Review of the Financial Plan of the City of New York

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Report 8-2005 **December 2004**

On October 21, 2004, the City of New York submitted to the New York State Financial Control Board a modification to its four-year financial plan for fiscal years 2005 through 2008 (the "October Plan"). The October Plan shows a balanced budget for FY 2005, but budget gaps of $3 billion for FY 2006, $4.2 billion for FY 2007, and $3.3 billion for FY 2008.

The October Plan shows only a marginal improvement in the out-year budget gaps since the June Plan, despite significantly higher tax revenue forecasts. Tax revenues are now projected to be higher than the June forecast by about $550 million annually, but the benefit will be partly offset by a shortfall in anticipated State aid, and higher spending.

Even though actions taken by the State will benefit the City by $199 million in FY 2005, the June Plan had anticipated a benefit of $400 million. Importantly, one of the State's actions to provide budget relief to localities is a three-year phased takeover of the cost of the Family Health Plus program. The program has been a major factor behind the growth in the local share of Medicaid costs in recent years. However, other factors, such as increased costs for pharmaceuticals and long-term care, continue to drive costs higher.

Most of the increase in tax revenues during the financial plan period stems from continued strength in the real estate sector, which is partly offset by a reduction in projected revenue from personal income, business, and sales taxes as a result of reduced forecasts for Wall Street profits. Profits were strong during the first quarter of calendar year 2004, but they declined by 68.1 percent during the second quarter, and preliminary reports indicate that the third quarter was weak as well. Accordingly, the City now projects that Wall Street profits will decline to $12.8 billion in 2004 after rising by nearly $10 billion to reach $16.8 billion in 2003.

The City closed a $6.4 billion budget gap in FY 2004, ended that year with a $1.9 billion surplus after an unanticipated surge in tax revenue, and also balanced the budget in FY 2005, but nevertheless the City continues to project large out-year budget gaps. The gaps reopen beginning in FY 2006 because the FY 2005 budget was balanced with $3.2 billion in nonrecurring resources (twice the FY 2004 level); temporary taxes approved by the State at the City's request have begun to expire; and nondiscretionary spending continues to grow rapidly.

Nondiscretionary spending is projected to increase by $3 billion, or 17.5 percent, between fiscal years 2004 and 2006. Pension contributions alone are projected to rise by 73 percent, or $1.7 billion, over that two-year period, and health insurance costs for City employees and Medicaid are projected to increase by nearly $1.9 billion between fiscal years 2004 and 2008. Overall City-funded spending grew by 9.5 percent in FY 2004, and is projected to grow by another 9.4 percent in FY 2005.

The City has managed well through the financial crisis that was precipitated by the terrorist attack on the World Trade Center and has enjoyed the benefits of the economic recovery, but the City still faces a number of budget risks that could significantly widen the out-year gaps. Our review has quantified about $650 million in risks beginning in FY 2006, which, if they materialize, would widen the FY 2006 budget gap to $3.6 billion and the FY 2007 budget gap to $4.9 billion.

The City faces other budget risks as well, but these are more difficult to quantify at this time. For example, the unions that represent the City's teachers, police officers, and firefighters are seeking larger wage increases than assumed in the October Plan. Each additional 1 percent wage increase for these employees above the amount assumed in the October Plan would increase costs by about $150 million annually.

Also, on November 30, 2004, a panel appointed by the State Supreme Court recommended that the State implement a funding plan that would phase in, over a four-year period beginning next year, an annual increase of $5.6 billion to ensure that the New York City public school system receives the funding necessary to provide a sound basic education. The panel also recommended that the State implement a funding plan to provide New York City with $9.2 billion over a five-year period for capital projects. The panel stated that the State Legislature should determine how these additional costs are split between the State and the City, but that the burden placed on New York City cannot be arbitrary or unreasonable.

Finally, the Metropolitan Transportation Authority and the Health and Hospitals Corporation each face large and growing budget gaps. A recent report by the State Comptroller found that the MTA had borrowed more for its capital program than it can now afford to repay, and urged the MTA to develop a comprehensive long-term plan to restore fiscal stability that includes larger savings from management improvements. It is likely that any long-term solution to the financial problems facing these agencies will require additional City funding.

Despite these risks, we conclude that FY 2005 will end in balance. The City has prudently increased the budget stabilization account by $354 million, to reach $574 million in FY 2005. The October Plan has used this account to narrow the FY 2006 budget gap, but it is available for use in FY 2005 if needed to maintain budget balance. In addition, the October Plan includes other reserves that could be drawn upon if needed in the current fiscal year.

The City also has outlined a gap-closing program that would balance the FY 2006 budget and narrow the out-year gaps. Unfortunately, the gap-closing program lacks details and relies heavily on optimistic expectations of federal and State assistance and short-term solutions.

In recent years, the City has relied on substantial amounts of nonrecurring resources to help balance its budget. That approach has not addressed the fundamental imbalance between recurring revenues and expenses, and the City has not taken full advantage of the time afforded it by this strategy to implement permanent changes that would produce recurring benefits.

