Review of the Financial Plan of the City of New York

Thomas P. DiNapoli
New York State Comptroller

Kenneth B. Bleiwas
Deputy Comptroller

Report 7-2008 **December 2007**

- **New York City's budget gap for FY 2011 represents 14.9 percent of City fund revenues, the largest gap to be forecasted at this point in the financial planning process since November 2002.**
- **The City projects Wall Street profits will decline from $20.9 billion in 2006 to $14.8 billion in 2007 and then to $12.7 billion in 2008—a drop of almost 40 percent over the two-year period.**
- **The rate of growth in the number of residential real estate transactions in Manhattan slowed during 2007, and declined sharply in the other boroughs, especially in the second and third quarters.**
- **In FY 2008, the City expects revenues from taxes on real estate transactions to decline by 27.8 percent—a reduction of more than $900 million that will return collections to approximately the level received in FY 2005.**
- **Collections from personal income, business, and real estate property transaction taxes are expected to decline by $1.1 billion, or 7 percent, in FY 2009.**
- **Labor and fringe benefit costs are projected to rise by 36 percent over the four-year period ending in FY 2011.**
- **Debt service is projected to reach $6.1 billion in FY 2011, an increase of 26 percent during the course of the financial plan period, or nearly four times the inflation rate.**
- **Nondiscretionary spending (i.e., pension contributions, debt service, Medicaid, and employee health insurance costs) will consume 49 percent of City revenues in FY 2011, up from 37 percent in FY 2003.**
- **The Off-Track Betting Corporation, the New York City Housing Authority, and the Health and Hospitals Corporation continue to face significant long-term fiscal challenges.**

Over the past three years, unanticipated revenues from extraordinary growth on Wall Street and strength in the real estate market helped New York City generate successively larger record budget surpluses. These surpluses were used to close projected budget gaps, reduce taxes, build reserves, and assist City-related public authorities. The City's October 2007 modification to its four-year financial plan, however, shows that the City's fiscal outlook has changed course.

The "October Plan" shows that the City drew down $296 million in reserves to maintain balance in the current year; that the FY 2009 budget gap has grown by $1.2 billion, to $2.7 billion; and that the FY 2010 gap has widened by $1.4 billion, to $4.8 billion. The FY 2011 budget gap, which has grown by $2.1 billion, now totals $6.5 billion—nearly the same size as the out-year gaps at the height of the fiscal crisis that was precipitated by the last recession and the attack on the World Trade Center. The growth in the budget gaps reflects revised economic assumptions and higher collective bargaining costs.

The October Plan is predicated on the assumption that the local and national economies will slow, but avert recession, and that the City's residential real estate market will weaken but not collapse. Tax collections are projected to decline by $2 billion in FY 2008, but most of the decline ($1.3 billion) is due to tax cuts approved before the problems in the credit markets were apparent. Tax collections are projected to remain flat in FY 2009 before slow growth resumes in FY 2010.

Our review has identified risks that could widen the projected budget gaps to over $7 billion by FY 2011 (see Figure 1). Although tax collections are likely to exceed the City's estimates in the current fiscal year based on the strength of year-to-date collections, they could be slightly weaker than anticipated in subsequent years. In addition, the October Plan assumes that the State will restore revenue sharing payments to the City.

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

		Better/(Worse)		
	FY 2008	**FY 2009**	**FY 2010**	**FY 2011**
Gaps Per October Plan	**$ - - -**	**$ (2,730)**	**$ (4,821)**	**$ (6,459)**
State AIM Payments (Revenue Sharing)	(327)	(327)	(327)	(327)
Uniformed Agency Overtime	(90)	(120)	(120)	(120)
Public Assistance Shelter Allowance	(5)	(13)	(17)	(18)
Tax Revenue	200	(150)	(200)	(200)
Federal Work Participation Rate	- - -	- - -	(100)	(100)
MTA Subsidy	- - -	- - -	- - -	(300)
PlaNYC 2030 Financing Authority	50	220	260	275
Other Tax Cuts Not Yet Approved	18	19	23	26
OSDC Risk Assessment[1]	**$ (154)**	**$ (371)**	**$ (481)**	**$ (764)**
Gaps to be Closed	**$ (154)**	**$ (3,101)**	**$ (5,302)**	**$ (7,223)**

[1] The October Plan assumes that the City sales tax rate, which is scheduled to decline from 4 percent to 3 percent on July 1, 2008 upon the termination of the Municipal Assistance Corporation, will be reauthorized by the State at the current level, preventing the loss of $1.2 billion annually. The October Plan also includes a general reserve of $300 million annually.

mortgage companies, banks, and securities firms reported a sharp drop-off in profitability in the third quarter—some even reported large losses—as tens of billions of dollars of mortgage-backed securities were written off. Early indications suggest that the fourth quarter will also be difficult.

The October Plan assumes that Wall Street profits will decline from $20.9 billion in 2006 to $14.8 billion in 2007 and then to $12.7 billion in 2008 (see Figure 2)—a decline of almost 40 percent over two years.

The difficulties in the credit markets are expected to exact a heavy toll on Wall Street profits and other financial institutions that operate in the City, such as banks and insurance companies. The October Plan assumes, for example, that Wall Street profits will decline to $12.7 billion by calendar year 2008, nearly 40 percent less than the 2006 level. The impact on the local economy and City tax revenues will depend largely on the depth and the duration of the credit crunch.

