Review of the Financial Plan of the City of New York

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Highlights

- **Employment increased by 21,000 jobs in 2004, the first annual gain since 2000, and wage income grew at an estimated rate of 6.4 percent—the largest gain in four years.**
- **With signs that merger and acquisition activity is improving, Wall Street profits will grow from $12.8 billion in 2004 to $14.4 billion in 2005. Despite high profits, Wall Street, the economic engine of the City, is not adding jobs.**
- **The tax revenues from real estate-related transactions account for half of the $1.5 billion gain in taxes since the June Plan.**
- **Medicaid, debt service, pensions, and health insurance are projected to consume 52 percent of City fund revenues by FY 2009, compared with 39 percent in FY 2004.**
- **The Governor's proposed Campaign for Fiscal Equity (CFE) settlement would provide only two thirds of the resources recommended by a court-appointed panel.**
- **If the City were required to fund 40 percent of a CFE settlement as proposed by the Governor, the budget gaps could widen by $525 million in FY 2006, growing to $2.2 billion by FY 2009.**
- **The City assumes that all employees will reach labor agreements similar to the terms concluded with District Council 37, but teachers, police officers, and firefighters are seeking substantially larger wage increases.**
- **Staffing levels are projected to grow by 3,600 employees during fiscal years 2004 and 2005; reversing about one-quarter of the reduction between fiscal years 2001 and 2003.**
- **The preliminary ten-year capital program restores about $9.9 billion, or 91 percent, of the cuts imposed in January 2003.**

On February 2, 2005, the City of New York released a revised four-year financial plan (the "February Plan"). The February Plan projects a balanced budget for FY 2005 but a budget gap of $3.4 billion for FY 2006 and large out-year gaps.

Despite balancing the FY 2005 budget, the City projects gaps because nonrecurring resources that were used to balance the FY 2005 budget have not been replaced with recurring resources, nondiscretionary spending is growing faster than revenues, and temporary taxes that were approved by Albany at the City's request to help it through its recent fiscal crisis are set to expire next year.

Fortunately, the budget has benefited for the second year in a row from an unexpected surge in tax revenue. Last year, Wall Street activity was the driving force; this year the unexpected revenue comes from the real estate industry.

The City now projects a surplus of $1.8 billion in FY 2005. These resources, combined with $220 million in surplus funds from FY 2004, will be used to narrow the FY 2006 gap to $1.7 billion. To balance the FY 2006 budget and to narrow the out-year gaps, the Mayor has outlined a gap-closing program that includes City actions and that counts on federal and State assistance.

Our review has identified budget risks of $340 million for FY 2006—manageable for this point in the financial planning process. The risk lies largely in the City's anticipation of federal and State assistance, though it is partly offset by our higher revenue forecast. The budget gaps, however, could reach $4.3 billion by FY 2007 (see Table 1). The City faces additional budget risks from the potential for higher collective bargaining costs and the impact of the President's proposed federal budget, and the possible need to contribute toward a Campaign for Fiscal Equity settlement or to help the Health and Hospitals Corporation close large projected budget gaps.

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

	Better/(Worse)				
	FY 2005	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009**
Gaps per February 2005 Plan	**$ - - -**	**$ - - -**	**$ (3,718)**	**$ (3,565)**	**$ (3,179)**
Tax Revenues	350	350	- - -	- - -	- - -
Asset Sale	(150)	150	- - -	- - -	- - -
Productivity Savings	(95)	(290)	(300)	(300)	(300)
State Actions	- - -	(250)	(200)	(100)	(100)
Federal Actions	- - -	(250)	- - -	- - -	- - -
Uniformed Agency Overtime	- - -	(50)	(50)	(50)	(50)
OSDC Risk Assessment	**$ 105**	**$ (340)**	**$ (550)**	**$ (450)**	**$ (450)**
Gaps to be Closed	**$ 105**	**$ (340)**	**$ (4,268)**	**$ (4,015)**	**$ (3,629)**
Other Risks and Potential Offsets					
Pay-As-You-Go Capital Financing	200	200	200	200	200
Campaign for Fiscal Equity Settlement	- - -	(525)	(1,000)	(1,700)	(2,200)
Anticipated Pension Savings	- - -	(325)	(200)	- - -	- - -
Wage Increases at the Projected Inflation Rate[1]	- - -	(280)	(800)	(1,300)	(1,800)
TSASC Trapping Event	- - -	(120)	(61)	(60)	(60)

[1] The financial plan assumes that future wage increases will be funded entirely with productivity savings. Wage increases without any offsetting productivity improvements would increase the projected gaps by the amounts shown in the table.

