Review of the Financial Plan of the City of New York

Alan G. Hevesi
New York State Comptroller

Kenneth B. Bleiwas
Deputy Comptroller

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- **New labor agreements with most of the municipal workforce remove the largest budget risk that was facing the City.**
- **The November Plan counts on a $300 million increase in State education aid to help fund the teachers' agreement.**
- **Inflation, interest rates, and energy costs have risen, and the federal budget and trade deficits continue to grow.**
- **Real estate transaction tax collections are expected to approach last year's record level, despite a reduction in refinancings.**
- **Medicaid, debt service, pension contributions, and health insurance are expected to consume about half of City fund revenues in FY 2007, compared with 37 percent in FY 2003.**
- **Debt service is projected to consume 14.8 percent of City fund revenues by FY 2009—the highest level in 15 years.**
- **Energy costs averaged $564 million during fiscal years 2003 and 2004; grew to $654 million in FY 2005; and will total $829 million in FY 2006.**
- **City and State contributions to education will continue to be the subject of debate until the Campaign for Fiscal Equity lawsuit is resolved.**
- **Two federal audits have questioned the validity of $531 million in Medicaid claims submitted by the Department of Education.**
- **The OTB's financial condition continues to deteriorate and it could run out of cash by April 2006 unless it aggressively manages its cash flow.**

The November 2005 Financial Plan projects a surplus of $1.7 billion for FY 2006 based on a revised revenue forecast that is $2 billion higher than assumed in the July 2005 Plan—the largest increase at this point in the budget cycle, and among the largest on an annual basis.

These additional resources allowed the City to offset unanticipated costs associated with recent labor agreements, and to reduce the FY 2007 budget gap from $4.5 billion to $2.3 billion. The labor agreements are notable for substantial increases in wages, as well as significant productivity improvements and other cost savings.

The City's less conservative tax revenue forecast for FY 2006 diminishes the potential for unexpected tax revenues during the balance of the fiscal year. Thus, other factors will come into play if the surplus is to approach last year's record of $3.5 billion.

For example, the November Plan does not reflect the changes in actuarial assumptions and methodologies that were recently approved by the boards of the City's pension funds, which would reduce pension contributions for fiscal years 2006 and 2007 by $1.4 billion. Although these changes will increase future costs, the short-term benefit, combined with other potential resources, could increase the FY 2006 surplus to $2.8 billion and reduce the FY 2007 budget gap to a manageable level of $647 million.

Despite the substantial improvement in the City's short-term fiscal outlook, the budget gaps for fiscal years 2008 and 2009 remain essentially unchanged from the July forecast, at about $4 billion. These gaps could grow depending on the outcome of the next round of collective bargaining. In addition, while the local economy continues to show modest growth, troubling trends are developing that could have an adverse impact in future years.

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

	FY 2006	FY 2007	FY 2008	FY 2009
		Better/(Worse)		
Gaps Per Nov 2005 Plan	**$ - - -**	**$ (2,250)**	**$ (4,120)**	**$ (3,466)**
Change in Pension Methodologies	860	580	- - -	(290)
Savings from Prior Years' Expenses	200	- - -	- - -	- - -
Delayed Hiring	50	- - -	- - -	- - -
Planned Debt Refunding	- - -	70	- - -	- - -
FY 2005 Pension Fund Investment Earnings	- - -	18	35	55
Anticipated State Education Aid	- - -	(100)	(100)	(100)
Uniformed Agency Overtime	(20)	(40)	(40)	(40)
Health Insurance Contributions	- - -	(15)	(15)	(15)
OSDC Risk Assessment	**$ 1,090**	**$ 513**	**$ (120)**	**$ (390)**
Surplus Transfer	(1,090)	1,090	- - -	- - -
Surplus/(Gaps) to be Closed*	**$ - - -**	**$ (647)**	**$ (4,240)**	**$ (3,856)**

* The November Plan includes a general reserve of $290 million in FY 2006 and $300 million annually thereafter. The November Plan assumes that future wage increases will average 1.25 percent during fiscal years 2007 through 2009. Wage increases at the projected inflation rate would increase costs by $100 million in FY 2007, $330 million in FY 2008, and $620 million in FY 2009.

Economic Overview

Since the City's budget was adopted in June 2005, inflation, energy prices, and interest rates have risen, and there are signs that the real estate market is cooling. Consumer confidence is now weaker, and consumers will have less disposable income as the effects of higher interest rates and energy costs begin to take their toll. While the national and local economies continue to grow at modest rates, these risks, combined with rising federal budget and trade deficits, are likely to adversely affect the New York City economy in the years ahead.

Hurricanes Katrina and Rita ravaged the nation's Gulf Coast, seriously disrupting the energy industry and leading to a surge in energy prices and inflation, and also placing a new demand on limited federal resources. Although gasoline price increases have eased, the impact of much higher home heating oil and natural gas prices has yet to be fully experienced.

In addition, 18 months of steady interest rate increases by the Federal Reserve are now affecting the economy. Higher mortgage rates have reduced real estate affordability, slowed the growth in prices, and increased the time needed to sell property. Higher interest rates are increasing the costs of credit, such as home equity loans.

