# Review of the Mayor's Executive Budget for Fiscal Year 2005

*May 2004*

***Report 4-2005***


New York State
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# I. Executive Summary

On April 26, 2004, the Mayor released his Executive Budget for FY 2005 and the associated four-year financial plan (see Table 1). Although the April 2004 Financial Plan projects a surplus of $1.3 billion for FY 2004 and a balanced budget for FY 2005, the Plan also projects large out-year budget gaps because the FY 2005 budget would be balanced largely with nonrecurring resources.

A little more than one year ago, the City faced its most serious fiscal challenge since the 1970s. The City was able to balance the FY 2004 budget by making tough choices and with the assistance of the federal and State governments. The City now expects to end FY 2004 with a surplus of $1.3 billion, even though expenses were higher than anticipated, because revenue collections will exceed the estimates in the adopted budget by $1.8 billion—owing largely to higher tax revenues from increased Wall Street activity and real estate–related transactions.

While most economic indicators are showing signs of improvement, they remain well below pre-recession levels. The greatest recovery is in Wall Street profits, which totaled $16.8 billion in 2003—more than twice the 2002 level and second only to the record set in 2000. While in the short term there may be some upside potential to the City's tax revenue forecasts, which could increase the FY 2004 surplus to more than $1.5 billion, we are increasingly concerned that rising interest rates and large federal deficits will put a damper on economic activity.

The April Plan shows a balanced budget for FY 2005 but large out-year budget gaps, because FY 2005 would be balanced with $3.2 billion in nonrecurring resources (nearly twice the FY 2004 level); because temporary taxes approved by the State last year are scheduled to be phased out; and because nondiscretionary spending continues to grow rapidly. Nondiscretionary spending is projected to increase by $4.1 billion, or 24 percent, between fiscal years 2004 and 2006. Pension contributions alone are projected to rise by 73 percent, or $1.7 billion, and Medicaid is projected to rise by 17 percent over the two-year period.

The April Plan projects budget gaps of $3.8 billion in FY 2006, or 11.5 percent of City fund revenues; $4.2 billion in FY 2007; and $3.6 billion in FY 2008. The Plan, however, makes no provision for wage increases during these years. Wage increases at the projected inflation rate and without offsetting productivity savings would widen the budget gaps by $220 million in FY 2006, $700 million in FY 2007, and $1.2 billion in FY 2008.

The recent decision by the Court of Appeals that allows the Municipal Assistance Corporation refinancing initiative to go forward removes a large budget risk from the financial plan. Our review, however, has identified other risks with a net value of about $600 million in FY 2005 and about $1.2 billion in subsequent years (see Table 2). Most of the uncertainty in the Plan involves actions that depend on other levels of government or the outcome of collective bargaining. The impact of these risks would be reduced by about $250 million annually if competing proposals by the Mayor and the City Council President to reduce property taxes are not enacted.

The April Plan assumes that the State and federal governments will increase aid to the City by $550 million annually, and while the City will probably receive some increase, the amount and form is not yet known. In addition, the Court of Appeals ruled last year that the State education formula shortchanges New York City and other school districts with high concentrations of low-performing students. The Governor and a commission he appointed both recommended that the City increase funding to the public school system as part of any increase in State aid, which could range from $100 million to $400 million annually.

The City recently reached a tentative collective bargaining agreement with District Council 37, which represents most civilian employees. The agreement calls for a $1,000 one-time payment to all employees, a 3 percent wage increase in FY 2004, and a 2 percent wage increase in FY 2005 that would be funded with productivity and other savings. About one quarter of the savings would come from reducing starting salaries and leave benefits, and the balance would come from not filling vacant positions. The April Plan assumes that this agreement will set the pattern for agreements with other unions. Unless the City obtains productivity savings from the other unions to offset the FY 2005 wage increase, City spending would increase by $90 million in FY 2005 and about $300 million annually thereafter.

Our review also found that the Health and Hospitals Corporation will continue to face serious fiscal challenges despite a large increase in City support, and that the Off-Track Betting Corporation will likely end FY 2004 with a loss of $7 million. In addition, the Metropolitan Transportation Authority faces large gaps in both its operating and capital budgets.

In conclusion, the April Plan projects large out-year budget gaps and our review has identified a number of substantial budget risks that could further increase the size of the gaps. While these risks should not interfere with the City's ability to balance the FY 2005 budget because of the availability of reserves and other resources, the City should begin the process to identify recurring actions in order to close the FY 2006 budget gap and narrow the out-year gaps.

# Table 1
## Four-Year Financial Plan
(in millions)

| | FY 2005 | FY 2006 | FY 2007 | FY 2008 |
|---|---|---|---|---|
| **REVENUES** | | | | |
| Taxes | | | | |
| General Property Tax | $11,832 | $ 12,340 | $ 12,931 | $ 13,549 |
| Other Taxes | 14,637 | 14,902 | 15,336 | 16,161 |
| Tax Audit Revenue | 508 | 508 | 509 | 509 |
| Tax Reduction Program | (250) | (259) | (263) | (267) |
| Miscellaneous Revenue | 5,769 | 4,279 | 4,233 | 4,265 |
| Unrestricted Governmental Aid | 562 | 562 | 562 | 562 |
| Anticipated Federal and State Aid | 550 | 550 | 550 | 550 |
| Less: Intra-City Revenues | (1,133) | (1,132) | (1,132) | (1,131) |
| Grant Disallowances | (15) | (15) | (15) | (15) |
| *Subtotal: City Funds* | $ 32,460 | $ 31,735 | $ 32,711 | $ 34,183 |
| Other Categorical Grants | 806 | 830 | 840 | 839 |
| Inter-Fund Revenues | 345 | 332 | 328 | 328 |
| Total City & Inter-Fund Revenues | $ 33,611 | $ 32,897 | $ 33,879 | $ 35,350 |
| Federal Categorical Grants | 4,716 | 4,644 | 4,632 | 4,622 |
| State Categorical Grants | 8,573 | 8,548 | 8,624 | 8,694 |
| **Total Revenues** | $ 46,900 | $ 46,089 | $ 47,135 | $ 48,666 |
| **EXPENDITURES** | | | | |
| Personal Service | | | | |
| Salaries and Wages | $ 16,954 | $ 17,176 | $ 17,165 | $ 17,067 |
| Pensions | 3,376 | 4,107 | 4,515 | 4,502 |
| Fringe Benefits | 5,177 | 5,475 | 5,788 | 6,162 |
| Subtotal – Personal Service | $ 25,507 | $ 26,758 | $ 27,468 | $ 27,731 |
| Other Than Personal Service | | | | |
| Medical Assistance | $ 4,766 | $ 4,997 | $ 5,194 | $ 5,401 |
| Public Assistance | 2,295 | 2,304 | 2,305 | 2,305 |
| Pay-As-You-Go Capital | 200 | 200 | 200 | 200 |
| All Other | 12,856 | 12,774 | 12,954 | 13,129 |
| Subtotal – Other Than Personal Service | $ 20,117 | $ 20,275 | $ 20,653 | $ 21,035 |
| Debt Service | 3,415 | 3,650 | 4,013 | 4,285 |
| Budget Stabilization | (1,306) | - - - | - - - | - - - |
| General Reserve | 300 | 300 | 300 | 300 |
| Subtotal – Expenditures | $ 48,033 | $ 50,983 | $ 52,434 | $ 53,351 |
| Less: Intra-City Expenses | (1,133) | (1,132) | (1,132) | (1,131) |
| **Total Expenditures** | $ 46,900 | $ 49,851 | $ 51,302 | $ 52,220 |
| **Gaps To Be Closed** | **$ - - -** | **$ (3,762)** | **$ (4,167)** | **$ (3,554)** |

Sources: NYC Office of Management and Budget; OSDC analysis

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

| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 |
|---|---|---|---|---|---|
| | | | *Better/(Worse)* | | |
| **Gaps per April 2004 Plan** | **$ - - -** | **$ - - -** | **$(3,762)** | **$ (4,167)** | **$ (3,554)** |
| Anticipated State Aid | - - - | (400) | (400) | (400) | (400) |
| Anticipated Federal Aid | - - - | (150) | (150) | (150) | (150) |
| Uniformed Agency Overtime | - - - | (150) | (150) | (150) | (150) |
| TSASC Trapping Event | - - - | (116) | (59) | (61) | (60) |
| Education Matching Grant[1] | - - - | (100) | (100) | (100) | (100) |
| Productivity Savings | - - - | (95) | (290) | (300) | (300) |
| Teacher Sabbaticals | - - - | (34) | (34) | (34) | (34) |
| Judgments and Claims | (25) | (30) | (35) | (40) | (40) |
| Tax Revenue | 250 | 200 | - - - | - - - | - - - |
| Health Insurance | - - - | 35 | 40 | 45 | 50 |
| **OSDC Risk Assessment** | **225** | **(840)** | **(1,178)** | **(1,190)** | **(1,184)** |
| Surplus Transfer | (225) | 225 | - - - | - - - | - - - |
| **Gaps to be Closed** | **$ - - -** | **$ (615)** | **$ (4,940)** | **$ (5,357)** | **$ (4,738)** |
| | | | | | |
| **Other Risks and Offsets** | | | | | |
| Pay-As-You-Go Capital | 200 | 200 | 200 | 200 | 200 |
| General Reserve | 40 | 300 | 300 | 300 | 300 |
| Real Property Tax Rebate | - - - | 250 | 259 | 263 | 267 |
| Savings from Prior Years' Expenses | - - - | 250 | - - - | - - - | - - - |
| Wage Increases at the Projected Inflation Rate[2] | - - - | - - - | (220) | (700) | (1,200) |

[1] The Governor's Executive Budget would require the City to match a State grant of $100 million that would serve as a down payment to address a Court of Appeals ruling that the State had shortchanged New York City on public school education funding. A commission appointed by the Governor made recommendations that could require the City to increase its contribution by between $200 million and $475 million annually.

[2] Wage increases at the projected rate of inflation, without offsetting productivity savings for fiscal years 2006 through 2008, would increase the projected gaps by the amounts shown in the table.

# II. Economic Overview

The City continues to project an improving economic outlook as more reports confirm that employment has finally begun to increase after two years of a "jobless recovery." The national economy created about 870,000 jobs in the first four months of 2004, after losing nearly 2.5 million jobs since the beginning of the recession. The job gains, stemming from increased business confidence and investment, should help sustain consumer spending as the positive income effects of tax cuts and the mortgage refinancing boom are about to fade. Robust consumer and business spending continue to help boost the Gross Domestic Product (GDP), which grew at an annual rate of 4.2 percent in the first quarter of 2004, following gains of 8.2 percent and 4.1 percent in the last two quarters of 2003.

According to the City, the national economy is projected to grow at 4.8 percent in calendar year 2004, driven largely by growth of 12.3 percent in business spending on equipment and software. GDP growth is then expected to slow to 3.8 percent in 2005 and to 2.6 percent in 2008 as both consumer and business spending slow down in response to gradually rising interest rates. Growth in national employment is expected to increase through the rest of calendar years 2004 and 2005 (averaging 1.1 percent and 2.3 percent, respectively), after which gains slow through 2008 to 1 percent in step with the slowing of the economy. The growth of employment is lower than in previous recoveries, as strong productivity gains are expected to continue to hold back employment expansion.

The City's economy has begun to show signs of recovery after three years of contraction. Private sector employment has grown for the past three months (February through April 2004, the latest months for which data are available) compared to the same time last year. Employment gains in some export-oriented sectors, such as in portions of the professional and business services sector and in many tourism-related industries, began growing as early as last summer as the national economy accelerated. Total City employment growth is projected to resume in calendar year 2004 with a gain of 1 percent, followed by growth of 1.3 percent in 2005. The rate of job growth is expected to ease slightly in subsequent years in response to a slowdown in the national economy. As with national employment, the projected pace of job growth in the City is much lower than the pace experienced in the late 1990s. Nonetheless, the City's resurgence is expected to be broad-based across both export- and local market–oriented sectors—with the exception of manufacturing, which will continue to decline.

Wage growth is expected to resume at 6.3 percent in calendar year 2004 and then average 5.1 percent annually from 2005 to 2008, driven by employment gains and strong profit growth on Wall Street. The City's forecast of inflation remains low at 2.7 percent in calendar year 2004, and averages 2.4 percent annually during the 2005 through 2008 period. The City's forecast assumes that current high oil prices will come down and that gradual interest rate increases by the Federal Reserve, beginning in the second half of calendar year 2004, will keep inflation under control.

Increasing profits on Wall Street are also helping the City's recovery. Wall Street firms account for about one fifth of total wages paid to the City, and each new job creates two additional jobs in other industries. The City has revised up its Wall Street profits forecasts in response to an improved outlook on the national economy. Wall Street profits rebounded to $16.8 billion in calendar year 2003, from $6.9 billion in 2002, as the stock markets surged and securities firms controlled expenses and continued to trim employees. As the stock market growth cools down and the securities industry resumes hiring, the City projects that Wall Street profits will ease slightly, to $16.4 billion in 2004 and $14 billion in 2005, but then gradually return to the 2004 level by 2008.

The City's forecasts are more or less consistent with the April forecasts from Global Insight and the Blue Chip Economic Consensus. The City's forecasts of national employment growth and national personal income growth throughout the Plan period are also generally higher than those of Global Insight. However, the City's forecasts of growth in local employment and local personal income are lower than Global Insight's for 2005 and 2007. The City anticipates slightly higher GDP and inflation across the years than either Global Insight or Blue Chip. Both the City and Global Insight expect the Federal Reserve to raise short-term interest rates by 50 basis points by the end of this year, but recent statements by the Federal Reserve have caused some analysts to believe that rates could increase by twice that amount by the end of the year. In light of recent developments, we are increasingly concerned that rising interest rates and large federal deficits will put a damper on economic activity.

# III. Fiscal Year 2004

The April Plan assumes that FY 2004 will end with a surplus of $1.3 billion, even though spending will exceed the City's initial estimates, because revenues are expected to be higher by $1.8 billion, owing largely to higher-than-projected tax revenues from increased Wall Street activity and real estate–related transactions (see Table 3). Although revenues are now projected to be higher by $1.6 billion in FY 2005 and by about $1 billion in each of fiscal years 2006 and 2007, spending is projected to grow even faster during fiscal years 2006 and 2007. Consequently, although the FY 2005 gap was reduced, the out-year gaps have grown by $810 million in FY 2006 and by $1.2 billion in FY 2007.

## A. Revenue Changes

A surge in revenue collections—primarily tax revenues—is responsible for the improvement in the City's fiscal condition in FY 2004. Overall, revenues are expected to be $1.8 billion higher than originally forecast last June, with taxes accounting for $1.4 billion of the increase.