Economic Overview

New York City's economy has continued to strengthen. Preliminary data indicate that total employment in the City increased by 21,000 jobs in calendar year 2004, the first annual gain since 2000. Citywide wage income is expected to have increased by 6.4 percent, the strongest gain in four years.

Despite the rise in short-term interest rates, long-term rates have basically remained unchanged, which allowed the residential and commercial real estate markets to stay strong and to produce much of the additional revenue growth in FY 2005. The local inflation rate, however, increased in 2004 at the highest rate since 1992, fueled by price increases for energy, food, and housing.

The City has raised its economic forecasts slightly compared with those in the October Plan. The changes reflect a stronger outlook for the national economy, which is a major influence on local economic growth. Nonetheless, growth in the national and local economies is still forecast to slow over the course of the Plan period.

Although Wall Street profits fell by $4 billion to $12.8 billion in 2004, the year's performance was still the fourth-best on record. With improved merger and acquisition activity, the City has raised its forecast for Wall Street profits in 2005 by $900 million to $14.4 billion, and projects that profits will reach $18.2 billion by 2009.

Local employment is forecast to increase by about 44,000 jobs in 2005, but then slow to an average of 37,000 annually for the rest of the Plan period. The majority of these new jobs are expected to be in professional services, tourism-related sectors, and education and health services. Wall Street employment is forecast to rise only marginally.

Despite improvement in the economy, the lack of participation from Wall Street raises concerns. Wall Street is the main engine of the City's economy, and its good and bad years have a clear impact on the City. Profits fell in 2004, and although the year was still one of the most profitable on record, the industry did not create jobs as it continued to face technological advances and the decentralization of operations. Wall Street has a large multiplier impact on the local economy, and the lack of job growth will hold back the economic performance of the City.

In addition, the economy faces many more risks that might raise interest rates, increase inflation, and depress growth. These risks include oil prices that remain near recent peaks, high debt levels for consumers and businesses, the large and expanding federal budget and trade deficits, the potential cost of social security reform, and the significantly lower value of the dollar.

Fiscal Year 2005

The City ended FY 2004 with a surplus of $1.9 billion. The surplus was realized in large part from a surge in tax revenues, and this strong revenue performance has continued into FY 2005. Unlike last year, the revenue surge in FY 2005 was caused by unexpected strength in the real estate industry.

The February Plan assumes that FY 2005 will end with a surplus of nearly $1.8 billion (see Table 2), slightly less than last year's surplus, and that the resources will be used to help balance the FY 2006 budget. The FY 2005 surplus results largely from $1.5 billion in unexpected tax revenues and $518 million from agency cost-reduction initiatives. Although agencies identified new spending needs and Medicaid is now projected to be substantially higher than previous forecasts, these costs were offset in FY 2005 from a reduction in the general reserve, savings from overestimating prior years' expenses, and lower pension and debt service costs.

Revenue Reestimates

In October 2004, the City raised its tax revenue forecast by $500 million and in the February Plan the City increased its forecast by another $1 billion. Wall Street has not been a major factor in the current revenue surge. Nearly half of the additional FY 2005 tax revenue ($734 million) comes from real estate–related taxes.

Although the Federal Reserve has been increasing short-term interest rates over the past seven months, long-term rates have not followed suit, and mortgage rates remain near last year's levels. Refinancings have begun to taper off, but purchase

Table 2
Financial Plan Reconciliation
June 2004 Plan vs. February 2005 Plan
(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 Tax	$ 41	$ 281	$ 509	$ 632
Real Estate–Related Taxes	734	109	81	94
Personal Income Tax	319	308	219	161
Business Taxes	237	161	129	122
All Other Taxes	197	130	114	88
Subtotal	**1,528**	**989**	**1,052**	**1,097**
Anticipated State and Federal Aid	(251)	(196)	(94)	(77)
Tobacco Settlement	(120)	120	(2)	(2)
Other	34	68	20	23
Total	**1,191**	**981**	**976**	**1,041**
Expenditures				
Medicaid*	(168)	(301)	(475)	(666)
Agency Needs	(185)	(144)	(132)	(199)
Department of Education	(147)	(60)	(60)	(60)
Energy Costs	(49)	(81)	(83)	(7)
Hudson Yards Debt Service	(6)	(46)	(95)	(139)
Pension and Fringe Benefits	114	(149)	(21)	(224)
City Debt Service	115	25	(56)	(79)
Total	**(326)**	**(756)**	**(922)**	**(1,374)**
Reserves				
Prior-Year Expenses	200	- - -	- - -	- - -
General Reserve	200	- - -	- - -	- - -
Total	**400**	- - -	- - -	- - -
Agency Actions	**518**	- - -	- - -	- - -
Net Change During FY 2005	**$ 1,783**	**$ 225**	**$ 54**	**$ (333)**

* Excludes the benefit of the State takeover of the Family Health Plus program, which is reflected in the category "Anticipated State and Federal Aid."

