Review of the Financial Plan of the City of New York

July 2006

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I. Executive Summary

On July 3, 2006, New York City submitted to the New York State Financial Control Board a four-year financial plan (the "July Plan") based on the budget adopted for FY 2007. The City accumulated unplanned resources of $6.1 billion during FY 2006, and it used $2.3 billion of that amount to improve its financial position and to provide supplemental financial assistance to certain City-related public authorities. The remaining net surplus of $3.8 billion—a new record—was used to balance the FY 2007 budget, but future years show large budget gaps.

Almost $4 billion of the unplanned resources in FY 2006 came from tax collections that were much higher than expected as a result of conservative forecasts and an improving local economy. Real estate transaction tax collections were higher by $1.2 billion; personal income tax collections were higher by $1.3 billion, driven by job gains[1] and profits from stock market transactions; and business and all other tax revenue exceeded expectations by $1.5 billion. Other developments, combined with spending restraint, resulted in net savings of $1.7 billion in FY 2006.

Among the steps taken by the City to improve its financial position is the creation of a retiree health benefits trust fund. New accounting rules require state and local governments to estimate the liability of post-employment benefits other than pensions, such as health insurance. Although the City is under no obligation to fund the liability, which could exceed $50 billion, it transferred $1 billion to the trust fund in FY 2006 and plans to transfer $1 billion in FY 2007. As an added benefit, the trust fund could also serve as a rainy-day fund, although that is not its intended purpose.

The City also prepaid $350 million in debt service that is not due until FY 2008, and deferred the receipt of $454 million in tobacco settlement revenues until FY 2008, when it will be needed. These actions are largely responsible for a 15 percent reduction in the budget gap that was projected for FY 2008 one year ago. In addition, the City increased its reserve for disallowances by $235 million, in the event that the federal government imposes financial penalties stemming from audits of Medicaid services provided to schoolchildren; and allocated $200 million annually to fund the capital program on a pay-as-you-go basis.

The FY 2007 budget also includes resources to hire 800 police officers and 400 civilians to free up an equal number of police officers from desk duty, and also continues, for the third consecutive year, a $400 property tax rebate for home owners. Furthermore, New York City residents will benefit from a new property tax rebate program that was adopted by the State.

[1] Job growth accelerated during calendar year 2005 as the City added 49,100 jobs, which helped push the unemployment rate down to 5.8 percent in 2005, the lowest level since before the recession in 2000.

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

Despite these favorable developments, the July Plan projects budget gaps of $3.8 billion in FY 2008, $4.6 billion in FY 2009, and $4.1 billion in FY 2010. Even though our review indicates that revenue collections could exceed the City's forecasts, the additional revenue would not be sufficient to close these gaps. Moreover, the City's projections do not reflect the cost of the tentative deal recently struck with District Council 37, which could form the basis for negotiations with the other municipal unions and could widen the projected budget gaps by at least $950 million by FY 2010. In total, the projected budget gaps could reach $5 billion by FY 2009.

The City projects large out-year budget gaps because the FY 2007 budget is relying, to an unprecedented degree, on the prior year's surplus to achieve budget balance; and also because expenditures, especially debt service and fringe benefits, are projected to grow much faster than recurring revenues. Debt service—the fastest-growing area of the budget—will increase by more than 60 percent during the financial plan period to $6.3 billion by FY 2010. Outstanding debt will nearly double from $50.2 billion in FY 2000 to $92.3 billion in FY 2010, which is equivalent to $29,266 per New York City household.

The City faces additional budget risks. For example, our revenue forecasts assume that the current economic recovery, which is showing signs of slowing down, does not stall in response to higher interest rates, inflation, and energy costs. The City also could be called upon during the financial plan period to increase its funding for education as part of any resolution of the Campaign for Fiscal Equity lawsuit. In addition, the federal government projects daunting budget deficits, and efforts to close those gaps could adversely affect New York City.

The City's fiscal condition has improved steadily over the past four years, and it is commendable that the City has used surplus resources to strengthen its financial position. The underlying imbalance between recurring revenues and expenditures, however, has not been addressed and would become more apparent during an economic slowdown. While the out-year budget gaps are large, the City has demonstrated its ability to close gaps of this magnitude in the past. In addition, the City has time to implement a multiyear strategy to close the out-year budget gaps because FY 2007 will likely end with a substantial surplus.

Table 1
New York City Financial Plan
(in millions)

	FY 2007	FY 2008	FY2009	FY 2010
REVENUES				
Taxes				
General Property Tax	$ 12,972	$ 13,838	$ 14,495	$ 15,173
Other Taxes	19,040	18,947	19,514	20,449
Tax Audit Revenue	509	509	509	510
Tax Reduction Program	- - -	(256)	(256)	(256)
Miscellaneous Revenue	5,155	5,195	4,782	4,809
Unrestricted Intergovernmental Aid	340	340	340	340
FY 2005 Discretionary Transfer				
Less: Intra-City Revenues	(1,355)	(1,333)	(1,335)	(1,335)
Grant Disallowances	(15)	(15)	(15)	(15)
Subtotal - City Funds	**$ 36,646**	**$ 37,225**	**$ 38,034**	**$ 39,675**
Other Categorical Grants	967	982	995	1,000
Inter-Fund Revenues	395	373	365	365
Total City & Inter-Fund Revenues	**$ 38,008**	**$ 38,580**	**$ 39,394**	**$ 41,040**
Federal Categorical Grants	5,063	5,057	5,055	5,057
State Categorical Grants	9,869	9,952	10,048	10,162
Total Revenues	**$ 52,940**	**$ 53,589**	**$ 54,497**	**$ 56,259**
EXPENDITURES				
Personal Services				
Salaries and Wages	$ 19,248	$ 19,499	$ 19,747	$ 20,042
Pensions	4,891	5,614	5,859	5,724
Fringe Benefits	6,920	6,253	6,557	6,804
Subtotal - Personal Services	**$ 31,059**	**$ 31,366**	**$ 32,163**	**$ 32,570**
Other Than Personal Services				
Medical Assistance	$ 4,935	$ 5,083	$ 5,222	$ 5,376
Public Assistance	2,199	2,202	2,202	2,202
Pay-As-You-Go Capital	200	200	200	200
All Other	15,410	15,257	15,635	15,948
Subtotal - Other Than Personal Services	**$ 22,744**	**$ 22,742**	**$ 23,259**	**$ 23,726**
General Obligation, Lease, and MAC Debt Service	3,943	4,324	4,694	5,067
FY 2006 Budget Stabilization & Discretionary	(3,751)	- - -	- - -	- - -
General Reserve	300	300	300	300
Subtotal - Expenditures	**$ 54,295**	**$ 58,732**	**$60,416**	**$61,663**
Less: Intra-City Expenses	(1,355)	(1,333)	(1,335)	(1,335)
Total Expenditures	**$52,940**	**$ 57,399**	**$59,081**	**$60,328**
Gap To Be Closed	**$ ----**	**$ (3,810)**	**$ (4,584)**	**$ (4,069)**

Source: NYC Office of Management and Budget

Table 2
OSDC Risk Assessment of NYC Financial Plan

(in millions)

	Better/(Worse)			
	FY 2007	**FY 2008**	**FY 2009**	**FY 2010**
Gaps Per July 2006 Plan	**$ - - -**	**$ (3,810)**	**$ (4,584)**	**$ (4,069)**
Tax Revenues	625	475	375	375
Medicaid	100	100	100	100
Debt Service Savings	60	- - -	- - -	- - -
Uniformed Agency Overtime	(125)	(100)	(100)	(100)
Collective Bargaining Costs	(250)	(450)	(800)	(950)
OSDC Risk Assessment	**$ 410**	**$ 25**	**$ (425)**	**$ (575)**
Surplus/(Gaps) to be Closed[2]	**$ 410**	**$ (3,785)**	**$ (5,009)**	**$ (4,644)**
Additional Risks and Offsets				
Welfare to Work Penalties	(223)	(223)	(223)	(223)
Savings from Prior Years' Expenses	300	- - -	- - -	- - -
Campaign for Fiscal Equity Settlement	- - -	(589)	(1,053)	(1,676)

[2] The July Plan includes an annual general reserve of $300 million. In addition, the City contributed $1 billion to a retiree health insurance trust fund in FY 2006 and intends to make a similar contribution in FY 2007; the City believes it could draw upon this fund in times of need by forgoing its planned annual contribution to the trust.

II. Economic Overview

New York City's economy has remained strong in the first half of calendar year 2006 despite higher energy prices and gradually rising interest rates. Rising interest rates squeezed Wall Street's broker/dealer profits in 2005, but revenues and profits at the largest firms rose sharply because of their diversified operations, and contributed to record year-end bonuses. Recent employment data revisions showed that employment in the City grew more than originally estimated in 2004 and 2005 (by 18,600 jobs and 49,100 jobs, respectively), and the current rate of job growth is strong by post–fiscal crisis historical standards. These job gains pushed the unemployment rate down to 5.8 percent in calendar year 2005, its lowest level since 2000 (before the recession).

In addition, the real estate market has surged—the average market value of a single-family home, for example, rose by 149 percent to $524,400 between fiscal years 2000 and 2007. While there are signs the market has begun to soften, prices have yet to decline as both commercial and residential supplies are limited and office vacancy rates are improving. Tourism is booming, pushing up hotel occupancy and room rates. Inflation excluding energy and food—so-called core inflation—rose at an annual rate of 3 percent in the City in the first half of 2006, compared to a 2.2 percent increase in the nation. Energy prices, however, were up in the first half of 2006 by 20 percent on an annual basis in the City, and by more than 21 percent in the nation.

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

At the local level, the City expects that strong gains from mergers and acquisitions will lift overall Wall Street broker/dealer profits in 2006, but that rising interest costs will reduce profits and bonuses in 2007. The City assumes that the economy will rebound in 2008, and that Wall Street profits will follow the same path, rising throughout the balance of the financial plan period. Because Wall Street's high bonuses and incomes affect the overall rate of wage growth, the City projects that wage gains will increase in 2006, slow in 2007, and then rise again. The City's employment forecast also follows a similar path and does not show a decline. The Wall Street and tourism-related sectors (e.g., finance and insurance, professional and business services, leisure and hospitality, and retail trade) and the education and health care sector are expected to account for most of the job gains throughout the financial plan period. The City expects sales of residential real estate to fall and prices to decline between 2006 and 2010, but anticipates continued strength in the commercial real estate market.