Rising energy and interest costs are squeezing household finances and starting to depress consumer spending (which accounts for two thirds of economic activity), putting a drag on the economy. The November Plan projects a gradual slowing in national economic growth through 2007, and assumes this will filter down to slow the City's economy. For the nation, continued strong business spending should offset some of the slowdown in consumer spending in the near term. Post-hurricane rebuilding will also provide a national boost, but will not benefit New York City.

Inflation continues to rise faster than the City has projected it would. The November Plan assumes that local inflation will average 3.7 percent in calendar year 2005—substantially higher than the forecast in the July Plan—but actual inflation is rising more quickly. In the first ten months of 2005, local inflation averaged 3.9 percent—half a point higher than the national rate.

The City expects falling energy prices to reduce inflation to 2.6 percent by 2007. Although some Federal Reserve officials are concerned that raising rates too high to battle inflation could adversely affect economic growth, the Federal Reserve is expected to continue raising rates as its incoming Chairman will need to establish his inflation-fighting credentials.

Table 2
Financial Plan Reconciliation
July 2005 Plan vs. November 2005 Plan
(in millions)

	Better/(Worse)			
	FY 2006	**FY 2007**	**FY 2008**	**FY 2009**
Surplus/(Gaps) Per July 2005 Plan	**- - -**	**$ (4,507)**	**$ (4,470)**	**$ (3,925)**
Revenues				
Real Estate Transaction Taxes	$ 736	$ 65	$ - - -	$ - - -
Personal Income Tax	653	806	782	792
Business Taxes	375	300	304	379
All Other Taxes	201	264	241	286
Subtotal	**1,965**	**1,435**	**1,327**	**1,457**
Non-Tax Revenues	78	(15)	(16)	(18)
Total	**2,043**	**1,420**	**1,311**	**1,439**
Expenditures				
Collective Bargaining	(661)	(1,081)	(1,178)	(1,177)
Energy Costs	(101)	(102)	(88)	(83)
State Education Aid	35	300	337	337
Medicaid	450	- - -	- - -	- - -
Debt Service	33	35	27	8
Other Agency Expenses	(56)	(58)	(59)	(65)
Total	**(300)**	**(906)**	**(961)**	**(980)**
Net Change During FY 2006	**$ 1,743**	**$ 514**	**$ 350**	**$ 459**
Surplus Transfer	**(1,743)**	**1,743**		
Surplus/(Gaps) Per November 2005 Plan	**$ - - -**	**$ (2,250)**	**$ (4,120)**	**$ (3,466)**

Sources: NYC Office of Management and Budget; OSDC Analysis

The City lowered its forecast of Wall Street profits in calendar year 2005, from $14.4 billion to $12.6 billion, in response to the industry's lackluster performance in the first half of 2005—when profits totaled only $4.4 billion, or 36.1 percent below the level in the same period of 2004. The poor performance was primarily due to rapidly rising interest expenses. The Securities Industry Association projects a strong second half due to significant gains from equity underwriting and mergers and acquisitions. While the City's profit forecast for the year is somewhat lower than the $13.7 billion earned in 2004, we expect Wall Street bonuses to be higher than last year.

In the first ten months of 2005, total employment in the City rose by 36,000 jobs. The City projects a gain of 39,000 jobs in 2005, slowing to 30,000 jobs in 2007. Wall Street employment is projected to increase by 5,700 jobs in 2005, but then remain relatively stable through 2008. The rate of wage growth, which reached 7.9 percent in 2004, is expected to slow to about half that rate by 2007.

Overall, rising inflation, energy prices, and interest rates—and their impacts on consumer spending—have increased the downside risk to the City's economic forecast. The perceptible change in the real estate market carries its own risks, because rising home values have fueled borrowing that helped support consumer spending. The resulting high debt level is now more difficult to support. Mounting pressure on the federal budget deficit could also hamper future economic growth.

Fiscal Year 2006

The November Plan projects a surplus of $1.7 billion for FY 2006 based largely on a $2 billion increase in revenues—an unprecedented increase at this point in the budget cycle. The dramatic rise in anticipated revenues allowed the City to reduce the budget gap projected for FY 2007 from $4.5 billion to $2.3 billion, and to offset higher-than-planned costs associated with recent collective bargaining agreements.

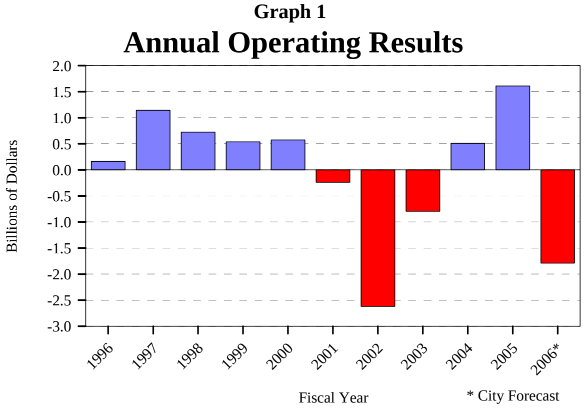
Real estate transaction taxes are expected to exceed the estimates in the July Plan by $736 million. This revision reflects strength in current collections and an expectation that the real estate market will remain strong. The City also assumes that year-to-date trends in the personal income and business taxes will continue through the rest of the year, yielding higher collections of $653 million and $375 million, respectively.