Although an improvement in the economy was factored into the City's original forecasts, the improvement has been much greater than expected. Wall Street profitability has increased markedly, with profits in calendar year 2003 reaching $16.8 billion—the second-highest level on record—compared to $6.9 billion in 2002. The higher profits were translated into higher income, which has filtered throughout the City's economy. A recent report from this office highlighted the link between Wall Street and job creation and income flows.[3]

Business tax collections have risen by 26 percent through April 2004 compared to the same ten-month period last fiscal year, and the City has raised its forecast for these taxes for the entire fiscal year by $372 million since June 2003. Personal income tax collections have increased by 21 percent during this ten-month period, although part of that growth is due to the tax surcharge on upper-income residents, and the personal income tax forecast has been raised by $181 million since June 2003. Finally, record-low interest rates have continued to encourage residential and commercial real estate sales and mortgage refinancings. Collections for the mortgage-recording and real property transfer taxes have risen 34 percent in the first ten months of the fiscal year, and the forecast for these taxes is now $592 million greater than it was in June 2003.

[3] See OSDC's recent report 1-2005, *The Impact of Wall Street on Jobs and Tax Revenues,* April 2004.

# Table 3
## Financial Plan Reconciliation
## Cumulative Changes Since the June 2003 Plan
(in millions)

| | *Better/(Worse)* | | | |
|---|---|---|---|---|
| | **FY 2004** | **FY 2005** | **FY 2006** | **FY 2007** |
| **Surplus/(Gaps) per June 2003 Plan** | **$ - - -** | **$ (2,014)** | **$ (3,238)** | **$ (3,285)** |
| **Revenues** | | | | |
| Tax Revenues | 1,395 | 1,024 | 876 | 901 |
| MBBA Proceeds for Education[4] | 197 | - - - | - - - | - - - |
| Reimbursement for Stock Exchange Costs | 71 | - - - | - - - | - - - |
| Delay in Airport Lease Payment | (200) | 200 | - - - | - - - |
| Other Non-Tax Revenue | 383 | 409 | 131 | 134 |
| **Subtotal** | **1,846** | **1,633** | **1,007** | **1,035** |
| **Expenditures** | | | | |
| Medicaid | (448) | (388) | (475) | (668) |
| Collective Bargaining | (333) | (652) | (580) | (574) |
| Uniformed Agency Overtime | (164) | (23) | (23) | (23) |
| Private Bus Subsidy | (75) | (159) | (157) | (161) |
| Public Assistance | (59) | (69) | (69) | (69) |
| Health and Hospitals Corporation | - - - | (200) | (150) | (150) |
| Pension Contributions | 195 | 133 | 143 | 136 |
| Debt Service | 293 | 200 | 140 | (38) |
| Other Agency Expenses | (231) | (693) | (646) | (651) |
| **Subtotal** | **(822)** | **(1,851)** | **(1,817)** | **(2,198)** |
| **Other Changes** | | | | |
| Agency Actions[5] | 324 | - - - | - - - | - - - |
| Reestimate of Prior Years' Expenses | 300 | - - - | - - - | - - - |
| General Reserve | 260 | - - - | - - - | - - - |
| Pay-As-You-Go Capital[5] | (100) | - - - | - - - | - - - |
| MAC Refinancing Initiative | (502) | 502 | - - - | - - - |
| **Net Change During FY 2004** | **1,306** | **284** | **(810)** | **(1,163)** |
| **Surplus/(Gaps) per April Plan** | **$ 1,306** | **$ (1,730)** | **$ (4,048)** | **$ (4,448)** |

Sources: NYC Office of Management and Budget; OSDC analysis

In addition, the City received $424 million in bond proceeds from the Municipal Bond Bank Agency in FY 2004, which were not anticipated in the June 2003 Plan. The proceeds represent a lump sum payment in lieu of State education aid that was owed to the City from prior school years. About half of the amount was used to remove a receivable from the City's books, and the remaining $197 million was

[4] The Municipal Bond Bank Agency (MBBA) issued bonds to cover State obligations for prior years' education aid.

[5] The recurring values of these actions have been reflected in the FY 2005 gap-closing program.

used to fund the City's operating budget. The State provided the City with $62 million for prior-year payments in the current fiscal year, and the City assumes that the State will appropriate a similar amount to pay debt service on the bonds over the next 20 years. In another transaction, the Industrial Development Agency issued bonds to reimburse the City for $71 million in costs associated with the initial development of the proposed expansion site of the New York Stock Exchange. The project was cancelled in the wake of the World Trade Center attack. The City also received $151 million from the Federal Emergency Management Agency to cover previously incurred expenses, such as enhanced security and disability pension costs, related to the attack on the World Trade Center.

## B. Expenditure Changes

The April Plan assumes that agency and programmatic spending will be higher by a net total of $822 million in FY 2004, about $1.8 billion in each of fiscal years 2005 and 2006, and by nearly $2.2 billion in FY 2007 compared with the estimates in the June 2003 Plan.

The rapid and unexpected growth in Medicaid and the expected cost of new collective bargaining agreements account for nearly the entire net increase in spending during FY 2004, and for more than half of the increase in subsequent years. Medicaid spending is expected to be 11 percent higher than projected one year ago because enrollment in the Family Health Plus program has grown much faster than expected. The April Plan now assumes that Medicaid will cost $448 million more in FY 2004 than projected last June, and $668 million more by FY 2007. In addition, the April Plan assumes that all of the municipal unions will reach new labor agreements with economic terms similar to the tentative agreement negotiated with District Council 37. That agreement provides for a $1,000 per employee cash payment upon ratification; a 3 percent wage increase retroactive to July 1, 2003; and a 2 percent wage increase at the beginning of FY 2005 that will be funded with savings from productivity and other operational savings.

In addition, overtime costs in the uniformed agencies are projected to be higher by $164 million in FY 2004, and public assistance costs have increased because of rising caseloads and a State increase in benefit levels. Contrary to what was assumed in the January Plan, the MTA assumed the operational but not financial responsibility of the private bus companies. Finally, all other agency costs are projected to exceed the estimates made last June by $231 million in FY 2004 and by $651 million by FY 2007. Most of the additional funding was devoted to implementing the new lead abatement law; creating a third-grade intervention program at the Department of Education; resuming weekly recycling and more frequent garbage pickups;

developing parks, zoos, and a new integrated 911 system; and providing health and welfare services.

The growth in City-funded spending will be partly offset by a reduction in pension contributions and debt service costs. Pension contributions are now projected to be $195 million less in FY 2004 than projected in June 2003 because of actuarial reestimates, slightly higher-than-expected returns in FY 2003, and lower financial services fees. Similarly, debt service costs are projected to be lower than those projected in the June 2003 Plan, by $293 million in FY 2004, because interest rates and seasonal borrowing needs were lower than anticipated, and because the FY 2003 surplus was $110 million greater than assumed in the June 2003 Plan.

## C. Municipal Assistance Corporation Bond Refinancing Delay

In May 2003, the State Legislature passed legislation over the Governor's veto that would provide an annual $170 million payment to New York City through the Local Government Assistance Corporation (LGAC), with the understanding that these resources would be assigned by the City to a local development corporation (the Sales Tax Asset Receivable Corporation) that would refinance outstanding MAC bonds that date back to the 1970s fiscal crisis. While this transaction would benefit the City budget by $2.5 billion over the four-year period, the cost to the State would total $5.1 billion if the bonds were to be amortized over 30 years as contemplated. The Comptroller believes that the refinancing is imprudent because it is costly, entails borrowing for operating budget purposes, and stretches out fiscal crisis debt that is due in less than five years.

On August 13, 2003, the LGAC[6] filed a lawsuit challenging the constitutionality of the legislation and seeking to prevent the refinancing. The State Supreme Court granted the City's motion for summary judgment, but the plaintiffs appealed to the State Appellate Division, which had previously issued a preliminary injunction preventing the new local development corporation from issuing bonds pending appeal. Oral argument on the appeal took place on November 18, 2003, and on March 4, 2004, the State Appellate Division upheld that the LGAC must make the $170 million annual payment. The LGAC again filed an appeal and arguments were heard in the Court of Appeals on April 28, 2004.

The April Plan assumes that the City will succeed in its defense of the MAC bond refinancing initiative, but that the court decision will come too late to realize previously planned savings of $502 million in FY 2004. Instead, the April Plan

[6] The State Comptroller is a director of the Local Government Assistance Corporation.

anticipates that the FY 2004 savings will be delayed until FY 2005, providing $1 billion in budget relief that year and about $500 million in each of fiscal years 2006 through 2008. On May 13, 2004, the Court of Appeals upheld the City's position that the refinancing plan does not violate the State constitution, and the City plans to move expeditiously to complete the refinancing. The MAC bonds will be refinanced in two sales, with the first scheduled for June 15 and the second planned for July.

## D. Other Changes

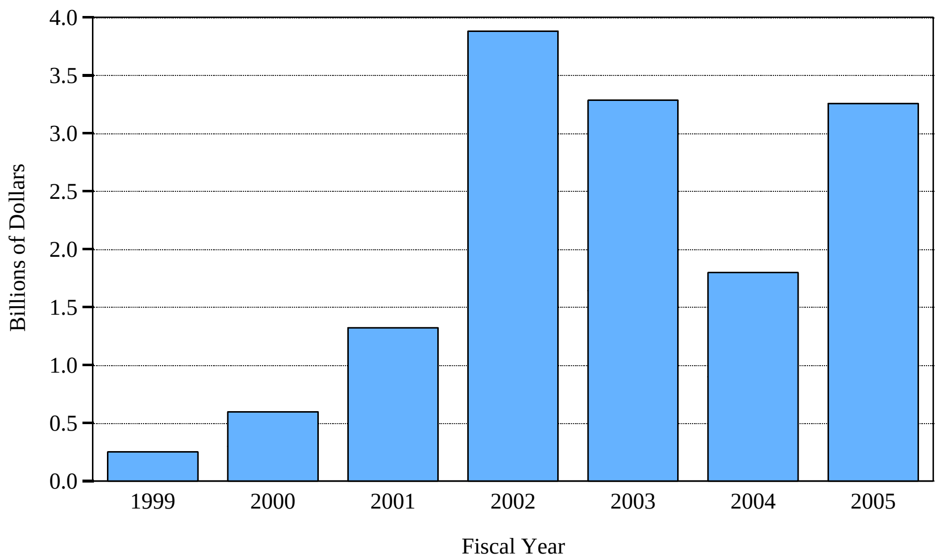
The City made other, mostly technical changes in its four-year financial plan over the past year. As usual, the City drew down the current-year general reserve by $260 million as the year progressed, leaving a balance of $40 million, and recognized savings of $300 million from overestimating prior years' expenses. The City also restored the FY 2005 general reserve to $300 million because it was unable to fund a FY 2006 budget stabilization fund as planned in January 2004.

# IV. Balancing the FY 2005 Budget

The April Plan includes nearly $3.2 billion in nonrecurring resources (see Appendix A) to help balance the FY 2005 budget—far more than the $1.8 billion that benefited the FY 2004 budget (see Graph 1). Previously, the City had reduced its reliance on one-time resources as the 1990s progressed and the local economy boomed, but during fiscal years 2002 and 2003 the City resorted to unprecedented levels of nonrecurring resources, including deficit financing, in the wake of the recession and the impact of the attack on the World Trade Center. The City was able to reduce its reliance on nonrecurring resources in FY 2004 because the economy improved faster than expected and revenues exceeded the City's initial estimate for FY 2004 by $1.8 billion.

**Graph 1**

**Nonrecurring Resources**




Sources: NYC Office of Management and Budget; OSDC analysis

After the application of nonrecurring resources, including the FY 2004 surplus, the FY 2005 budget gap would be reduced to $424 million. The April Plan assumes that a combination of City, State, and federal actions will close this gap, fund a modest property tax rebate, and pay a small portion of the Department of Education's capital projects on a pay-as-you-go basis (see Table 4). Because the City is relying on nonrecurring actions to balance the FY 2005 budget, the City is projecting large budget gaps of $3.8 billion for FY 2006 and $4.2 billion for FY 2007.

**Table 4**
**FY 2005 Gap-Closing Program**
(in millions)

| | *Better/(Worse)* | | |
|---|---|---|---|
| | **FY 2005** | **FY 2006** | **FY 2007** |
| **Gap to be Closed** | **(424)** | **(4,048)** | **(4,448)** |
| Agency Actions | 324 | 195 | 194 |
| State Actions | 400 | 400 | 400 |
| Federal Actions | 150 | 150 | 150 |
| Property Tax Rebate | (250) | (259) | (263) |
| Pay-As-You-Go Capital | (200) | (200) | (200) |
| **Total** | **424** | **286** | **281** |
| **Remaining Gaps** | **$ - - -** | **$ (3,762)** | **$ (4,167)** |

Sources: NYC Office of Management and Budget; OSDC analysis

## A. Agency Actions

The April Plan includes a modest agency program comprised of revenue enhancements and expense reductions that are valued at $324 million in FY 2005 and less than $200 million in subsequent years. About half of the $295 million in expense reductions in FY 2005 would come from spending reestimates and from actions that would shift costs to other levels of government. The remainder would come from a number of other actions. The Police Department expects savings of $70 million from higher-than-planned attrition of police officers and from reductions in the number of civilian positions and overtime. The Administration for Children's Services anticipates savings of $24 million in FY 2005, mostly as a result of fewer children being placed in foster care. The Department of Education is expected to contribute savings of $55 million, including $34 million annually from reducing the number of teachers who take sabbaticals. The union representing the teachers, however, has won a grievance against this proposal and thus these savings are not likely to materialize.

## B. State Actions

The April Plan assumes that New York State will provide the City with an additional $400 million in annual gap-closing assistance. The Mayor has presented the State with a menu of actions to choose from that, in total, would benefit the City's budget by $1.1 billion. The largest of these items include a State takeover of the local share of Family Health Plus ($342 million), Medicaid cost-containment ($200 million), removal of the State caps on reimbursement for social service administrative costs ($152 million), and a State takeover of the local share of Medicaid long-term care costs ($117 million).

In the aggregate, the Governor's proposed executive budget for State fiscal year 2004-2005 would provide the City with $362 million in budget relief (see Table 5)—slightly less than anticipated in the Mayor's budget for City fiscal year 2005—and another $56 million in additional education aid (for a further discussion, see page 41 of this report). As of May 18, 2004, however, budget negotiations between the Governor and the Legislature were stalled and the amount and form of any additional assistance to the City remains uncertain. For a detailed discussion of the Governor's proposals see OSDC report 13-2004, *Review of the Five-Year Financial Plan for the City of New York*, issued February 12, 2004.