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

	Better/(Worse)			
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**
Gaps per October 2004 Plan	**$ - - -**	**$ (2,965)**	**$ (4,176)**	**$ (3,347)**
Department of Education	(200)	(200)	(200)	(200)
Productivity Savings	(95)	(290)	(300)	(300)
Tax Revenues	125	- - -	- - -	- - -
FY 2004 Pension Fund Investment Performance	30	75	135	210
Medicaid	- - -	(130)	(200)	(200)
Uniformed Agency Overtime	- - -	(100)	(100)	(100)
Medicare Part B Premiums	- - -	(14)	(14)	(14)
Debt Service	- - -	48	(31)	(49)
OSDC Risk Assessment	**$ (140)**	**$ (611)**	**$ (710)**	**$ (653)**
Gaps to be Closed	**$ (140)**	**$ (3,576)**	**$ (4,886)**	**$ (4,000)**
Other Risks and Potential Offsets				
General Reserve[1]	300	300	300	300
Savings from Prior Years' Expenses	250	- - -	- - -	- - -
TSASC Trapping Event	(121)	(59)	(61)	(60)
Wage Increases at the Projected Inflation Rate	- - -	(220)	(700)	(1,200)

[1] The City also has set aside $574 million in a budget stabilization fund to narrow the FY 2006 budget gap.

Given the size of the out-year budget gaps and the budget risks facing the City, the State Comptroller urges the City to expeditiously implement its FY 2006 gap-closing program and to maximize the amount of recurring resources.

Economic Overview

New York City's economy has shown substantial improvement since the 2001 terrorist attack, with Wall Street rallying from its bear market in 2003 and local employment growth resuming in calendar year 2004. Wage growth also increased markedly in 2004, and the real estate markets remain strong.

These developments contributed to a surge in revenue collections in FY 2004, which has continued into the first quarter of FY 2005. The October Plan, however, assumes that the economic recovery will be weaker than the assumptions made in the June Plan. The revised forecast reflects projections made by the City and other leading forecasters that the national economy, which has a major impact on the finance and business service sectors of the local economy, is likely to grow more slowly in the near term than previously forecast.

Most notably, the City has significantly trimmed its forecast for Wall Street profits in calendar year 2004, which will adversely affect other industries that rely on Wall Street. Although profits were strong in the first quarter of the year, declining revenues from commissions and gains on trading accounted for a 68.1 percent decline in profits in the second quarter (compared to the same quarter of 2003). Preliminary reports indicate that profits were weak in the third quarter as well. Accordingly, the City now projects that Wall Street profits will decline by $4 billion, falling to $12.8 billion in 2004, after rising nearly $10 billion to reach $16.8 billion in 2003.

While another economic downturn is not expected, a number of other issues could affect the strength of the recovery. These include rising interest rates; the large federal deficit and how it is addressed; federal tax policy; high consumer debt; high energy prices; the situation in the Middle East; the international economy, which appears to be slowing down; and the reluctance of businesses to hire.

Fiscal Year 2005

After closing a projected budget gap of $6.4 billion in FY 2004, the City ended that year with a surplus of $1.9 billion. The FY 2004 surplus was realized in large part from a surge in tax revenues, and this strong revenue performance has continued during the first quarter of FY 2005. The City used $1.7 billion of the surplus to help balance the FY 2005 budget, and deposited the remaining $220 million into a budget stabilization account, which has been used to narrow the FY 2006 budget gap.

The October Plan projects a surplus of $354 million for FY 2005, which the City has used to increase the budget stabilization account to $574 million. These resources, combined with a projected increase in tax revenues, have reduced the FY 2006 budget gap from $3.7 billion to $3 billion, and marginally narrowed the out-year gaps (see Table 2).

Tax revenues are now projected to exceed the amounts in the June Plan by $577 million in FY 2005 and by similar amounts in subsequent years. The higher estimates result primarily from increases in real property transaction and property tax revenues, as well as from increases in baseline projections of nonproperty taxes as a result of strong FY 2004 collections. These revenues are partially offset, however, by the impact of a lower forecast of Wall Street profits.

Other non-tax revenues are now projected to be higher by $33 million in FY 2005. In addition, the October Plan also recognizes the receipt of $120 million in bond proceeds from the Municipal Assistance Corporation (MAC) refinancing initiative to reimburse the City for debt service costs incurred due to a delay in completing the refinancing initiative.