Collective bargaining costs are projected to exceed the amounts set aside in the July Plan by $661 million in FY 2006 and by about $1.1 billion in subsequent years. To help fund the new labor agreement with the City's teachers, the November Plan assumes a $300 million increase in State education aid beginning in FY 2007. Energy costs are also projected to be higher as a result of interruptions caused by recent Gulf Coast hurricanes and increased international demand for oil. A one-time $450 million reduction in Medicaid costs in FY 2006 is associated with the implementation of a State cap on growth in the local share of Medicaid costs.

Revenue and Expenditure Trends

The November Plan assumes that the FY 2006 surplus will be transferred into FY 2007 to help narrow that year's budget gap. The transfer of resources between years, however, masks the structural imbalance 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.

Graph 1



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

Every fiscal year from 1996 through 2000 ended with a current-year operating surplus. Although in that period City-funded expenditures (adjusted for surplus transfers) grew by 22 percent—far faster than the local inflation rate—revenues fueled by the Wall Street boom grew even faster. This pattern changed, however, beginning in FY 2001. Expenditures continued their rapid growth, increasing by 9.8 percent, but revenues grew more slowly, by only 6.5 percent. Consequently, expenditures exceeded revenues by more than $200 million in FY 2001—a clear sign of fiscal stress (see Graph 1). This stress was masked by the City's practice of transferring the prior year's surplus to the following year.

The FY 2002 budget did not address the imbalance, and instead called for spending to rise by 5.7 percent. The budgetary impacts of the economic slowdown and the terrorist attack on the World Trade Center, however, resulted in a decline in revenues—the first since FY 1995 and the largest in more than 20 years. The City balanced the FY 2002 budget, but only after taking into account surplus transfers from prior years and bond proceeds from the Transitional Finance Authority (TFA). In the absence of these resources, the City would have incurred a deficit of $2.6 billion from its current-year operations.

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

The City ended FY 2004 with a current-year operating surplus of $511 million—the first such surplus since FY 2000. The surplus reflected a combination of City, State, and federal actions taken to help the City get through its fiscal crisis; and also a sharp rebound on Wall Street. Budget balance in FY 2004 was also aided by the use of $2.2 billion in nonrecurring resources.

During FY 2005, the City generated a record $1.6 billion current-year operating surplus. Although spending grew at the relatively fast rate of 10.3 percent, revenues grew at an even faster rate of 13.5 percent. Still, the City could have incurred an operating deficit in FY 2005 if not for $1 billion in budget relief from the State-approved Municipal Assistance Corporation refinancing initiative, and $744 million in retroactive airport lease payments from the Port Authority of New York and New Jersey.

Even though the November Plan projects a budget surplus of $1.7 billion for FY 2006, the City is on track to end the fiscal year with a current-year operating deficit of $1.8 billion—which has been masked by the transfer of $3.5 billion in surplus resources from prior years. The operating deficit largely reflects the expiration of temporary taxes that helped the City through its latest fiscal crisis, and continued rapid growth in nondiscretionary spending. Unless the FY 2006 surplus reaches $3.5 billion, the City will have spent more than it earned in the current fiscal year—revealing an underlying structural imbalance between recurring revenues and expenditures.

Revenue Trends

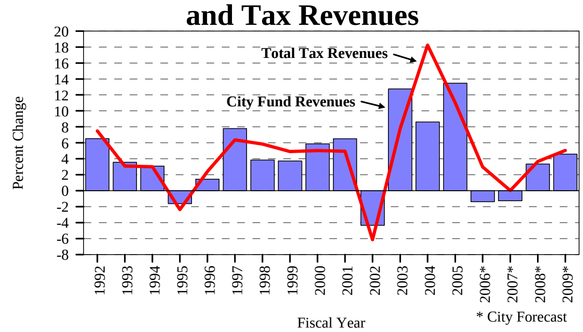
In FY 2005, City fund revenues[1] grew by 13.5 percent—the fastest rate of growth since the budget was first balanced in accordance with Generally Accepted Accounting Principles in FY 1981. The July Plan assumed that City fund revenues would decline by 6.7 percent in FY 2006, but the November Plan raised City revenue forecasts by $2 billion—an unprecedented amount for this point in the budget cycle. Virtually all of this increase is from tax revenues. The increase is the largest first quarter tax revenue adjustment on record, and on an annual basis is only exceeded by the entire tax revenue adjustment in fiscal years 2000, 2004, and 2005. The adjustment represents 6.5 percent of the annual estimate of tax collections made in July, and is more than twice the size of the next-largest first quarter increase.

The revised forecast trimmed the projected decline to 1.4 percent (see Graph 2). The City still anticipates a large reduction in nonrecurring resources, but tax revenues are now projected to grow by 3 percent in FY 2006. The low rate of expected tax revenue growth compared to prior years reflects a projected slowing in the economy and the expiration of temporary tax increases.

In the past two years, the City has recorded large budget surpluses that were fueled by unanticipated tax revenues. These revenues grew by 31.2 percent during fiscal years 2004 and 2005—the largest two-year growth since the fiscal crisis of the 1970s. The City, however, raised its tax revenue forecasts incrementally over the course of these fiscal years rather than all at once. While the City may ultimately realize the projected increase of $2 billion in tax revenues in FY 2006, only about one third of the revenues are currently in hand. Moreover, the revenue increase was not accompanied by an upward revision to the City's economic outlook. Thus, this less conservative approach reduces the likelihood that unanticipated revenues will contribute further to the FY 2006 surplus.