The Governor's proposed budget recommended the repeal of the sales tax exemption on clothing and footwear items that cost less than $110. The exemption, which originally became effective on March 1, 2000, was temporarily repealed for a one-year period beginning on June 1, 2003 to help both the State and City close large budget gaps. In its place, the Governor has proposed four one-week holidays for purchases under $500. Since the April Plan assumes that the original exemption will be reinstated as scheduled, its repeal would increase revenues by a net of $152 million in FY 2005. Although the Mayor has voiced his opposition to this tax increase, the State has postponed the restoration of the exemption for one month pending the outcome of State budget negotiations.

**Table 5**
**Impact of the Governor's Proposed Budget on FY 2005**
(in millions)

| | *Better/(Worse)* |
|---|---|
| Sales Tax Exemption | $ 152 |
| Medicaid Cost-Containment | 141 |
| State Takeover of Medicaid Long-Term Care Costs | 33 |
| Early Intervention Cost-Containment | 34 |
| Child Welfare and Public Assistance | (49) |
| Other | 51 |
| **Subtotal Gap-Closing Aid** | **362** |
| Education Aid[7] | 56 |
| **Total** | **$ 418** |

Sources: NYS Division of the Budget; OSDC analysis

[7] The Governor also proposes to eliminate $62 million in education aid that was intended to pay off claims for prior years' State education aid or to fund debt service on bonds that were issued by the Municipal Bond Bank to reimburse the City for past education aid claims. Because there is no debt service on these bonds until FY 2006 and there are no outstanding claims, the Governor maintains that this cut would have no adverse impact. The City maintains that this represents a cut because it was permitted by the State to use these resources during fiscal years 2003 and 2004 to fund ongoing educational services.

## C. Federal Actions

The April Plan assumes that the federal government will provide the City with an additional $150 million in annual gap-closing assistance, which is only half of the amount anticipated in the January Plan because the City no longer expects the federal government to extend the increase in the federal Medicaid reimbursement rate beyond FY 2004. In FY 2004, the federal Medicaid reimbursement rate was increased from 50 percent to 53 percent, which saved the City $232 million in FY 2004, and if that rate were continued the City would have saved $242 million in FY 2005.

The City has offered the federal government a menu of actions, totaling $306 million, from which it could choose to provide the additional assistance. The largest of these items include: an increase in federal funding for the State Criminal Alien Assistance program ($87 million); the closure of tax loopholes ($75 million), including requiring the sellers of tobacco products to pay taxes for Internet sales; permission to the City to collect real estate taxes on certain property owned by foreign countries and used for non-diplomatic purposes ($50 million); and the restoration of federal Medicaid funding for legal immigrants ($34 million).

While it is still early in the federal budget process, the prospects for additional federal gap-closing assistance are poor given the size of the projected federal budget deficits. In fact, the President's proposed budget would eliminate funding to the State Criminal Alien Assistance program, which would cost the City up to $15 million in FY 2005, and would not restore Medicaid funding for legal immigrants. In addition, the President has proposed a large reduction in funding for Section 8 housing vouchers, which could result in the loss of 10,872 vouchers in New York City.

## D. Real Property Tax Rebate

The April Plan assumes that the City Council and the State will approve the Mayor's proposal to offer $400 annual rebates of real property taxes to qualified home, cooperative, and condominium owners beginning in FY 2005. The Mayor has proposed enabling State legislation that would make the rebate permanent, but would provide the City with the annual option of suspending it by passing a local law. If approved, this initiative would cost $250 million in the first year and rise to $267 million by FY 2008. The City Council Speaker has proposed instead an across-the-board reduction in the average real property tax rate, which would cost a similar amount. The City Council has the authority to set local property tax rates, but all other changes to the property tax law—such as the creation of a rebate—require State approval.

The Mayor's rebate would apply only to property owners who paid property taxes in the prior fiscal year and proved ownership of their primary residence—thereby excluding renters, absentee landlords, and commercial property owners from receiving the rebate. The rebate is a fixed amount equivalent to the annualized average tax increase for one-, two-, and three-family homes in FY 2004. Since the rebate is a fixed amount and does not vary by location, size, or type of home, it provides a proportionally greater benefit to homes of lower value, which are generally in the outer boroughs.

Taxpayers would automatically receive a rebate if they are currently enrolled in the New York State School Tax Relief (STAR) program. If not, they would have to apply for the rebate, with applications due by the later of June 30 or 60 days after enactment of the necessary State legislation. The April Plan assumes that fewer than 60 percent of eligible owners will apply for a rebate, which is only slightly higher than the STAR participation rate.

## E. Pay-As-You-Go Capital Financing for Education

In November 2003, the Department of Education proposed a five-year $13.1 billion capital plan for fiscal years 2005 through 2009, which would be funded equally between the State and the City. (The Governor's proposed budget, however, did not include the State's share of these resources.) The City plans to meet its funding obligation by issuing $5.5 billion in bonds and using $1 billion in pay-as-you-go financing.[8]

In February, the Department of Education revised its five-year capital program. Under the new plan, total funding and the ratio of City and State funding remain the same as the department's previous plan. The February plan allocates $4.1 billion to bring current facilities to a state of good repair, including the upgrading of lighting, electrical, safety, and security systems; $4.2 billion for system expansion, including the construction and leasing of space to create 90 new schools and 66,000 new seats (5 more schools and 3,000 more seats than the earlier plan); and $4.8 billion for educational enhancements, including $2 billion for restructuring and enhancing the physical facilities of approximately 671 schools where students are not demonstrating math and reading skills at grade level, and $1 billion to upgrade or provide technology to classrooms.

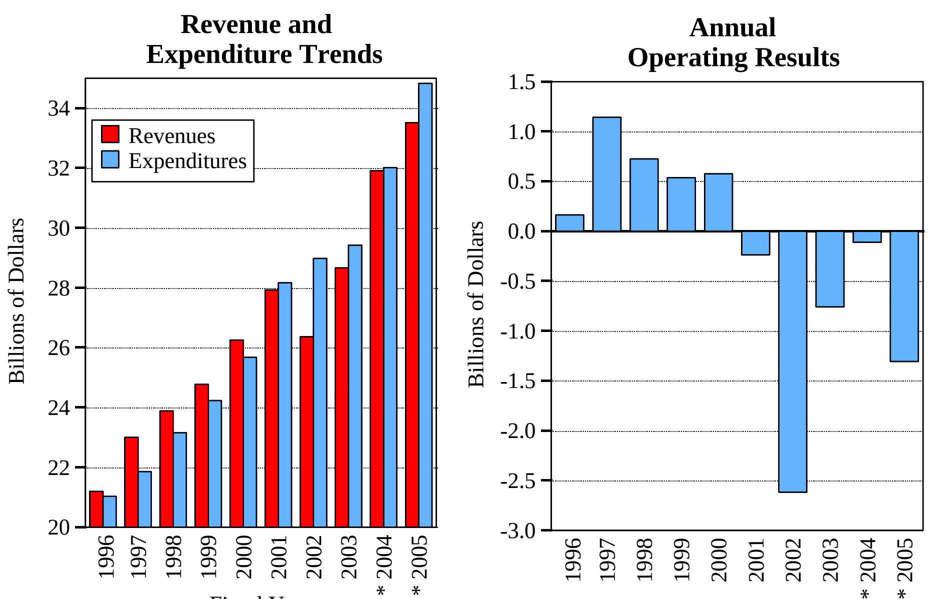
8 It could be more beneficial to the City to utilize pay-as-you-go funding for other capital needs that do not qualify for tax-exempt financing, because the interest costs on tax-exempt bonds are lower than the interest costs on taxable bonds.

Members of the New York City Council, which is required to approve the department's proposed five-year capital plan, have expressed several concerns. First, the department does not have a fallback plan containing lower funding levels in the event that $6.5 billion in State aid does not materialize. In addition, City Council members feel that there is little accountability in the department's plan, which lacks timelines and cost estimates for many of the proposed projects.

# V. Revenue and Expenditure Trends

Between fiscal years 1996 and 2000, City-funded spending grew by 22 percent, an annual average growth rate of 5.1 percent—more than twice the local inflation rate.[9] Under normal circumstances, the City would have been unable to support such a rapid rate of growth, but revenues fueled by the Wall Street boom grew even faster (see Graph 2). While expenditures continued their rapid rate of growth in FY 2001—increasing by 9.7 percent—revenues grew more slowly, by only 6.4 percent. Consequently, expenditures exceeded revenues by more than $200 million in FY 2001—a clear sign of fiscal stress, which was masked by the City's practice of transferring the prior year's surplus to the following year.

**Graph 2**




* City forecast

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

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

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

Transitional Finance Authority. In the absence of these resources, the City would have incurred a deficit of $2.6 billion from current-year operations (see Graph 2).[10]

The City was on course in November 2002 to incur an operating deficit of $3.5 billion in FY 2003 as a result of lower revenue forecasts, rising pension costs, and other factors, but instead ended FY 2003 with a deficit of $759 million. The deficit was reduced when the City enacted a mid-year property tax increase and took other actions to generate recurring benefits. The FY 2003 operating deficit was offset by $1.5 billion in bond proceeds (i.e., deficit financing) from the Transitional Finance Authority to cover revenue losses related to the attack on the World Trade Center.

The operating deficit is projected to decline to $111 million in FY 2004, which reflects a combination of City, State, and federal actions taken last year to help the City balance its budget, aided by better-than-expected improvement in the local economy, and hence higher tax revenues. The FY 2005 operating deficit is projected to balloon to $1.3 billion because the growth in nondiscretionary spending is projected to outpace the growth in recurring revenues. Moreover, the City projects out-year budget gaps of $3.8 billion in FY 2006 and $4.2 billion in FY 2007 because of the absence of $3.2 billion in nonrecurring resources that were used to help balance the FY 2005 budget and continued growth in nondiscretionary spending.

## A. Revenue Forecasts

City fund revenues[11] are projected to increase by 5.1 percent in FY 2005, after an expected gain of 5.8 percent in FY 2004 (see Graph 3). The growth in FY 2004 reflected an expected 15.1 percent gain in tax revenues—the largest component of City fund revenues—due to enacted increases in the real property, personal income, and sales taxes that yielded $2.7 billion. The increases in the personal income and sales taxes will begin to be scaled back in FY 2005, and the Mayor has proposed the rebate of a portion of the real property tax increase to homeowners. Nonetheless, $2.2 billion of the increase is expected to recur in FY 2005. Although the economy is improving—the forecasts for FY 2005 tax collections have been raised by $1 billion since last June—the scaling back of the tax increases holds projected tax revenue growth to 0.6 percent in FY 2005. The balance of the expected City fund revenue growth in FY 2005 is due to a significant increase in one-time resources. Three of the largest items—retroactive airport lease payments, the delayed receipt of FY 2004

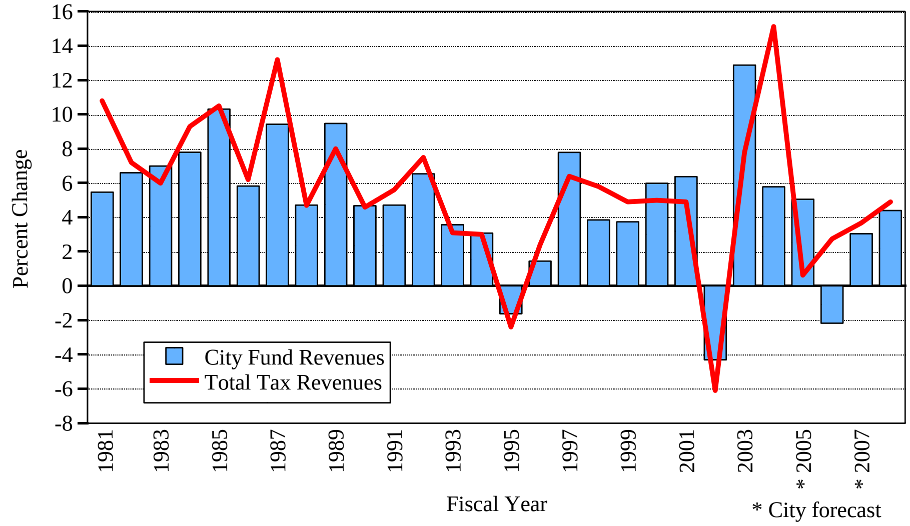
[10] Current-year operations measure revenues and expenditures that were generated in the current fiscal year, and exclude the benefits of prior years' surpluses and deficit financing.

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

Municipal Assistance Corporation bond refinancing proceeds, and a land sale to the Battery Park City Authority—yield over $1.3 billion in revenue.

**Graph 3**

**Annual Change in City Fund Revenues and Tax Revenues**




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

City fund revenues are projected to decrease by 2.2 percent in FY 2006. The loss of the significant one-time resources in FY 2005 pulls down miscellaneous revenue collections by over 30 percent, which more than offsets projected tax revenue gains. Tax revenue growth in FY 2006 is expected to be 2.7 percent, as the continued improvement in the economy overcomes revenue losses from additional phaseouts of the FY 2004 tax increases. However, City fund revenue growth is projected to resume with a gain of 3 percent in FY 2007, followed by expected growth of 4.4 percent in FY 2008. With all the recent personal income and sales tax increases phased out, tax revenues are expected to grow by 3.7 percent in FY 2007 and 4.9 percent in FY 2008. Miscellaneous revenues show minimal changes during these years.

### 1. Tax Revenues

Real property tax revenues, which comprise 35.6 percent of City fund revenues, are projected to total $11.8 billion in FY 2005 and grow at an annual rate of 4.5 percent during the Plan period (see Table 6). The growth in real property tax revenues reflects an expected increase in assessed value of 4.2 percent in FY 2005 and about 4.9 percent in subsequent years. After raising average Citywide real property tax rates by 18 percent in January 2003, the April Plan assumes that the average rate will remain unchanged during the Plan period. The April Plan also assumes that the Mayor's proposed real property tax rebate for homeowners receives City Council and State approval, which would hold down revenue growth to 4 percent during the Plan period. The Mayor's proposal would not reduce the average tax rate, but an alternative proposal from the City Council Speaker would cut average rates and would not require State approval.

