report by the State Comptroller released in May 2005 found that new resources approved by the State will help the MTA balance its 2006 operating budget without the need for 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. Despite these positive developments, the report projects that budget gaps will reappear beginning in 2008 because the new sources of revenue approved by the State are insufficient beyond 2007 to close the MTA's projected budget gaps, which are largely driven by excessive borrowing to help finance the MTA's capital program.[21] Since the issuance of the report, the expected decline in the real estate markets has not occurred, and tax revenues from real estate transactions continue to exceed expectations.

The new State-approved resources also helped the MTA to fund a new capital program for 2005-2009. Although the amended capital program was funded at levels that were considerably lower than previously planned, it will still permit restoration, modernization, and network expansion projects to move forward. On July 13, 2005, the MTA Capital Program Review Board[22] approved the MTA's capital program.

The Comptroller's report pointed out that the MTA will continue to rely heavily on debt to finance its capital program. Debt service costs are expected to 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 (debt service as a percent of revenues) is expected to rise from 11 percent in 2004 to 18.6 percent in 2008, and then to

[21] See our report 1-2006, *Financial Outlook for the Metropolitan Transportation Authority,* May 2005.

[22] The Capital Program Review Board includes representatives of the Governor, the Speaker of the State Assembly, the Senate Majority Leader, and the Mayor of the City of New York. The Mayor is entitled to vote only with respect to plans for New York City Transit and the Staten Island Rapid Transit Operating Authority (SIRTOA).

23 percent in 2015. If the transportation bond act is rejected by voters in November, the MTA may have to increase borrowing or further scale back the capital program.

E. New York City Transitional Finance Authority

The New York City Transitional Finance Authority (TFA) has reached its legal issuing limit, and the Mayor has proposed raising the limit. The proposal would allow the City to issue TFA debt as long as the amount outstanding that exceeds the current cap of $11.5 billion, when combined with outstanding general obligation (GO) debt, does not exceed the City's constitutional debt limit. The City may seek legislative approval to increase the TFA's borrowing cap.

The TFA was created in 1997 as the City was reaching its constitutional debt limit for GO bonds. To help the City meet its ongoing capital needs, the State authorized the TFA to issue debt primarily backed by the City's personal income tax and then its sales tax. TFA bonds have had the benefit of a high revenue to debt service coverage ratio. Because of this high coverage, TFA bonds have provided the City with interest cost savings. In addition, TFA bonds have provided a source of diversification as a financing vehicle, which relieves pressure on GO bonds and also lowers borrowing costs.

On March 14, 2005, both Standard & Poor's and Moody's Investors Service raised their ratings on TFA debt, to "AAA" from "AA+" and to "Aa1" from "Aa2," respectively. Standard & Poor's noted that the rating upgrade is based on the "high debt service coverage levels" resulting in part from the refunding of New York City's Municipal Assistance Corporation debt, causing an "absence of any competing intercept" of the City's sales tax. Moody's noted that revenues supporting TFA bonds are "steady and diverse," and further noted the "strong insulation from city and state fiscal stress."

Currently, the City plans to issue $18.3 billion in GO bonds during fiscal years 2006 to 2009. If the TFA's debt-issuing capacity were raised, City officials have stated that the City would replace up to half of its forecast GO bond amount during the Financial Plan period in order to fund the City's capital program. If the City were able to issue TFA bonds during the Financial Plan period in an amount equal to that of its GO bonds, it would realize savings of nearly $16 million in interest expenses, because TFA interest rates have averaged about 10 basis points (one basis point is equal to one one-hundredth of a percent) lower than GO bonds in the secondary market.

F. TSASC Inc.

The downgrade of major tobacco companies below investment grade has resulted in a trapping event for TSASC. This trapping event requires TSASC to reserve a portion of the revenues from the national settlement with tobacco companies until the total amount trapped equals 25 percent of the outstanding principal, which currently totals $1.3 billion.

The City and TSASC are considering alternatives to eliminate the trapping requirement, but if the requirement were to continue, it is estimated that revenues that would otherwise accrue to the City's budget will be reduced by $120 million in FY 2006, from the expected release of funds trapped and held in a reserve account; and expected future trappings of about $60 million annually during fiscal years 2006 through 2008—a total reduction of about $300 million.