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

These risks converge with the uncertainty surrounding the path of future interest rates. The Federal Reserve is trying to craft an interest rate policy that balances fighting inflation with sustaining economic growth. As of mid-July, the Federal Reserve had raised rates 17 times since mid-2004. Long-term interest rates have begun to respond to these changes and are starting to rise. The pace of economic growth is moderating, but inflation—driven by higher energy prices—continues to be a major threat. Although recent Congressional testimony by the Chairman of the Federal Reserve suggests that the bank may pause in its interest rate increases, the determination to control inflation could cause the Federal Reserve to raise rates more than necessary and thereby severely dampen economic growth. Such a development would also reduce profitability for the markets, which are already struggling with higher interest costs.

III. Fiscal Year 2006

The City expects to end FY 2006 with almost $6.1 billion more in resources than it projected at the beginning of the fiscal year (see Table 3). Most of these unanticipated resources stem from much-higher-than-expected tax collections, changes in pension assumptions and methods, and unexpected one-time savings in the Medicaid program from State actions that capped the growth in the local share of spending on this program.

These unanticipated resources have permitted the City to strengthen its financial position and to assist financially troubled City-related public authorities, while still leaving a net surplus of $3.8 billion that has been used to balance the FY 2007 budget without raising taxes or cutting services. As a result of the actions taken by the City over the course of the fiscal year, the budget gap projected for FY 2008 has been reduced by 15 percent, to $3.8 billion. The budget gap projected for FY 2009, however, has increased—from $3.9 billion to $4.6 billion.

A. Revenue Estimates

For the third year in a row, revenue collections have significantly exceeded the City's expectations, with the forecast for FY 2006 now $4.4 billion higher than in the July 2005 Plan (see Table 3).[3] This is a much greater variance than in each of the previous two fiscal years (FY 2005 revenues exceeded initial expectations by $3.3 billion, and in FY 2004 the variance was $1.9 billion). As in the previous two years, these additional collections have been factored into the City's revenue base, yielding higher projected collections of $3.1 billion in FY 2007 and nearly $1.7 billion in each of fiscal years 2008 and 2009.

Tax revenues again account for the bulk of this additional revenue, with the current forecast for FY 2006 now higher by $4 billion. In general, the City's economy has performed better than expected—creating more jobs, generating more capital gains, and most notably, enjoying a housing boom that has defied predictions of a sharp decline. Major tax revenue changes include the following.

- Real estate transaction taxes (the mortgage-recording and real property transfer taxes) are forecast to be higher by $1.2 billion in FY 2006 and by an average of about $450 million in each of fiscal years 2007 through 2009. Commercial transactions remain strong, and the City believes that residential activity is being supported by refinancings from home owners converting from interest-only mortgages to conventional fixed-rate loans.

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

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

	Better/(Worse)			
	FY 2006	**FY 2007**	**FY 2008**	**FY 2009**
Surplus/(Gaps) Per July 2005 Plan	**- - -**	**$ (4,507)**	**$ (4,470)**	**$ (3,925)**
Revenues				
Personal Income Tax	$ 1,256	$ 982	$ 796	$ 883
Real Estate Transaction Taxes	1,230	553	400	382
Business Taxes	621	471	364	299
Tax Audits	275	- - -	- - -	- - -
All Other Taxes	578	338	203	218
Subtotal	**3,960**	**2,344**	**1,763**	**1,782**
Non-Tax Revenues	408	611	98	95
Agency Gap-Closing Program	92	95	74	74
Anticipated Federal Aid	(50)	- - -	- - -	- - -
Extension of Property Tax Rebate	- - -	- - -	(256)	(256)
Total	**4,410**	**3,050**	**1,679**	**1,695**
Expenditures				
Collective Bargaining	(669)	(1,214)	(1,507)	(1,664)
Education	(136)	(328)	(328)	(329)
Energy Costs	(60)	(163)	(186)	(181)
Restorations and Initiatives	- - -	(283)	(50)	(50)
Changes in Pension Assumptions and Methods	924	567	(165)	(465)
Medicaid	450	- - -	- - -	- - -
Agency Gap-Closing Program	162	204	146	145
Debt Service	149	168	176	158
General Reserve	260	- - -	- - -	- - -
Savings from Overestimating Prior Years' Expenses	400	- - -	- - -	- - -
State Aid for Collective Bargaining	35	300	337	337
Other Agency Expenses	149	(719)	(328)	(319)
Total	**1,664**	**(1,468)**	**(1,905)**	**(2,368)**
Net Change During FY 2006	**6,074**	**1,582**	**(226)**	**(673)**
Discretionary Actions				
Surplus Transfer	(3,751)	3,751	- - -	- - -
Retiree Health Benefits Trust Fund	(1,000)	(1,000)	- - -	- - -
Health and Hospitals Corporation Subsidies	(385)	279	82	(8)
Transitional Finance Authority Debt Prepayment	(350)	16	350	- - -
Reserve for Disallowances	(235)	- - -	- - -	- - -
TSASC Revenue Deferral	(233)	(121)	454	22
New York City Housing Authority Subsidy	(120)	- - -	- - -	- - -
Surplus/(Gaps) Per July 2006 Plan	**$ - - -**	**$ - - -**	**$ (3,810)**	**$ (4,584)**

Sources: NYC Office of Management and Budget; OSDC analysis

- Personal income tax collections are now forecast to be higher by $1.3 billion in FY 2006 and by an average of nearly $900 million annually thereafter, reflecting a higher base in FY 2006 due to strong wage growth (notably from Wall Street) and strong capital gains realizations (some of which were derived from real estate transactions).
- Business taxes are expected to be higher by $621 million in FY 2006 and by $408 million, on average, during fiscal years 2007 through 2009. Corporate profitability was strong in calendar year 2005, and contributed to a sizable increase in collections in the spring. In addition, the City expects to realize an additional $275 million in FY 2006 from tax audits stemming mostly from a joint State and City initiative that takes advantage of recent changes in federal regulations concerning tax shelters.

Other significant developments since the beginning of the fiscal year include a $408 million increase in non-tax revenues—nearly half comes from higher interest income from City deposits as a result of higher interest rates. The City did not receive the $50 million in federal aid it anticipated during FY 2006, and the July Plan makes no assumption of future increases. In addition, the City's gap-closing program includes revenue initiatives (such as fees and fines) in the agencies; these are expected to produce $92 million in resources in FY 2006, falling to $74 million by FY 2009. Finally, the City intends to seek State approval to extend the real property tax rebate through FY 2010, at an annual cost of $256 million.

B. Expenditure Estimates

City-funded expenditures in FY 2006 are nearly $1.7 billion lower than projected in July 2005 (see Table 3, previous page).[4] The difference is largely attributable to lower-than-planned pension contributions associated with changes recently approved by the pension boards ($924 million); savings associated with State Medicaid reforms ($450 million); anticipated savings from prior years' expenses ($400 million); and a drawdown of the general reserve ($260 million). As discussed below, a number of other significant developments occurred during the year.

- Collective bargaining costs are expected to be higher than projected at the beginning of the fiscal year by $669 million in FY 2006 and by an average of almost $1.5 billion annually in subsequent years based on recently negotiated or anticipated agreements. (State education aid to the City increases by $472 million in FY 2007 in the enacted State budget, and the City intends to use $300 million of this amount to help fund the recently negotiated teachers' contract.)

[4] This estimate excludes almost $1.9 billion in various planned discretionary actions. When included, these actions would increase planned spending by a net of $190 million since the beginning of the fiscal year.

- Energy costs are expected to be higher by $60 million in FY 2006, largely due to increased usage of electricity, and higher by an average of $177 million annually during fiscal years 2007 through 2010, largely because of increased international demand for oil.
- Education expenditures are expected to be higher by $136 million in FY 2006 and by an average of $328 million annually thereafter, largely because of growth in charter school enrollment; tuition and transportation costs for privately provided special education; and because the Department of Education will no longer claim federal Medicaid reimbursement for special education transportation and speech therapy.
- Agency actions are expected to generate savings of $162 million in FY 2006, mostly from reestimates, shifting costs to the federal and State governments, and reductions in subsidies to libraries and cultural institutions. Most of these savings are expected to recur.
- Debt service is expected to be lower by $149 million in FY 2006 and by about $167 million in subsequent years because the State has agreed to fund half of the Department of Education's capital program; a reduction in short-term borrowing due to the City's large cash balance; and a refunding of high-coupon debt. (These estimates exclude the impact of an initiative that provided assistance to the Health and Hospitals Corporation.)

C. Discretionary Actions

As previously mentioned, the City realized nearly $6.1 billion in unanticipated resources in FY 2006. The City intends to use $2.3 billion of this amount to benefit future years, improve its financial position, and provide assistance to the Health and Hospitals Corporation and the New York City Housing Authority (see Table 4). The remaining $3.8 billion will be used to help balance the FY 2007 budget. In addition, the City had previously allocated $200 million annually to help fund the capital program on a pay-as-you-go basis, which will reduce planned borrowing by $1 billion and produce debt service savings of $144 million through FY 2010.

Table 4
Impact of Discretionary Actions
July 2006 Plan
(in millions)

	(Increase)/Decrease			
	FY 2006	**FY 2007**	**FY 2008**	**FY 2009**
Retiree Health Benefits Trust Fund	$ (1,000)	$ (1,000)	$ - - -	$ - - -
Health and Hospitals Corporation	(385)	279	82	(8)
Transitional Finance Authority Debt	(350)	16	350	- - -
Increase Reserve for Disallowances	(235)	- - -	- - -	- - -
TSASC Inc.	(233)	(121)	454	22
NYC Housing Authority	(120)	- - -	- - -	- - -
Total	**$ (2,323)**	**$ (826)**	**$ 886**	**$ 14**

Source: NYC Office of Management and Budget

The discretionary actions include the following.

- The City created a health benefits trust fund for current and future retirees, transferred $1 billion from the general fund to the trust in FY 2006, and will make a similar contribution in FY 2007. Changes in accounting rules will require governments to begin reporting the value of their post-employment benefits other than pensions (primarily health care benefits). Although governments are not required to fund these liabilities, the credit rating agencies, when determining their ratings, will consider the size of these liabilities and how they are addressed. By using some of its available resources to begin funding this liability, the City is working to improve its financial condition. (For more information, see "Retiree Health Benefits Trust Fund" in Section VII of this report.)
- The City delayed the recognition of $454 million in TSASC revenues[5] from fiscal years 2006 and 2007 until FY 2008, when those resources will be needed. (For more information, see "TSASC Inc." in Section VII of this report.)
- The City increased its payments to the Health and Hospitals Corporation from the level planned at the beginning of the fiscal year, by a net of $385 million in FY 2006. The net change reflects a one-time supplemental Medicaid payment of $575 million in FY 2006 that would be partly offset by a reduction in City subsidies for debt service, fringe benefits, and other needs. (For more information, see "New York City Health and Hospitals Corporation" in Section VII of this report.)