Because New York State did not adopt a new budget until August 2004—four months overdue, and after the City adopted its annual budget—the October Plan is the first opportunity for the City to reflect the impact of the adopted State budget. While the City's June Plan had assumed that the State would take actions that would provide the City with a recurring benefit of $400 million, the City now estimates that the State budget will increase aid to the City by $199 million in FY 2005, $204 million in FY 2006, and about

Table 2
Financial Plan Reconciliation
June 2004 Plan vs. October 2004 Plan

(City Funds, in millions)

		Better/(Worse)		
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**
Surplus/(Gaps) per June 2004 Plan	**$ - - -**	**$ (3,674)**	**$ (4,522)**	**$(3,681)**
Revenues				
Real Property & Real Estate–Related Taxes	$ 438	$ 343	$ 288	$ 256
Business Taxes	67	109	93	96
All Other Taxes	72	137	163	172
Subtotal	**577**	**589**	**544**	**524**
Other Non-Tax Revenue	33	- - -	- - -	- - -
Total	**610**	**589**	**544**	**524**
Shortfall in Anticipated State Aid	**(201)**	**(196)**	**(94)**	**(77)**
Expenditures				
Department of Education	(87)	- - -	- - -	- - -
Energy Costs	(40)	(65)	(65)	(65)
City Debt Service	72	27	(39)	(48)
Total	**(55)**	**(38)**	**(104)**	**(113)**
Net Change During FY 2005	**354**	**355**	**346**	**334**
Change in Budget Stabilization Account	**(354)**	**354**	**- - -**	**- - -**
Surplus/(Gaps) per October 2004 Plan	**$ - - -**	**$ (2,965)**	**$ (4,176)**	**$ (3,347)**

Sources: NYC Office of Management and Budget; OSDC analysis

$300 million in each of fiscal years 2007 and 2008.

Most of the additional State aid in FY 2005 has come from postponing the reinstatement of the sales tax exemption on clothing items that cost less than $110. In addition, the State's phased takeover of the Family Health Plus program will reduce City costs by $77 million in FY 2005, another $254 million in FY 2006, and $374 million by FY 2008.

Expenditures are projected to be only slightly higher in the October Plan than in projections last June. The most significant change was a one-time increase in City funding for education ($87 million), mostly to offset a $62 million shortfall in anticipated State education aid. Energy costs are also expected to be higher during the Plan period because Con Edison and the New York Power Authority intend to pass along to the City proposed increases in fuel and distribution charges that are currently being reviewed by the Public Service Commission. These higher costs have been partly offset during fiscal years 2005 and 2006 by debt service savings from the elimination of short-term borrowing in FY 2005, and lower-than-forecast interest rates.

Closing the Out-Year Budget Gaps

The October Plan projects out-year budget gaps of $3 billion for FY 2006, $4.2 billion for FY 2007, and $3.3 billion in FY 2008. To balance the FY 2006 budget and to narrow the out-year gaps, the City has outlined a gap-closing program that includes resources from agency actions, the elimination of funding for pay-as-you-go capital financing, asset sales, increases in State and federal aid, and anticipated pension and health insurance savings (see Table 3).

While the City has established a target for agency actions, it has yet to offer any details on how these resources would be achieved, other than to note that the amounts represent about 6 percent of agency funding on an annual basis, and that the Department of Education and the City University of New York would be exempt. The City's heavy reliance on additional State and federal aid appears

Table 3
Out-Year Gap-Closing Program
(in millions)

	Better/(Worse)			
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**
Gaps to be Closed	**$ - - -**	**$ (2,965)**	**$ (4,176)**	**$ (3,347)**
Agency Actions	300	600	600	600
Eliminate Pay-As-You-Go Capital Financing	200	200	200	200
Asset Sales	75	315	150	150
State Actions	- - -	650	400	400
Federal Actions	- - -	300	300	300
Pension/Health Insurance Savings	- - -	325	200	- - -
Total	**575**	**2,390**	**1,850**	**1,650**
Prepay FY 2006 Expenses	(575)	575	- - -	- - -
Remaining Surplus/(Gaps)	**$ - - -**	**$ - - -**	**$ (2,326)**	**$ (1,697)**

Sources: NYC Office of Management and Budget; OSDC analysis

optimistic given the budget gaps projected for these entities, and the City should be prepared with alternatives in the likely event that these resources do not materialize.

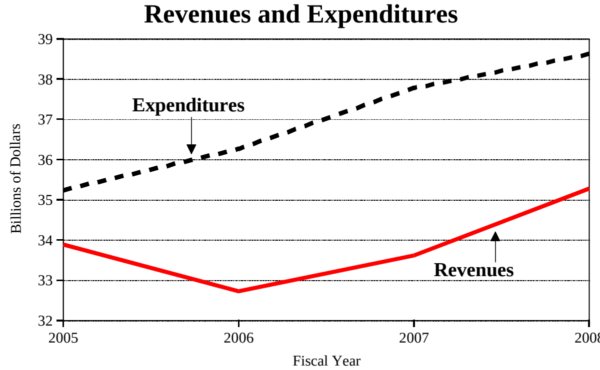
Although the City has not indicated how it would generate $525 million in pension and health insurance savings over a two-year period, the City Actuary is considering changes in the methods and assumptions used to calculate the City's pension contributions that would generate significant short-term savings. The changes under consideration include implementing a one-year lag in the calculation of pension contributions, and increasing the phase-in period of investment gains and losses (from five to seven years). Savings from these changes could be partly offset by other changes also under consideration, such as the funding of the full cost of permanent cost-of-living adjustments for retirees instead of phasing in the costs over a ten-year period.