Graph 2

Annual Change in City Fund Revenues and Tax Revenues



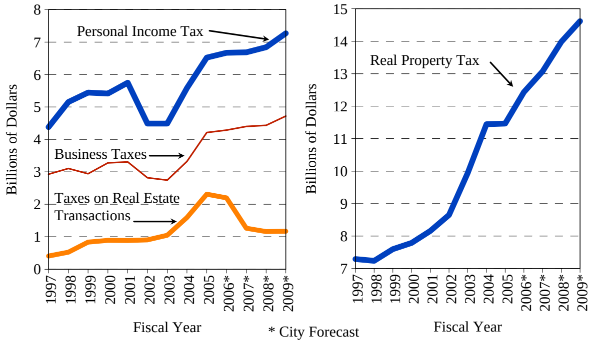
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

Major revenue trends include the following.

- Real estate transaction tax revenues—the mortgage-recording and real property transfer taxes—were forecast in the July Plan to decline by 37.5 percent, in anticipation of a real estate market slowdown in response to rising interest rates. While actual collections through the first four months of the fiscal year exceeded the City's expectations by about $250 million, mortgage rates have now begun to rise and recent data indicate that mortgage applications have begun to slow, especially applications for mortgage refinancings. Nevertheless, the November Plan increased the forecasts for these taxes by $736 million, and assumes that collections will approach last year's record level (see Graph 3). The November Plan anticipates that the decline in collections will occur next year—a reduction of 42.6 percent from the level forecast for FY 2006. Our analysis, however, indicates the decline is likely to be less than forecast by the City.

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

Graph 3
Trends in City Tax Revenues



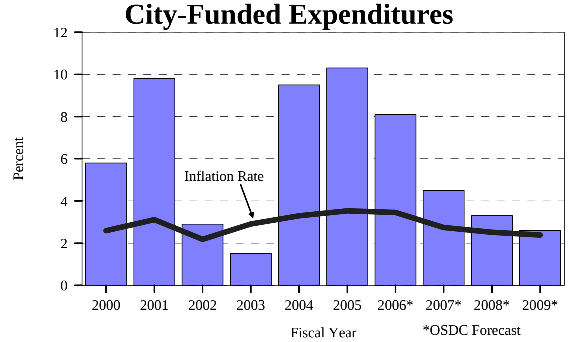
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

- Personal income tax collections are projected to rise by 2.3 percent in FY 2006, which reflects strong quarterly estimated payments covering self-employment and unearned income, combined with weak withholding after the temporary personal income tax surcharge expires at the end of the calendar year. In contrast, personal income tax collections grew by 45.3 percent during fiscal years 2004 and 2005. The falloff reflects modest job growth, lower expectations of wage growth and capital gains, the absence of a surge in Wall Street profits, and the expiration of the temporary high-income personal income tax surcharge.
- Business taxes—the general corporation, banking corporation, and unincorporated business taxes—are projected to increase by 1.8 percent in FY 2006, which is a significant increase over the level that was forecast in the July Plan. Even though business taxes grew at an annual rate of 23.8 percent during fiscal years 2004 and 2005, the slowing in the City's forecast for FY 2006 reflects the projected softening in the economy. Collections are expected to rise only modestly over the remainder of the Financial Plan period.
- Sales tax collections are projected to increase by 4.8 percent—excluding the restoration of the sales tax exemption on clothing purchases under $110—based on tourism and wage growth. Adjusted collections are expected to increase by 3.7 percent annually during fiscal years 2007 and 2008.
- Real property tax collections will grow by about $1 billion in FY 2006 and by another $2.2 billion during fiscal years 2007 through 2009 (see Graph 3). Despite signs that the real estate market may have peaked, tax collections will remain strong because State law phases in changes in assessed values over a five-year period, which has created a pipeline of future increases that have not yet been phased in.

Expenditure Trends

City-funded spending grew, on average, at less than the local inflation rate during fiscal years 2002 and 2003, and then at an annual average rate of nearly 10 percent during fiscal years 2004 and 2005 (see Graph 4). The November Plan assumes that spending will grow by 8.1 percent in FY 2006—more than twice the projected local inflation rate.

Graph 4
Annual Change in City-Funded Expenditures



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

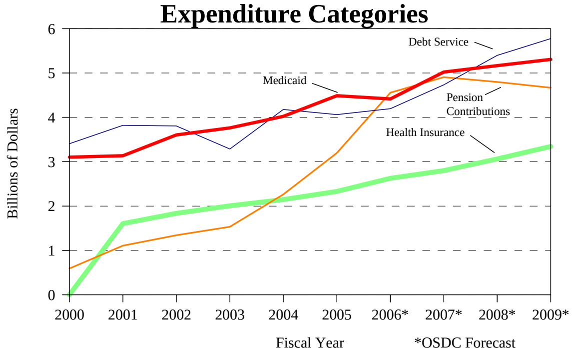
About half of the growth in FY 2006 spending is due to a 42.6 percent increase in pension contributions. The November Plan, however, does not reflect changes in assumptions and methods recently approved by the boards of trustees of the City's pension funds that would reduce pension contributions by $860 million in FY 2006 and $580 million in FY 2007.