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

- The Transitional Finance Authority retained, at the City's request, $350 million in personal income tax revenue in FY 2006, to legally defease TFA debt coming due in FY 2008. The transaction is expected to generate $16 million in interest earnings, which will benefit FY 2007, and to provide $350 million of budget relief in FY 2008.
- The City increased the reserve for disallowances of State and federal categorical aid by $235 million in FY 2006, reflecting the likely imposition of financial penalties stemming from a federal audit of the Medicaid program in the Department of Education. (For more information, see "Department of Education" in Section VII of this report).
- The City provided the New York City Housing Authority (NYCHA) with $100 million in transitional financing in FY 2006 to help close a large budget gap projected for the current calendar year,[6] while the NYCHA seeks approval from the federal government to implement its gap-closing program. The City has also provided $20 million to the NYCHA in order to provide additional housing vouchers to families. (For more information, see "New York City Housing Authority" in Section VII of this report.)

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

IV. Annual Operating Results

The City projects a net surplus of $3.8 billion for FY 2006—a new record, and among the largest as a percent of City fund revenues.[7] The City intends to transfer the surplus to FY 2007 to help balance that year's budget, continuing a practice it has followed in past years. The transfer of resources between years, however, masks the relationship between recurring revenues and expenditures. We believe a more accurate picture of the City's fiscal condition would be obtained by examining the results of current-year operations—the difference between revenues and expenditures incurred in the current year. Viewed from this perspective, the City has recorded increasingly larger surpluses since FY 2003 after three years of losses.

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

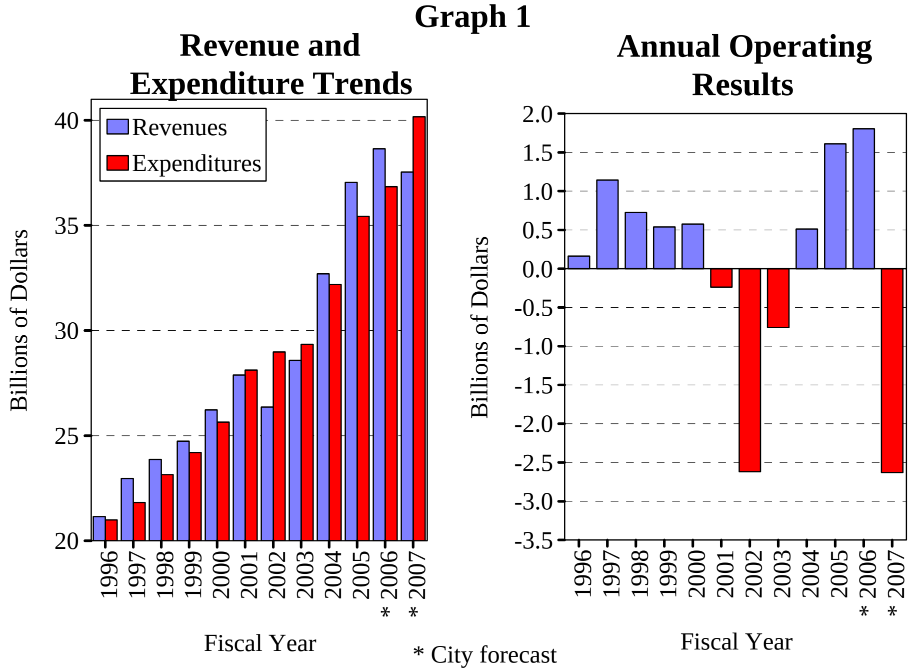
Less than three years after the terrorist attack on the World Trade Center, the City ended FY 2004 with a current-year operating surplus of $511 million—the first such surplus since FY 2000. The surplus was due to a combination of City, State, and federal actions taken to help the City through its fiscal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

In FY 2005, the City's fiscal condition continued to improve as the current-year operating surplus grew to $1.6 billion. This outcome was aided by $1 billion in budget relief from the State-approved Municipal Assistance Corporation refinancing initiative, as well as $744 million in retroactive airport lease payments from the Port Authority of New York and New Jersey. An additional $1.9 billion in resources was

[7] The City realized unanticipated resources of $6.1 billion in FY 2006, and intends to use a portion of these resources to improve its financial position and assist financially troubled public authorities, which results in a net surplus of $3.8 billion.

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

Graph 1



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

Despite the loss of these nonrecurring resources in FY 2006, which dampened revenue growth, the City should end the year with a record current-year operating surplus of $1.8 billion.[8] The practice of balancing the budget one year at a time, however, works only as long as the surplus lasts. While the City has balanced the FY 2007 budget with resources from prior years, current-year expenditures are expected to exceed current-year revenues by $2.6 billion in FY 2007. The current-year operating deficit will most likely narrow as the year progresses and the City revises its revenue and expenditure forecasts.

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

V. Revenue and Expenditure Trends

Over the past few years, the City has been able to build large surpluses—both on a budgetary and a current-year operating basis—because revenues have grown at a much faster pace than expenditures have, even as expenditure growth has surged as a result of spending pressures in such areas as pensions, debt service, health insurance, and Medicaid. While the City projects a balanced budget for FY 2007, that budget depends on the transfer of surplus resources from prior years, and the City projects budget gaps of $3.8 billion in FY 2008, $4.6 billion in FY 2009, and $4.1 billion in FY 2010.

Revenue growth in recent years has been fueled by an improving economy—reflected in rising employment, higher Wall Street earnings, increased capital gains realizations, and a boom in the real estate market—as well as temporary tax increases enacted during the recession. Revenue growth is projected to slow dramatically, averaging only 1.3 percent annually during fiscal years 2007 through 2010, as temporary tax increases expire and as the pace of economic growth eases.

Expenditure growth, after adjusting for surplus transfers, is also forecast to slow—but it will far exceed the projected growth in revenues, increasing at an average annual rate of 4.1 percent during these years. This estimate, moreover, assumes that municipal employees will receive annual wage increases of 2 percent during fiscal years 2007 and 2008, and 1.25 percent during fiscal years 2009 and 2010, and these are substantially lower than the projected inflation rate. Although State actions have reduced the rate of growth in Medicaid costs, the City's costs for debt service, pensions, and health insurance continue to grow rapidly.

The July Plan reflects the impact of the State budget on the City's operating and capital budgets. The operating budget will have a net benefit of nearly $400 million in FY 2007, with most of the assistance coming from an increase in education aid ($472 million) and an increase in the number of red light camera districts ($4 million in FY 2007 and about $12 million annually thereafter), and offset by the impact of State-authorized tax reductions and other initiatives. The State also enacted a property tax rebate, which will benefit home owners and renters but will not have a budgetary impact.

The State also approved certain changes in actuarial assumptions and methodologies, at the request of the City, that will help lower pension costs during fiscal years 2006 and 2007 by $1.5 billion, but that will increase future contributions. The City also has not decided when to sell 150 newly authorized taxi medallions for vehicles equipped for passengers with disabilities, which could generate up to $60 million at current prices.

In addition, the State authorized the Dormitory Authority of the State of New York to issue $1.8 billion in bonds and to allocate those proceeds in support of the Department of Education's capital program. The State also authorized the Transitional Finance Authority (TFA) to issue up to $9.4 billion in debt outstanding in support of the education capital program, which would be funded with State building aid.

Although the City has proposed a number of ways the federal government could provide additional assistance, it seems more likely that future federal actions could have an adverse impact on the City. For example, both houses of Congress have passed separate spending plans, which have yet to be reconciled, that would reduce spending on education, social services, training, and housing assistance; transportation; and energy conservation.

A. Revenue Estimates

City fund revenues are projected to decline by 2.9 percent in FY 2007 after increasing by 4.3 percent in FY 2006 (see Graph 2).[9] Taxes, the largest component of City fund revenues, are expected to decline by 3.2 percent in FY 2007. The growth in collections from real property and sales taxes is projected by the City to be more than offset by declines in personal and business income taxes, and from taxes on real estate transactions. City fund revenues are projected to decline again in FY 2008 but then resume growing during the final two years of the financial plan period, increasing by 4.3 percent in FY 2009 and 4.2 percent in FY 2010, as tax revenue growth recovers. As discussed below, our analysis indicates that tax collections are likely to be greater than assumed in the July Plan, but overall growth during the financial plan period is likely to be less robust than in the past three years.

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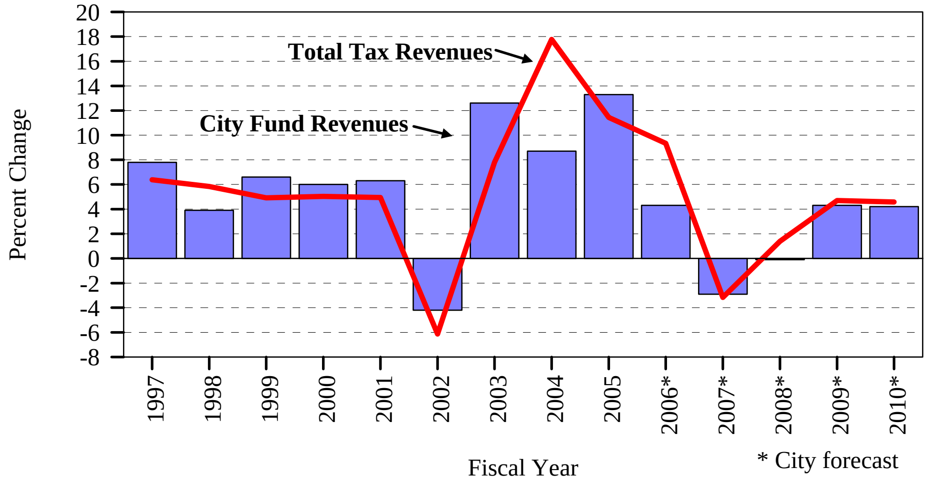
[9] Our estimates of City fund revenues include the portion of personal income tax revenues dedicated to pay debt service on bonds issued by the TFA, and revenues dedicated to pay debt service on tobacco bonds. The estimate has also been adjusted for the transfer of TSASC revenues to benefit FY 2008.

Graph 2

Annual Change in City Fund Revenues and Tax Revenues



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

The City's economy has improved dramatically in the last three years, and tax revenues have far exceeded expectations at the start of each fiscal year. These additional collections have been factored into the City's tax base, yielding higher projected collections throughout the entire financial plan period. While the City's economy is forecast to slow somewhat in calendar year 2007 and does face additional risks—in particular from dependence on Wall Street, as well as risks related to interest rates, energy prices, and the value of real estate—it appears unlikely that City fund revenues would fall to the levels of the most recent recession. The projected slowing in the City's economy, coupled with the expiration of temporary tax increases,[10] is expected to depress tax growth during the early part of this period—and virtually all the gains in tax collections are attributable to the real property tax (see Table 5). Nonetheless, our review indicates that the City's revenue forecasts are too conservative and that tax collections could continue to exceed the City's expectations—by $625 million in FY 2007, $475 million in FY 2008, and $375 million in each of fiscal years 2009 and 2010.