**Table 6**
**City Fund Tax Revenues**
(in millions)

| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | Four-Yr Avg Growth Rate |
|---|---|---|---|---|---|---|
| **Property Tax** | | | | | | |
| Property Tax | $ 11,353 | $ 11,832 | $ 12,341 | $ 12,931 | $ 13,549 | 4.5% |
| Property Tax Rebate | - - - | (250) | (259) | (263) | (267) | - - - |
| **Subtotal** | **11,353** | **11,582** | **12,082** | **12,668** | **13,282** | **4.0%** |
| **Nonproperty Taxes** | | | | | | |
| Personal Income Tax | 5,396 | 5,571 | 5,572 | 5,603 | 5,987 | 2.6% |
| Sales Tax | 3,972 | 3,981 | 4,049 | 4,197 | 4,373 | 2.4% |
| Business Taxes | 3,155 | 3,331 | 3,519 | 3,687 | 3,849 | 5.1% |
| Real Estate–Related Taxes | 1,848 | 1,452 | 1,443 | 1,515 | 1,578 | -3.9% |
| Other Taxes | 1,790 | 1,771 | 1,781 | 1,820 | 1,865 | 1.0% |
| **Subtotal** | **16,161** | **16,105** | **16,364** | **16,822** | **17,652** | **2.2%** |
| **Total Taxes After Rebate** | **$ 27,514** | **$ 27,687** | **$ 28,446** | **$ 29,490** | **$ 30,934** | **3.0%** |

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

With the economy strengthening and the enactment of several temporary tax increases, collections for the City's economically sensitive nonproperty taxes have rebounded, with growth projected to reach 18.8 percent in FY 2004. Personal income, sales, and business taxes constitute over three quarters of the City's nonproperty tax base (see Table 6) and have all been affected by these developments. The rebound in Wall Street profits and year-end bonuses has particularly benefited business and personal income taxes, while continued low interest rates have fueled commercial and residential real estate sales and refinance activity, reflected in real estate–related taxes.

Some of the strength from FY 2004 will carry over into FY 2005 collections. Indeed, the City has raised its expectation of FY 2005 tax collections by $1 billion since last June. However, as Table 6 shows, several taxes are expected to show minimal growth in fiscal years 2005 through 2007. The personal income tax shows very little change from the projected collections of $5.6 billion annually during this period. While both employment and wages are projected to grow, the temporary rate increase begins to phase out until full expiration is reached during FY 2006, offsetting most of the collection gains from the improving economy.[12] Adjusting for rate and base changes, underlying personal income tax collections grow by 6.8 percent in FY 2005, but the offsetting tax changes hold growth to 3.2 percent instead.

Similarly, sales tax collections are projected to remain near $4 billion through FY 2006 as temporary tax increases gradually expire.[13] In June 2004, the exemption for sales tax on individual clothing items that cost less than $110 is scheduled to be restored, although the Governor has recommended its repeal in his executive budget proposal. The one-eighth of a percentage increase in the sales tax rate will expire in June 2005.

Business tax collections, however, are projected to grow throughout the Plan period, advancing by 5.6 percent in FY 2005, 5.7 percent in FY 2006, 4.8 percent in FY 2007, and 4.4 percent in FY 2008. Wall Street profits, a key factor in collections, are expected to total $16.4 billion in calendar year 2004, down only slightly from the $16.8 billion reported in calendar year 2003. A growing national economy helps provide additional lift in FY 2005 to the City's export-oriented sectors such as business and professional services. However, a gradual rise in interest rates by the Federal Reserve begins to slow the national economy in the later years of the Plan period, contributing to a slight slowdown in the rate of projected business tax growth.

Although current low interest rates have helped stimulate collections in the City's real estate transaction taxes (the mortgage-recording and real property transfer taxes)—thereby boosting receipts from around $900 million in FY 2002 to an expected $1.4 billion in FY 2004—the interest rate environment is expected to change shortly, with the Federal Reserve beginning to gradually raise interest rates starting in the second half of 2004. The higher rates will begin to adversely affect home affordability and reduce opportunities for refinancing, eventually leading to a pullback in collections for the two transaction taxes. While the City has expected such a scenario to develop for some time, the likelihood of higher rates is becoming more certain. Nonetheless, the City apparently has a large backlog of transactions to process, which may help support collections through the rest of FY 2004 and into early FY 2005. The final real estate–related tax is the commercial rent tax, whose collections were expected to rise by 10.7 percent in FY 2004 as the increase in the

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[12] The temporary personal income tax rate increase is valued at $681 million in FY 2004, $538 million in FY 2005, and $308 million in FY 2006.

[13] The temporary sales tax increase is valued at $309 million in FY 2004 and $110 million in FY 2005.

real estate tax was passed through to commercial tenants. With employment rising and vacancy rates slowly falling, commercial rent tax collections should gradually improve over the Plan period. Nonetheless, the decline in the two transaction taxes results in a projected decline of over 21 percent for the three real estate–related taxes in FY 2005.

The City's revenue forecasts are based upon an economic scenario of recovery and growth, but recent tax collection data indicate much greater revenue strength than anticipated, and that strength is expected to continue in the short term. As a result, FY 2004 collections are likely to be about $250 million above Plan forecasts. Given recent collections experience, both business and personal income tax collections may be understated relative to the City's economic assumptions. Although collections for the real estate transaction taxes are expected to fall sharply as interest rates begin to rise, the recent surge in transactions has created a backlog in processing that might slightly delay the expected falloff in revenue. Overall, FY 2005 revenues may be $200 million greater than the City currently projects.

### 2. Miscellaneous Revenues

Miscellaneous revenues are non-tax revenues less state and federal grants, and include user fees, rental income, fines, City asset sales, and interest income. These revenues are not economically sensitive, as annual changes are dependent upon discrete actions such as changes in fine or fee levels. Miscellaneous revenues are projected to total $5.3 billion in FY 2005, an increase of $1.3 billion over the amount forecast for FY 2004. These additional revenues primarily reflect the expected receipt of a $783 million lump sum settlement from the Port Authority of New York and New Jersey for a revised lease of the City's two airports; reimbursement of $502 million for the debt service incurred by the City associated with the delay in the refunding of MAC bonds; and $150 million from a sale of City-owned land to the Battery Park City Authority. Revenues from the tobacco settlement are also expected to increase by $100 million in FY 2005. Miscellaneous revenues are projected to decline by $1.5 billion in FY 2006 with the loss of retroactive Port Authority airport lease payments and other nonrecurring resources.

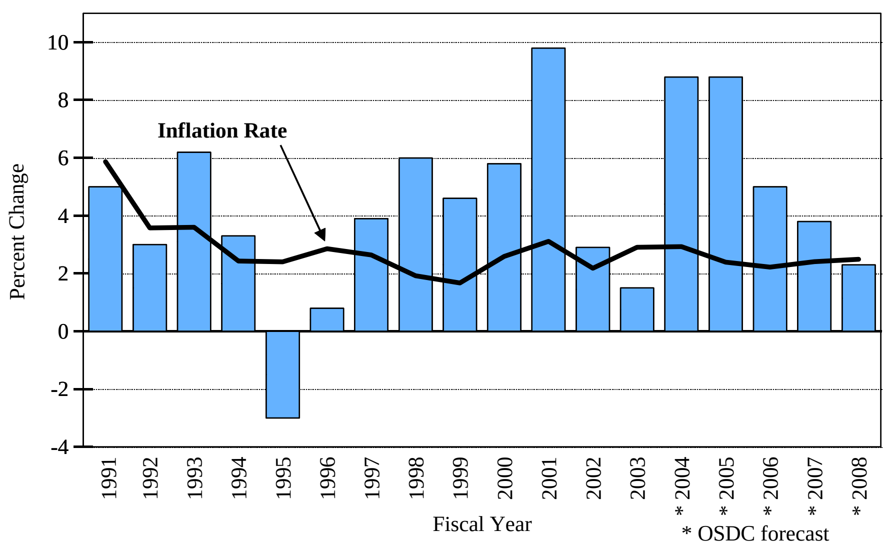
## B. Expenditure Forecasts

After increasing far more quickly than the local inflation rate during fiscal years 1997 through 2001, growth in City-funded expenditures during fiscal years 2002 and 2003[14] averaged 2.2 percent, which is slightly lower than the average inflation rate for those years. City-funded spending, however, is projected to resume growing at a rapid rate, and is now projected to surge by 8.8 percent in each of fiscal years 2004 and 2005(see Graph 4), or $5.4 billion during the two-year period. Although expenditure growth is projected to slow to 3.7 percent, on average, during fiscal years 2006 through 2008, this estimate is twice the projected inflation rate and does not take into account the cost of potential wage increases during this period.

The rapid growth in City-funded expenditures is largely due to nondiscretionary spending. For example, nondiscretionary spending is projected to increase by $4.1 billion, or 24 percent, between fiscal years 2004 and 2006. Pension contributions alone are projected to rise by 73 percent, or $1.7 billion, and Medicaid is projected to rise by 17 percent over the two-year period.

**Graph 4**

**Changes in City-Funded Expenditures**




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

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

In FY 2005, pension contributions are projected to rise by $932 million, to $3.2 billion, and then increase by $730 million in FY 2006 and by $407 million in FY 2007 (see Table 7). Health insurance costs for municipal employees are projected to increase at an average annual rate of 10.7 percent during the Plan period; debt service costs[15] are projected to increase by $933 million during the Plan period, an average annual rate of 5.1 percent; and Medicaid costs are projected to increase by $1.1 billion, an average annual growth rate of 6.1 percent (see Table 7). Salary and wage costs are projected to grow by 4.3 percent in FY 2005 and FY 2006, and then remain level afterwards based on the assumption that a 2 percent wage increase to be granted to all City employees in FY 2005 and all future wage increases will be funded entirely with productivity savings.

**Table 7**
**City-Funded Expenditures**
*(Adjusted for Surplus Transfers)*
(in millions)

| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | Four-Year Avg Growth Rate |
|---|---|---|---|---|---|---|
| Salaries and Wages | $ 9,757 | $ 9,871 | $ 10,177 | $ 10,167 | $ 10,069 | 0.8 % |
| Debt Service[15] | 4,238 | 4,348 | 4,500 | 4,885 | 5,171 | 5.1 % |
| Medicaid | 4,140 | 4,618 | 4,850 | 5,047 | 5,242 | 6.1 % |
| Pension Contributions | 2,272 | 3,204 | 3,934 | 4,341 | 4,328 | 17.5 % |
| Health Insurance | 2,143 | 2,426 | 2,666 | 2,915 | 3,215 | 10.7 % |
| Public Assistance | 487 | 538 | 542 | 542 | 542 | 2.7 % |
| Pay-As-You-Go Capital | 200 | 200 | 200 | 200 | 200 | 0.0 % |
| Other | 8,785 | 9,625 | 9,689 | 9,862 | 10,065 | 3.5 % |
| **Total** | **$32,022** | **$34,831** | **$36,558** | **$37,959** | **$38,832** | **4.9 %** |

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

### 1. Personal Service Costs

City-funded personal service costs (i.e., salaries, wages, fringe benefits, and pension contributions) are projected to increase by nearly $3.6 billion during fiscal years 2005 through 2008. This represents an average annual increase of 5.1 percent and is more than twice the projected inflation rate, even though the April Plan assumes that wage increases granted in FY 2005 and beyond will be funded with

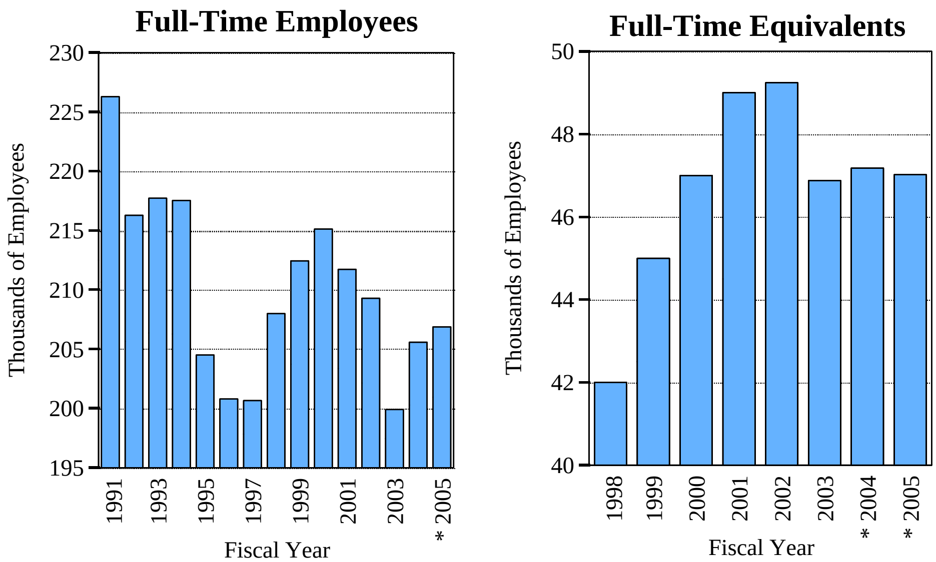
15 Debt service estimates include City general obligation bonds, revenue bonds of the TFA, MAC, and TSASC, and lease payments. These estimates have also been adjusted in FY 2004 to reflect the prepayment of $624 million in TFA debt service in FY 2003. The April Plan assumes that MAC bonds will be retired, which will generate annual savings of $1 billion in FY 2004 and about $500 million during fiscal years 2006 through 2008.

productivity savings. Instead, the rapid increases in personal service costs reflect the projected growth in health insurance premiums and pension contributions.

The full-time City-funded workforce declined by 15,234 employees during fiscal years 2001 through 2003, but is now projected to rise by 5,678 employees during FY 2004 (see Graph 5). Most of the increase is concentrated in the Department of Education (2,075 employees) and the Department of Social Services (1,113 employees), and includes 806 employees funded under vendor contracts that will be transferred to personal service lines. For FY 2005, the April Plan assumes that the full-time workforce will expand by an additional 1,303 employees, mostly due to the transfer of another 1,008 employees funded under vendor contracts. The April Plan also assumes the addition of 1,276 employees, including an increase of 337 employees at the Department of Housing Preservation and Development for lead abatement activities, and the loss of 981 positions to help fund a 2 percent wage increase to members of District Council 37. The number of part-time employees declined by 2,363 employees during FY 2003 but is expected to remain stable during fiscal years 2004 and 2005. (Appendix B shows projected changes in combined full-time and part-time staffing levels.)

**Graph 5**

## City-Funded Workforce




* City forecast

Sources: NYC Office of Management and Budget; OSDC analysis

*Collective Bargaining*

On April 20, 2004, the City reached a tentative agreement with District Council 37, which represents most civilian employees. The agreement calls for a one-time cash payment of $1,000 (equal to a wage increase of about 3 percent) payable upon ratification; a 3 percent wage increase retroactive to July 1, 2003; and a 2 percent wage increase in FY 2005 that would be funded entirely with productivity improvements and other operational savings.[16] The District Council 37 agreement would increase wages by 5.1 percent over a three-year period. By comparison, the MTA agreement with the Transport Workers Union increases wages by 6.1 percent over three years, and the State agreement with the Civil Service Employees Association increases wages by 11.0 percent over four years.