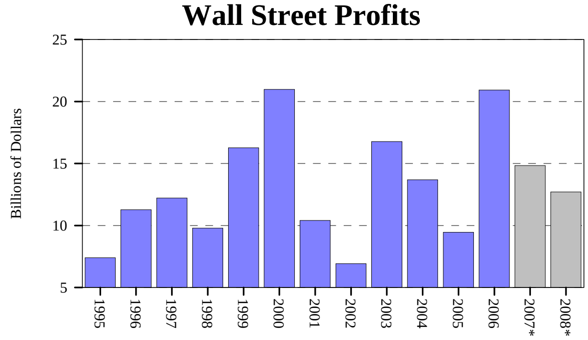
Although the impact of the impending economic slowdown may not become evident in tax collections until later in the fiscal year, the Mayor has prudently instructed City agencies to prepare cost-reduction initiatives now for inclusion in the January 2008 financial plan. These are expected to reduce planned spending by about $500 million in FY 2008 and $1 billion annually in future years.

Given the increasing share of the budget that is devoted to education and nondiscretionary spending (e.g., debt service), it is unlikely that expenditure reductions alone will be sufficient to close the out-year budget gaps. The Mayor and the City Council, however, have repeatedly demonstrated their commitment to fiscal responsibility and have made difficult budgetary choices in the past.

Economic Trends

The ongoing turmoil in the credit and housing markets will have serious implications for the City's economy. After a strong first half of 2007, Wall Street profits totaled $8.9 billion in the first half of 2007—only 4 percent less than the first half of 2006—but they will be much weaker in the second half of the year. While profits at the seven largest financial firms headquartered in New York City grew by 41 percent during the first half of the year, these firms reported a 65 percent decline in profitability during the third quarter.

Figure 2
Wall Street Profits



* City forecasts
Notes: Profits are for broker/dealer operations of NYSE member firms.
Sources: New York Stock Exchange; Securities Industry and Financial Markets Association; NYC Office of Management and Budget

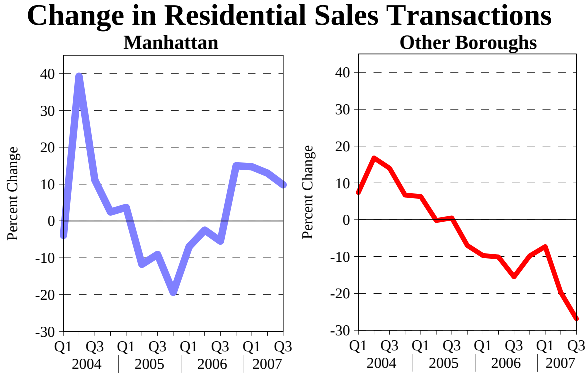
Even though Wall Street's problems are not yet evident in the City's employment data, the pace of overall job growth has already begun to ease. The City added 54,200 jobs during the first ten months of 2007, on an annualized basis, compared with a gain of 62,200 jobs during 2006. The pace of job growth is expected to slow even further during 2008 as layoffs in the financial sector affect other parts of the economy. The October Plan assumes a net gain of only 12,100 jobs in 2008 based on the assumption that the education and health care sector will remain strong.

The City's real estate market has been notably resilient at a time when the real estate markets in other parts of the nation have experienced large declines. The residential market in the outer boroughs has begun to weaken, but the slowdown—at least so far—has been much milder than in other parts of the country.

Manhattan's residential market remains robust for now. In fact, the number of residential real estate transactions in Manhattan increased during the first three quarters of 2007 compared with one year ago, although at a slower pace. However, fewer transactions occurred in the outer boroughs during this period, especially during the second and third quarters (see Figure 3).

Figure 3

Change in Residential Sales Transactions



Note: Residential includes single- and multi-family homes, cooperatives, and condominiums.
Sources: NYC Department of Finance; OSDC analysis

Average citywide sales prices continue to rise, driven by the cooperative and condominium markets in Manhattan. Sale prices have flattened in the outer boroughs and price declines have occurred in some neighborhoods. In addition, the number of foreclosures has increased dramatically.

The combination of strong demand and limited supply for primary commercial properties in Manhattan continues to push rental rates higher and vacancy rates lower. At the end of the third quarter of 2007, the rental rate for premium office properties in Manhattan was $76.30 per square foot—up $20.70 from one year earlier. The vacancy rate had reached 5.8 percent, down 2.1 percentage points from the previous year.

The Federal Reserve has responded to the credit crunch with several interest rate reductions aimed at increasing liquidity, stabilizing the financial markets, and preventing a recession. Recent reports show that while the national economy is still growing, the rate of growth has slowed. The October Plan assumes that the national economy will slow further in 2008 but will avert a recession, with minimal jobs and wage gains, before strengthening in 2009.

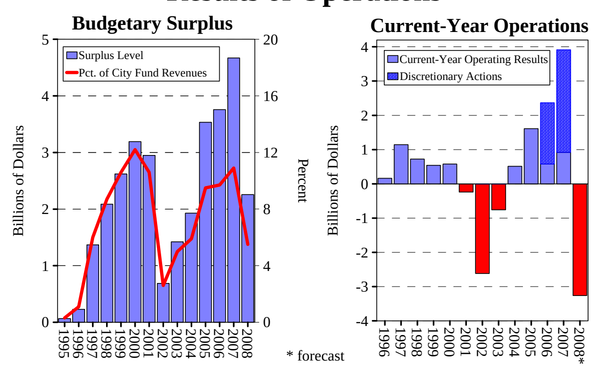
Currently, the greatest risks to the City's economy are a sustained downturn on Wall Street and a housing-induced recession. Wall Street faces continued pressures from the credit crunch, and a further deterioration in the housing markets could cause consumers to cut back on spending—which accounts for two thirds of the national economy. At the same time, consumers face pressure from continued high energy prices. Although the tourism and hotel industries in the City have benefited from a weak dollar, its decline in value makes imported goods more expensive.