[10] These are projected to reduce FY 2007 collections by $432 million, primarily from the expiration of the personal income tax surcharge on high-income earners.

Table 5
City Fund Revenues
(in millions)

	FY 2006	FY 2007	Annual Growth	FY 2008	FY 2009	FY 2010	Average Three-Year Growth Rate
Taxes							
Property Tax	$ 12,447	$ 12,972	4.2%	$ 13,582	$ 14,239	$ 14,917	4.8 %
Personal Income Tax	7,265	6,857	-5.6%	6,854	7,361	7,768	4.2 %
Sales Tax	4,447	4,528	1.8%	4,590	4,817	5,052	3.7 %
Business Taxes	4,799	4,569	-4.8%	4,493	4,639	4,832	1.9 %
Real Estate Transaction Taxes	2,693	1,753	-34.9%	1,557	1,553	1,602	-3.0 %
Other Taxes	2,643	2,530	-4.3%	2,593	2,639	2,690	2.1 %
Subtotal	**34,294**	**33,209**	**-3.2%**	**33,669**	**35,248**	**36,861**	**3.5 %**
Miscellaneous Revenues	4,113	4,008	-2.6%	3,498	3,538	3,566	-3.8 %
Unrestricted Intergovernmental Aid	489	340	-30.5%	340	340	340	0.0 %
Grant Disallowances	(250)	(15)	-94.0%	(15)	(15)	(15)	0.0 %
Total	**$ 38,646**	**$ 37,542**	**-2.9%**	**$ 37,492**	**$ 39,111**	**$ 40,752**	**2.8%**

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

Major revenue trends include the following.

- Real property tax revenues are forecast to increase annually between fiscal years 2006 and 2010, growing at an average annual rate of 4.6 percent. The expected level of revenue growth appears contrary to concerns that real estate values will ease following a period of large market value growth (annual market value growth for all properties in the City has averaged higher than 10 percent between fiscal years 2000 and 2006). Growth can be maintained because provisions of State law which limit the amount of annual increases in assessed values for property owners during periods of rapid growth in property values also act to limit the risk to City revenues during periods when the growth in values is more sluggish.
- Collections from taxes on real estate transactions (the mortgage-recording and real property transfer taxes) are expected to decline by $940 million (34.9 percent) in FY 2007, to $1.8 billion. Revenues from these taxes have been forecast to decline for several years, but rising property values and only a modest increase in mortgage rates resulted in a strong real estate market in calendar year 2005. Recent data, however, indicate that the expected easing in the market may have finally arrived. The Mortgage Bankers Association reports that at the end of June mortgage interest rates were at their highest level since the first quarter of 2002, and that year-to-date mortgage originations have fallen by more than 35 percent from the

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

- Personal income tax collections are expected to grow at an average annual rate of 1.7 percent during the financial plan period. Collections are projected by the City to decline by 5.6 percent in FY 2007, reflecting the expiration of the temporary surcharge on high-income wage earners and the City's assumption that capital gains realizations will be lower in calendar year 2006 compared with 2005. The July Plan assumes that personal income tax collections will increase in subsequent years as the economy strengthens in 2008.

- Business tax collections are projected to rise by only 0.8 percent in FY 2007—adjusted for the nonrecurring audit revenue—and then decline by 1.7 percent in FY 2008 based on the July Plan's assumption of less robust economic conditions. The City believes that the poor performance of smaller financial firms—compared to the strong performance of larger firms—has particularly affected the unincorporated business tax.

- Sales tax collections are forecast to increase at an average annual rate of 3.2 percent through FY 2010. While growth is dampened in fiscal years 2007 and 2008 by the July Plan's assumption of a slowdown on Wall Street, which would limit wage increases and therefore also limit consumer spending, tax collections are expected to increase based on continued strength in the City's tourism sector. (Hotel tax revenues are projected to increase at an average annual rate of 3.9 percent in this period).

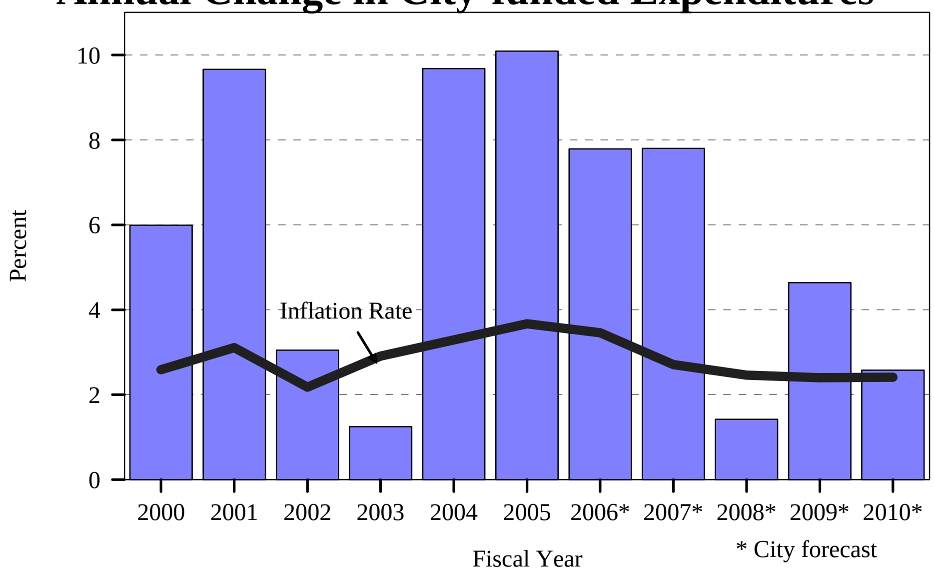
B. Expenditure Estimates

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

The July Plan assumes that expenditures will rise by 7.8 percent in FY 2006, but this estimate includes a $1 billion discretionary transfer to the City's retiree health benefits trust fund. Excluding this transfer, the growth rate would be held down to 3.9 percent in FY 2006, due mostly to extraordinary one-time savings associated with the State Medicaid cap. Expenditures are projected to grow by another 7.8 percent in FY 2007[11] because pension contributions, debt service, and health insurance costs are projected to increase at double-digit rates of growth (see Graph 4).

Graph 3

Annual Change in City-funded Expenditures



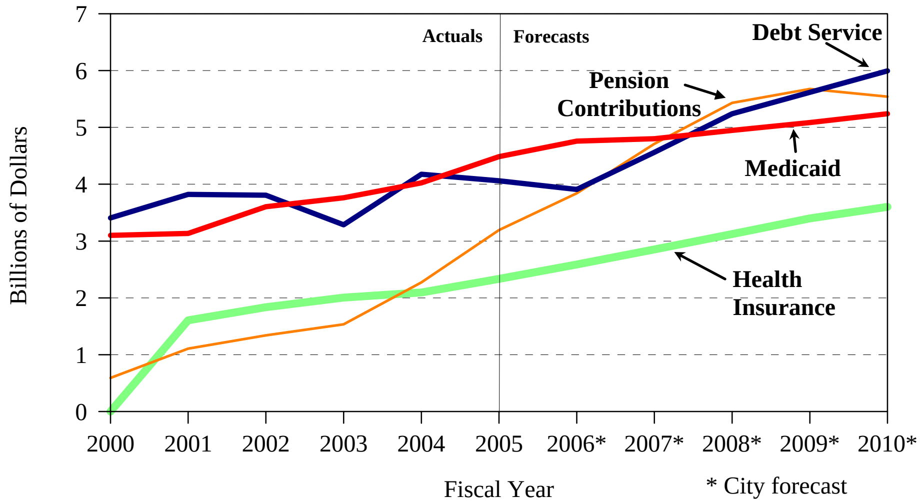
Note: Adjusted for surplus transfers.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

Expenditure growth is projected to average only 2.9 percent during fiscal years 2008 through 2010, which reflects the July Plan's assumptions of modest wage increases during these years; a slowing in the rate of growth of pension contributions; and the impact of the State cap that will limit the annual growth in the City's share of Medicaid to about 3 percent during these years. Nevertheless, debt service, pension contributions, health insurance, and Medicaid (including payments to the Health and Hospitals Corporation) are expected to consume 49 percent of City fund revenues in FY 2010, compared with 39 percent in FY 2006.

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

Graph 4

Trends in Selected City-Funded Expenditure Categories



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

The City-funded workforce has been growing steadily over the past few years and is projected to reach 259,500 by June 2007, an increase of 2,964 employees over the level projected for June 30, 2006. The planned additions to the workforce include 800 police officers, which would increase the police force to 37,838 officers by June 2007. Although the force would still be lower (by 2,916 officers) than the peak reached in October 2000, New York City is the "safest" large city in the nation, according to statistics collected by the Federal Bureau of Investigation. The City also intends to add 400 civilians to the Police Department as part of a consent decree with District Council 37, which stems from a grievance initially filed in 1995 that claimed the Police Department was assigning clerical and administrative duties to able-bodied police officers.

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

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

	FY 2006	FY 2007	Annual Growth	FY 2008	FY 2009	FY 2010	Average Three-Year Growth Rate
Salaries and Wages	$10,721	$11,192	4.4%	$11,509	$11,775	$12,072	2.6 %
Debt Service *	3,907	4,562	16.8%	5,239	5,618	5,994	9.5 %
Medicaid **	3,599	4,016	11.6%	4,165	4,310	4,446	3.5 %
Pension Contributions	3,839	4,710	22.7%	5,432	5,676	5,541	5.6 %
Health Insurance	2,588	2,852	10.2%	3,123	3,399	3,603	8.1 %
Judgments and Claims***	367	412	12.3%	455	508	558	10.7 %
Public Assistance	475	497	4.4%	497	497	497	0.0 %
Pay-As-You-Go Capital	200	200	0.0%	200	200	200	0.0 %
Health Benefits Trust Fund	1,000	1,000	0.0%	---	---	---	NA
Payments to HHC	1,286	853	-33.7%	877	955	975	4.6 %
Energy	615	695	13.0%	696	688	689	-0.3 %
Other	9,595	10,183	6.1%	9,563	10,069	10,246	0.2 %
Total	**$38,192**	**$41,172**	**7.8%**	**$41,756**	**$43,695**	**$44,821**	**2.9 %**

* Includes TFA and TSASC debt service, but does not include debt service on TFA education facilities bonds, which will increase total debt service to $6.3 billion by FY 2010. We have also adjusted the City's estimates for prepayment, in FY 2006, of $350 million in TFA debt service that is due in FY 2008.