Sources: NYC Office of Management and Budget; OSDC analysis activity remains strong, so the expected sharp drop in transaction activity has not yet occurred.

While tax collections for real estate transactions are now expected to drop sharply in FY 2006, rising property values in the tentative property tax roll will significantly increase real property tax revenues during fiscal years 2006 through 2008.

The City also increased its forecast of personal income tax collections by $247 million in the February Plan for a cumulative increase of $319 million since the June 2004 Plan. The forecast for business taxes rose by $171 million since October and by $237 million since June. These changes primarily reflect increased capital gains realizations and an improving economy.

Tobacco settlement revenues are now projected to be lower by $120 million in FY 2005 because a downgrade of tobacco manufacturers' investment ratings required TSASC to increase its reserves for the protection of its bondholders. Unless the City takes steps to eliminate the trapping requirement, tobacco revenues that currently benefit the City's operating budget would be reduced by $120 million in FY 2006 and by about $60 million annually during fiscal years 2007 through 2009.

The late passage of the State budget—in August 2004—did not give the City a chance to reflect the impact in its June Plan. The City estimates that the State budget provided the City with $199 million in increased aid, primarily from a postponement of the reinstatement of the sales tax exemption for clothing and a phased takeover of the Family Health Plus program. However, the aid was $201 million less than anticipated in the June Plan. The City also did not realize an additional $50 million in expected federal aid.

Expenditure Reestimates

The February Plan assumes that expenditures will exceed estimates in the October Plan by $271 million, for a cumulative change of $326 million since the June Plan. The budgetary impact was more than offset in FY 2005 by drawing down from the general reserve and savings from overestimating prior years' expenses.

Medicaid costs are now forecast to be higher than projected in June 2004 by $168 million in FY 2005, growing to $666 million by FY 2008. The February Plan also recognizes higher-than-anticipated spending at the Department of Education, and other agency needs including higher personal service costs at the Fire Department, a new labor agreement for day care workers, higher franchise bus costs, and partial funding for labor agreements with other social service providers. Energy costs are also expected to be higher than projected in the June Plan because Con Edison and the New York Power Authority have increased prices.

Pension contributions in FY 2005 are now expected to be lower than previously projected because of a delay in finalizing certain labor agreements, but these costs will now be incurred in FY 2006. The February Plan also reflects savings from actual FY 2004 pension fund investment performance, which was twice the 8 percent assumed rate of return. The City has created a reserve of $250 million in each of fiscal years 2008 and 2009 to cover the potential costs associated with recommendations made by an actuarial consultant.

Debt service costs in FY 2005 will be lower than assumed in the June Plan because there is no need for short-term borrowing given the City's large cash balances. Debt service costs will be higher in fiscal years 2007 and 2008, however, from an expansion of the capital program and costs related to developing the far West Side of Manhattan.

Balancing the FY 2006 Budget

The February Plan projects out-year gaps of $3.4 billion in FY 2006, $4.5 billion for FY 2007, and $4 billion for FY 2008. Gaps of this magnitude represent about 10 percent of City fund revenues in FY 2006 and 13.1 percent in FY 2007. The gap estimates, however, do not take into account the possibility that teachers, police officers, and firefighters will reach new labor agreements that provide for larger wage increases than those granted to District Council 37. Moreover, the Plan does not include funds to provide wage increases for any employees after the current round of collective bargaining expires in FY 2005, nor does it include additional education funding in the event that the City is required to contribute to a CFE settlement.

In October, the City projected a surplus of $354 million for FY 2005 and used these resources to narrow the FY 2006 budget gap. The February Plan assumes that the FY 2005 surplus will be larger by $1.4 billion and that these resources will also be used to narrow the FY 2006 budget gap. To close the remaining gap of $1.7 billion and to narrow the out-year gaps, the gap-closing program counts on a combination of federal, State, and City actions (see Table 3).