The Westchester Tobacco Securitization Corporation recently completed the refunding of its 1999 bonds that required the same trapping event as TSASC bonds. By refunding these bonds, the Westchester Tobacco Securitization Corporation was able to eliminate the trapping requirement and release the funds. This could be one of the alternatives the City might pursue to release the trapped funds.

G. 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.[23]

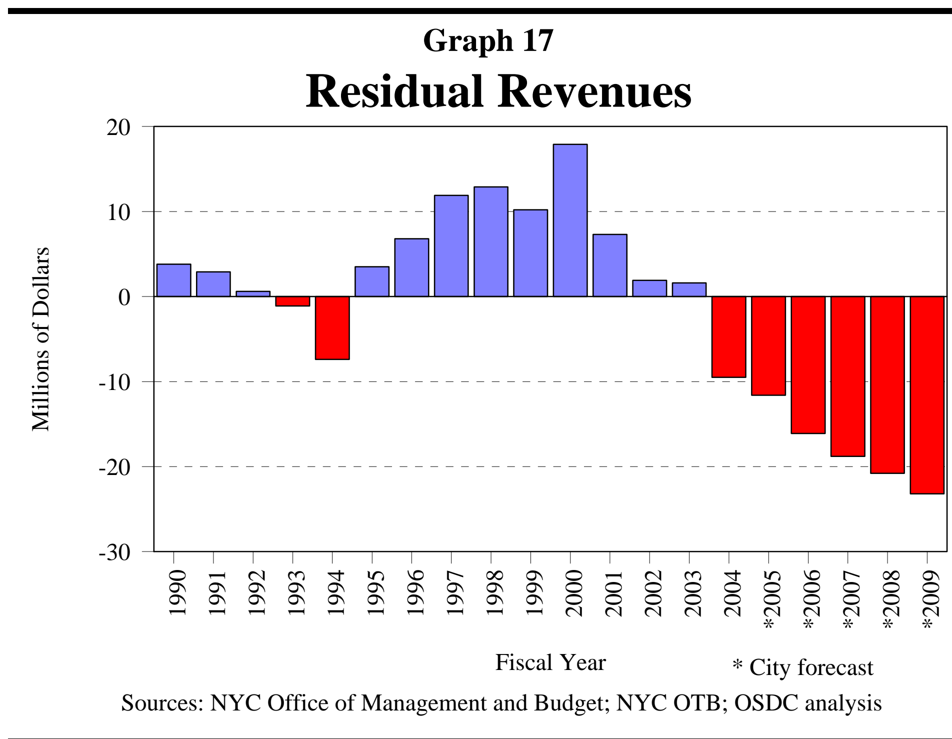
While surcharge revenues have remained relatively flat since FY 1996, at about $17 million, in FY 2004 the OTB experienced a loss of $9.5 million—its first loss in a decade (see Graph 17). The surcharge payment to the City in FY 2004 was made in part from the OTB's cash reserves. OTB finances have continued to deteriorate, and the OTB projects residual losses of $11.6 million in FY 2005, $16.1 million in FY 2006, and more than $23 million in FY 2009.

To help manage its cash flow, the OTB temporarily delayed payment of its monthly surcharge to the City by two months during FY 2005, and has delayed a $3 million payment due to the State (thereby incurring a one-time late payment fee of

[23] 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.

5 percent and monthly interest charges of 1 percent). OTB management is also considering closing some branches or reducing service hours.

Graph 17



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

The State recently reduced the pari-mutuel tax that the OTB pays to the State on wagers on in-state races, which is expected to increase the amount of wagers on races conducted within New York State. The State Senate estimates that this could save the OTB about $1 million a year, but the OTB's preliminary estimates are significantly lower.

In the past, the City has solicited bids for the sale of the OTB, and interested parties have included Magna Entertainment Inc., and Churchill Downs, Inc., two of the largest racetrack operators in the nation. A planned sale of OTB was put on hold by the City in 2002 to allow a newly appointed management team at the OTB time to increase profitability, something that has not occurred. In December 2004, the Mayor indicated that the City was still interested in pursuing the sale of the OTB.