To fund the cost of the 2 percent wage increase (estimated to cost $65 million), the agreement calls for a 15 percent reduction in starting salaries for new employees for the first two years of employment, and a reduction in time and leave benefits for new employees. The April Plan, however, assumes that these changes will fund only 50 percent of the cost of the wage increase and that additional resources will be obtained by not replacing 981 District Council 37 employees when they leave City employment. Nearly half of the positions to be eliminated are located in the City's health and welfare agencies, such as the Department of Social Services.

The April Plan also assumes that the District Council 37 agreement will set the pattern for contracts with other municipal unions, including those that represent teachers and uniform employees. Recently, the City reached three agreements with unions representing 11,000 City employees that mirror the District Council 37 agreement. Consistent with this assumption, the April Plan includes $533 million in FY 2004,[17] $652 million in FY 2005, and about $575 million in subsequent years to fund such agreements. The Plan, however, does not provide funding for wage increases beyond FY 2005. Wage increases at the projected inflation rates, without offsetting productivity savings, would increase costs by $220 million in FY 2006, $700 million in FY 2007, and $1.2 billion in FY 2008.

Applying the productivity terms of the District Council 37 agreement to the unions that represent teachers and uniformed employees could prove challenging. The last agreement with the City's teachers significantly raised starting salaries in recognition of the difficulties of recruiting certified teachers. Similarly, the City has

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16 The agreement also provides for an additional wage increase of 1 percent in FY 2005 if the parties can agree on productivity improvements to cover the cost.

17 The net impact was reduced to $333 million because the City had $200 million in its reserve for collective bargaining.

had difficulty recruiting and retaining police officers because of competition from surrounding counties. Moreover, it is unrealistic to assume that the City will reduce the number of teachers and police officers to fund a wage increase in FY 2005, because the City is under heightened security and the police force has already contracted by 13.7 percent since June 2000. While the City and these unions could negotiate other productivity improvements to offset the cost of a 2 percent wage increase in FY 2005, the failure to do so would increase costs by $95 million in FY 2005, $290 million in FY 2006, and $300 million annually thereafter.[18] The presidents of the United Federation of Teachers (UFT) and the Patrolmen's Benevolent Association (PBA) have already indicated that the District Council 37 agreement is unacceptable.

On May 15, 2004, State Public Employment Relations Board (PERB) declared an impasse in the negotiations between the City and the PBA, which represents 25,000 police officers. PERB will now appoint a mediator and could appoint a fact-finding panel. Pursuant to law, a fact-finding award is binding for the unions that represent police officers and firefighters. A fact-finding panel set the terms of the last agreement, which, except for contract duration, mirrored the contracts negotiated with most other uniformed employee unions in 2001. The UFT has also requested that PERB declare an impasse in its negotiations. However, PERB is holding its decision in abeyance, pending further efforts to reach an agreement. If PERB were to declare an impasse, it would it would appoint a mediator and could subsequently appoint a three-member fact-finding panel, which could make nonbinding recommendations to help to reach an agreement.

*Pension Fund Contributions*

The City's contribution to the pension funds averaged $1.4 billion during fiscal years 1981 through 1999, and totaled $1.5 billion in FY 2003. Contributions are expected to total $2.3 billion in FY 2004, but are projected to rise by $932 million during FY 2005 to $3.2 billion and to $4.3 billion by FY 2007 (see Graph 6). Pension contributions are projected to increase at an average annual rate of 24 percent through FY 2007, which is nearly six times faster than other City-funded expenditures. The rapid rise in pension contributions reflects investment shortfalls of the three past years, which are phased in over a five-year period, and higher benefits and other enhancements that were adopted when the pension funds experienced extraordinary investment gains. Pension contributions are not expected to increase further in

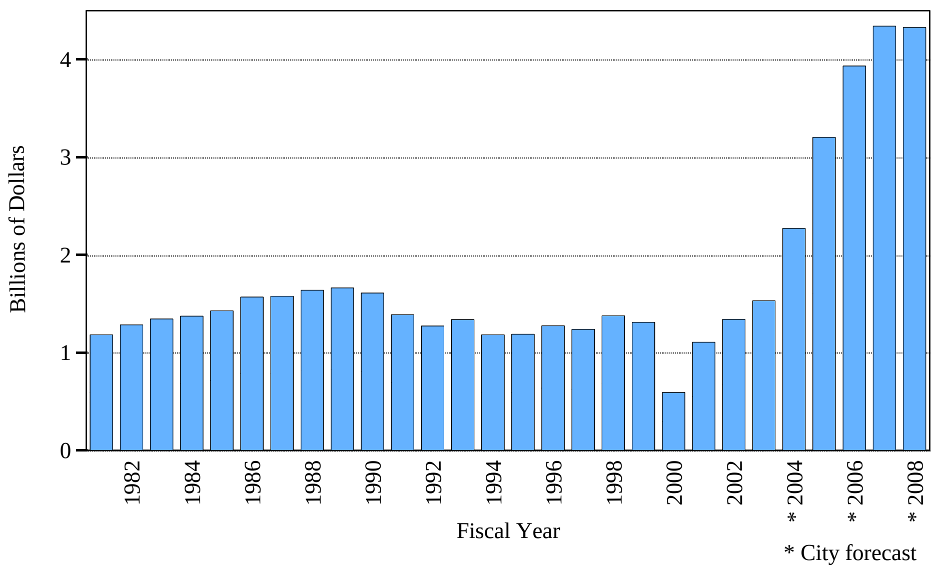
[18] These estimates include teachers and paraprofessionals in the Department of Education, and uniformed employees in the Police, Fire, Correction, and Sanitation departments, where wages follow parity relationships.

FY 2008 because the investment shortfalls of the past three years will have been fully phased in by then.

The pension funds lost more than 8 percent on their investments in each of fiscal years 2001 and 2002, and gained only 3.8 percent in FY 2003 compared with the actuarial assumption of an 8 percent gain. While the pension funds are on track to meet, or possibly exceed, their investment goals for FY 2004, meeting them is less certain than it was two months ago. During the first nine months of FY 2004 the pension funds earned about 16 percent on their investments, but during the past six weeks have lost 4.5 percent. While the pension funds have earned 11.5 percent through May 14, 2004, the stock market can be volatile and there can be no assurance that the pension funds will exceed or even meet their investment goals for the year.

**Graph 6**

**City-Funded Pension Contributions**




Sources: NYC Office of Management and Budget; OSDC analysis

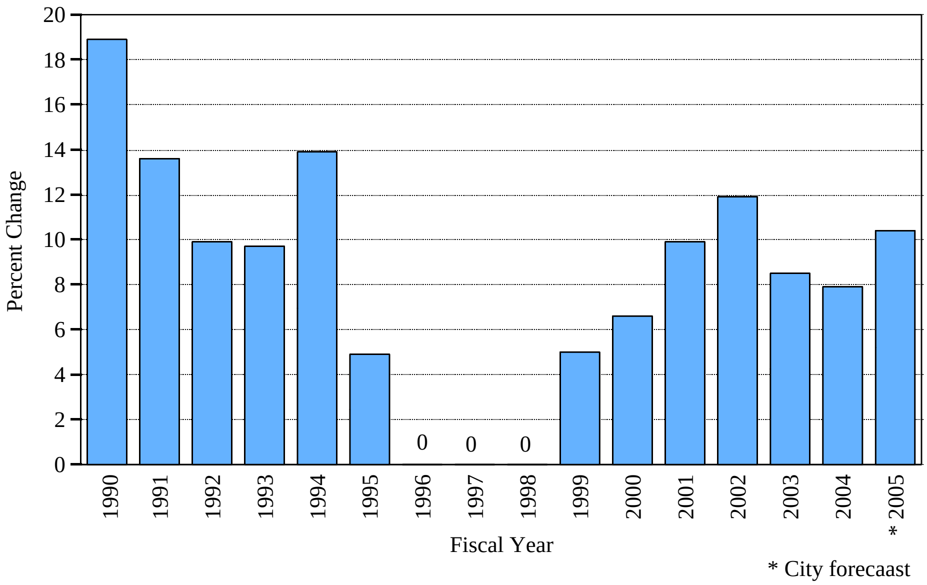
An actuarial consultant hired by the City has completed a biennial review of the methodologies and assumptions used to calculate pension contributions, as required by law. The consultant did not propose changes in the investment earnings and wage assumptions, but did propose changes in a number of other assumptions, such as overtime, which could increase City pension contributions by approximately $250 million annually. The actuary has not indicated whether he will implement the consultants' recommendations or make other changes in the actuarial assumptions or methods of estimation that would affect pension contributions.

### *Health Insurance*

City-funded health insurance costs are projected to grow from $2.1 billion in FY 2004 to $2.4 billion in FY 2005 and then to $3.2 billion by FY 2008, reflecting rapidly rising health insurance premiums. Premiums grew at a double-digit pace during the early 1990s, but the City then negotiated a three-year freeze in rates for fiscal years 1996 through 1998 as part of a package to help it balance its budget during a period of fiscal stress. Since then, health insurance premiums have resumed rapid growth, reflecting national cost trends for medical and hospital care (see Graph 7). For example, the Health Insurance Plan of Greater New York (HIP) increased premiums by 9.9 percent in FY 2001, 11.9 percent in FY 2002, 8.5 percent in FY 2003, and 7.9 percent in FY 2004.[19]

**Graph 7**

**Annual Change in Health Insurance Premiums**




Sources: NYC Office of Management and Budget; HIP

The April Plan reflects HIP's intention to increase premiums for active employees and retirees who are under the age of 65 by 10.4 percent in FY 2005. The Plan assumes that premiums for these employees will increase by 8 percent annually thereafter, which is somewhat lower than increases in the recent past. While the April Plan anticipates that health insurance premiums for Medicare-eligible retirees will

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

increase by 14 percent in FY 2005 and in each subsequent year, the actual rate of growth will be substantially lower because recent federal actions, such as the prescription drug program, will reduce the liabilities of private health insurance companies that cover City retirees. The health insurance companies that provide coverage to the majority of Medicare retirees recently notified the City that rates are expected to decline by an average of about 1.8 percent in FY 2005. A rate reduction of this magnitude in FY 2005 would reduce health insurance costs by $35 million in FY 2005, $40 million in FY 2006, $45 million in FY 2007, and $50 million in FY 2008. Further savings could accrue to the City if Medicare premiums in subsequent years do not rise as quickly as assumed in the April Plan.

### 2. Debt Service

Debt service costs declined in FY 2003, reflecting savings from bond refundings and the release of reserve funds, but are projected to increase by $928 million in FY 2004 to $4.2 billion, even after adjusting for debt prepayments that can distort expenditure trends. Debt service costs are projected to increase by nearly $1 billion by FY 2008, to $5.2 billion, which is an annual average increase of 5.1 percent or nearly twice the projected inflation rate.

The debt service burden[20] declined from 16.8 percent in FY 2002 to about 13.7 percent during fiscal year 2003, but is projected to increase to 15.3 percent in FY 2004 and then steadily rise to about 16.6 percent by FY 2008 (see Graph 8). The debt service burden was on track to approach 20 percent by FY 2005 but the City refinanced outstanding debt, cut the capital program, and increased property and personal income taxes. In addition, the April Plan anticipates the implementation of the MAC refinancing initiative, and tax revenues have been growing much faster than previously projected in response to an improving economy.

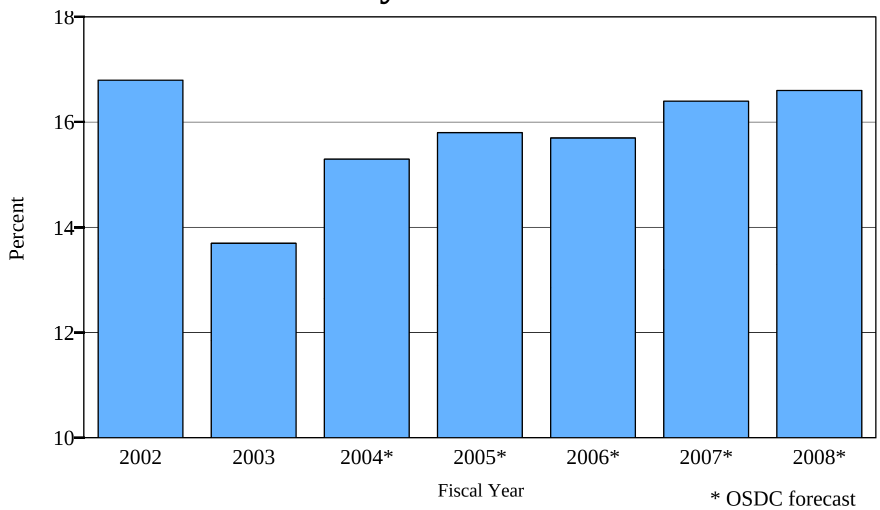
The Transitional Finance Authority (TFA) has reached its legal issuing limit, and the Mayor and Governor have each proposed raising the limit. Both proposals would allow the City to issue TFA debt, as long as the amount issued and outstanding that is above the existing cap of $11.5 billion, when combined with outstanding general obligation (GO) debt, does not exceed the City’s constitutional debt limit. 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 backed by the City’s personal income tax. TFA bonds have had the added benefit of coverage that is nearly six times the covenanted maximum annual

[20] The debt service burden is defined as debt service as a percent of tax revenues and offsetting revenues, including amounts to support TFA and TSASC debt service.

debt service.[21] Because of this high coverage, TFA bonds have provided the City with borrowing 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.

**Graph 8**

**New York City Debt Service Burden**




Note: Debt service burden is defined as debt service as a percent of tax revenues and offsetting revenues, including amounts to support TFA and TSASC debt service.

Sources: NYC Office of Management and Budget; OSDC analysis

Currently the City plans to issue $15.4 billion in general obligation bonds during fiscal years 2005 through 2008. If TFA's debt issuing capacity were raised, the City would use its general obligation debt and TFA debt equally, with both issuing $7.7 billion in bonds over the four-year plan period. During this fiscal year, TFA interest rates have averaged 17 basis points (one basis point is equal to one one-hundredth of a percent) lower than general obligation bonds in the secondary market, and such a reduction in rates could save the City about $23 million in interest expense over the Plan period.

In May 2003, Moody's Investor Service downgraded a major original participating manufacturer, R.J. Reynolds, to below investment grade, which triggered a "trapping event" in TSASC bonds. Bonds issued by TSASC are backed by revenues from the national settlement with tobacco companies. This event requires TSASC to reserve a portion of the revenues until the total amount trapped equals 25 percent of

[21] Covenanted maximum annual debt service is $1.32 billion annually, based on an assumption of $12 billion of Senior Bonds outstanding at a maximum interest rate of 9 percent.

the outstanding principal, which currently would total $1.3 billion. Unless the City takes actions to release the trapped funds, it is estimated that tobacco settlement revenues that would otherwise accrue to the City's budget would be reduced by about $60 million annually during fiscal years 2004 through 2008, for a total reduction of $311 million. City officials have stated that the City is considering options that would release the trapped funds, including restructuring outstanding TSASC bonds. Since recent events have made TSASC bonds more costly, the City no longer intends to fund a portion of its capital program with TSASC bond proceeds.