** Medicaid payments to the Health and Hospitals Corporation are reflected in the "Payments to HHC" category.

*** These estimates exclude payments by the HHC for medical malpractice suits and other judgments and claims totaling $161 million in FY 2006 and about $190 million annually thereafter.

Note: Totals may not add due to rounding.

Sources: NYC Office of Management and Budget; OSDC analysis

- Salary and wage costs are projected to increase by 4.4 percent in FY 2007, reflecting the cost of current and anticipated labor agreements. The July Plan assumes that municipal employees will receive wage increases of 3.15 percent in 2006, annual wage increases of 2 percent during fiscal years 2007 and 2008, and 1.25 percent during fiscal years 2009 and 2010. The City subsequently reached a tentative agreement with District Council 37 that provides for wage increases of 10 percent over a 32-month period (3.15 percent in the first year and 6 percent over the following 20 months). The District Council 37 agreement could form the basis for negotiations with the other municipal unions and could increase the City's costs by at least $250 million in FY 2007, $450 million in FY 2008, $800 million in FY 2009, and $950 million in FY 2010. Although the tentative agreement does not include provisions that would reduce the City's fringe benefit costs, the City is still committed to achieving such savings.

The United Federation of Teachers and the Patrolmen's Benevolent Association (PBA) are seeking wage increases larger than those agreed to by District Council 37. The City and the PBA have not made progress in their negotiations, and the City has asked the Public Employees Relations Board to declare an impasse and to appoint an arbitration panel. The UFT and the PBA were unable to reach agreements with the City without the assistance of the Public Employees Relations Board during the last round of collective bargaining. An arbitration panel awarded members of the PBA annual wage increases of 5 percent in fiscal years 2003 and 2004, which was partly offset by cost savings, and a fact-finding panel recommended larger wage increases for members of the UFT than had been proposed by the City.

Overtime spending by the uniformed agencies is projected to total $650 million in FY 2006, and then to decline to $570 million in FY 2007. Actual costs, primarily in the Police and Fire departments, are likely to exceed planned levels by $125 million in FY 2007 and about $100 million annually in subsequent years. In FY 2007, the budgetary impact could be greatly mitigated by reserves in the Police Department and the receipt of federal grants.

- Debt service is projected to reach $4.6 billion in FY 2007, an increase of 16.8 percent, and then rise at an average annual rate of 9.5 percent during the balance of the financial plan period—reaching $6 billion by FY 2010. Since debt service is projected to grow more rapidly than City fund revenues, it is expected to consume a larger share of revenues, leaving less for other municipal services. (See Section VI, "Financing the City's Capital Program," for a more detailed discussion.) Our analysis shows the City could realize debt service savings of $60 million in FY 2007 because planned bond issuances by the Hudson Yards Infrastructure Corporation have been delayed.
- Medicaid payments to providers other than the Health and Hospitals Corporation (HHC) are projected to rise by 11.6 percent in FY 2007 because of extraordinary one-time savings in FY 2006 from the State's cap on growth in the local share of Medicaid expenditures. (In the absence of these one-time savings, Medicaid costs would have grown by only 1 percent in FY 2007.) In subsequent years the annual growth rate is expected to average 3.5 percent, and even less when Medicaid payments to the HHC are factored in. Together with other actions taken by the State in recent years to hold down the growth in the local share of Medicaid, such

as a takeover of the local share of the Family Health Plus program, the City is expected to realize cumulative savings of $4 billion through 2010. Our analysis indicates the amount of savings could be higher by $100 million annually in FY 2007 and beyond.

- Pension contributions are projected to increase by 22.7 percent in FY 2007, continuing the rapid growth of recent years. While the rate of growth is expected to slow during the next two years and then decline in 2010, contributions will average about $5.5 billion during fiscal years 2008 through 2010. (In contrast, pension contributions averaged about $1.7 billion during fiscal years 2000 through 2005.) The July Plan reflects the impact of changes in actuarial assumptions and methods that defer planned contributions for 2006 and 2007 to future years.[12] The pension funds have earned about 10 percent on their investments through June 30, 2006, which is higher than the actuarial assumption and could result in lower contributions in future years.

- Health insurance costs for municipal employees are projected to grow from $2.6 billion in FY 2006 to $3.6 billion in FY 2010—an average annual rate of 8.6 percent—which reflects the financial plan assumption that health insurance premiums will continue to grow much faster than the local inflation rate. In addition, the City contributed $1 billion to a retiree health benefits trust fund in FY 2006 as a way to help fund future liabilities, and it intends to make a similar contribution in FY 2007.

- Judgments and claims are expected to grow by 12.3 percent in FY 2007 and by an average annual rate of 10.7 percent during the remainder of the financial plan period as a result of anticipated growth in the number of settlements and in the average size of all awards. The July Plan assumes that the City will not incur any liability arising from the cleanup of the World Trade Center site. The City expects that such claims will be covered by its captive insurance company, but at this time it is impossible to determine whether the $1 billion insurance fund will be sufficient to cover all eligible claims that may be brought against the City.

- Public assistance expenditures are projected to increase by 4.4 percent in FY 2007 based on a projected increase in average benefit levels. As of June 2006, 393,764 people received public assistance in New York City, a 66 percent decline since the peak month of March 1995. The City projects

[12] These changes include a one-year lag in calculating contributions, as was recently adopted by the State; the extension of the phase-in period for investment gains and losses, from five to six years; full funding of retiree cost-of-living adjustments; and changes in demographic assumptions.

that the caseload will rise slightly to 411,120 people by June 2007. The July Plan assumes no growth in caseload or costs beyond FY 2007. The City, however, could incur annual penalties of up to $223 million, starting in FY 2007, if it fails to meet federally mandated work participation rates. Beginning in October 2006, the federal government will no longer credit states for their caseload reductions since federal fiscal year (FFY) 1995 when calculating mandated work participation rates. Instead, the base year will be revised to FFY 2005.

- Medicaid payments and subsidies to the HHC are projected to total nearly $1.3 billion in FY 2006. This estimate includes a $575 million supplemental Medicaid payment that will enable the HHC to leverage an equal amount of federal funds. In succeeding years, the City's payments to the HHC will decline because the Medicaid supplement is nonrecurring. (For more information, see "Health and Hospitals Corporation" in Section VII of this report.)

- Energy costs, which include electricity, natural gas, steam, heating fuel, and gasoline, are projected to total $695 million in FY 2007 and then to remain at about that level through FY 2010. Strong global demand and uncertainty in some oil-producing nations are causing energy prices to increase, but the July Plan assumes that usage will not increase through FY 2010.

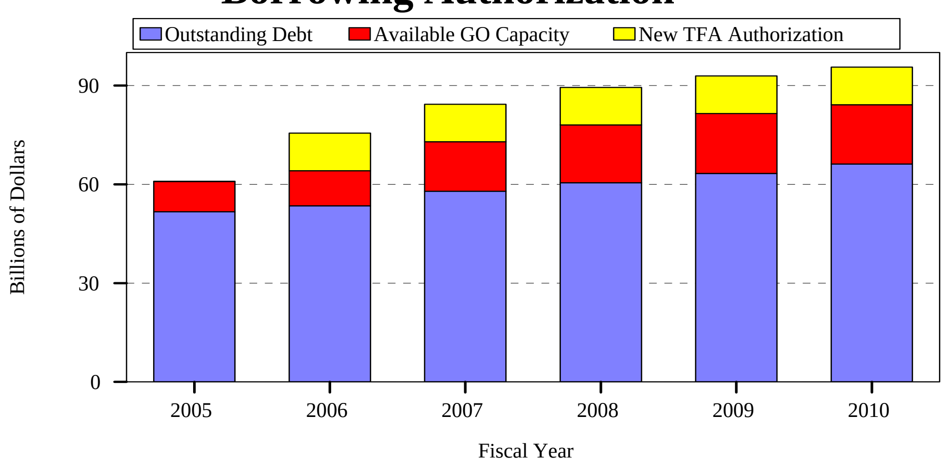
VI. Financing the City's Capital Program

General obligation (GO) bonds, which are funded with property tax revenues and backed by the City's full faith and credit, traditionally have been the primary vehicle for financing the City's capital program. The State Constitution, however, limits the amount of GO debt the City can issue to 10 percent of the five-year moving average of taxable real property values.

To overcome this restriction, the City (with the State's assistance) has created closely related but legally separate entities that issue debt funded with resources that would have otherwise benefited the City's operating budget, such as personal income and tobacco settlement revenues. Most recently, the State authorized the New York City Transitional Finance Authority (TFA) to securitize school building aid to help finance the capital program of the New York City Department of Education. The State Legislature approved a $2 billion increase to the TFA borrowing cap for general capital purposes and has forwarded the bill to the Governor for his consideration.

The amount of debt that can be issued for the City's benefit—either by the City directly or by related entities—will rise from $61 billion in FY 2005 to $96 billion by FY 2010 (see Graph 5). About 60 percent of the increase reflects the actual and projected growth in taxable real property values, and the balance represents new authorization granted to the TFA in the last legislative session.

Graph 5
Borrowing Authorization



Note: Estimates assume that HYIC issues $3 billion in debt during FY 2007 and that a $2 billion increase in the TFA bond cap is enacted into law. Estimates exclude water and sewer debt, which is expressly exempt from the State constitutional debt limit.
Sources: NYC Office of Management and Budget; OSDC analysis

A. New York City Transitional Finance Authority

The New York City Transitional Finance Authority (TFA) was created by the State in March 1997 to help finance the City's capital program after an erosion in real property values caused the City to approach the constitutional debt limit for GO bonds. As its name implies, the TFA was meant to be a temporary measure until the debt limit was amended. Such a constitutional amendment, however, has never been introduced into the State Legislature. Instead, the City has sought statutory relief from the constitutional debt limit.

Unlike GO bonds, which are funded with real property tax revenue, TFA general purpose bonds are funded with the City's personal income tax and, if needed, sales tax revenues. As an alternate financing vehicle for the City, TFA bonds relieve pressure on GO bonds, and because TFA bonds have been rated higher than GO bonds they also reduce borrowing costs. The TFA reached its issuance cap for general capital purposes in September 2003. (The TFA was initially authorized to issue up to $7.5 billion in debt for general capital purposes, but the authorization was raised in June 2000 to $11.5 billion.[13])

In April 2006, the State authorized the TFA to issue $9.4 billion in bonds exclusively to help finance the capital program of the New York City Department of Education ("education facilities bonds"). Since the cap for these bonds is on debt outstanding rather than on debt issued, the TFA can issue additional debt as education facilities bonds come due. The City plans to use $4.7 billion of the authorization[14] to help fund the department's current $13.1 billion five-year capital program. The balance of the capital program will be funded with $1.8 billion in capital grants from the Dormitory Authority of the State of New York and $6.5 billion in City GO bonds. (Overall, TFA education facilities bonds will fund 16.6 percent of the City's overall capital program.)