Annual Operating Results

Surging Wall Street profits and rising real estate values and transactions, combined with conservative revenue forecasts, resulted in successively larger budget surpluses during fiscal years 2003 through 2007 (see Figure 4). The City transferred most of these resources to future years to close projected budget gaps, but also used a significant portion to fund discretionary actions that improved the City's fiscal position.

Figure 4

Results of Operations



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

The transfer of resources between years masks the relationship between recurring revenues and expenditures. A clearer picture of the City's fiscal condition is obtained by examining the results of current-year operations—the difference between revenues and expenditures in the current year. This entails adjusting for surplus transfers and other factors that impede transparency.

In the three years following the start of the last recession and the attack on World Trade Center, current-year expenditures outpaced current-year revenues. The City balanced the budget in those years by drawing down surplus resources generated in prior years and by using bond proceeds from the Transitional Finance Authority. In the years that followed, the City generated increasingly larger current-year surpluses, which peaked at $3.9 billion in FY 2007.

The October Plan reveals that spending is on pace to exceed revenues in FY 2008 by $3.3 billion as a result of the economic slowdown, tax cuts, and higher labor and fringe benefit costs. The FY 2008 budget will be balanced nonetheless, with surplus resources accumulated in prior years.

Financial Plan Reconciliation

Over the past few years, the City has realized large amounts of unanticipated resources, which it has used to close budget gaps, cut taxes, and to fund fiscally prudent initiatives such as the Retiree Health Benefits Trust Fund. Most of the resources that accrued to the City during FY 2007 were used to balance the FY 2008 budget, to narrow the FY 2009 budget gap from $4.6 billion to less than $1.6 billion, and to reduce the FY 2010 gap from $4.1 billion to less than $3.4 billion.

The October Plan shows a reversal in the City's fiscal fortune. For example, the City reduced the 2008 budget stabilization account by $296 million (to $2.3 billion) to close a budget gap in the current year; the FY 2009 budget gap has widened by $1.2 billion to reach $2.7 billion; and the FY 2010 gap has grown by $1.4 billion to reach $4.8 billion (see Figure 5).

Moreover, the $6.5 billion budget gap projected for FY 2011, which has grown by $2.1 billion, is nearly the size of the out-year gaps projected in November 2002 at the height of the fiscal crisis that was precipitated by the last recession and the attack on the World Trade Center. The FY 2011 gap represents 14.9 percent of City fund revenues, which is the second-largest gap at this point in the financial planning process since the City first balanced the budget in FY 1981.

The change in the City's fiscal outlook reflects the deterioration in the economic outlook for the City and the national economies, but is due mostly to the cost of actual and anticipated labor agreements. While FY 2007 pension fund investment earnings were more than twice the actuarial assumptions, the considerable savings that resulted was not nearly enough to offset adverse developments.

Figure 5
Financial Plan Reconciliation
June 2007 Plan vs. October 2007 Plan
(in millions)

	Better/(Worse)			
	FY 2008	**FY 2009**	**FY 2010**	**FY 2011**
Surplus/(Gaps) Per June 2007 Plan	**$ - - -**	**$ (1,550)**	**$ (3,397)**	**$ (4,369)**
Revenue				
Real Estate Transaction Taxes	$ (256)	$ (181)	$ (226)	$ (306)
Personal Income Taxes	(59)	(303)	(313)	(462)
Business Taxes	(47)	(114)	(76)	(59)
All Other Taxes	115	18	(27)	(30)
Subtotal	**$ (247)**	**$ (580)**	**$ (642)**	**$ (857)**
Tax Audit	100	- - -	- - -	- - -
Total	**$ (147)**	**$ (580)**	**$ (642)**	**$ (857)**
Expenditures				
Collective Bargaining	(90)	(436)	(1,072)	(1,608)
Agencies	(64)	(28)	(29)	(30)
Pension Asset Gains	- - -	125	240	350
Debt Service	5	35	79	55
Total	**(149)**	**(304)**	**(782)**	**(1,233)**
Net Change During FY 2007	**$ (296)**	**$ (884)**	**$ (1,424)**	**$ (2,090)**
Reverse FY 2007 Surplus Transfer	**296**	**(296)**	**- - -**	**- - -**
Surplus/(Gaps) Per October 2007 Plan	**$ - - -**	**$ (2,730)**	**$ (4,821)**	**$ (6,459)**

Sources: NYC Office of Management and Budget; OSDC analysis

In response to the burgeoning budget gaps, the Mayor instructed City agencies to prepare cost-reduction initiatives for inclusion in the January 2008 Financial Plan. These initiatives will reduce City-funded spending by 2.5 percent in FY 2008 and 5 percent annually in subsequent years, which would generate savings of about $500 million in FY 2008 and $1 billion in FY 2009.

Revenue Trends

Even though the economy was strong during the spring of 2007, the June 2007 Plan assumed that Wall Street profits would decline precipitously during calendar years 2007 and 2008 and that tax collections from real estate transactions would plummet by 18.9 percent in FY 2008. Thus, the June Plan had already factored in much of the downside budgetary risks associated with the summer's credit and housing market turmoil.