Expenditure growth after FY 2006 is projected to ease, primarily because the growth in pension contributions and Medicaid is expected to moderate. Debt service, however, is projected to grow more rapidly in fiscal years 2007 through 2009 as the impacts of past and planned borrowings accumulate.

As shown in Graph 5, the growth in City-funded expenditures has been fueled by increases in so-called nondiscretionary spending. For example, City-funded spending for Medicaid, debt service, pension contributions, and health insurance grew at an average annual rate of 15.2 percent during fiscal years 2004 and 2005, and is projected to increase by another 12.2 percent in FY 2006. These costs are expected to consume about half of City fund revenues in FY 2007, compared with 37.1 percent in FY 2003.

Graph 5

Trends in Selected City-Funded Expenditure Categories



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

Major expenditure trends include the following.

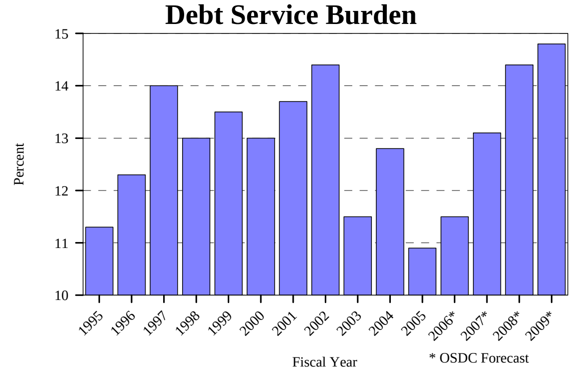
- Pension contributions are projected to rise to $4.6 billion in FY 2006—an increase of $1.4 billion—and then grow to $4.9 billion in FY 2007 before declining slightly in fiscal years 2008 and 2009.[2] These estimates, however, do not reflect changes in actuarial assumptions and methodologies recently approved by the boards of the City's pension funds. When implemented, these changes would reduce planned contributions by a net of $860 million in FY 2006 and $580 million in FY 2007, but would increase future contributions by $290 million in FY 2009 and a similar amount in FY 2010.

  The changes include a one-year lag in calculating contributions, which was recently adopted by the State; an increase from five to six years in the phase-in period for investment gains and losses; funding of the full cost of cost-of-living-adjustments for retirees; and demographic and other changes recommended by the City's independent actuarial consultant. Some of these changes require State approval, which is expected.

- Salary and wage costs are projected to grow at an average annual rate of 4 percent during fiscal years 2006 and 2007, and then at an average annual rate of 2.2 percent during fiscal years 2008 and 2009. These projections reflect the cost of recent labor agreements, as well as the City's assumption that agreements with firefighters and sanitation workers will set the pattern for those unions whose contracts have expired. The City also expects that future labor agreements will increase wages at an annual rate of 1.25 percent.

Graph 6

Debt Service Burden



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

- Debt service is projected to reach $4.2 billion during FY 2006, which is an increase of $135 million or 3.3 percent from the previous fiscal year. Debt service costs, however, are projected to increase by nearly $1.6 billion to reach almost $5.8 billion by FY 2009—an average annual growth rate of 11.2 percent. The debt service burden[3] is projected to rise from 11.5 percent in FY 2006 to 14.8 percent in FY 2009, the highest level in the past 15 years (see Graph 6). These estimations do not reflect a planned refunding, which would lower costs by $70 million in FY 2007.

- Medicaid costs totaled $4.5 billion in FY 2005 and are projected to grow to $5.3 billion by FY 2009—a 4.3 percent average annual rate of growth. These estimates reflect State actions taken over the past two years in order to reign in the growth in the local share of Medicaid; the actions are expected to produce savings of

[2] The pension funds earned 10.1 percent on their investments during FY 2005, compared with the actuarial assumption of 8 percent. Hence, future contributions could be less than assumed in the November Plan by $18 million in FY 2007, $35 million in FY 2008, and $55 million in FY 2009.

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

$730 million in FY 2006, rising to $1 billion by FY 2009.

- Health insurance costs for municipal employees are projected to increase by 12.7 percent (or $295 million) to reach $2.6 billion in FY 2006, and then grow at an average annual rate of 8.4 percent to reach $3.3 billion in FY 2009. These trends reflect the rapid rise in health insurance premiums. Moreover, the Health Insurance Plan of New York is proposing a slightly larger rate increase (8.6 percent) for FY 2007 than was assumed in the November Plan; this could increase planned costs by about $15 million annually beginning in that year.

- Energy costs (including electricity, natural gas, steam, heating fuels, and gasoline) averaged $564 million during fiscal years 2003 and 2004, and jumped to $654 million in FY 2005. These costs are projected to rise to $829 million in FY 2006.

  Electricity accounts for more than half of these costs, and it is provided to the City under a long-term contract (adjusted each year to reflect the cost of production) with the New York Power Authority. The rapid rise in energy costs reflects the impact of hurricanes Katrina and Rita, and increased international demand for oil. In total, the City funds about 78 percent of its energy costs. The balance is paid by State and federal governments.