The State currently reimburses the City for about half of the debt service on capital projects for school facilities. Under the recent TFA legislation, the Mayor may assign to the TFA all or any portion of State building aid to back education facilities bonds.[15] In addition, the State pledges not to change the current State building aid

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

[14] The remainder of the authorization could be used to help fund future education capital programs.

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

reimbursement formula for *approved projects*, although it reserves the right "to amend, modify, repeal or otherwise alter statutes" relating to building aid for *future projects*. State building aid will still be subject to annual appropriation.

The City has indicated that it intends to assign to the TFA all of the State building aid, which will total $495 million in FY 2006.[16] Also, the City expects that incremental building aid will be sufficient to fund the debt service on the education facilities bonds.[17] If not, the TFA could draw against existing building aid, though doing so would create a liability for the City's budget. Any building aid above the amounts needed to fund debt service on the bonds would be returned to the City.

TFA education facilities bonds are not City-funded debt because they are funded with State building aid, but we consider them to be City obligations because the Mayor has chosen to assign State building aid, which benefits the City's operating budget, to the TFA, which was created exclusively to help finance the City's capital budget. The TFA's board of directors is comprised exclusively of City officials.

In May 2006, the City proposed replacing the existing statutory cap on TFA general purpose bonds with 10 percent of the five-year rolling average of personal income of New York City residents. This would have increased the TFA's borrowing authority by $26.6 billion by FY 2010 even though the City is comfortably under the GO debt limit[18] and even though the State just authorized the TFA to issue up to $9.4 billion in debt for educational facilities. Instead, the State Legislature raised the TFA borrowing cap for general capital purposes by $2 billion, which will allow the City to realize the cost savings associated with TFA bonds. The bill has been forwarded to the Governor for his consideration.

B. Debt Outstanding

The amount of debt issued by the City and City-related entities is projected to rise from $40 billion in FY 2000 to $70.9 billion in FY 2010, an increase of 77 percent (see Graph 6). This estimate includes $4.7 billion in education facilities bonds to be issued by the TFA by FY 2010, and $3 billion to be issued by the Hudson

[16] Building aid assigned by the Mayor to support TFA education facilities bonds would be subject to prior claim by the Municipal Bond Bank Agency, the Educational Construction Fund, and, if needed, City education bonds that are in default.

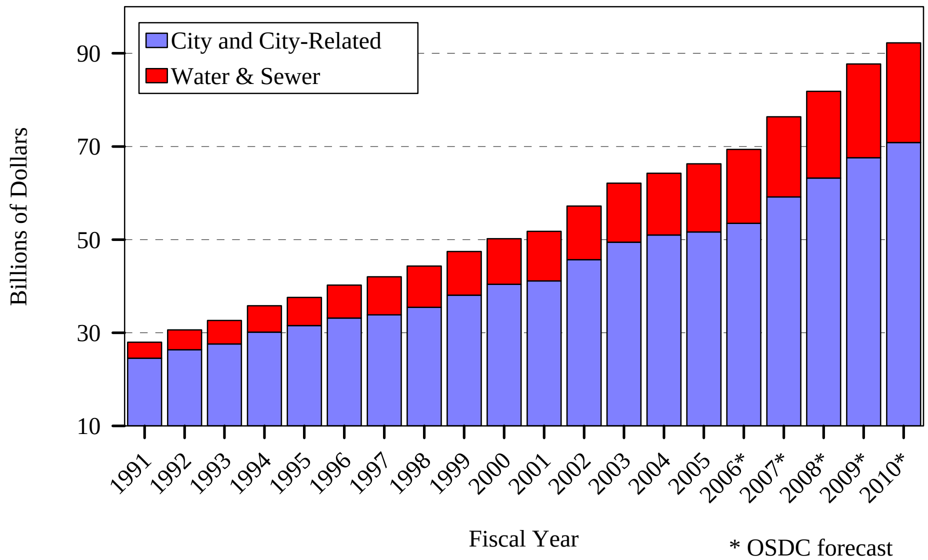
[17] State building aid would need to increase by $364 million by FY 2013 in order to cover the debt service on the $4.7 billion in TFA education facilities bonds.

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

Yards Infrastructure Corporation for the redevelopment of the far West Side of Manhattan. The amount of debt issued by the New York City Municipal Water Finance Authority (MWFA) is projected to more than double from $9.8 billion in FY 2000 to $21.4 billion in FY 2010. In total, debt issued by the City, City-related entities, and the MWFA is projected to nearly double over the course of the decade, from $50.2 billion in FY 2000 to $92.3 billion in FY 2010.

Graph 6

Debt Outstanding

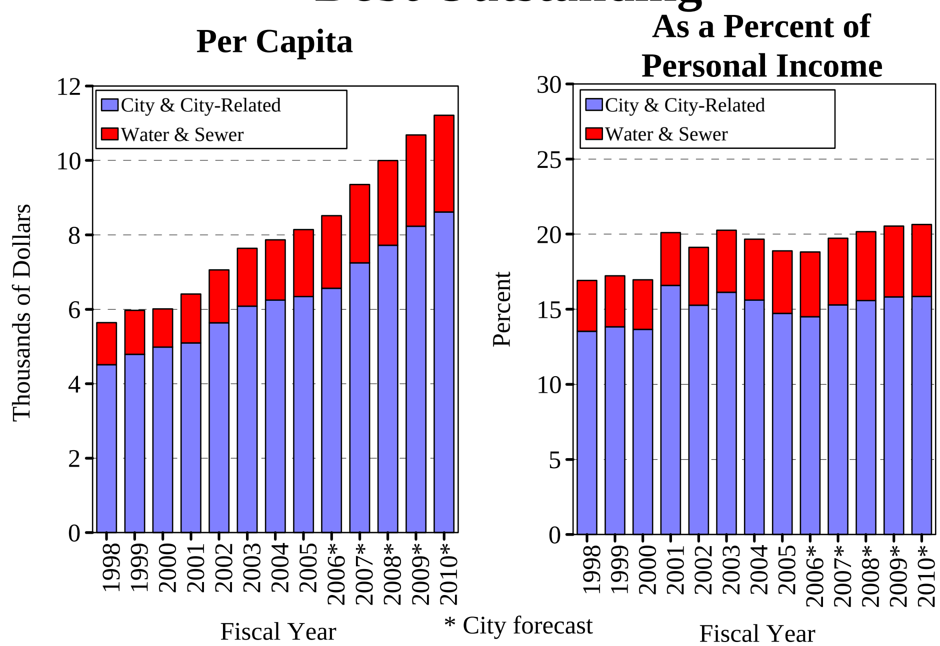


Sources: NYC Comptroller; NYC Office of Management & Budget; OSDC analysis

C. Debt Affordability Measures

New York City's debt burden is relatively high regardless of how it is measured. Outstanding debt per capita (including water and sewer debt) grew at an average annual rate of 3.2 percent during fiscal years 2003 through 2005, but is projected to grow at more than twice that rate (7.1 percent) during fiscal years 2006 through 2010. Given these trends, debt per capita will reach $11,213 by FY 2010, which is 37.7 percent more than the FY 2005 level (see Graph 7). This is equivalent to outstanding debt of $29,266 per New York City household.

Graph 7
Debt Outstanding



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

Debt is also consuming a larger share of the City's wealth. New York City personal income is projected to increase at an annual rate of 5 percent for fiscal years 2006 through 2010, while debt outstanding is forecast to increase by 7 percent annually over the same period. Outstanding debt represented about 17 percent of personal income during most of the 1990s but then peaked at more than 20 percent in FY 2003 (see Graph 7). Although the ratio declined during the next three years, it is projected to exceed the historic peak by FY 2010.

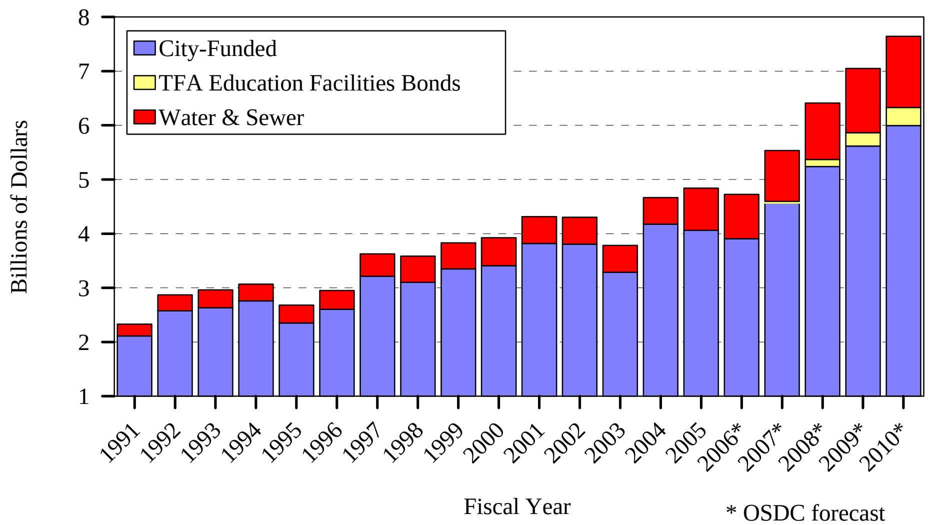
D. Debt Service

After declining during the last three fiscal years, debt service funded directly through the City's operating budget or with City funds that would have otherwise benefited the City's operating budget (i.e., City funded debt) is projected to increase by 50 percent, from $3.9 billion in FY 2006 to $6 billion in FY 2010 (see Graph 8). The rate of increase grows to 62 percent when the debt service on TFA education facilities bonds is included.

Moreover, these estimates already reflect the benefit of the MAC refinancing initiative approved by the State in 2003, which was designed to relieve pressure on the City's operating budget as a result of the recession of the early 2000s and the attack on the World Trade Center. Under this initiative, outstanding MAC debt (due to be fully paid by FY 2008) was refinanced by the Sales Tax Asset Receivable Corporation, a local development corporation organized by the City. The debt service on the new bonds is funded with annual payments of $170 million from the Local Government Assistance Corporation, a State entity. Consequently, the City will save $2.5 billion during fiscal years 2005 through 2008—but the State will incur costs of $5.1 billion over 30 years.