Revenue and Expenditure Trends

The City continues to have a structural imbalance between revenues and expenditures, with expenditures growing at a faster rate than revenues. During fiscal years 2005 and 2006, revenues remain essentially unchanged in the October Plan, reflecting modest economic growth offset by the introduction of the property tax rebate program and the expiration of previously enacted tax revenues. By contrast, expenditures grow at an average annual rate of 6.1 percent, fueled by increases in pension, health insurance, and Medicaid costs.

Budget balance in FY 2005 was achieved through the use of a significant level of nonrecurring resources, including the surplus generated in FY 2004. This surplus was used to prepay FY 2005 debt service costs. Adjusting for these prepayments shows that the City has an operating shortfall of $1.3 billion in FY 2005, which grows to almost $4.2 billion by FY 2007 (see Graph 1).

Graph 1
Structural Imbalance Between City Fund Revenues and Expenditures



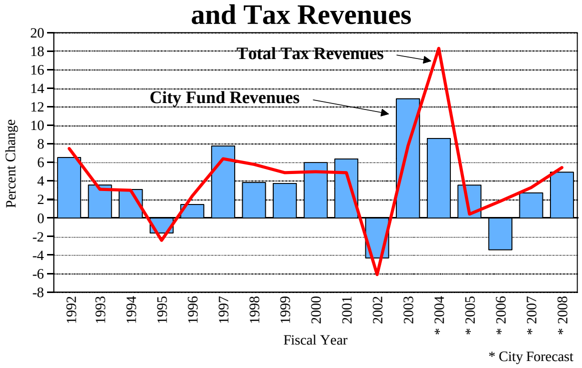
Note: Expenditures adjusted for surplus transfers.
Sources: NYC Office of Management and Budget; OSDC analysis.

While the City's gap estimates narrow slightly in FY 2008, they do not reflect some significant costs that the City will face, such as future labor settlements. A wage agreement at the prevailing rate of inflation, but without any productivity savings, could increase the FY 2008 gap by $1.2 billion.

Revenue Forecasts

City fund revenues[1] are projected to increase by 3.6 percent in FY 2005, even though tax revenues are projected to grow by 0.4 percent (see Graph 2), because of the City's heavy reliance on nonrecurring resources to help balance the FY 2005 budget. In subsequent years, City fund revenues are forecast to decline by 3.4 percent in FY 2006 (as the nonrecurring revenues used in FY 2005 are not replaced), and then increase by 2.7 percent in FY 2007 and 4.9 percent in FY 2008 as tax revenue growth improves.

Graph 2
Annual Change in City Fund Revenues and Tax Revenues



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

The City raised its FY 2005 tax revenue forecast by $800 million in the October Plan, which reflects continued strength in real estate–related transactions and the postponement by the State of the sales tax exemption on clothing purchases costing less than $110. The annual rate of tax revenue growth, however, is expected to be minimal because of an anticipated decline in Wall Street profits, slightly lower economic forecasts, the implementation of a $400 real property tax rebate for homeowners, and the phaseout of temporary tax increases approved by the State in June 2003 to help the City overcome the fiscal crisis brought on by the recession and the attack on the World Trade Center.

[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.

The scheduled rollback in the personal income tax and the elimination of a one-eighth percent increase in the sales tax rate will reduce tax revenues by $557 million in FY 2006 and by about $900 million in each of fiscal years 2007 and 2008. The October Plan also assumes that the City will continue to offer the real property tax rebate program to homeowners, which will cost $250 million in each of fiscal years 2006 and 2007. The phasing out of the temporary taxes combined with the real property tax rebate account for lost revenues of $800 million in FY 2006, $1.1 billion in FY 2007, and $900 million in FY 2008.

Major tax revenue trends (see Table 4) include the following.

- Real property tax collections are projected to grow by only 1.5 percent in FY 2005 even though market values have risen sharply in recent years (by over 20 percent in FY 2005 alone). Much of the growth in market value cannot be captured because of State-imposed caps that limit the growth in assessed values. Growth in FY 2005 is also reduced by the rebate program, valued at $250 million.

- The mortgage-recording and the real property transfer taxes account for nearly half ($356 million) of the increase in the City's FY 2005 tax forecast. Previously, the City assumed that mortgage rates would rise and that there would be a sharp falloff in tax revenue, but mortgage rates continue to hover near historic lows and collections have remained strong. Year-to-date collections are exceeding even the City's revised estimates, which accounts for the bulk of the additional $125 million in tax revenues we expect the City to realize in FY 2005.

- The City's personal income tax forecast was increased only marginally in the October Plan, and shows virtually no growth until FY 2008. Although the tax is showing a strong year-to-date gain, the City expects that gain to be eliminated as collections respond to lower Wall Street profits and the new earned income tax credit is paid out in the spring.