- The City projects expenditures for judgments and claims to total $601 million in FY 2006, $647 million in FY 2007, $690 million in FY 2008, and $743 million in FY 2009—an average annual increase of 7.3 percent.

- Since FY 2003, the City-funded workforce has been steadily rising, and it is projected to reach nearly 256,400 employees by June 2006 (see Graph 7). During fiscal years 2004 and 2005 the City added more than 5,800 employees, including 2,300 contract workers transferred to the City's payroll.

  In FY 2006, the City plans to add an additional 2,275 employees, mostly in health and social services agencies. The City was 3,255 employees short of its October target (excluding the Department of Education). We estimate that delayed hiring during FY 2006 could yield savings of $50 million in FY 2006.

Graph 7
City-Funded Workforce
(Full-Time and Full-Time-Equivalent Employees)

Sources: NYC Office of Management and Budget; OSDC Analysis

Other Issues

The following issues could significantly affect the City during the Financial Plan period.

Collective Bargaining

After protracted delays and sometimes contentious negotiations, the City has reached new labor agreements with most of the municipal workforce (outlined below). While the agreements provide for substantial wage increases, the City obtained significant productivity improvements and other savings that will help fund the increased costs.

- In April 2004, nearly two years after the expiration of its labor agreement, District Council 37 (which represents most civilian employees) reached a new agreement with the City that called for a $1,000 lump sum payment and a 6.1 percent wage increase over a 36-month period. The agreement was to be funded, in part, with productivity and other cost savings, including a reduction in starting salaries and agency staffing reductions.

- In June 2005, an arbitration panel awarded the Patrolmen's Benevolent Association (PBA) a two-year retroactive wage increase of 10.25 percent that covered fiscal years 2003 and 2004. The panel also awarded productivity and other cost savings, such as a 38 percent reduction in starting salaries and a longer salary progression schedule.

- In September 2005, the Correction Officers' Benevolent Association negotiated a 27-month agreement that followed the wage and productivity pattern set by the PBA award.

- In October 2005, shortly after the release of recommendations by a nonbinding fact-finding panel, the City and the United Federation of Teachers reached an agreement that calls for a 15 percent wage increase over a 52-month period. The agreement includes productivity gains, such as extending the workday by 50 minutes and the work year by three days, and granting administrators more control over the assignment of teachers.

- In October 2005, the Uniformed Sanitationmen's Association reached an agreement that calls for a 17 percent wage increase over a 51-month period and productivity improvements. These include one-person collection vehicles on certain routes, increases in refuse and recycling targets, and a reduction in starting salaries. The sanitation agreement is patterned after the PBA award in the first two years, but adds two more years with wage increases of 3 percent in FY 2005 and 3.15 percent in FY 2006.

- In October 2005, the Uniformed Firefighters Association negotiated a tentative 50-month agreement that follows the wage and productivity pattern set by the sanitation workers' agreement.

- A tentative agreement with the Detectives' Endowment Association, which followed the pattern of the sanitation workers' agreement, was rejected by the rank and file in early December 2005.

The November Plan funds wage increases for all employees through FY 2006 at terms similar to those reached with the City's sanitation workers. While the outcome of negotiations may result in somewhat higher or lower costs, the impact on the Financial Plan will likely be minimal. The November Plan assumes that future wage increases will average 1.25 percent during fiscal years 2007 through 2009. Wage increases at the projected inflation rate would increase costs by $100 million in FY 2007, $330 million in FY 2008, and $620 million in FY 2009.

Uniformed Agency Overtime

Overtime costs in the uniformed agencies are projected to decline from $745 million in FY 2005 to $609 million in FY 2006, but actual spending exceeded planned levels during the first four months of the fiscal year. Consequently, overtime costs could exceed planned levels by $115 million, but accruals, federal funding, and other factors could reduce the funding shortfall to $20 million in FY 2006 and $40 million annually thereafter.

- The Police Department exceeded its overtime budget by $40 million during the first four months of the fiscal year, mostly as a result of counterterrorism efforts. Although the November Plan increased the department's overtime budget by $78 million to reach $339 million in FY 2006, overtime could exceed $400 million given recent overtime spending patterns. Unfunded costs could be offset, however, by reserves, federal grants, and other sources.

- The Fire Department exceeded its overtime budget during the first four months of the fiscal year by $23 million. More than half of this amount is expected to be reimbursed by FEMA, which the City anticipates will pay for the cost of firefighter participation in hurricane relief efforts. Although the November Plan increased the department's overtime budget by $36 million, current-year trends indicate the department could exceed its annual overtime budget by $10 million in FY 2006.

- The Department of Correction exceeded its overtime budget by almost $7 million during the first four months of the fiscal year because of staffing shortfalls. Though the November Plan increased the overtime budget by $10 million, we expect overtime will exceed budgeted levels by $10 million in FY 2006.

Medicaid

Congress is debating legislation to cut Medicaid expenditures by a minimum of $15 billion over the next ten years. Because states damaged by the 2005 hurricanes will continue to require extraordinary federal assistance, Congress may allocate a larger-than-usual share of the cuts to populous states like New York and California. How these changes could affect New York State and New York City remains to be seen.