Graph 8

Debt Service



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

Debt service on water and sewer bonds, which is paid by user fees, averaged $485 million during fiscal years 1997 through 2004, but a trend of rising debt service began in FY 2005. Debt service on these bonds is expected to grow from $779 million in FY 2005 (an increase of 59 percent over the FY 2004 level) to $1.3 billion in FY 2010—an average annual rate of 11 percent. In total, debt service on City debt and water and sewer bonds is projected to grow from $4.7 billion in FY 2006 to $7.3 billion by FY 2010, an increase of more than 50 percent.

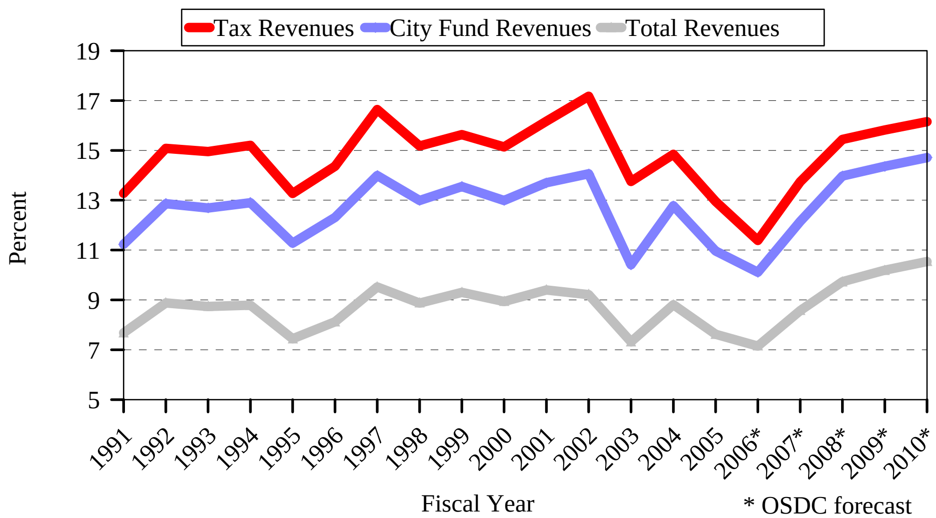
E. Impact on the Operating Budget

Whether the growth in debt service is measured as a percentage of total revenues, tax revenues, or City fund revenues,[19] it is projected to outpace the projected growth in revenues during the July Plan period. Consequently, debt service

[19] City fund revenues include those that are retained by closely related entities but would have otherwise flowed to the City.

will consume an increasing share of municipal resources during the financial plan period (see Graph 9), leaving fewer resources for other services. For example, debt service is expected to increase at an annual rate of 9.5 percent during fiscal years 2007 through 2010, which is more than three times the growth rate of City fund revenues.

Graph 9
Debt Service as a Percent of Revenues



Note: Each revenue source includes offsetting revenues for TFA and TSASC.
Sources: NYC Comptroller; NYC Office of Management & Budget; OSDC analysis

The following points highlight the trend in debt service.

- The percentage of tax revenues consumed by debt service declined for the past three years to 11.4 percent, but the ratio is projected to exceed 16 percent by FY 2010, nearly equaling the historic peak reached in FY 2002.
- Debt service consumed, on average, about 13.6 percent of City fund revenues during fiscal years 1997 through 2002. The rate declined to 10 percent in FY 2006 but is now projected to rise to 14.7 percent by FY 2010, which would be the highest level since FY 1984.
- Debt service consumed, on average, about 9.2 percent of total revenues during fiscal years 1997 through 2002. The ratio declined to 7.2 percent in FY 2006 but is now projected to rise to 11 percent by FY 2010, which would be the highest level since FY 1984.

VII. Semi-Autonomous Agencies

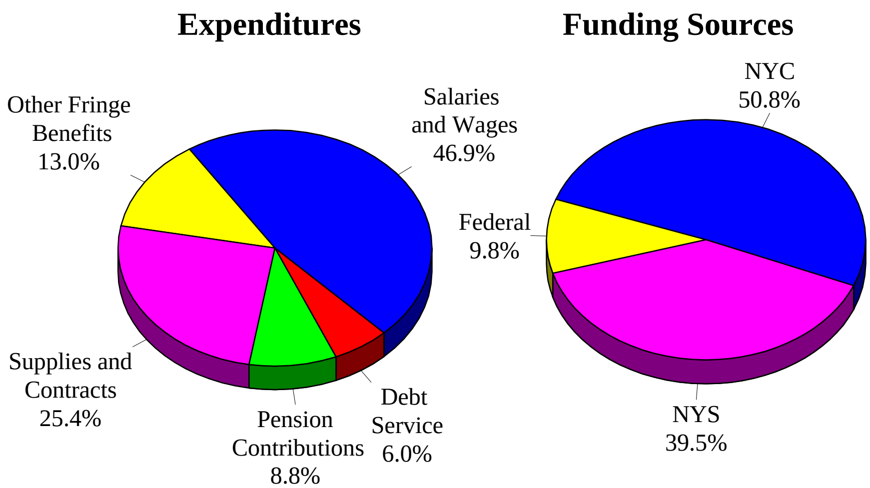
The following public authorities and other entities have a financial relationship with the City.

A. Department of Education

The City's FY 2007 budget provides $18.1 billion for education ($8.5 billion for salaries and wages, $4.6 billion for supplies and contracts, $2.4 billion for other fringe benefits, $1.6 billion for pension contributions, and $1.1 billion for debt service), which is $948 million more than forecast for FY 2006. New York City will fund 50.8 percent of the FY 2007 education budget; the State will fund 39.5 percent; and the federal government and other sources will fund the remainder (see Graph 10).

Graph 10

FY 2007 Education Budget



Sources: NYC Office of Management and Budget; OSDC analysis

State and City funding for education will continue to be debated as the State attempts to resolve a lawsuit over its system of education finance, *Campaign for Fiscal Equity v. State of New York*. Beginning in 2001, the courts have ruled that the State's system of education finance is unconstitutional and have ordered the State to ensure that the City's public schools receive sufficient resources to provide a sound basic education. In October 2005, the Governor appealed a court order that operating aid to the City's public schools be increased by $5.6 billion over four years and that capital funding be increased by $9.2 billion over five years. In March 2006, the Appellate Division ruled in favor of the plaintiffs and ordered the State to take steps to ensure that the City's schools receive an increase in operating aid of between $4.7 billion and $5.6 billion, and $9.2 billion in capital funds.

Shortly after the Appellate Division ruling, the State and the City reached an agreement that will provide $11.2 billion in capital funding for school construction projects. The State authorized the Dormitory Authority of the State of New York to provide the City's public school system with $1.8 billion in capital grants.[20] Also, the State intends to fund half of the debt service on $9.4 billion in bonds to be issued by both the City and the Transitional Finance Authority in support of the Department of Education's current $13.1 billion five-year capital program.[21] (For more information, see Section VI, "Financing the City's Capital Program.") Together, the two contributions from the State represent half of the cost of the department's current five-year capital program.

The plaintiffs in the Campaign for Fiscal Equity lawsuit have stated that the capital improvement plan adopted by the State "satisf(ies) the City schools' constitutionally recognized capital needs," although they have filed an appeal with the Appellate Court to compel the State to fully comply with an earlier court order to enact a multiyear increase in operating aid.[22] In their appeal, the plaintiffs also seek to clarify whether the court has the authority to compel the State to comply with its rulings regarding the allocation of education funding. Oral arguments will begin in October 2006.

The Governor, the Assembly Speaker, and the Senate Majority Leader have suggested that the City should fund part of any settlement. If the City were required to contribute the share of additional assistance recommended in the past by the Governor (40 percent), and if the Court of Appeals ordered the State to increase funding by the maximum of $5.6 billion, the City could be required to increase its contributions by as much as $589 million in FY 2008, $1.1 billion in FY 2009, and $1.7 billion in FY 2010.

The City will also fund the Mayor's "Empowerment Schools" initiative. In June 2006, the Mayor and the Chancellor announced that 331 schools would

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

[21] The City is already committed to funding $1.8 billion of the department's current five-year capital program using general obligation bonds.

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

participate in the initiative for the 2006-2007 school year. If these schools meet specific performance goals, their principals will be given greater control over school budgets, hiring, and curricula. Participating schools will receive $250,000 in additional funding for principals' training and other benefits. The initiative will be funded in part from planned administrative efficiencies (totaling $45 million annually) and from the elimination of 350 administrative positions from regional offices.

Another matter that could require City funding is the likely imposition of financial penalties following federal audits of the Department of Education's Medicaid claims for transportation and speech therapy services. In audits released in June 2005 and September 2005, auditors found $531 million in questionable federal reimbursements, and the City could be held responsible for as much as half of that amount. In FY 2006, the department stopped claiming federal Medicaid reimbursement and instead paid for the services with City funds, totaling $86 million annually. In addition, the City increased its Citywide FY 2006 reserve for disallowances by $235 million to mitigate any potential additional loss of federal revenues. The State is currently awaiting the final draft of the third federal audit, which may be released in September 2006.

B. New York City Health and Hospitals Corporation

The Health and Hospitals Corporation (HHC) expects to end FY 2006 with a surplus of $322 million, on an accrual basis, and a cash balance of $370 million. For fiscal years 2007 through 2010, HHC projects annual budget gaps, on an accrual basis, that approach $1 billion. HHC has proposed a gap-closing program, which even if successful would reduce but not eliminate the gaps. HHC expects to end FY 2007 with a cash balance of $475 million, and plans to use these resources to balance the FY 2008 on a cash basis.

The sizeable cash balances projected for fiscal years 2006 and 2007 are attributable to the anticipated receipt of an estimated $1.3 billion Medicaid enhancement in FY 2006, which is available to hospitals and nursing homes that serve a large percentage of uninsured and medically needy patients. To assist HHC in obtaining the enhancement, the City has provided $575 million to leverage an equal amount of federal funding. At the same time, the City reevaluated the need to provide certain other subsidies to HHC, such as debt service and fringe benefits, given the positive cash position projected by HHC for each of fiscal years 2006 and 2007. As a result, the City reduced its subsidies to HHC by $198 million in FY 2006, $287 million in FY 2007, and $90 million in FY 2008. While the Medicaid enhancement will permit HHC to balance the FY 2006 budget on an accrual basis and will provide a substantial cash reserve for use in FY 2008, it does not address the underlying structural imbalance between HHC revenues and expenditures.

C. New York City Housing Authority

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

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

Although the City is under no legal obligation to provide any additional assistance, the City provided the NYCHA with $100 million in transitional assistance to help balance its 2006 budget and another $20 million to provide Section 8 vouchers to 3,000 families. To close the remaining gap projected for 2006 and to close the budget gaps projected for future years, the NYCHA will seek additional federal assistance, raise rents on higher-income tenants, and implement a number of management initiatives.