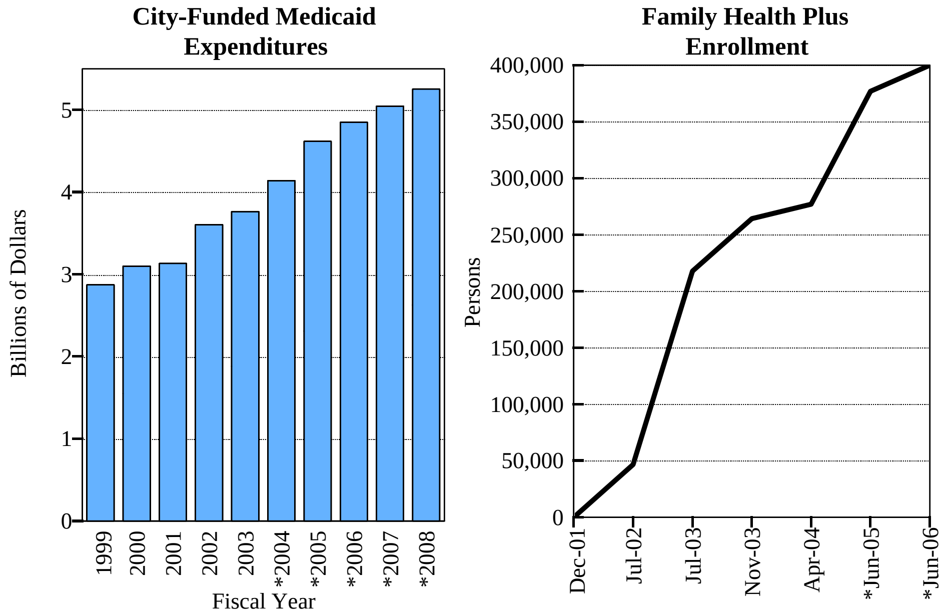
As part of the federal assistance package to New York City after the terrorist attack on the World Trade Center, the federal government authorized the City and the State to refinance for a second time up to $9 billion of outstanding tax-exempt bonds. While the State has used most of its share, the City has $1.3 billion remaining and is seeking an extension from December 2004 to December 2009. The United States Senate recently approved a one-year extension, which if enacted into law, would reduce debt service costs by an estimated $20 million in FY 2005.

**3. Medical Assistance**

The April Plan assumes that City-funded Medicaid expenditures will rise by $480 million, from $4.1 billion in FY 2004 to $4.6 billion in FY 2005, and then increase to $4.8 billion in FY 2006, $5 billion in FY 2007, and $5.3 billion in FY 2008 (see Graph 9). This represents an average annual increase of 6.1 percent during fiscal years 2005 through 2008. Since this rate of growth is faster than the projected growth rate for City fund revenues, Medicaid is projected to consume an increasing share of City fund revenues. Medicaid consumed, on average, about 12.5 percent of revenues during fiscal years 1999 through 2003, but would consume about 15.1 percent of City fund revenues between fiscal years 2005 and 2008.

The growth in Medicaid expenditures is due to the continuing rise in the cost of medical services and prescription drugs for enrollees not in Medicaid managed care, and the rapid expansion in the Family Health Plus program. Family Health Plus is a managed care program funded by Medicaid that serves adults whose incomes exceed limits allowed under regular Medicaid. The April Plan projects that enrollment in Family Health Plus will grow to 277,000 by April 2004, rise by 100,000 during FY 2005, and then stabilize at about 400,000 during FY 2006. We estimate that the Family Health Plus program will cost the City approximately $260 million in FY 2004, and the City's April Plan assumes that the program will cost $342 million in FY 2005, $381 million in FY 2006, and $394 million in FY 2007.

**Graph 9**




*City forecast

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

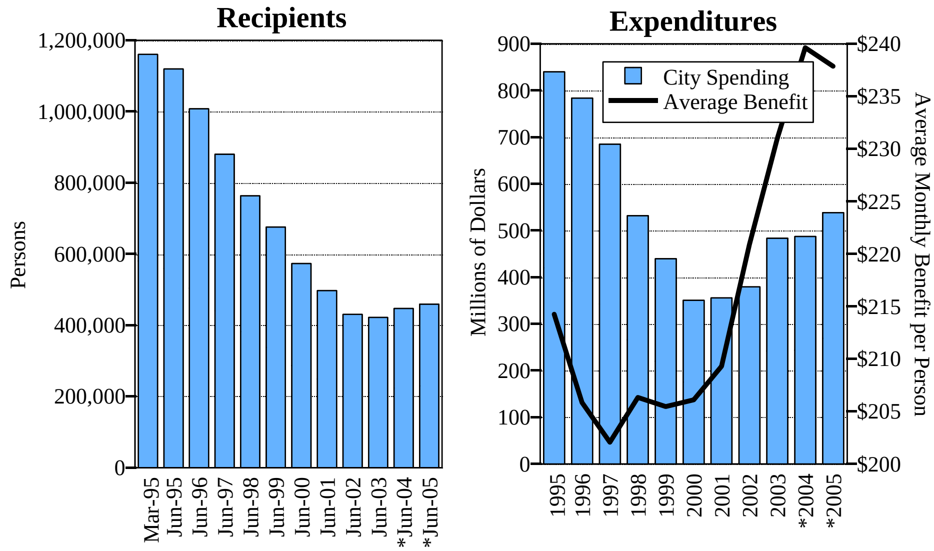
## 4. Public Assistance

Public assistance in New York State effectively consists of three programs. The largest, Family Assistance, uses the federal welfare block grant to provide aid to families with children for a maximum of five years. The other two programs are components of Safety Net Assistance, which is equally funded by the State and City. One program primarily serves adults and the other serves families who exhaust their federal benefits.

After declining each year since 1995, the public assistance caseload increased by 3 percent during the first ten months of FY 2004 to 438,062 persons. Most of the increase occurred in the adult Safety Net Assistance program, which added 11,645 recipients. The April Plan assumes that the caseload will increase by an additional 2 percent to 446,902 during the last two months of FY 2004, and then increase by another 3 percent during FY 2005 to 458,902 persons (see Graph 10).

The April Plan assumes that rising caseload and average benefits per person will increase City-funded public assistance spending to $487 million in FY 2004, $538 million in FY 2005, and $542 million annually thereafter. In FY 2001, the average monthly benefit was $209.41, but the benefit averaged $239.73 per person during the first 10 months of FY 2004. The increase primarily reflects the rising cost of rent in New York City, but also the greater prevalence of cases with more costly needs, such as beneficiaries with chronic illnesses or large families, because most employable recipients have left the caseload.

**Graph 10**
**Public Assistance**




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

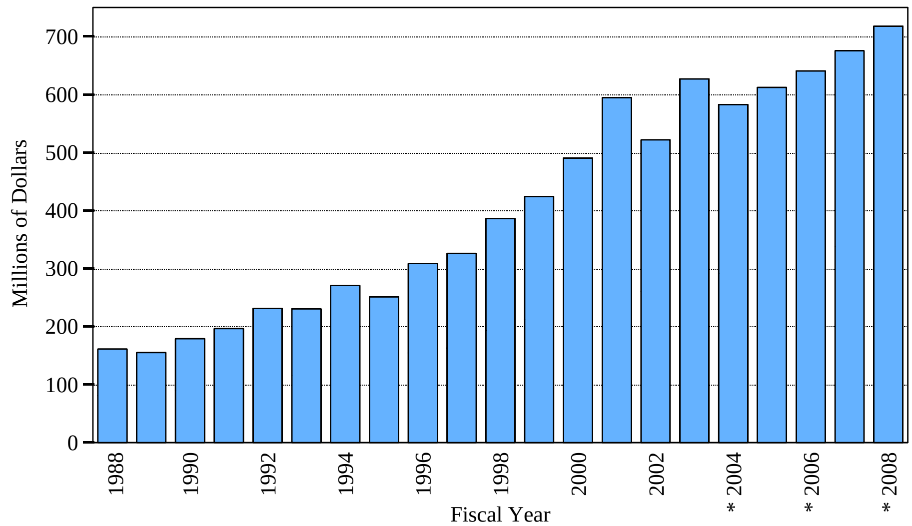
## 5. Judgments and Claims

The costs of judgments and claims have increased steadily since FY 1990 and have more than doubled since FY 1996 (see Graph 11). The April Plan assumes that judgments and claims will decline by 7 percent in FY 2004, to $583 million, because the City believes that settlements for cases under a million dollars will be lower, and that settlements of cases over a million dollars will be similar to last year's levels. However, through the first nine months of FY 2004, settlements of cases under a million dollars were essentially the same for the comparable period in FY 2003 and settlements of cases over a million dollars were higher by $21 million. Based on these trends, we estimate that judgments and claims will be higher than assumed in the April Plan by $25 million in FY 2004, $30 million in FY 2005, $35 million in FY 2006, and $40 million in each of fiscal years 2007 and 2008.

The City's estimates do not reflect any potential liability arising from the Staten Island Ferry accident of October 15, 2003, or from the World Trade Center attack on September 11, 2001. To date, the City has received 190 claims seeking an estimated $3.4 billion for wrongful death, personal injury, and emotional distress related to the Staten Island Ferry accident. In December 2003, the City filed a petition in federal court asking that all claims be consolidated, and that its exposure be limited to $14.4 million (the value of the ferry) under the Federal Maritime Act of 1851.

**Graph 11**

## Judgments and Claims




Sources: NYC Comptroller's Office; NYC Office of Mangement and Budget
* City forecast

The World Trade Center disaster generated more than 2,000 lawsuits and notices of claim against the City, with an aggregate value of $13 billion. The City's potential liability has been reduced to $1.6 billion because about 1,900 claimants, mostly firefighters and other emergency response workers, opted to file with the federal Victim Compensation Fund before the deadline of December 22, 2003.

Included in the remaining $1.6 billion in claims is a potential liability of $1.1 billion from the insurers of 7 World Trade Center and from Consolidated Edison and its insurers, alleging that the City was responsible for that building's collapse on September 11, 2001. However, legislation passed by the federal government in the aftermath of the World Trade Center attack limits the City's liability to $350 million "for all claims, whether for compensatory or punitive damages or for contribution or indemnity arising from the terrorist-related aircraft crashes of September 11, 2001." The City's Law Department therefore believes that if the City were found liable in these cases that compensation would be capped at $350 million.

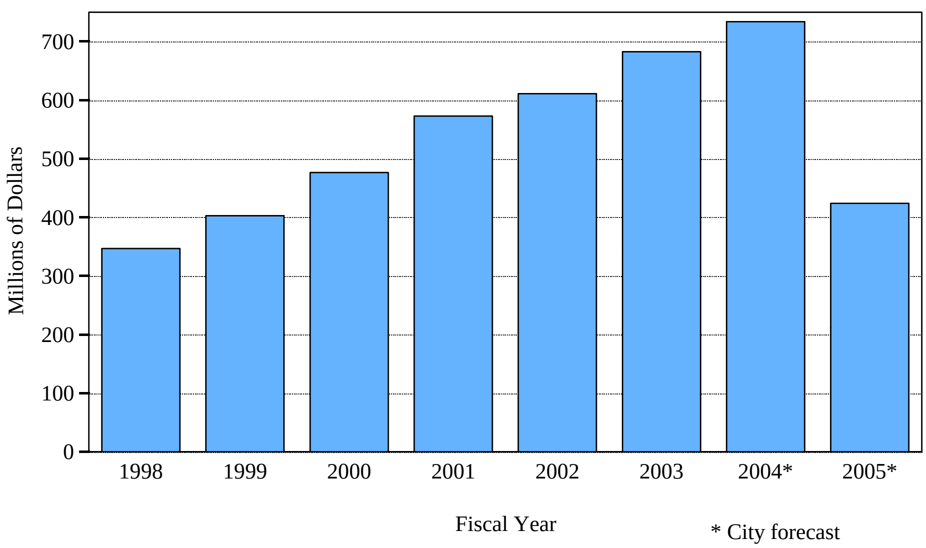
The federal government has authorized the creation of an insurance company that would fund $1 billion in potential liability to cover the cost of injuries incurred from debris removal at the World Trade Center site from September 11, 2001, onward, and would cover current and future health-related claims that may develop against the City and the four contractors it hired for site clean-up. The contractors began work at the site before obtaining insurance to protect themselves from possible lawsuits because they were unable to obtain such insurance at a reasonable cost. The City's Law Department believes that nearly all of the remaining 100 cases, with an aggregate value of about $500 million, will be covered by this insurance.

**6. Uniformed Agency Overtime**

Over the past six years, overtime costs (excluding overtime associated with the attack on the World Trade Center) in the uniformed agencies has more than doubled, from $347 million in FY 1998 to $734 million planned in FY 2004 (see Graph 12).

**Graph 12**

**Uniformed Agency Overtime**




Note: FY 2002 excludes World Trade Center expenses.
Sources: NYC Office of Mangement and Budget; NYC Financial Information Services Agency

The rapid and steady rise in costs is largely due to increased security; a reduction in the size of the police force, which has been partly compensated through overtime; the loss of 343 firefighters during the destruction of the World Trade Center; and the retirement of hundreds of firefighters since the disaster.

The Adopted Budget for FY 2004 assumed that the Police Department would spend $189 million on overtime, but the April Plan projects a total of $409 million, which would represent a new record (excluding overtime associated with the attack on the World Trade Center). Although the April Plan assumes that overtime will decline to an average of $198 million annually during the Plan period, the City has yet to demonstrate an ability to bring these costs under control. Thus, police overtime costs could exceed the Plan estimates by $150 million annually beginning in FY 2005.

The Fire Department spent a record $178 million on overtime in FY 2003 to maintain adequate staffing with simultaneous high rates of retirement, sick leave, and line-of-duty injuries related to the World Trade Center tragedy. The April Plan assumes that overtime costs in the Fire Department will total $168 million in FY 2004, but then decline to $102 million in FY 2005, well below recent trends in actual overtime spending. While this represents an ambitious reduction in overtime costs, our analysis indicates that it may be achievable if the department can maintain its current staffing levels.

# VI. Semi-Autonomous Agencies

Covered organizations are semi-autonomous agencies subject to the Financial Emergency Act, which include but are not limited to the Board of Education,[22] 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, the City has proposed the creation of a local benefit corporation (the Hudson Yards Infrastructure Corporation) to finance development of the far West Side of Manhattan.