In June and September 2005, the federal government released audits of the Department of Education's Medicaid claims for transportation and speech therapy services. Auditors found lax record-keeping that resulted in $531 million in questionable federal reimbursements; this could lead to a disallowance. State officials disagree with the audit findings and hope to negotiate a much smaller settlement. Under State law, the department could be held responsible for half of any federal Medicaid disallowance. City officials believe the department should not be penalized because it complied with State regulations. Findings from a third federal audit are pending.

New York State Health Care Reform

The 2005-06 State budget authorized the creation of the Commission on Health Care Facilities in the 21st Century to examine the State health care system and to develop a selection method for hospitals and nursing homes that will be closed, resized, consolidated, or converted. The commission is also reviewing formulas used by public and private insurance programs to reimburse hospitals, and is looking for areas in which the State's health care technology and capital plan can be improved. The commission has held three meetings around the State and has planned four additional meetings in 2006. Recommendations are scheduled to be presented to the Governor by December 2006.

In November 2005, the commission agreed to a method for ranking hospitals and nursing homes for potential closure or restructuring. The framework considers the populations served; availability of services; quality of care; utilization; financial status; and economic impact. Hospitals and nursing homes would be ranked with a score ranging from -6 to +6.

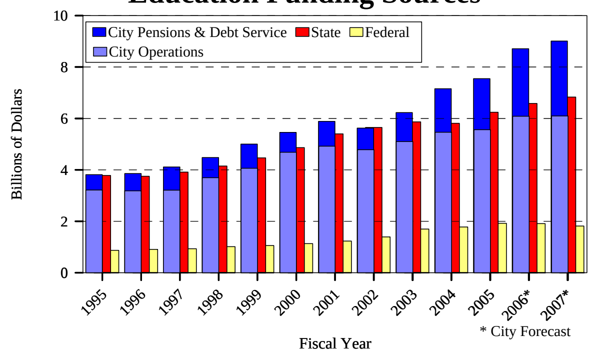
Funding for Education

The November Plan allocates $14.6 billion to the Department of Education for operations in FY 2006, an increase of $749 million over the FY 2005 level. Of that amount, the City would fund 42 percent; the State would fund 45 percent; and the federal government, private grants, and miscellaneous fees would fund the remainder. After taking into account mandatory funding for pension contributions and debt service ($2.6 billion), which are funded elsewhere in the City's budget, the City's contribution rises to 51 percent and the State's contribution falls to 38 percent (see Graph 8).

State and City education contributions will continue to be the subject of debate as the State attempts to resolve a lawsuit over the adequacy and fairness of its system of education finance, *Campaign for Fiscal Equity v. State of New York*. In October 2005, the Governor appealed a court order that the State provide City schools with $5.6 billion in operating aid over four years and $9.2 billion in capital budget funding over five years. The Appellate Division has not yet issued a decision. If the decision is not in favor of the plaintiffs, the Campaign for Fiscal Equity is expected to appeal to the Court of Appeals, the State's highest court.

Graph 8

Education Funding Sources



Note: Analysis includes debt service and pensions.
Sources: NYC Office of Management and Budget; OSDC Analysis

The Governor, the Assembly Speaker, and the Senate Majority Leader have suggested that the City should be required to fund part of any settlement. If the City were required to contribute the share of additional assistance recommended by the Governor (40 percent), it would need to increase contributions by as much as $550 million in FY 2007, $1 billion in FY 2008, $1.6 billion in FY 2009, and $2.3 billion in FY 2010.

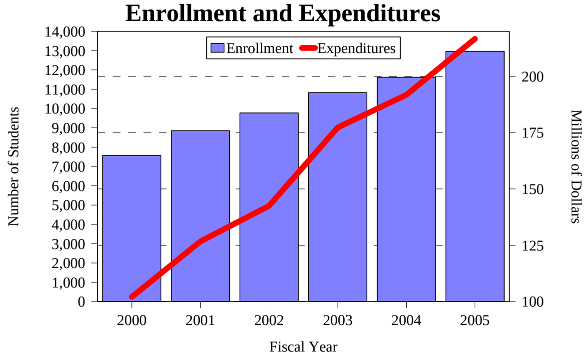
In October 2005, the City and the United Federation of Teachers reached a new labor agreement that exceeded the amounts set aside in the July Plan. The November Plan assumes that, to help fund the contract, the State will increase education aid to the City by $300 million in FY 2007. While the City has received a similar amount of aid in each of the past two years, the actual increase remains uncertain until the State budget process is concluded.

Special Education

The Department of Education pays for privately provided special education services in limited circumstances, such as when the department cannot offer appropriate services or when it fails to adhere to due process in evaluating and placing students with disabilities in appropriate educational settings.

Since FY 2000, expenditures for school-age private special education (ages 4 through 21) have grown far faster than all other areas of the education budget. In FY 2000, the department spent $102 million providing services to over 7,000 students. By FY 2005, these costs more than doubled, to $217 million, and enrollment increased to over 12,000 students (see Graph 9).

Graph 9
Nonpublic School-Age Special Education Enrollment and Expenditures



Sources: NYC Department of Education; NYC Office of Management and Budget; OSDC Analysis

In January 2005, the U.S. District Court in the Southern District of New York ruled that under federal law the parent of a student with special needs was ineligible for private school tuition reimbursement because the child had never been enrolled in the City's special education program. The court found that federal education law precludes tuition reimbursement when a student was not previously enrolled in a public program.