As shown in Table 7, federal actions are expected to generate about $43 million in 2006, $101 million in 2007, and about $74 million in subsequent years. In the short term, most of the resources would come from increased flexibility in the use of certain federal grants by applying for the federal Moving to Work demonstration program (MTW), which is designed to reduce reliance on public housing. Participation in this program would enable the NYCHA to combine its federal grants (Section 8, operating, and capital grants) and ease many of the regulations that define how the NYCHA can use federal funds, but participation could have programmatic implications. In addition, the NYCHA is seeking federal approval to offer new Section 8 vouchers to 8,400 tenants in State and City facilities who presently receive no subsidy for maintenance and operations from the federal, State, or City governments. The U.S. House of Representatives, however, is considering legislation that, if enacted into law, could adversely affect some of these proposals.

Table 7
NYCHA Gap-Closing Program
(in millions)

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

Sources: New York City Housing Authority; OSDC analysis

The NYCHA also intends to raise rents for tenants who spend less than 30 percent of their household income on rent. It proposes to phase in rent increases of 10 percent, 20 percent, and 40 percent over two years, depending on tenants' household income. This will raise the rent for approximately 27 percent of NYCHA residents.

In addition, the NYCHA has proposed a number of management initiatives, including development fees for NYCHA-owned land ($10 million annually in 2006, 2007, and 2008); higher user fees for parking and electrical appliances; staff reductions; energy efficiencies; and consolidation of management offices.

D. New York City Off-Track Betting Corporation

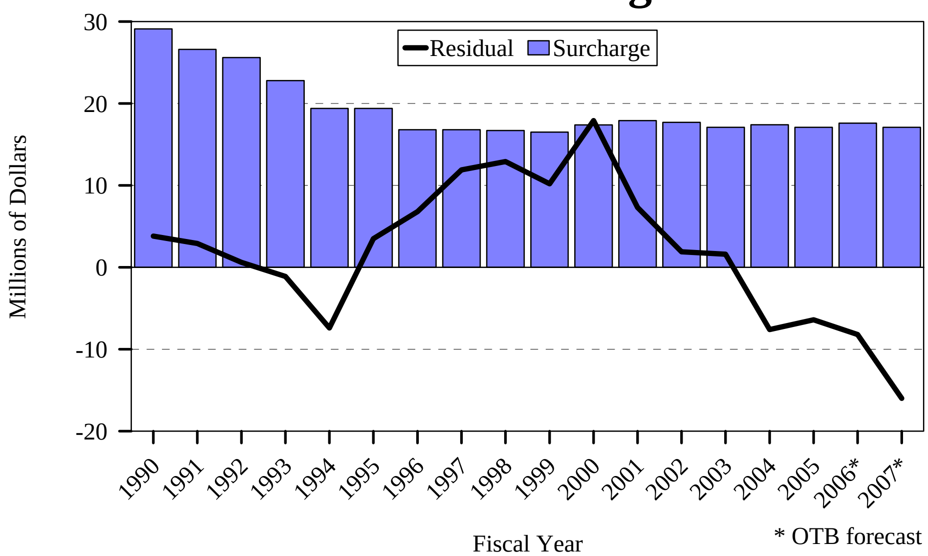
The New York City Off-Track Betting Corporation (OTB) is a public benefit corporation that provides legalized pari-mutuel wagering that generates revenue for the City, the State, and the horse racing and breeding industries. The OTB typically provides New York City with revenues from a 5 percent surcharge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

The OTB collected $1.07 billion in "handle" (total bets received) in FY 2006, which is the largest handle in its history and an increase of 4 percent over FY 2005. The handle growth may be attributable, at least in part, to the temporary closing of the Yonkers Raceway, which is expected to reopen by the end of calendar year 2006. As a result of the unanticipated handle growth, the OTB projects that its mandatory surcharge payments to the City will total $17.6 million in FY 2006 and $17.1 million in FY 2007.

While the OTB has taken steps to reduce costs and improve operating efficiency, its distributions to the City, State, and racing industry still exceed its net operating income. In FY 2006, the OTB will pay $8.2 million more in distributions than it will earn in net operating income (see Graph 11), and by FY 2010 this difference will rise to $22.6 million.[23]

Graph 11

Residual and Surcharge Revenues



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

In its February 2006 Financial Plan, the City suggested a number of actions that the State could take to improve the OTB's finances, such as changes to the system that distributes OTB revenue to governmental entities and the racing industry, so that the OTB would not be required to distribute more than its total net revenue after operating expenses. Although the State did not change the distribution system in the last legislative session, the State Legislature did authorize the OTB to allow its

23 The OTB had delayed making payments to the City during FY 2006 to preserve cash, but as of the end of the fiscal year the OTB was caught up with its statutorily mandated distributions.

customers to place bets via wired or wireless devices, such as the Internet. The bill has been forwarded to the Governor for his consideration.

In addition, the OTB is one of the 16 entities that have responded with an expression of interest to a request for proposals for the rights to operate the New York Racing Association (NYRA) racing franchise, which will expire on December 31, 2007. The bids for the NYRA's racing franchise (Aqueduct, Belmont, and Saratoga Springs racetracks) are due by August 29, 2006, and a committee appointed by the Governor and the Legislature will make its recommendation on the bids by September 29, 2006.

E. Retiree Health Benefits Trust Fund

In June 2004, the Governmental Accounting Standards Board issued Statement Number 45 (GASB45), which requires governmental entities to calculate and report their current and future obligations for post-employment benefits other than pensions in a manner that is similar to their accounting for pension obligations. These other post-employment benefits include health insurance, supplemental welfare benefits, and Medicare Part B, all of which the City currently funds on a pay-as-you-go basis. Of these benefits, health insurance for retirees accounts for the majority of these expenses. New York City is required to comply with GASB45 in its FY 2008 financial statements.

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

In FY 2006, the City created a retiree health benefits trust fund and contributed $1 billion to help pay down these unfunded accrued liabilities. The July Plan assumes that the City will contribute an additional $1 billion in FY 2007. The combined $2 billion contribution would be invested, and the principal and interest would be dedicated to retiree health benefits. In addition, the July Plan assumes that the City will annually contribute an amount equal to the projected cost on a pay-as-you-go basis, which is expected to grow from $1.3 billion in FY 2006 to $1.8 billion by FY 2010.

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

F. TSASC Inc.

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

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

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

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

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

G. Hudson Yards Infrastructure Development Corporation

On July 7, 2006, the Mayor and the Speaker of the City Council presented an offer to the Metropolitan Transit Authority (MTA) to purchase the development rights over the Western Rail Yard and a portion of the transferable development rights over the Eastern Rail Yards. According to the offer, the City would purchase the development rights over the Western Rail Yard for $300 million, which would be funded through the City's capital program. The Hudson Yards Infrastructure Corporation (HYIC), a local development corporation created by the City to spur economic development on the far West Side of Manhattan, would purchase three quarters of the transferable development rights over the Eastern Rail Yard for $200 million.[24] The proposed transaction is an integral part of the City's plan to transform the far West Side of Manhattan into a high-density, mixed-use community.

The City has asked the MTA to formally accept its offer at the MTA Board meeting on July 26, 2006. The Attorney General and others have expressed concerns about the lack of time to consider the City's offer, and have asked the MTA to engage in a competitive bidding process to ensure that it receives fair market value for the rights.

As part of the City's effort to encourage development on the far West Side, the HYIC would issue $3 billion in bonds to finance the extension of the No. 7 subway line and construct a network of streets and open spaces in the Hudson Yards Special District, and private developers would construct a mix of commercial and residential high-rise buildings within the district. HYIC bonds would be backed primarily by payments-in-lieu-of-taxes (PILOTs) assessed on new development within the Hudson Yards Special District, as well as by proceeds from the sale of the transferable development rights purchased from the MTA, which would in turn be sold by the HYIC to private developers.

[24] The MTA would retain approximately one quarter of the transferable development rights over the Eastern Rail Yard and all of the development rights over the property.

While the City and the MTA have taken steps that they believe will minimize the potential of cost overruns on the extension of the No. 7 line, there is currently no agreement as to who will fund such costs should they occur. In addition, in order for the HYIC to move forward with its planned bond issuance in September, the City and the MTA must come to an agreement over the disposition of the West Side properties; formalize the tax credits and PILOTs to be assessed within the Hudson Yards Special District; and release the details of its financing plan to the rating agencies and the general public.

The HYIC is expected to incur debt service costs beginning in 2007, but development is not projected to generate sufficient revenues to cover the interest costs until at least 2015. The City Council has expressed its support of a City undertaking to pay, subject to an annual appropriation, the interest on HYIC bonds to the extent that project revenues are insufficient to cover these costs. While the City estimates the interest costs at nearly $1 billion through 2015, there is no limit on the City's liability. Repayment of the principal would begin in 2018 or later, assuming the project generates sufficient revenues.

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

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

H. Lower Manhattan Redevelopment

Redevelopment plans for the World Trade Center (WTC) site have been significantly revised based on a recent agreement between the Port Authority of New York and New Jersey, Governor Pataki, Mayor Bloomberg, and Silverstein Properties, the leaseholder of the WTC site. Under the agreement, Silverstein will be responsible for financing three of the five buildings at the site, and the Port Authority will be responsible for financing the remaining two—the Freedom Tower and Tower 5. (Silverstein will construct all of the buildings on the site except for Tower 5.)

The agreement also moves the completion date of the project up to 2012 (three years earlier than originally planned). In addition, the agreement could reduce the total amount of commercial space to be built on the site from 10 million square feet to 8.8 million square feet, because the use of Tower 5 is undetermined and may be residential.

As part of the agreement, the Port Authority will receive about $750 million in Liberty Bonds. The balance of the Liberty Bonds ($2.6 billion) will be used to finance the remaining commercial buildings. In addition, the State pledged $250 million toward the construction of the Freedom Tower.

Under the agreement, which represents a conceptual framework, the Port Authority will also receive $970 million of the WTC insurance proceeds owed to Silverstein. Seven of the 23 insurance companies that hold policies on the WTC have refused to provide assurances that transferring insurance proceeds to the Port Authority does not alter their obligations. Silverstein and the Port Authority have filed a suit against these companies, which are responsible for approximately $1.5 billion in future payments, to ensure that they honor their obligations.

Plans for a memorial and museum have been revised to reduce costs from $1 billion to $500 million; to address security concerns; and to accommodate design modifications requested by families of the WTC victims. The Port Authority has assumed responsibility for building the memorial and museum, and will provide $100 million for infrastructure costs associated with the memorial. The WTC Memorial Foundation is responsible for securing the remainder of the funding.

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