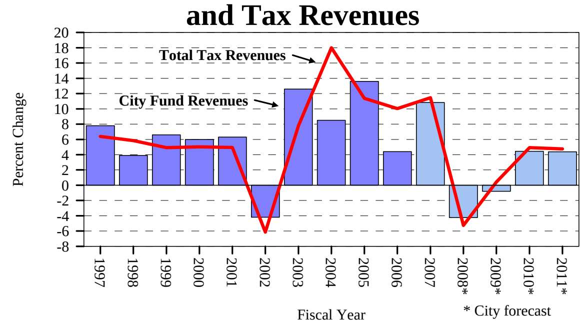
The October Plan assumes that tax revenues will decline by $2 billion, or 5.3 percent, in FY 2008 (see Figure 6). Although most of the decline ($1.3 billion) is due to tax cuts approved before the impact of the turmoil in the credit markets was apparent, a significant portion reflects the anticipated change in the City's economic outlook. Overall, City fund revenues will decline by 4.2 percent in FY 2008 (see Figure 7).

The October Plan further assumes that tax revenues will increase by 0.4 percent in FY 2009, but only because of continued strength in real property tax collections. Collections are projected to increase by more than $1 billion in each of fiscal years 2009 through 2011, reflecting the recent strength in the real estate market.

Personal income, business, and real property transaction tax collections are forecast to decline by another $1.1 billion, or 7 percent, in FY 2009. These estimates assume that the State will act to prevent the City's sales tax rate from dropping from 4 percent to 3 percent (a value of $1.2 billion) upon the termination of the Municipal Assistance Corporation on July 1, 2008.

Figure 6

Annual Change in City Fund Revenues and Tax Revenues



Notes: Includes the proposed tax reduction program. Adjusted 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

Overall, City fund revenues are projected to decline by another 0.8 percent in 2009 as a result of the loss of nonrecurring resources and lower interest income. This estimate assumes that the

Figure 7

City Fund Revenues

(in millions)

	FY 2007	FY 2008	Annual Growth	FY 2009	FY 2010	FY 2011	Average Three-Year Growth Rate
Taxes							
Property Tax	$ 12,958	$ 12,983	0.2%	$ 14,098	$ 15,183	$ 16,167	7.6 %
Personal Income Tax	7,720	7,434	-3.7%	7,031	7,271	7,541	0.5 %
Sales Tax	4,645	4,644	0.0%	4,660	4,842	5,084	3.1 %
Business Taxes	6,994	5,987	-14.4%	5,562	5,739	6,016	0.2 %
Real Estate Transaction Taxes	3,296	2,380	-27.8%	2,106	2,090	2,066	-4.6 %
Other Taxes	2,914	3,066	5.2%	3,191	3,323	3,400	3.5%
Subtotal	**38,526**	**36,495**	**-5.3%**	**36,648**	**38,448**	**40,275**	**3.3%**
Miscellaneous Revenues	4,470	4,288	-4.1%	3,806	3,823	3,857	-3.5 %
Unrestricted Intergovernmental Aid	35	340	NA	340	340	340	0.0 %
Grant Disallowances	(103)	(15)	-85.4%	(15)	(15)	(15)	0.0 %
Total	**$ 42,929**	**$ 41,107**	**-4.2%**	**$ 40,779**	**$ 42,595**	**$ 44,457**	**2.6%**

Note: Allocates the tax reduction program to individual taxes. 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

State will restore $327 million in annual unrestricted intergovernmental aid revenue-sharing payments under the Aid and Incentives for Municipalities (AIM) program that had been eliminated in FY 2007. City fund revenue growth is expected to average 4.4 percent annually in fiscal years 2010 and 2011 as the economy improves. While tax revenues in FY 2008 are likely to be $200 million higher than the City's forecast based on the strength of year-to-date collections, they could be lower than the City's projections in subsequent years.

The October Plan includes a number of modest tax cuts, such as small business tax credits, which have not been enacted by the State and which have an annual value of $26 million by FY 2011. Also, the City proposed in the spring of 2007 that the State and the City each contribute to a new authority that would finance regional transportation projects, and the October Plan includes the City's share of $50 million in FY 2008 and up to $275 million by FY 2011. The State has not yet acted on the City's proposal.

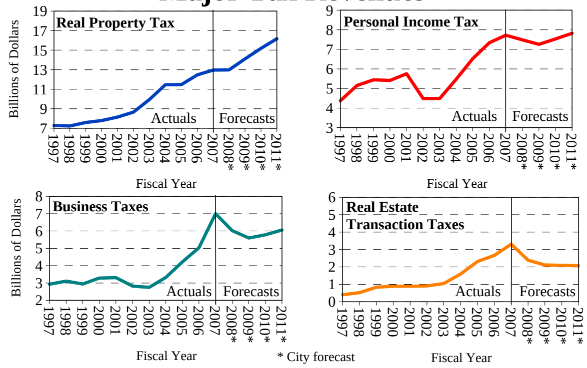
Forecasts for individual taxes are discussed below.

- Real property tax collections are projected to remain virtually flat in FY 2008 because a 7 percent reduction in the real property tax rate will offset an expected increase in collections (of more than $1 billion) based on rising real property values. The October Plan assumes that the rate cut will continue through FY 2011, although it is subject to annual approval by the City Council, and the Mayor has stated that continuation should depend on the City's financial condition. The property tax rate is completely within the City's control, while nearly all other tax law changes require State approval.

  Even assuming continuation of the reduction in the real property tax rate, collections are expected to increase throughout the financial plan period (see Figure 8), growing by about $1 billion annually (an average annual rate of 7.6 percent) in fiscal years 2009 through 2011. The growth is driven primarily by expected strength in the commercial real estate market—commercial properties pay 41.1 percent of the real property tax. In addition, increases in assessed values (except for single-family homes) are phased in over five years under State law, which will soften the tax impact of declining residential values on assessments.