Table 4
City Fund Tax Revenues
(in millions)

	FY 2004	FY 2005	Percent Change	FY 2006	FY 2007	FY 2008	3-Year Avg. Growth Rate
Property Tax	**$ 11,445**	**$ 11,616**	**1.5%**	**$ 12,087**	**$ 12,618**	**$ 13,427**	**4.9%**
Nonproperty Taxes							
Personal Income Tax	5,582	5,593	0.2%	5,621	5,632	6,012	2.4%
Sales Tax	4,043	4,153	2.7%	4,029	4,220	4,404	2.0%
Business Taxes	3,318	3,397	2.4%	3,628	3,779	3,944	5.1%
Real Estate–Related Taxes	2,061	1,823	-11.5%	1,713	1,743	1,781	-0.8%
Other Taxes	1,806	1,809	0.2%	1,831	1,868	1,941	2.4%
Subtotal	**16,829**	**16,776**	**-0.2%**	**16,822**	**17,242**	**18,082**	**2.5%**
Total Taxes	**$ 28,274**	**$ 28,392**	**0.4%**	**$ 28,909**	**$ 29,860**	**$ 31,510**	**3.5%**

Note: Personal income tax includes a portion of such revenues used to pay debt service on bonds issued by the Transitional Finance Authority. Totals may not add due to rounding.

Sources: NYC Office of Management and Budget; OSDC analysis

- The June forecast assumed that the State would reauthorize the sales tax exemption on clothing items valued at less than $110. Because the State has postponed the reauthorization, the City will receive an extra $177 million in FY 2005.
- Business taxes in FY 2005 are now forecast to be $67 million higher than projected in June. The revised forecast primarily reflects a $119 million increase in revenues from the banking corporation tax, based on stronger year-to-date collections. Banks had overpaid their liabilities in prior years, generating credits that reduced their payments last year, but these credits are now being exhausted and payments are rising again.

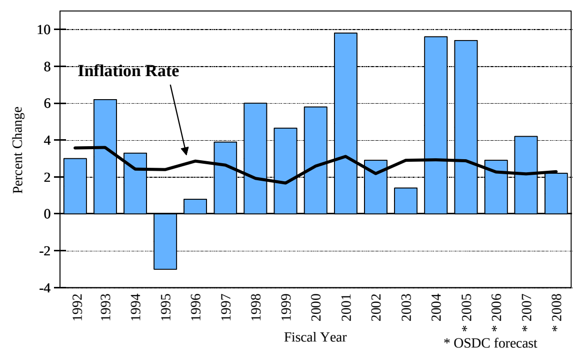
Expenditure Forecasts

City-funded spending grew by 9.5 percent in FY 2004 and is projected to increase by another 9.4 percent in FY 2005, which is nearly four times faster than the local inflation rate (see Graph 3). The rapid growth in City-funded expenditures is primarily due to nondiscretionary spending.

For example, as shown in Graph 4 and Table 5 (on next page), pension contributions are projected to rise by 41 percent, or about $930 million, in FY 2005, while health insurance costs for City employees and Medicaid are projected to increase by about $850 million. Although expenditure growth is projected to slow to an average annual

Graph 3

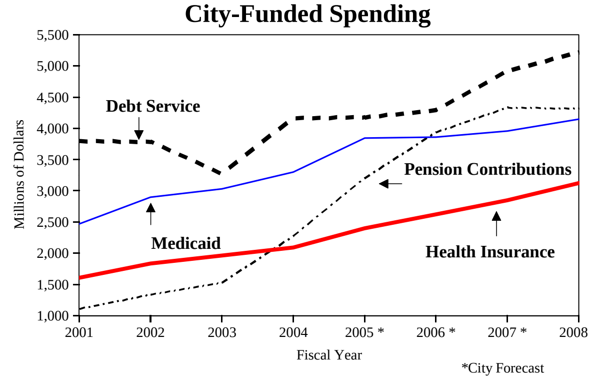
Changes in City-Funded Expenditures



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

rate of 3.1 percent during fiscal years 2006 through 2008, this estimate is 50 percent greater than the projected inflation rate and does not take into account the cost of potential wage increases during this period.