State and federal investigations of the New York Racing Association (NYRA) concluded that a culture of criminality existed within the NYRA that raised questions of corporate accountability.[24] The State Comptroller recommended in September 2003 that an Independent Private Sector Inspector General (IPSIG) be appointed to monitor

[24] The NYRA holds a State franchise to operate three thoroughbred racetracks in New York State.

the NYRA's operations. In December 2003, the U.S. Attorney's Office for the Eastern District of New York indicted employees of the NYRA and the NYRA itself for several crimes, including defrauding the government and aiding and abetting false tax filings. The NYRA entered into a Deferred Prosecution Agreement with the U.S. Attorney's Office, and one of the conditions of this agreement was the appointment of an IPSIG, or Federal Monitor, by the federal district court to monitor the NYRA. This Federal Monitor was appointed in March 2004 and has reported to the Comptroller, the U.S. Attorney's Office, and the federal district court. The term of the Federal Monitor's oversight was extended from July 1, 2005, to July 24, 2005, to coincide with the end of the Belmont racing season. The Federal Monitor is expected to issue a public report on its work, as well as its recommendations, in the near future.

In an audit report released by the State Comptroller on June 15, 2005, that covered NYRA operations from January, 2002 through December, 2004, the Comptroller found that NYRA had routinely violated State law and its own policies in purchasing goods and services. The audit concluded that NYRA had purchased many goods and services that were unnecessary for its operations, were not documented as being received, or were simply too expensive, especially for a racing association operating at a continuous deficit. The audit also found that NYRA routinely disregarded the competitive bidding requirements set forth in the Racing Law and in its own purchasing policies. The audit recommended that NYRA's new management, to the extent not already addressed by the Monitor, investigate the questionable procurement activities, develop additional controls needed to prevent their recurrence, and take corrective or disciplinary action, as needed. The Comptroller did note that since the Monitor was appointed, NYRA has begun to improve its operations and practices.

Recent legislation created a Non-Profit Racing Association Oversight Board. Once formed, this board will be empowered to review and approve NYRA's operating and capital budgets, and to take over its operations—including the video lottery terminals to be located at Aqueduct Racetrack—if the franchise is revoked or voluntarily relinquished before it expires on December 31, 2007. In that event, the Governor would appoint an ad hoc committee to solicit proposals for the exclusive right to operate and maintain the facilities currently operated by NYRA.

H. West Side Development

In February 2004, the Mayor announced an ambitious redevelopment plan to transform the far West Side of Manhattan into a high-density, mixed-use community. The plan has three major components: first, the extension of the No. 7 subway line; second, the building of a platform over the Eastern Rail Yards; and third, the creation

of a network of streets and open spaces in the Hudson Yards Redevelopment Area. In conjunction with these projects, the City's plan calls for private developers to construct 14 high-rise office towers and more than 12,000 new housing units on the rezoned far West Side.

The City's plans for the West Side also included the renovation and expansion of the Jacob K. Javits Convention Center and the construction of a multi-use sports and convention facility, which would have been used by the New York Jets and was the centerpiece of the City's bid for the 2012 Olympics.

In June 2005, the Public Authority Control Board did not approve the multi-use stadium; on July 6, 2005, the International Olympics Committee rejected the City's bid to host the Olympics. Despite these developments, the Jets, who were awarded development rights to the Hudson Rail Yards by the MTA, have indicated that they are still interested in building a stadium on this site.

The Hudson Yards Infrastructure Corporation (HYIC), a City-created local development corporation, plans to issue $3 billion in bonds to finance the extension of the No. 7 subway line and other infrastructure improvements to spur private investment on the far West Side of Manhattan. The MTA, however, could be responsible for any cost overruns on the No. 7 line extension.

HYIC is expected to incur debt service costs beginning in 2006, but development is not projected to generate sufficient revenues to cover the interest costs until at least 2015. The City Council has expressed its support of a City undertaking to pay, subject to an annual appropriation, the interest on HYIC bonds to the extent that project revenues are insufficient to cover these costs. While the City estimates the interest cost at nearly $1 billion through 2015, there is no limit on the City's liability. Repayment of principal would begin in 2018 or later assuming the project generates sufficient revenues.