Figure 8

Major Tax Revenues



Note: Excludes impact of proposed tax reduction program.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

- Personal income tax collections are forecast to decline by $286 million, or 3.7 percent, in FY 2008, the first decline since FY 2002. Although $122 million of the projected decline can be attributed to tax cuts that were previously included in the adopted budget for FY 2008, the remainder accounts for the expectation of an economic slowdown.

  Recent wage data revisions indicate that Wall Street bonuses exceeded $34 billion in 2006, much higher than the previous data suggested. Lower profits on Wall Street are expected to reduce the size of the bonus pool in 2007 and adversely affect personal income tax collections. With weak job and wage growth now forecast for FY 2009, tax collections are projected to decline by an additional 3.1 percent in FY 2009 before increasing by nearly 4 percent in each of fiscal years 2010 and 2011.

- Collections from business taxes (the general corporation, banking corporation, and unincorporated business taxes) are expected to decline by just over $1 billion (14.4 percent) in FY 2008. The reduction reflects not just the impact of the credit crunch on the financial sector, but also reduced profitability throughout the economy. The October Plan assumes that national corporate profits will remain flat during the financial plan period and that Wall Street profits will not begin to increase again until calendar year 2009. Thus, business taxes are expected to decline by another 7.1 percent in FY 2009 and then increase at an average annual rate of 4 percent in fiscal years 2010 and 2011.

- Collections from taxes associated with real estate transactions (the mortgage recording and real property transfer taxes) are forecast to deteriorate further in response to problems in the mortgage lending market and the weakening of the housing market. In FY 2008, the City expects these tax revenues to decline by 27.8 percent—a reduction of more than $900 million that will return collections to approximately the level received in FY 2005. Over the past five years, rising real estate demand and increasing property values boosted collections at an average annual rate of 29.5 percent. Continued declines in real estate transactions are projected to reduce collections by 11.5 percent in FY 2009.

Expenditure Trends

City-funded expenditures grew at average annual rates of nearly 10 percent during fiscal years 2004 and 2005, and 8.6 percent during fiscal years 2006 and 2007.[1] Most of the growth was due to the rising cost of debt service, Medicaid, pensions, and other employee benefits. The City also contributed $2.5 billion to the Retiree Health Benefits Trust Fund ($1 billion in FY 2006 and $1.5 billion in FY 2007), and retired nearly $1.3 billion in outstanding debt in FY 2007. Excluding these discretionary actions, spending would have grown more slowly, by 2.5 percent in FY 2006 and by 7.3 percent in FY 2007.

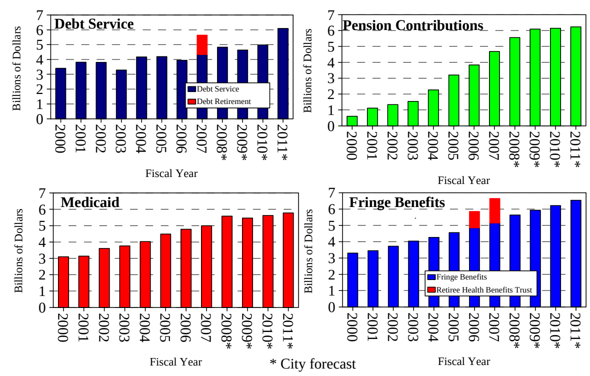
Although the expenditure growth rate is projected to slow to 5.6 percent in FY 2008, the rate of growth is still more than twice the projected local inflation rate. Primary sources of spending include rising costs for salaries and wages ($1.2 billion), Medicaid ($587 million), pension contributions ($871 million), and other fringe benefits ($486 million). In fiscal years 2009 through 2011, spending will rise by 4.8 percent annually, driven by higher costs for employee compensation, Medicaid, and debt service.

Despite higher-than-anticipated pension fund investment earnings, as well as State efforts to reduce Medicaid spending by local governments, the City's nondiscretionary spending (i.e., pensions, debt service, Medicaid, and employee health insurance benefits) is projected to consume an increasing share of City revenues, rising from 37 percent in FY 2003 to 49 percent in FY 2011.

The number of City-funded full-time and full-time-equivalent employees is expected to reach 270,424 by June 30, 2008. (Through September 2007, the City-funded staffing level totaled 266,219.) The October Plan assumes a net addition of 4,205 employees during FY 2008, primarily in social services, children's services, and homeless services (2,672); health and mental hygiene (909); correction (596); and sanitation (253). In October 2007, the Mayor imposed a hiring freeze on all City-funded positions except those that directly affect public health and safety until a citywide gap-closing plan is implemented in January 2008.

Major factors behind the growth in City-funded expenditures are shown in Figures 9 and 10, and are discussed below.

Figure 9
Trends in Selected City-Funded Expenditures



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

- Salaries and wages will increase by 11.2 percent in FY 2008 and by 8 percent in each subsequent year through FY 2012, reflecting the cost of actual and anticipated labor agreements through 2011.

  Overtime in the uniformed agencies is projected to total $689 million in FY 2008, and then to decline to $643 million in FY 2011. These costs could exceed the City's forecast by $90 million in FY 2008 and by $120 million annually thereafter because of a high medical absence rate and more ambulance tours in the Fire Department; difficulty in recruiting officers to the Police

[1] Adjusted for surplus transfers and for debt service on bonds issued by the Transitional Finance Authority (TFA) and by TSASC.

and Correction departments; and because of the continued threat of terrorism.