Graph 4
Trends in Nondiscretionary City-Funded Spending



Note: Medicaid excludes Health and Hospitals Corporation.
Sources: NYC Office of Management and Budget; OSDC analysis

Table 5
City-Funded Expenditures
(Adjusted for Surplus Transfers)
(in millions)

	FY 2004	FY 2005	Percent Change	FY 2006	FY 2007	FY 2008	3-Year Avg. Growth Rate
Salaries and Wages	$9,782	$ 10,049	2.7%	$10,260	$ 10,250	$ 10,150	0.3%
Pension Contributions	2,272	3,204	41.0%	3,934	4,341	4,328	10.5 %
Debt Service	4,170	4,175	0.1%	4,288	4,919	5,215	7.7 %
Medicaid[1]	3,302	3,847	16.5%	3,863	3,959	4,148	2.5 %
Health Insurance	2,093	2,401	14.7%	2,624	2,851	3,124	9.2 %
Public Assistance	487	538	10.5%	542	542	542	0.2 %
Pay-As-You-Go Capital[2]	200	200	- - -	200	200	200	- - -
Other[3]	9,905	10,823	9.3%	10,552	10,736	10,918	0.3 %
Total	**$32,211**	**$35,236**	**9.4%**	**$36,263**	**$37,797**	**$38,625**	**3.1%**

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

[1] Excludes City-funded Medicaid payments to HHC, which total about $760 million annually.
[2] In FY 2004 the City redirected $200 million, which was previously planned for pay-as-you-go capital financing, to pay down high-coupon debt during FY 2006.
[3] The growth in the "Other" component in FY 2005 is reduced to 3.1 percent when adjusted to remove the $260 million increase in the general reserve in FY 2005, and $329 million in savings from prior years' expenses realized in FY 2004.

Some of the key factors driving the growth in City-funded spending are outlined below.

- Pension contributions will double during fiscal years 2004 and 2005 to reach $3.2 billion, and are projected to increase by $1.1 billion during fiscal years 2006 and 2007, to $4.3 billion. Pension costs could be lower by $30 million in FY 2005, and by $210 million by FY 2008, as the City recognizes the market gains that occurred in FY 2004.

- Debt service costs are projected to remain stable between fiscal years 2004 and 2006, and then increase by about $1 billion during fiscal years 2007 and 2008. The rapid increase in the second half of the Plan period reflects the restoration of previously planned cuts in capital commitments.

  Debt service costs could be lower by $48 million in FY 2006 because of a securitization initiative (see the "Other Issues" section of this report), and because of savings from a recent bond refunding. These savings would be partly offset by higher costs from the cost of bond issuances now that the City intends to abandon previous plans to finance a portion of its capital program on a pay-as-you-go basis.

- Health insurance costs for municipal employees are projected to increase by more than $700 million during the Plan period. Current estimates, however, do not reflect the recent 17 percent increase in Medicare Part B premiums that could increase City costs by about $14 million annually starting in FY 2006.

- Medicaid costs are projected to grow by 16.5 percent in FY 2005, but then increase at an annual average rate of 2.5 percent during the later years of the Plan period, which reflects the planned State takeover of Family Health Plus.

  Medicaid costs, excluding Family Health Plus, are projected to grow at an average annual rate of 4.7 percent during fiscal years 2006 through 2008. The driving factor behind the growth in Medicaid during these years is the increased cost and utilization of pharmaceuticals and long-term care services. These expenses account for about 35 percent of Medicaid expenditures and are projected to grow at an annual rate of nearly 13 percent during this period. Moreover, our review indicates that Medicaid costs could be even higher than planned by $130 million in FY 2006 and by $200 million in each of fiscal years 2007 and 2008.

- Salary and wage costs are projected to grow by only $101 million during the Plan period based on the assumption that a planned 2 percent wage increase for all City employees in FY 2005, as well as all future wage increases, will be funded entirely with productivity savings.
- Public assistance spending is projected to remain stable during the Plan period based on projections that the caseload will remain at current levels.

Other Issues

Our review has identified the following issues that could have a significant impact on the City during the Plan period.

Campaign for Fiscal Equity

In June 2003, the Court of Appeals upheld a 2001 State Supreme Court ruling that the formula for allocating State education aid was unconstitutional, and gave the State until July 30, 2004, to determine the cost of providing a sound basic education in New York City and to enact necessary reforms. The State failed to comply with this deadline, prompting the Supreme Court Justice to appoint a three-person panel of special masters.

On November 30, 2004, the panel recommended that the State implement a funding plan that would phase in over a four-year period beginning next year an increase of $5.6 billion to ensure that the New York City public school system receives the funding necessary to provide a sound basic education. The panel also recommended that the State implement a funding plan to provide New York City with $9.2 billion over a five-year period for capital projects. The panel stated that the State Legislature should determine how these additional costs are split between the State and the City, but that the burden placed on New York City cannot be arbitrary or unreasonable.

The Supreme Court is expected to issue a final order based on the panel's recommendations in January 2005, after which the State would have 90 days to implement the court order unless the decision is appealed. Alternatively, the parties to the litigation could reach a negotiated settlement.

Collective Bargaining

In April 2004, the City reached an agreement with District Council 37, which represents most civilian employees, for wage increases of 5.1 percent during the 2002-2005 period. The October Plan assumes that teachers, police officers, firefighters, and all other City employees will agree to similar terms. The unions representing teachers, police officers, and firefighters, however, are seeking larger wage increases but have been unable to reach agreements with the City. Each additional 1 percent wage increase would increase the City's costs by about $150 million annually.