Table 3
Gap-Closing Program
(in millions)

	FY 2006	FY 2007	FY 2008
	Better/(Worse)		
Gaps to be Closed	**$ (1,666)**	**$ (4,468)**	**$ (4,014)**
Agency Actions	506	350	349
State Actions	500	200	100
Pension Savings	325	200	- - -
Federal Actions	250	- - -	- - -
Debt Service	85	- - -	- - -
Total	**1,666**	**750**	**449**
Remaining Gaps	**$ - - -**	**$ (3,718)**	**$ (3,565)**

Sources: NYC OMB; OSDC analysis

Agency Actions

Agency actions are expected to generate $506 million in FY 2006, but nearly one third less in subsequent years because many actions are expected to generate only one-time savings. The Police Department has the largest program ($131 million in FY 2006); nevertheless, most of these resources would come not from management initiatives but from an overestimation of salary costs and federal reimbursement for overtime related to homeland security.

The Fire Department is expected to contribute $51 million by reducing overtime, eliminating the fifth firefighter at 49 engine companies (this remains a controversial issue with the union), and other management initiatives. The Department of Sanitation expects to save $38 million from a delay by the State Department of Environmental Conservation in approving final plans for the closure of the Fresh Kills Landfill. The Department of Correction anticipates savings of $45 million from an overestimation of personal service costs, federal reimbursement for housing illegal aliens, and other savings related to lower-than-projected inmate population.

Social services agencies are expected to contribute $79 million in FY 2006, with about half coming from a decline in the foster care caseload. The caseload declined from 50,000 in FY 1992 to 19,500 in FY 2005, and is projected to decline to 17,500 in FY 2006. The agency program also includes $31 million in subsidy reductions to the Health and Hospitals Corporation, libraries, and cultural institutions. In the past, the City Council has partially restored such cuts. The City also has reduced its projection for other-than-personal-service expenditures by $37 million by eliminating the adjustment for inflation.

Pension Savings

The gap-closing program anticipates pension savings of $325 million in FY 2006 and $200 million in FY 2007. The City Actuary is considering changes in actuarial assumptions and methodologies, some that would increase costs and others that would defer contributions.

Changes that would defer costs include a one-year lag in the calculation of pension contributions, and retroactively increasing the phase-in period of investment gains and losses from five years to six years. Changes that would increase costs include recognizing the full cost of cost-of-living-adjustments for retirees instead of phasing in the cost over a ten-year period and implementing recommendations made by an actuarial consultant.

The Actuary's estimates are still preliminary and subject to change, but it appears that there could also be savings of about $150 million in FY 2005 if the changes were implemented. These changes will require approval by the pension fund boards of trustees and, in some cases, the State.

State Actions

The February Plan assumes that the State will take actions to produce $500 million in gap-closing assistance in FY 2006, $200 million in FY 2007, and $100 million in each subsequent year. The City has offered a menu of initiatives, totaling $1.1 billion, from which the State could choose.

According to the State Division of the Budget (DOB), the Governor's proposed budget would benefit the City by $91 million in FY 2005 and by $927 million in FY 2006 (see Table 4). Most of the benefit in FY 2006 would come from implementing Medicaid cost-containment initiatives, imposing a cap on the local share of Medicaid, increasing State education aid, and eliminating the sales tax exemption for clothing purchases under $110.

Because education aid cannot be used for gap-closing purposes, the amount of State funds available to help balance the City's budget would be reduced to $647 million in FY 2006. Also, the Health and Hospitals Corporation (HHC) estimates that the Governor's Medicaid cost-containment initiatives would widen its $612 million budget gap in FY 2006 by up to $275 million. If the City were required to increase its subsidy to HHC, the net benefit of the Governor's proposals would be reduced to $372 million.

Given the uncertainty surrounding adoption of the Governor's Medicaid proposals, it is reasonable to assume at this point in the financial planning process that the City will realize half of its FY 2006 target for additional State aid based on the assumption that the State will eliminate the sales tax exemption on clothing purchases.

Table 4
Impact of the Governor's Proposed Budget
(in millions)

	Better/(Worse) FY 2006
Medicaid Cost-Containment	$ 229
Eliminate Clothing Sales Tax Exemption	215
Medicaid Cap	190
Sound Basic Education Aid	195
School Aid	85
Other	13
Total	**$ 927**

Source: NYS Division of the Budget

In addition, the proposed budget may require SUNY and CUNY to raise tuition. Moreover, the Governor's proposed Medicaid cuts could harm the City's neediest populations and negatively impact private hospitals and nursing homes, which could adversely affect the City's economy because health care is the City's largest employer.

The following proposals would have the greatest impact on the City's budget.