- Fringe benefits will increase by 9.5 percent to $5.6 billion in FY 2008, reflecting a 9.4 percent increase in health insurance premiums and planned staff additions. Health insurance premiums are projected to rise at a similar pace in subsequent years, but other fringe benefits are projected to grow much more slowly. Fringe benefits costs are projected to reach $6.5 billion by FY 2011—29 percent higher than the FY 2007 level.

- Medicaid will increase by 11.8 percent in FY 2008, even though State law caps the growth in the local share of Medicaid at 3 percent per year, as a result of the City's decision to provide assistance to the Health and Hospitals Corporation.

- Debt service will decline by more than $800 million in FY 2008 because the City retired nearly $1.3 billion in debt that was due in fiscal years 2009 and 2010. Debt service is projected to reach $6.1 billion by FY 2011, an increase of 26 percent compared with the FY 2008 level because of a planned expansion in the capital program.

- Pension contributions averaged about $1.5 billion during most of the 1990s, but have increased rapidly over the past five years as a result of shortfalls in investment earnings, increased benefits, and demographic changes. Pension contributions will increase by 18.6 percent in FY 2008 to reach $5.6 billion and then rise slowly, to $6.2 billion by FY 2011. These estimates include reserves of $200 million beginning in FY 2009 to fund the recommendations of a City Charter–mandated biennial audit, and $240 million in FY 2011 for actuarial reestimates that year.

  In FY 2007, the City pension funds earned 18.2 percent on their investments, more than twice the actuarial assumption of 8 percent. The City will realize the benefit over six years, and thus has reduced its planned contributions by $125 million in FY 2009, $240 million in FY 2010, $350 million in FY 2011, and $460 million in FY 2012. The stock market has been exceptionally volatile since the beginning of the current fiscal year, and as of November 28, 2007, the pension funds had a small gain on their investments.

Figure 10
Estimated City-Funded Expenditures
(Adjusted for Surplus Transfers, TFA, and TSASC)
(in millions)

	FY 2008	FY 2009	FY 2010	FY 2011	Average Three-Year Growth Rate
Salaries and Wages	$12,094	$12,930	$14,242	$15,411	8.4%
Debt Service	4,828	4,638	4,981	6,094	8.1%
Medicaid	5,580	5,467	5,621	5,781	1.2%
Pension Contributions	5,557	6,094	6,147	6,232	3.9%
Fringe Benefits	5,631	5,934	6,216	6,539	5.1%
Judgments and Claims	635	688	738	795	7.8%
Public Assistance	447	447	447	447	0.0%
Pay-As-You-Go Capital	100	200	200	200	0.0%
Energy	809	829	829	832	0.9%
General Reserve	300	300	300	300	0.0%
Other	8,227	7,921	8,077	8,285	0.2%
Total	**$44,208**	**$45,448**	**$47,797**	**$50,916**	**4.8%**

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

Semi-Autonomous Agencies

The following public authorities and other entities have a financial relationship with the City that could affect the City's financial plan.

Department of Education

State law prohibits the City from reducing its contribution to the Department of Education (excluding pensions and debt service), unless City revenues decline. If revenues decline, the City may reduce its contributions by an equal or lower percentage the following year.

The October Plan assumes that City revenues will decline by 4 percent in FY 2008 and by nearly 1 percent in FY 2009. Thus the City could reduce its spending on education by $316 million in FY 2009 and $63 million in FY 2010. Reductions in the City's contribution to the Department of Education, however, could run counter to the commitments made by the City and the State to increase funding as part of the resolution of the *Campaign for Fiscal Equity* lawsuit.

Health and Hospitals Corporation

In November 2006, the Health and Hospitals Corporation (HHC) projected annual budget gaps that approached $1 billion on an accrual basis of accounting. To help close these gaps, HHC obtained (with the assistance of the City and the State) supplemental federal Medicaid payments. These resources allowed HHC to end FY 2007 with an accrual surplus of $427 million and cash reserves of $1.2 billion. These cash reserves are expected to be sufficient to cover expenses through FY 2011.

Last year, Congress acted to delay the implementation of certain administrative rules that would have reduced supplemental payments to HHC and reduced funding for graduate medical education until May 2008. Other administrative changes are being considered that would limit supplemental payments for outpatient services. Without any mitigating actions by Congress, HHC estimates that it could lose $450 million annually.

Housing Authority

In May 2007, the New York City Housing Authority (NYCHA), which operates on a calendar-year basis, projected budget gaps of $225 million in 2007, $198 million in 2008, and $225 million annually in 2009, 2010, and 2011. Though NYCHA has adopted a gap-closing plan, it falls short of balancing the 2007 budget and the plan relies heavily on increased federal financial support in future years.

In August 2007, the State enacted benefit increases for public assistance recipients.[2] For recipients who are residents of NYCHA-operated public housing, the increases will provide $7 million in additional rent in 2007; this amount will rise to $47 million annually starting in 2010. In addition, the State increased its subsidy by $3 million.

Other actions taken by NYCHA include the reallocation of federal funds from the capital budget to the operating budget ($100 million); the sale of vacant land to the Housing Development Corporation ($50 million); and the institution of a partial hiring freeze and other personnel actions ($18 million). Nevertheless, with less than two months remaining in its fiscal year, NYCHA still projects a $47 million budget gap for FY 2007.

Off-Track Betting Corporation

The New York City Off-Track Betting Corporation (OTB) did not fulfill all of its statutory obligations in FY 2007, and projects that it will run out of cash by June 2008 if it makes statutorily mandated payments to the City, the State, and the racing industry. To manage its cash flow, the OTB has accrued, but not paid, $11 million in disputed payments to the Yonkers Raceway, as well as $12 million in distributions to the racing industry through September 2007—a strategy it has also relied on in previous years. In the OTB's financial statements for fiscal years 2005, 2006, and 2007, independent auditors questioned the ability of the OTB to continue as a "going concern."