The State Public Employment Relations Board (PERB) has declared an impasse in the City's negotiations with the Police Benevolent Association (PBA) and the United Firefighters Association (UFA). Pursuant to law, a fact-finding award is binding for these unions. The PERB has appointed an arbitrator to set the terms for a new agreement with the PBA; mediation between the City and the UFA is ongoing.

Negotiations between the City and the United Federation of Teachers (UFT) have stalled and the UFT has asked PERB to declare an impasse in the negotiations. If PERB finds that an impasse has been reached, it would appoint a mediator to facilitate negotiations. If mediation fails, PERB could appoint a fact-finding panel that would make nonbinding recommendations.

The October Plan also assumes that a 2 percent wage increase planned for FY 2005 will be funded entirely with savings from productivity improvements. Although District Council 37 agreed to reduce starting salaries to help fund the wage increase, these savings will not be enough and the City plans to reduce civilian staffing levels by 1,757 employees to cover the full cost.

Applying the productivity terms of the District Council 37 agreement to the unions that represent teachers and uniformed employees could prove difficult. While the City and these unions could negotiate other productivity improvements, the failure to do so would increase costs by $95 million in FY 2005, $290 million in FY 2006, and $300 million annually thereafter.

The October Plan further assumes that any wage increases granted after the current round of negotiations are completed will be funded entirely with productivity improvements. Wage increases at the projected inflation rate without offsetting productivity savings would widen the projected budget gaps by $220 million in FY 2006, $700 million in FY 2007, and $1.2 billion in FY 2008.

Metropolitan Transportation Authority

In July 2004, the Metropolitan Transportation Authority (MTA) projected budget gaps of $745 million in 2005, $1.4 billion in 2006, $1.7 billion in 2007, and $2.1 billion in 2008. In addition, the MTA proposed a $27.8 billion five-year capital program, but the program has a funding gap of $16.2 billion.

A report issued by this office on October 28, 2004 (Report 7-2004, *Review of the Proposed Financial Plan and Capital Program for the Metropolitan Transportation Authority*), found that the current financial crisis was brought on by past decisions by the MTA to borrow beyond its means to finance its capital programs, and by other bad management decisions.

The report pointed out that the MTA failed to produce legally required five-year plans between September 1999 and October 2003, which prevented the public and its elected officials from seeing the ramifications of the MTA Board's decisions. Had the MTA acted sooner, the current crisis could have been eased or possibly even averted.

Since October 2003, the MTA has issued regularly scheduled four-year financial plans and has instituted other reforms, including implementation of budget regulations promulgated by the State Comptroller that enhance transparency and accountability.

The Comptroller's October 2004 report also was critical of the MTA's plan to address the current problem one year at a time through an endless cycle of higher fares and reduced services. Instead, the report recommended that the MTA develop a comprehensive long-term strategy to restore fiscal stability, which includes larger savings from management improvements.

On November 30, 2004, the MTA released a revised financial plan that reflected $320 million in additional resources during calendar years 2004 and 2005 from higher-than-anticipated revenues from real estate–related transactions (which have been fueled by very low mortgage rates), and from lower debt service costs. The MTA Executive Director has proposed that the MTA use these resources to scale back some of the service reductions planned for 2005 and to create a $200 million reserve rather than rescind a 5 percent fare hike planned for 2005.

Even if the MTA Board votes to approve the 2005 fare increase—which is uncertain because the Mayor and others have voiced their opposition—and approves the revised budget cuts, the MTA will still face budget gaps of $841 million in 2006, $1.1 billion in 2007, and $1.4 billion in 2008.

Rather than developing a long-term comprehensive plan to balance the budget as recommended by the State Comptroller, the MTA still proposes an endless cycle of fare increases and service reductions that would leave gaps that average about $650 million annually in calendar years 2006 and 2007, and nearly $1 billion in 2008 to be closed through other actions, possibly including higher subsidies from the State or City.

On December 3, 2004, the MTA Chairman proposed that the State increase taxes on businesses, real estate transactions, and petroleum products to help close the $16.2 billion funding gap in the proposed capital program. According to the MTA, the tax increases would generate an additional $850 million annually that would be used to back $12 billion in MTA bonds. The Governor and the State Senate Majority Leader, however, responded that they were opposed to raising taxes. The balance of the funding gap would be filled with an additional $4 billion in MTA bonds that would be backed largely by future fare and toll increases.

Health and Hospitals Corporation

In January 2004, the Health and Hospitals Corporation ("the Corporation") projected that cash expenses would exceed receipts by

$435 million in FY 2005 and by more than $600 million annually in subsequent years. To assist the Corporation in meeting its ongoing cash needs, the City increased its support by $200 million in FY 2005 and by $150 million thereafter.

Because the underlying causes of the Corporation's budget gaps have not been addressed, it still projects a cash deficit from current-year operations of $235 million for FY 2005 (adjusted for City prepayments), and more than $500 million for subsequent years. The major source of the Corporation's budget gaps is inadequate reimbursement for the services that it provides to uninsured patients (the Corporation provides care to 460,000 uninsured City residents each year).