## A. Department of Education

In FY 2004, funding for the Department of Education is projected to total $14.4 billion, an increase of $492 million over the FY 2003 level.[23] The City is forecast to contribute $5.2 billion for operations and another $1.6 billion for pensions and debt service, which represents 47 percent of the Department of Education budget. New York State is projected to contribute $5.8 billion, or 40 percent of the department's budget (see Graph 13). The federal government is projected to contribute $1.8 billion, or 12 percent of the budget. The balance comes from fees, grants, settlements, and restricted sources**.**

State law prohibits the City from reducing its funding for education (excluding pension and debt service) from one year to the next, unless there is a reduction in City revenues. The April Plan for FY 2005 includes City funding of $5.3 billion for operations, which exceeds the State's minimum requirement by $199 million, and which would establish a new higher base level for FY 2006.

In June 2003, the Court of Appeals ruled that the State formula for allocating education aid was unconstitutional and gave the State until July 30, 2004, to determine the cost of providing a sound, basic education in New York City and to implement appropriate reforms and a system of accountability. In response, the Governor appointed a commission to recommend reforms.

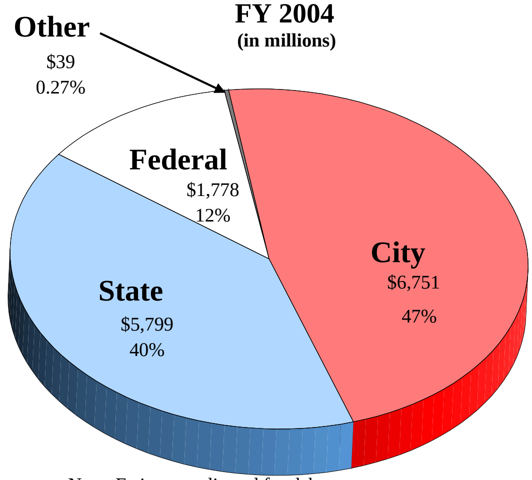
The Governor's executive budget, which was released before the commission completed its report, proposed increasing education aid to New York City by a net of $56 million, including a $100 million matching grant that would represent a down

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

[23] Estimates adjusted for debt prepayments, which can distort spending patterns.

payment toward settling the Campaign for Fiscal Equity lawsuit. The grant is intended to target schools with the highest concentrations of low-performing students, and the City would be required to match the State's $100 million contribution in FY 2005. Even though City funding to the Department of Education is projected to increase by $199 million next year, the City could still be required to increase funding to high-need schools or to reallocate resources from existing educational programs.

**Graph 13**
**Department of Education**
**Sources of Funding**
**FY 2004**
**(in millions)**




Note: Estimates adjusted for debt prepayments.
Source: NYC Office of Management and Budget; OSDC analysis

On March 29, 2004, the Governor's commission (the New York State Commission on Education Reform) issued a report that recommended that funding for public education from all sources increase by a total of between $2.5 billion and $5.6 billion. The commission recommended that the increase be phased in over a five-year period. A report by Standard and Poor's, which was the basis for the commission's recommendation, suggested that New York City would need between 78 percent and 84 percent of the increase to raise spending to a level comparable to successful school districts in the State. The plaintiffs in the lawsuit, however, are seeking significantly larger increases in education aid. Any proposed settlement would be subject to court approval.

The commission noted that the State funds almost half of the cost of public education statewide and recommended that this partnership be maintained. Thus, under these scenarios, New York City could expect to receive annual increases in

State education aid of about $200 million to $475 million.[24] Since there can be no assurances that the federal government will increase its contribution in the future, the City could be called upon to match the State contribution.

The Governor proposes, and the Commission on Education Reform endorses, funding any increases in State education aid to high-need school districts with the State's share of the proceeds from existing or planned video lottery terminal sites[25] and eight new lottery terminal sites. While new lottery sites would be prohibited in Putnam, Westchester, and Rockland counties, up to five new sites could be licensed in New York City—but their locations would be limited to Brooklyn, Staten Island, and south of 59th Street in Manhattan. The Governor estimates that his proposal would generate $325 million next year and about $2 billion annually by 2009.

## B. Health and Hospitals Corporation

In January 2004, the Health and Hospitals Corporation ("the Corporation") projected large cash budget gaps of $435 million in FY 2005 and over $600 million annually in subsequent years. Because the Corporation was on course to run out of cash to pay its bills in FY 2005, the City stepped in with an infusion of cash to buy some time. The April Plan increases the City's support to the Corporation by $200 million in FY 2005 and by $150 million thereafter. Since the underlying causes of the Corporation's budget gaps have not been addressed, the Corporation still projects budget gaps of $273 million in FY 2005 and more than $500 million during fiscal years 2006 through 2008.

The major source of the Corporation's budget gaps are inadequate reimbursement for the services it provides to uninsured patients (the Corporation provides care to 460,000 uninsured City residents each year). Also, the cost of providing outpatient services exceeds the Medicaid reimbursement rate (the Corporation provides medical care to 5.6 million outpatient visitors annually). In addition, State Department of Health data indicate that the Corporation has recently lost market share to voluntary and proprietary hospitals for inpatient care, a service for which the Corporation receives full reimbursement of its costs.

To close the projected operating gaps, the Corporation intends to draw down a projected opening cash balance of $170 million in FY 2005 and to take actions valued at $270 million in FY 2005, $415 million in FY 2006, $490 million in FY 2007, and

[24] These estimates exclude certain aid categories, such as building and transportation aid. The commission recommended reforms in these areas that could benefit New York City.

[25] Video lottery terminals opened at Saratoga Raceway in January 2004 and are planned for the Finger Lakes, the Buffalo Raceway in Hamburg, Yonkers Raceway, Batavia Downs, Monticello Raceway, and Aqueduct Raceway.

$515 million in FY 2008 (see Table 8). The largest of these initiatives involves resolving old claims for third-party reimbursement. The Corporation has hired consultants to assist in this effort, which it estimates could generate $60 million in FY 2005 and as much as $235 million by FY 2008. An effort to maximize revenue by reducing the number of claims denied by insurers, improving billing processes, and enrolling uninsured patients into public health insurance programs is expected to generate $30 million in FY 2005, $50 million in FY 2006, and $75 million annually thereafter.

**Table 8**
**Health and Hospitals Corporation**
**Gap-Closing Program**
(in millions)

| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 |
|---|---|---|---|---|---|
| State and Federal Actions | 41 | 150 | 250 | 300 | 325 |
| Spending Reductions | --- | 55 | 80 | 80 | 80 |
| Revenue Maximization | --- | 30 | 50 | 75 | 75 |
| City Agencies | --- | 35 | 35 | 35 | 35 |
| **Total** | **$ 41** | **$ 270** | **$ 415** | **$ 490** | **$ 515** |

Sources: NYC Office of Management and Budget; OSDC analysis

## C. New York City Transit Authority

The New York City Transit Authority, a covered organization, is the largest component of the Metropolitan Transportation Authority (MTA). On October 28, 2003, the MTA released a revised budget for 2003 and a four-year financial plan for calendar years 2004 through 2007. The October 2003 Plan was the first five-year financial plan released by the MTA since September 1999, and was prepared in accordance with new financial reporting procedures adopted by the agency in response to criticism by the State Comptroller that the MTA's December 2002 Plan secretly shifted surplus resources from 2002 to future years, and did not accurately show the size of the projected budget gaps during the debate over proposed fare and toll increases.

The October 2003 Plan showed budget gaps of $840 million in 2005, $1.3 billion in 2006, and $1.5 billion in 2007, which the MTA attributed to projected increases in debt service and pension costs and the depletion of nonrecurring budgetary actions. Our report on the October 2003 Plan commended the MTA for improving its financial plan presentation, but concluded that the MTA had underestimated the size of the gaps by $307 million in 2005, $358 million in 2006, and $649 million in 2007.[26] The gaps were underreported because the MTA had included speculative resources in the financial plan's baseline estimates, which reduced the size of the projected gaps.

Specifically, the October Plan underestimated expenditures by $80 million in 2005, $129 million in 2006, and $174 million in 2007 by counting on savings from unspecified cost reductions. In addition, the MTA agencies were directed by MTA headquarters to use employment forecasts prepared by Global Insight, the MTA's economic consultant, in making their fare and toll revenue projections—yet MTA headquarters increased the agency's forecasts by 5 percent in 2005, or $227 million, and by 10 percent in 2007, or $475 million, beyond the increases already assumed by the agencies in their budgets. MTA headquarters based its increases on hoped-for growth in utilization, but offered no economic basis for its projections. We believe it was unreasonable for MTA headquarters to include unsubstantiated increases in utilization in the financial plan, especially ones that contradicted the recommendations of its economic advisor. The financial plan assumes that the MTA board will approve reductions in fare and toll discounts to generate additional revenue if planned increases in utilization do not materialize.

On February 23, 2004, the MTA issued a revised financial plan, which was the first plan to be released under new regulations issued by the State Comptroller. These regulations were designed to further improve the transparency and accountability of the MTA's finances. The February Plan included, as required by the regulations, a certification from the MTA's Executive Director that the Plan was based on reasonable assumptions and methods of estimations, and that it complied with the Comptroller's regulations; a debt affordability statement; debt service estimates for the next capital program during the financial plan period; and a statement of nonrecurring resources and transactions that would shift resources from one year to another.

The February Plan showed budget gaps of $539 million in 2005, $1.2 billion in 2006, and $1.3 billion in 2007. Although the February Plan offered the MTA an opportunity to address the shortcomings in the October Plan, the February Plan still included speculative resources in its baseline estimates even though the regulations define budget gap as "the difference between projected revenues and expenses for any given fiscal year *before* [emphasis added] a proposed fare increase or other proposed management actions that increase revenues or reduce costs." When these speculative

[26] See OSDC Report 10-2004, *Review of the Financial Plan for the Metropolitan Transportation Authority*, issued December 2003.

resources are excluded, the budget gaps total $846 million in 2005, $1.5 billion in 2006, and $2 billion in 2007.

The inclusion of speculative resources in the February Plan also affected the MTA's calculation of the debt service burden. The MTA reported that the debt service burden would rise from 20 percent of fare and toll revenue in 2004 to 30 percent by 2007. That calculation, however, assumes that fare and toll revenues increase by 10 percent beyond the increases already projected by the MTA agencies. Excluding these speculative resources, the debt service burden would be 34 percent in 2007, which is substantially higher than estimated by the MTA.

The practice of including resources from future actions in the MTA financial plan has also led to confusion. A number of public accounts of the MTA's finances suggest that the MTA faces a $540 million budget gap in 2005 and that it is considering curtailing discounts to close this gap.[27] Yet even if the MTA curtailed discounts by 5 percent and reduced spending by $80 million, it would still be left with a budget gap of $540 million in 2005, because the financial plan already includes these resources. The MTA must correct this public misconception in its July 2004 financial plan before the public debate on the 2005 budget begins in earnest.

The MTA also intends to release a preliminary capital program for 2005-2009 in July and plans to forward a proposed five-year capital program to the Capital Program Review Board for its approval in October. In the absence of an approved capital program for 2005-2009, the February Plan made certain assumptions regarding the size of the next capital program in order to develop debt service projections for calendar years 2005 through 2007.

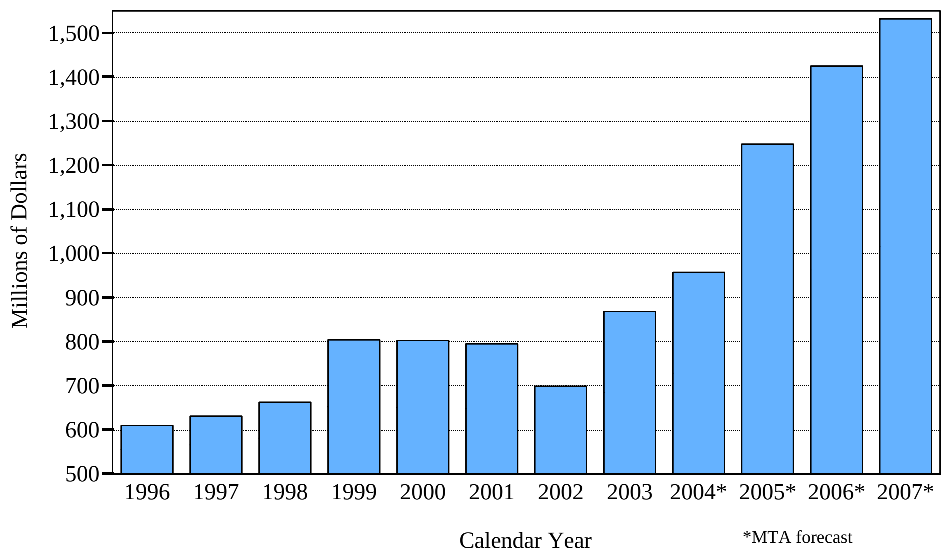
The debt service estimates in the February Plan were premised on the assumptions that the 2005-2009 capital program would total $26.6 billion—30 percent more than the current program—and would include $9.3 billion for expansion projects, such as the Second Avenue Subway and the East Side Access project. To fund a capital program of this magnitude, the MTA also made certain assumptions about the receipt of federal aid and assumed that the MTA would use debt to finance about the same portion of the 2005-2009 capital program as it funded during the current capital program. The February Plan anticipated no new resources from the State and only a minimal contribution from the City. The MTA analysis left a funding shortfall of $6.7 billion—the equivalent of 25 percent of the program—and large increases in future debt service costs.

[27] Celeste Katz, "MTA: Boost Aid or We May Derail Discounts," *New York Daily News*, April 1, 2004; Clemente Lisi, "MTA's Aid Gap Set to $ock Metrocard," *New York Post*, April 1, 2004; and Joshua Robin, "MTA Budget Meeting," *Newsday*, April 1, 2004.

The February Plan assumed that debt service costs used to finance past capital programs and to complete the 2000-2004 capital program would grow from $868 million in 2003 to $1.5 billion by 2007 (see Graph 14). The February Plan further assumes that the MTA would finance $9.8 billion of the next capital program with its own debt, which we estimate would increase debt service costs to $2.3 billion by 2014, placing extraordinary pressure on the operating budget. To maintain the same debt service burden in 2014 as is currently projected for 2004, fare and toll revenue would have to grow at an average annual rate of 9 percent, which is unlikely to occur without higher fares and tolls. Similarly, all sources of revenue, including State assistance, would have to grow at an average annual rate of 9 percent through 2014 to maintain the same debt service burden as projected for 2004.

**Graph 14**

**MTA Debt Service Costs**




Note: Projections exclude impact of proposed 2005-2009 capital program.