The State is still debating the renewal of the franchise to operate the State's thoroughbred racetracks, and how the outcome of these negotiations will affect the OTB is not yet known.

[2] The City plans to fund these costs in the January 2008 Financial Plan. We estimate that the change could increase costs by $5 million in FY 2008 and by up to $18 million annually by FY 2011.

Other Issues

The following issues could have a significant impact on the City's financial plan.

Collective Bargaining

The October Plan reflects the costs of the current two-year round of collective bargaining, which began in FY 2006, and the next two-year round that concludes in FY 2010. Wages for civilian employees are projected to increase by 2 percent in the first year and then by 4 percent in each of the next three years. Uniformed employees would receive annual wage increases of 4 percent during the four-year period, plus an additional contribution of 1.59 percent to union welfare funds during each contract period.

The Patrolmen's Benevolent Association is seeking larger wage increases through binding arbitration than the City has been willing to offer through negotiation for fiscal years 2005 and 2006. (The other uniformed unions accepted wage increases of 3 percent and 3.15 percent for those years.) The City's' recent agreements with the other uniformed unions include side letter agreements that permit the unions to reopen negotiations if another uniformed union receives larger wage increases through collective bargaining or arbitration.

Accounting Standards

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45, which establishes standards for measuring and reporting the expense and related liabilities of post-employment benefits other than pensions (OPEBs).

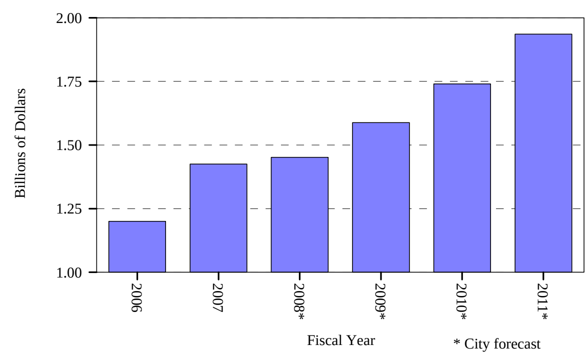
In October 2007, the Office of the Actuary reported that the City's actuarial accrued OPEB liability for past services was $56.1 billion as of June 30, 2006. The present value of future OPEB obligations was estimated at $45.9 billion. Overall, the present value of projected OPEB benefits, as of June 2006, totaled $102 billion, an increase of $10 billion over the prior year. The "normal cost," or the portion of the present value of future obligations that is attributed (on an actuarial basis) to services received in the current year, was estimated at $3.3 billion as of the June 2006 valuation, an increase of $300 million from the prior year.

Unlike pensions, the City funds OPEBs—primarily health insurance—on a pay-as-you-go basis. Recent accounting rules (i.e., GASB 45) require governmental entities to calculate and disclose their accrued actuarial liabilities and the normal cost of OPEBs for both past and present employees. The accounting rules do not require entities to fund these costs on an actuarial basis.

The City funds the cost of OPEBs on a pay-as-you-go basis. These costs are projected to rise from $1.2 billion to more than $1.9 billion by FY 2011 (see Figure 11), an increase of 61 percent. The City also contributed $2.5 billion in surplus resources during fiscal years 2006 and 2007 to the Retiree Health Benefits Trust Fund, which is intended to help fund the cost of future obligations.[3]

Figure 11

Pay-As-You-Go Cost of OPEBs



Sources: Office of the Actuary, NYC Office of Management and Budget; OSDC analysis

In addition, GASB 49, which becomes effective with respect to the City on July 1, 2008, affects the accounting treatment of pollution remediation costs. Currently, many of these costs are included in the City's capital budget and financed through the issuance of bonds. Unless there is a change in applicable law, these costs could not be financed through the issuance of bonds after GASB 49 becomes effective. According to the City, preliminary estimates indicate that GASB 49 could result in additional budget costs of approximately $500 million annually.

Rising Debt Burden

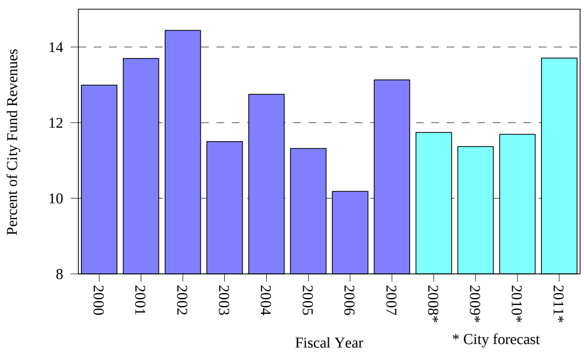
Debt service that is funded directly through the City's operating budget, or with funds that would have otherwise benefited the operating budget, is

[3] This trust fund was established by the City in FY 2006.

projected to rise from $4.8 billion in FY 2008 to $6.1 billion in FY 2011, an increase of 26 percent. In addition, debt service will consume an increasing share of City fund revenues (from 10.2 percent in FY 2006 to 13.7 percent by FY 2011) because revenue growth is expected to be stagnant (see Figure 12).

City-funded capital commitments, excluding those of the Municipal Water Finance Authority, are forecast to rise from $4.6 billion in FY 2007 to $8.3 billion in FY 2008—a 71 percent increase, which is an all-time high since we began tracking this statistic in 1980. For the four-year period from fiscal years 2008 through 2011, these commitments now total $27.1 billion, up from $16.1 billion during the previous four years (an increase of 63 percent).