The U.S. Supreme Court ruled in November 2005 that parents who seek reimbursement for privately provided special education services first have the burden of proving to an administrative law judge that placement offered by a school district is inadequate. This case appears to require other states to invoke what is already the present practice in New York City, and is unlikely to affect City enrollment and expenditure trends.

Off-Track Betting Corporation

The Off-Track Betting Corporation (OTB) provides legalized pari-mutuel wagering that generates a stream of revenue for the City, the State, and the horse racing and breeding industries. The OTB passes along to New York City the revenues from a mandated 5 percent surcharge on winning wagers, as well as residual revenues.[4] Surcharge revenues distributed to the City declined from $29.1 million in FY 1990 to $17.1 million in FY 2005, and are forecast to average $17.7 million through FY 2009.

More than half of the OTB's wagering commission revenues were distributed to the racing industry, the State, the City, and other local governments during fiscal years 2004 and 2005. The remaining revenues, however, were insufficient to cover expenses. Thus, the OTB experienced negative residual revenues of $9.5 million in FY 2004 and $6.4 million in FY 2005—a condition last encountered a decade ago. The OTB now projects negative residual revenues of $14.5 million in FY 2006, and negative residuals are projected to widen to $21.9 million by FY 2009.

According to its own audited financial statements, the OTB's "current liabilities exceed its current assets, it has a net asset deficit, and the statutory distribution requirements of New York State laws raise substantial doubt about its ability to continue as a going concern." Unless the OTB aggressively manages its cash flow, it could run out of cash by April 2006.

The financial deterioration of the OTB is the result of several factors—a saturated horse wagering market, increased competition for entertainment dollars, rising statutory distributions, and higher operating costs. OTB management has closed branches, reduced service hours, and taken other actions to help reduce costs. In addition, the City has deferred receipt of surcharge payments as a way to keep the OTB afloat. While these actions will provide some short-term relief, they do not solve the underlying problems.

Health and Hospitals Corporation

In July 2005, the Health and Hospitals Corporation (HHC) projected a balanced budget for FY 2006, after taking management initiatives into account.

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

As of October 2005, however, HHC's FY 2006 expenses exceeded planned amounts by $149 million. If not corrected, additional financial support from the City could be required.

Judgments and Claims

The City faces litigation on a number of fronts, particularly in connection to the attack on the World Trade Center (WTC) and the Staten Island ferry accident of October 15, 2003. The City continues to seek limitation of its liability in the ferry case to $14.4 million under an 1851 federal maritime law. To date, 99 cases totaling $3.4 million have been settled. The City and its contractors also face about $500 million in claims regarding debris removal work after the collapse of the WTC. It is expected that any liability will be covered by the WTC Captive Insurance Company, Inc., which was created with a $1 billion grant provided by the federal government.

The City also faces a $314 million property damage claim by Con Edison and its insurers regarding the loss of an electrical substation when 7 WTC collapsed. The City filed a motion to dismiss this claim, asserting that it was not responsible for the collapse. A decision on this motion is expected shortly. Although the Port Authority was recently found negligent for failing to safeguard the WTC before the buildings were bombed in 1993, the City does not believe this verdict will impact its motion to dismiss.

Lower Manhattan Redevelopment

The Lower Manhattan Development Corporation (LMDC) oversees the redevelopment of the WTC site. Redevelopment plans have experienced significant delays, and recent events could further affect the timing and outcome of the entire project.

Completion of the Freedom Tower, originally scheduled for 2008, has been delayed until at least 2010. In addition, the cultural center must be redesigned in response to the Governor's elimination of the International Freedom Center from the site, and to date no new tenants have been selected for the building. Also, the Fulton Street Transit Center, which is being constructed by the Metropolitan Transportation Authority and will replace the existing Fulton Street subway station, remains behind schedule and $35 million over budget, despite plan revisions intended to curb costs. Furthermore, the Mayor has called for the LMDC to revise the redevelopment plans to provide for greater residential development and less commercial development.

Hudson Yards Infrastructure Corporation

The Hudson Yards Infrastructure Corporation (HYIC) plans to issue $3 billion in bonds to finance the extension of the No. 7 subway line and other infrastructure to spur economic development on the far West Side of Manhattan. The HYIC is expected to incur debt service costs beginning in 2006, but development is not projected to generate sufficient revenues to cover the interest costs until at least 2015. The City will 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.

The City also plans to use the Transitional Finance Authority (TFA) as a credit enhancement for a portion of the HYIC bonds. In the event that project revenues are insufficient to meet debt service obligations, the TFA would purchase up to $750 million in HYIC bonds. Such a move could adversely affect the City's budget and credit rating. As discussed in previous reports, the State Comptroller does not believe the TFA is authorized under State law to purchase HYIC bonds; the City, however, contends that such purchases would be allowable.

Major contributors to this report include:

Michael Brisson	Leonard Liberto
James Chen	Jane Moore
Mark Chernoff	Cheryl Pahaham
Diane Diamond	Thomas Sommer
Adam Freed	Sandy Stevenson
Robert Horowitz	Tania Tinley-Porter
Bob Kepple	Jacinto Torres
John Lee	Christopher Wieda