Department of Education Overspending

City-funded spending at the Department of Education unexpectedly exceeded the amount budgeted in FY 2004 by $236 million, and the overspending was only discovered during the year-end close.

The adverse budgetary impact was partly offset by eliminating accruals that had been established in prior years and that were judged to be no longer needed. In its January 2005 Plan the City should address the financial implications of this event, which could require a combination of increased City funding and budget cuts that total up to $200 million annually. In addition, the City will require the Department of Education to adopt the City's Financial Management System (FMS), which has an excellent track record, in place of the department's own accounting system.

MAC Refinancing Initiative

In May 2003, the State Legislature passed legislation, over the Governor's veto, which requires the New York State Local Government Assistance Corporation (LGAC) to make an annual $170 million payment to New York City or its assignee with the understanding that the proceeds will be used to retire outstanding debt of the Municipal Assistance Corporation (MAC) in order to provide budget relief to the City.

On September 22, 2004, the Sales Tax Asset Receivable (STAR) Corporation, a local development corporation created by the City to issue bonds to finance the cost of debt service on MAC bonds, received the first $170 million annual payment from LGAC.

On November 4, 2004, STAR Corporation completed the refinancing, and the proceeds will be used to reimburse the City for $622 million of revenues retained by MAC and to provide MAC with an amount sufficient to defease its outstanding debt.

The economic impact of the refinancing will be to make available to the City approximately $1 billion in FY 2005 and $500 million annually during fiscal years 2006 through 2008, by reducing the amount of City revenues retained by MAC for its debt service or by reimbursing the City for revenues already retained during fiscal years 2004 and 2005.

TSASC "Trapping Event"

The downgrade of major tobacco companies below investment grade, along with an increase beyond 7 percent in the market share of the tobacco manufacturers that did not participate in the national settlement, have resulted in trapping events for TSASC. Consequently, TSASC is required to retain 25 percent of the revenues from the national settlement with tobacco companies in a reserve account for the benefit of its bondholders.

The City and TSASC are considering alternatives to eliminate the trapping requirement, but if the requirement were to continue, it is estimated that revenues that would otherwise accrue to the City's budget will be reduced by $121 million in FY 2005 and about $60 million annually during fiscal years 2006 through 2008, for a total reduction of $301 million.

FY 2005 Securitization Corporation

The Fiscal Year 2005 Securitization Corporation is a special-purpose local development corporation created by the City for the sole purpose of generating $47 million for the City's operating budget, which is $32 million more than anticipated in the October Plan.

The Securitization Corporation issued $499 million of bonds on December 2, 2004, and the proceeds were used to call City bonds that had been defeased to maturity under a previous refunding. By calling the bonds, the escrow account is no longer needed and the funds that were held in escrow have been transferred to the Securitization Corporation to pay debt service on its bonds. Because of favorable interest rates and the top rating of "AAA" on the bonds, the transaction generated an additional $47 million which was turned over to the City.

Judgments and Claims

The October Plan does not reflect any potential liability that could arise from the Staten Island Ferry accident of October 15, 2003. The potential value of claims filed for the ferry accident currently is $3.4 billion, although the City claims its liability under maritime law is limited to the value of the vessel ($14.4 million).

The World Trade Center disaster generated $13 billion in claims against the City, $11.3 billion of which were covered by the Federal Victims Compensation Fund. Of the remaining $1.7 billion in current claims, about $500 million will be covered by the WTC Captive Insurance Company, Inc. ("the Company"), which was established by the City as a nonprofit corporation. The Company is funded by the Federal Emergency Management Agency in the form of a $1 billion premium for a single-liability policy to insure the City and its 150 contractors and subcontractors for current and future health-related claims related to debris removal at the World Trade Center site following the events of September 11, 2001.

The remaining $1.1 billion liability relates to claims from both the insurers of 7 World Trade Center and the building's tenant, Con Edison, that the City was responsible for that building's collapse on September 11, 2001. The City believes that federal legislation passed in the aftermath of the events limits the City's liability to $350 million.

Uniformed Agency Overtime

The uniformed agencies exceeded the amount allocated by the City for overtime at the beginning of FY 2004 by $261 million. The Police Department accounted for 71 percent of the overspending and the Fire Department accounted for 10 percent. Most of the overspending was attributed to increased security needs related to the threat of another terrorist attack. The October Plan assumes that the uniformed agencies will spend $478 million on overtime during FY 2005—which is $190 million less than spent in FY 2004—and will spend similar amounts in subsequent years.

Our review indicates that overtime costs in the Police Department are likely to exceed the estimate in the October Plan by about $150 million in FY 2005. These costs, however, would be reduced by $50 million from reimbursements for costs associated with the Republican National Convention and the receipt of federal grants. The remaining $100 million in recurring overtime exposure will be offset in FY 2005 with one-time savings from an overestimation of annual salaries.

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