Figure 12
Debt Burden



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

UFT Pension Litigation

In March 2005, the United Federation of Teachers (UFT) filed a lawsuit in the New York Supreme Court against the City of New York and the Teachers' Retirement System, alleging that retirees covered under a retirement plan known as the 20-Year Pension Plan were not receiving the entire amount of benefits to which they were entitled. The UFT claimed the discrepancies occurred largely because of miscalculations relating to the interest earned on member contributions, and sought an award of $800 million to account for the difference. On October 17, 2006, the New York Supreme Court denied the City's motion to dismiss the proceeding.

On October 17, 2007, the City and the UFT agreed to resolve the dispute, and the City agreed to supplement retirement benefits for the affected group by a total of $160 million. Though the manner in which the settlement will be paid out has not yet been determined, the City will likely amortize the $160 million cost over approximately a ten-year period.

Davis v. Kentucky

New York State and New York City tax the interest of out-of-state municipal obligations, but do not tax the interest of New York municipal obligations. On November 5, 2007, the U.S. Supreme Court heard oral arguments regarding the decision of the Court of Appeals of Kentucky in the lawsuit *Davis v. Kentucky Department of Revenue of the Finance Administration Cabinet.* That decision held that the dormant commerce clause of the U.S. Constitution prohibits the Commonwealth of Kentucky from exempting interest on municipal bonds issued by Kentucky, its localities, and its authorities from state income tax while subjecting interest on bonds from other states to the same tax. The decision argued that such practice burdens interstate commerce.

A Supreme Court ruling to uphold the Kentucky appeals court decision could affect future borrowing costs for New York State and New York City, as their bonds would no longer receive preferential tax treatment over those issued by other states or by localities outside of New York, and subject them to claims for tax refunds. A decision on the case could come at any time, but not later than the end of the current session in June 2008. If the decision is upheld, Congress—which has the constitutional power to regulate interstate commerce—could permit states to exempt interest on bonds issued by the state and its localities from taxes.

World Trade Center Litigation

The City and its contractors currently face 4,400 legal claims that allege respiratory and other injuries from exposure to World Trade Center (WTC) dust and debris by individuals who performed rescue and cleanup work at the WTC site in the aftermath of the events of September 11, 2001. In October 2006, the City's motion to dismiss these claims was denied; the City appealed, and oral arguments began in October 2007. A decision is pending, though both the Mayor and plaintiff attorneys have expressed interest in discussing a potential settlement.

In 2004, the WTC Captive Insurance Company Inc., a not-for-profit corporation, was formed using $1 billion in federal aid to cover claims against the City and its contractors relating to the WTC site cleanup. The Mayor has asked Congress to indemnify the City and its contractors for liabilities, and to use the $1 billion allocated to the WTC Captive Insurance Company to fund health-related claims.

Federal Work Participation Rate

Since the federal Temporary Assistance to Needy Families program was reauthorized in February 2006, the State and the City have faced the risk of incurring financial penalties for failing to meet the federal work participation rate of 50 percent. In August 2007, the State's work participation rate was 38.3 percent (down from 42.3 percent in April 2007), and the City's rate was 42.2 percent (down from 48 percent). Unless the State and City are able to increase their participation rates or receive some relief from the new standards, the City's share of statewide penalties could total $100 million annually. Before imposing fines, the federal government will give the State the opportunity to develop a corrective action plan.

West Side Development

In October 2007, the Metropolitan Transportation Authority (MTA) received five proposals for development over its eastern and western rail yards in Manhattan; selection is expected during the first quarter of 2008. The proceeds will be used by the MTA to help fund its capital program.

As part of the City's plan to spur economic development in the Hudson Yards region, the MTA recently awarded a construction contract for the tunnel that will extend the No. 7 subway line from Times Square to 11th Avenue along 34th Street. A second station, planned at 41st Street and 10th Avenue, is not currently funded but could be included in the final project if funding is made available.

The City has agreed to fund the project's estimated cost of $2.1 billion with bonds issued by the Hudson Yards Infrastructure Corporation, but the MTA and the City have no agreement as to who would be responsible for any possible cost overruns—including the possible reinstatement of the 10th Avenue station project. Higher-than-anticipated revenues from the sale of development rights in the area have offset the City's interest costs in FY 2008, from $112 million to $29 million.

Metropolitan Transportation Authority

The MTA now projects a surplus of $521 million for 2007, which is $204 million more than projected in July when the MTA proposed raising fares and tolls by 6.5 percent in early 2008 to help close looming projected budget gaps. In July, the MTA projected budget gaps of $965 million in 2008, $1.4 billion in 2009, $1.8 billion in 2010, and nearly $2.1 billion in 2011. Debt service, which is a major factor behind the projected gaps, is projected to rise from $1.3 billion in 2006 to $2.0 billion in 2011—an increase of 50 percent.

The Governor and MTA officials recently announced that the MTA will use these resources to hold the base subway and bus fare in New York City at $2.00 and to limit the overall increase in fares and tolls to 3.85 percent in 2008. In addition, the Governor announced that he will commit $300 million in 2010 to help the MTA close the budget gap projected for that year, and added that he expects the City to match the State's contribution. The Governor's commitment represents substantial progress toward closing the MTA's out-year budget gaps and developing a long-term plan to finance the operating budget. The MTA will also need the assistance of the State and the City to finance the next five-year capital program to maintain the existing regional mass transit system and to fund major expansion projects, such as the Second Avenue Subway.