The City plans to use the Transitional Finance Authority (TFA), with its high credit rating, as a credit enhancement for $750 million of variable-rate long-term HYIC bonds to finance this project, which is outside the City's capital program. The City believes that the credit enhancement would enable these bonds to obtain a credit rating in the "AA" category, the minimum rating required by certain institutional purchasers to invest in variable-rate municipal bonds. Otherwise HYIC would not have access to the lower-cost variable-rate market. If the TFA is called upon to use its credit enhancement, the City believes the TFA would be able to purchase HYIC bonds, enabling HYIC to meet its debt service obligations in the event that project revenues were insufficient.

The TFA's enabling act authorizes the TFA to invest in obligations that may be legally purchased by the City pursuant to the General Municipal Law (GML). In addition, the enabling act contains provisions for the TFA to enter into certain contracts with its bondholders as to, among other things, investments. The purchase of low-rated HYIC bonds is not authorized under the GML, but the City contends that the TFA is not subject to this restriction because the TFA's enabling act permits the TFA's indenture to authorize it to invest in obligations that are not authorized under the GML. At a minimum, a purchase of HYIC bonds would require the TFA's Board of Directors to amend the TFA's indenture and its investment guidelines because the current guidelines only permit investment in high-rated bonds.

Such a purchase, if required, would adversely affect the City's budget because the revenues used to purchase these bonds, which are generated by the City's personal income tax (PIT), would otherwise flow to the City. Moreover, we believe that the authority to contract with bondholders as to investments was intended primarily to enable the bondholders to protect their interests and mitigate their risks. We do not believe that the enabling act was intended to permit the TFA, by agreement with its bondholders, to expand the TFA's investment powers by taking excess PIT monies, otherwise payable to the City, to purchase obligations issued for projects not within the City's capital program.

The use of the TFA as a credit enhancement was not expressly authorized by the State Legislature, and we believe its use for projects outside the City's capital program was never contemplated by the Legislature and is inappropriate. The TFA was specifically created to help the City fund its capital plan during a transition period as it approached its debt limit, and later, to assist the City "in financing its capital program."

The rating agencies have yet to rate HYIC bonds or comment on the potential impact on the City's or the TFA's credit ratings from the TFA's purchase of HYIC bonds. HYIC debt could be viewed as City-supported debt, because the City intends to fund the interest costs as long as revenues are insufficient to cover these costs and because the TFA, if called upon, would use City PIT revenues to purchase up to $750 million of HYIC bonds. This could negatively impact the City's credit rating, and effectively adds to the City's "debt" burden.

I. Convention Center Development Corporation

Last year, the State approved legislation authorizing the Convention Center Development Corporation, a subsidiary of the Empire State Development Corporation, to issue bonds to renovate and expand the existing Jacob K. Javits

Convention Center. The expansion will take place in two phases. Phase 1, which is estimated to cost $1.4 billion, will expand the center south to 33rd Street and north to 40th Street. Phase 2, which has not yet been funded and will account for 35 percent of the overall expansion, will expand the center from 40th Street to 42nd Street.

The City and the State will each contribute $350 million to the Phase 1 expansion. The City intends to use proceeds from future bond issuances. The State's contribution is expected to come from a variety of sources, including a refunding, although the details of the State contribution have not been supplied. The hotel industry has also agreed to a dedicated $1.50 per-key surcharge that was initiated in April 2005 and was expected to generate $500 million for the project. An additional $200 million in private financing is anticipated to help build a 1,500-room hotel at 42nd Street and 11th Avenue.

J. Lower Manhattan Redevelopment

The Lower Manhattan Development Corporation (LMDC) is a joint State-City corporation that was created in the aftermath of September 11, 2001, to plan and coordinate the rebuilding and revitalization of Lower Manhattan. The LMDC is responsible for coordinating the design and construction of the entire World Trade Center (WTC) site with city and state agencies. Projects at the site include the Freedom Tower and four additional office buildings, a cultural center and museum, a memorial and memorial museum to the victims of the terrorist attacks, and a permanent transportation hub. The LMDC is directly responsible for the deconstruction of the former Deutsche Bank building and the design and construction of the memorial and cultural facilities. The LMDC is also involved in funding development projects throughout Lower Manhattan, south of Houston Street, that range from the construction of parks along the Hudson and East rivers to the study of a downtown rail link to JFK Airport. In addition, the LMDC has allocated millions of dollars to projects and organizations throughout Lower Manhattan, and has overseen incentive programs to attract businesses and residents to the area. The LMDC's $2.78 billion allocation is a portion of the $20 billion allocated to New York City by the federal government after the terrorist attacks.