Sources: Metropolitan Transportation Authority; OSDC analysis

## D. Off-Track Betting Corporation

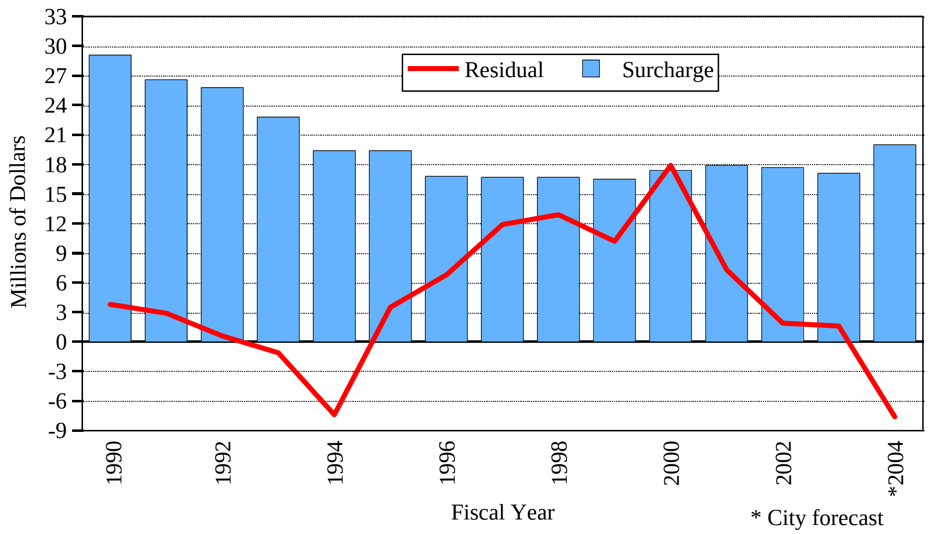
New York City's Off-Track Betting Corporation (OTB) was established by State law in 1970 as a public benefit corporation to operate a system of off-track betting parlors in New York City. It provides legalized pari-mutuel wagering that generates a stream of revenue for New York City, the State, and the horse racing and breeding industries.

OTB passes along to New York City the revenues from a mandated 5 percent surcharge on winning wagers, and its residual revenues.[28] Total distributions to New York City have declined from $32.9 million in FY 1990 to $18.7 million in FY 2003, which reflects a decline in both surcharge revenue and residual revenues.

Despite handling about $800 million in wagers, OTB reported negative residual revenues, or losses, of $1.1 million in FY 1993 and $7.4 million in FY 1994. Residual revenues improved in subsequent years, peaking at $17.9 million in FY 2000, but have steadily declined since then and totaled only $1.6 million in FY 2003.

**Graph 15**

**Residual and Surcharge Revenues**




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

The April Plan assumes that the loss to the City will be $7.6 million in FY 2004, the first loss in a decade. The projected loss is due to a number of factors, including State legislation that was enacted last year that requires OTB to pay an annual regulatory fee to the New York State Racing and Wagering Board for the right to simulcast thoroughbred racing at night. In addition, collective bargaining costs are projected to rise based on the tentative agreement with District Council 37, and pension contributions continue to grow rapidly. According to OTB, New York City's

[28] 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. Residual revenues are frequently referred to as operating profits.

share of revenues for distribution has declined from 38 percent in FY 1988 to 19.5 percent in FY 2003 as a result of a series of State laws that have increased the distribution to the racing industry.

The April Plan projects small amounts of residual revenues during fiscal years 2005 through 2008 based on the assumption that operating costs will remain essentially unchanged during the Plan period. To offset projected increases in personal service and lease costs, OTB intends to reduce staffing through attrition and hopes that the amounts wagered at OTB parlors will increase through a more targeted advertising campaign. However, OTB is likely to face increased competition for wagering dollars from the placement of video lottery terminals at Aqueduct Raceway and five other sites within New York City.

## E. Hudson Yards Infrastructure Corporation

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. Under the City's 30-year plan, private developers will construct 14 high-rise office towers and more than 12,000 new housing units on the rezoned far West Side. The plan has three major components: the extension of the No. 7 subway line and the creation of public open space, such as parks, with rezoning to allow for high-density commercial development; the creation of a convention corridor through the expansion of the Javits Convention Center; and the construction of a multi-use sports and convention facility, which would be used by the New York Jets and is the centerpiece of the City's bid for the 2012 Olympics.

To finance infrastructure improvements needed to encourage development on the far West Side, the Mayor has proposed the creation of the Hudson Yards Infrastructure Corporation (HYIC) to issue $4 billion in bonds. These bonds will fund $2.8 billion in construction costs for the western extension of the No. 7 line and the construction of a platform over the Metropolitan Transit Authority's (MTA) eastern rail yard and public amenities. Another $1 billion would be used to refinance short-term debt and the remaining $200 million will be used for bond-issuing expenses such as reserves and insurance.[29]

The City estimates that development of the far West Side will generate $16 billion in revenues to the City over a 30-year period, which could be drawn upon

[29] These estimates exclude the cost of the second phase of redeveloping the far West Side, which includes a subway station at 41st Street and 11th Avenue and the northern portion of a mid-block boulevard running between 10th Avenue and 11th Avenue.

to finance the infrastructure improvements. The projected revenues, which will be generated mainly by commercial payments in lieu of taxes (PILOTs) and residential property taxes, will be used to pay HYIC debt service. Since HYIC will incur debt service costs from the construction of the subway and other infrastructure improvements beginning in 2005 but development will not generate sufficient revenues until 2018, HYIC intends to issue short-term debt to pay interest costs not covered by revenues during the 13-year period. When revenues are sufficient to fund the debt service costs, HYIC would refinance an estimated $1 billion in short-term debt with long-term bonds. The City estimates that some of the bonds will be outstanding for as long as 40 years, with a total debt service cost of more than $10 billion.

The City plans to use the Transitional Finance Authority (TFA),[30] with its high "AA" credit rating, to provide credit-enhancement to the $1 billion of short-term debt. The TFA receives the City's personal income tax and, if required, the City's sales taxes (after the Municipal Assistance Corporation funds its expenditures) to meet TFA debt service and operating expenditure needs, with excess revenues passed along to the City. The TFA credit-enhancement could result in the TFA's utilization of funds that would otherwise benefit the City's budget should the revenues from the development be insufficient to allow HYIC to retire the short-term debt through the issuance of long-term debt. The amount of TFA liability (and by extension the City) depends on the total amount of short-term paper issued, but it could total as much as $1 billion by 2018. The potential liability will also depend on the steps HYIC and TFA take to respond to a revenue shortfall, and the nature and timing of the shortfall.

On March 25, 2004, two Memorandums of Understanding (MOUs) were signed to advance the redevelopment of the West Side. The first MOU, signed by the City and the State, included pledges by both entities to each provide $300 million for the construction of a multi-use facility and $350 million for the expansion of the Javits Center. The facility will be built on a platform to be constructed over the MTA's western rail yard. The total cost of each project is $1.4 billion.

The City plans to finance its $350 million commitment to the Javits Center expansion through the issuance of bonds from an as-yet unidentified entity. These bonds would be supported by funds from a special revenue account from the Battery Park City Authority (BPCA). The use of the BPCA funds requires the unanimous consent of the President of BPCA, the Mayor, and the City Comptroller, who recently stated that he would take a position on this project by the end of May. The dedication

[30] TFA is a public benefit corporation created by the State in 1997, when the City was approaching its State constitutional debt limit, to assist the City in funding its capital program.

of BPCA revenues for this project will not impact the City's budget; however, if these funds are not used for the Javits Center project they could be used for other purposes, such as affordable housing or education.

Additional funding in the amount of $500 million for the Javits expansion is expected to come from a $1.50 key surcharge that the hotel industry has agreed to charge its patrons, which is subject to State approval. In addition, a $200 million contribution is expected to come from a developer who would construct a hotel near the newly expanded convention center. While the expansion of the Javits Center is scheduled to occur in two phases, the overall $1.4 billion cost only covers the first phase of the project. Details as to the cost and financing of the second phase, which will provide 35 percent of the total expansion, have not yet been disclosed by the City or the State.

The second MOU, signed by the Empire State Development Corporation (ESDC), Jets Development LLC, and the MTA, outlines the financial responsibilities of each party involved in the construction of a multi-use sports and convention facility. The Jets would finance the construction of the facility, estimated at $800 million, and the City and State would each contribute $300 million to fund construction of a platform over the western rail yard and a retractable roof.

The City has not yet revealed the source of its $300 million contribution for the construction of the multi-use facility. The City expects to securitize a future revenue stream not yet identified, and it has not ruled out an income stream currently in the City's budget. The State expects that a subsidiary or affiliate of the ESDC will issue bonds to provide the proceeds needed to meet its $300 million commitment.

It is expected that the MTA will fund the debt service costs on the bonds to be issued by the ESDC to provide the State's $300 million contribution for the construction of a platform for the facility. While the MTA has consistently stated that it will be reimbursed for the debt service costs, it is not expected that the State will be under a contractual obligation to reimburse the MTA.

The MTA and the Jets will be commencing negotiations shortly regarding the value of the air rights over the rail yard and the Jets payment to the MTA for the use of the platform. Although the MTA maintains that it will obtain fair value for the use of the platform, it does not plan to competitively bid or seek an independent appraisal. Until an agreement is announced, we are unable to determine whether the Jets' payment to the MTA would be sufficient to cover the MTA's obligation to the ESDC, or whether there would be any residual to help fund the MTA's operating or capital budgets.

# Appendix A
# Nonrecurring Resources in Fiscal Year 2005

The April Plan includes nearly $3.2 billion in nonrecurring resources in FY 2005 (see Table 9). These resources will help the City balance the FY 2005 budget, but will provide no recurring benefit.

**Table 9**
**Nonrecurring and Other Extraordinary Actions**
(in millions)

| | |
|---|---|
| FY 2004 Surplus Transfer | $ 1,306 |
| Retroactive Port Authority Airport Lease Payment | 687 |
| MAC Refinancing | 502 |
| Pension COLA Stretch | 259 |
| Battery Park City Authority City Land Purchase | 150 |
| Debt Refunding | 103 |
| Asset Sales | 90 |
| Tobacco Settlement Revenues | 58 |
| **Total** | **$ 3,155** |

Source: OSDC analysis

# Appendix B
# City-Funded Staffing Levels
# (Full-Time and Full-Time Equivalents)

*Increase/(Decrease)*

| | Fiscal Year | | | Annual Change | | Two-Year Change |
|---|---|---|---|---|---|---|
| | FY 2003 | FY 2004 | FY 2005 | FY 2004 | FY 2005 | |
| **Public Safety** | **80,022** | **79,696** | **79,650** | **(326)** | **(46)** | **(372)** |
| Police Dept. Uniformed | 36,120 | 34,774 | 34,774 | (1,346) | - - - | (1,346) |
| Civilians | 14,054 | 14,529 | 14,631 | 475 | 102 | 577 |
| Fire Dept. Uniformed | 10,879 | 11,104 | 11,154 | 225 | 50 | 275 |
| Civilians | 4,297 | 4,328 | 4,328 | 31 | - - - | 31 |
| Correction Uniformed | 8,786 | 8,772 | 8,740 | (14) | (32) | (46) |
| Civilians | 1,323 | 1,416 | 1,397 | 93 | (19) | 74 |
| District Attys. & Prosecutors | 3,412 | 3,377 | 3,298 | (35) | (79) | (114) |
| Probation Department | 763 | 977 | 928 | 214 | (49) | 165 |
| Other | 388 | 419 | 400 | 31 | (19) | 12 |
| **Health and Welfare** | **21,837** | **23,802** | **25,337** | **1,965** | **1,535** | **3,500** |
| Social Services | 9,062 | 10,595 | 11,318 | 1,533 | 723 | 2,256 |
| Children's Services | 6,380 | 6,487 | 6,545 | 107 | 58 | 165 |
| Health and Mental Hygiene | 4,006 | 4,364 | 4,973 | 358 | 609 | 967 |
| Homeless Services | 2,109 | 2,098 | 2,289 | (11) | 191 | 180 |
| Other | 280 | 258 | 212 | (22) | (46) | (68) |
| **Environment & Infrastructure** | **16,563** | **16,987** | **16,772** | **424** | **(215)** | **209** |
| Sanitation Uniformed | 7,006 | 7,525 | 7,630 | 519 | 105 | 624 |
| Civilians | 1,751 | 1,815 | 1,846 | 64 | 31 | 95 |
| Dept. of Transportation | 2,035 | 2,093 | 2,177 | 58 | 84 | 142 |
| Parks & Recreation | 5,373 | 5,128 | 4,679 | (245) | (449) | (694) |
| Other | 398 | 426 | 440 | 28 | 14 | 42 |
| **General Government** | **8,041** | **8,816** | **9,082** | **775** | **266** | **1,041** |
| Finance | 2,166 | 2,458 | 2,453 | 292 | (5) | 287 |
| Law Department | 1,285 | 1,289 | 1,306 | 4 | 17 | 21 |
| Citywide Admin. Services | 1,346 | 1,414 | 1,606 | 68 | 192 | 260 |
| Taxi & Limo. Commission | 447 | 480 | 478 | 33 | (2) | 31 |
| Investigations | 269 | 279 | 274 | 10 | (5) | 5 |
| Board of Elections | 373 | 328 | 351 | (45) | 23 | (22) |
| Info. Technology & Telecomm. | 552 | 837 | 869 | 285 | 32 | 317 |
| Other | 1,603 | 1,731 | 1,745 | 128 | 14 | 142 |
| **Housing** | **1,399** | **1,514** | **1,847** | **115** | **333** | **448** |
| Buildings | 893 | 936 | 937 | 43 | 1 | 44 |
| Housing Preservation | 506 | 578 | 910 | 72 | 332 | 404 |
| **Department of Education** | **110,435** | **113,138** | **112,533** | **2,703** | **(605)** | **2,098** |
| Pedagogues | 90,049 | 91,376 | 90,963 | 1,327 | (413) | 914 |
| Non-Pedagogues | 20,386 | 21,762 | 21,570 | 1,376 | (192) | 1,184 |
| **City University of New York** | **6,033** | **6,185** | **6,120** | **152** | **(65)** | **87** |
| Pedagogues | 3,674 | 3,912 | 3,912 | 238 | - - - | 238 |
| Non-Pedagogues | 2,359 | 2,273 | 2,208 | (86) | (65) | (151) |
| **Elected Officials** | **2,446** | **2,618** | **2,558** | **172** | **(60)** | **112** |
| **Total** | **246,776** | **252,756** | **253,899** | **5,980** | **1,143** | **7,123** |

Sources: NYC Office of Management and Budget; OSDC analysis

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