The master plan for the WTC site was selected in 2003 after an extensive public process. Among the milestones already achieved are the topping off of WTC Building 7 in 2004 and the completion of the temporary PATH station and restoration of service in 2003. Plans for the Freedom Tower have been delayed for up to a year in response to new security concerns that necessitate a redesign of the tower. The tower will be topped off in 2009 and ready for occupation in 2010. The building is estimated to cost approximately $1.5 billion; however, infrastructure at the site may cost an

additional $1.5 billion. The tower's developer, Silverstein Properties, is in negotiations with the Port Authority of New York and New Jersey to decide who is responsible for the infrastructure costs. Silverstein Properties will fund the project with anticipated awards from insurance policies on the original WTC buildings. In total, the five buildings planned for the WTC site will contain 12.7 million square feet of office and ground-floor retail space, and are expected to cost $11 billion.

The World Trade Center memorial design "Reflecting Absence" was selected in January 2004 through an international design competition that generated over 5,200 submissions from around the world. The memorial is expected to break ground in early 2006. Construction on the Cultural Center will begin in 2007. A design for the Performing Arts Center is still in development. To date, $800 million is expected to fund the memorial and cultural projects—$500 million from anticipated private contributions and $300 million in LMDC funds.

The Port Authority of New York and New Jersey is constructing a new $2 billion permanent transportation hub, which will replace the temporary PATH station completed in 2003 at a cost of $455 million. The new hub will be funded with federal transit funds. Construction is expected to begin in the summer of 2005 and to be completed in 2009.

The Fulton Street Transit Center, to be constructed by the Metropolitan Transportation Authority, will replace the existing Fulton Street subway station, which serves seven subway lines. Plans for the transit center were altered in an effort to reduce the cost of the project. Despite the changes, which reduced the size of the aboveground portions of the station, narrowed underground concourses, and eliminated connections with two subway stations, the project remains $35 million over budget. The transit center is being funded with $750 million in funding from the Federal Emergency Management Administration. Originally scheduled for completion in 2007, the project's completion date has been moved to 2008.

The State Legislature recently passed a series of incentives to attract businesses to Lower Manhattan. These include rent subsidies for businesses that lease space at the WTC site and the adjacent WTC 7 building (also being developed by Silverstein Properties); the permanent elimination of the commercial rent tax for all WTC tenants, and a five-year exemption for all tenants of Lower Manhattan; an expansion of tax credits under the Relocation and Employment Assistance Program to all Lower Manhattan tenants; and sales tax exemptions for office furniture and equipment purchased by WTC tenants and tenant renovation costs for all leased space in Lower Manhattan.

Appendix

Nonrecurring Resources in Fiscal Year 2006

The July Plan includes $4.6 billion in nonrecurring resources in FY 2006 (see Table 8). These resources will help the City balance the FY 2006 budget, but will provide no recurring benefit.

Table 8
Nonrecurring and Other Extraordinary Actions
(in millions)

FY 2005 Surplus Transfer	$ 3,528
GO Debt Service Savings	406
Temporary Tax Increases	354
Tobacco Settlement Revenues	120
Sale of Taxi Medallions	67
Anticipated Federal Aid	50
Restructure of Escrow Account	48
TFA Debt Refundings	24
Total	**$ 4,597**

Source: OSDC analysis

Our estimate of nonrecurring resources in FY 2006 includes the following.

- $3.5 billion in surplus funds from FY 2005.
- $406 million from general obligation debt refundings and the retirement of some outstanding high-coupon general obligation debt.
- $354 million from temporary tax increases that were enacted by the State at the City's request to help it through its recent fiscal crisis. This estimate includes $308 million from a personal income tax surcharge on high-income earners that expires on December 31, 2005.
- $120 million from the release of funds held in a reserve account due to the expected elimination of the TSASC trapping requirement.

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