- Medicaid cost-containment measures would save the City $73 million in FY 2005 and $229 million in FY 2006. These measures include the elimination of certain inflation adjustments, the imposition of a tax on hospital revenues, and benefit reductions in the Family Health Plus program.
- If the Governor's cost-containment measures were adopted, which appears unlikely because similar measures were rejected last year by the State Legislature, the Governor also would cap the growth in the local share of Medicaid at 3.5 percent in 2006, 3.25 percent in 2007, and 3 percent annually thereafter.

  The DOB estimates that the cap would save the City $190 million in FY 2006 and more than twice that amount in subsequent years. Cities and counties also would be given an opportunity in calendar year 2008 to exchange a share of their sales tax (and personal income tax in the case of New York City) for a State takeover of the local share of Medicaid. Most localities are unlikely to pursue this option because these tax collections are likely to grow faster than the cap on the growth in the local share of Medicaid.
- The City would realize $215 million in FY 2006 from the elimination of the sales tax exemption on clothing purchases under $110. This exemption would be replaced with two weeks each year during which clothing purchases under $250 would be tax-exempt. Last year, the City benefited when the State Legislature temporarily eliminated the exemption to help balance the State budget.
- As part of a proposed settlement to the CFE litigation, the Governor proposes the creation of a $325 million Sound Basic Education fund that would be funded with proceeds from video lottery terminals. New York City would receive 60 percent, or $195 million, of the Statewide fund in FY 2006. The Governor also would increase regular school aid to the City by a net of $85 million, with most of the increase in categorical aid. The court subsequently ordered the State to provide $5.6 billion for operations over four years, but the Governor plans to appeal.

Federal Actions

The February Plan assumes that the federal government will provide the City with a one-time infusion of $250 million in gap-closing assistance. The City estimates, however, that the President's proposed budget for federal fiscal year 2006 would reduce federal funding to the City by $308 million, including a $207 million reduction in Community Development Block Grant funding that is used to fund day care, services for senior citizens, and literacy programs. The City also could face a reduction in homeland security funding. In addition, the President has proposed measures that would reduce revenues for HHC, and the New York City Housing Authority could face a reduction of $70 million in operating aid.

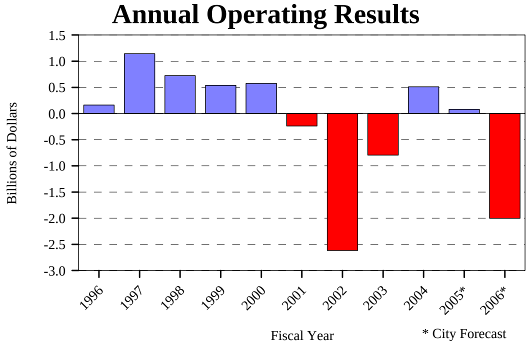
Revenue and Expenditure Trends

City fund expenditures (adjusted for surplus transfers) rose by 22 percent between fiscal years 1996 and 2000—far faster than the local inflation rate. Under normal circumstances, the City would have been unable to support such a rapid rate of growth, but revenues fueled by the Wall Street boom grew even faster.

While expenditures continued their rapid growth in FY 2001—increasing by 9.8 percent—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), which was masked by the City's practice of transferring the prior year's surplus to the following year.

Graph 1

Annual Operating Results



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

The FY 2002 budget did not address the imbalance, and instead called for spending to increase by 5.7 percent. The budgetary impacts of the economic slowdown and the 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. In the absence of these resources, the City would have incurred a deficit of $2.6 billion from current-year operations.

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

The City ended FY 2004 with a current-year surplus of $511 million—the first such surplus since FY 2000. The surplus reflects a combination of City, State, and federal actions taken to help the City through its fiscal crisis, and also a sharp rebound on Wall Street. The City is on course to end FY 2005 with a small current-year surplus, even though spending is projected to grow by 8 percent, because revenue collections remain strong. Current-year budget balance was aided significantly in fiscal years 2004 and 2005 through the use of nonrecurring resources—$1.2 billion in FY 2004 and $1.8 billion in FY 2005.

Based on current trends, the City will end FY 2006 with a current-year deficit of $2 billion, even with the successful implementation of the FY 2006 gap-closing program. The deficit results from the expiration of temporary taxes approved by the State, at the City's request, to help the City through its latest fiscal crisis; as well as from a continued rapid increase in nondiscretionary spending such as pensions, Medicaid, debt service, and health insurance. Although the projected deficit will probably decline as the year progresses, budget balance would be achieved by transferring prior-year surpluses.

Revenue Trends

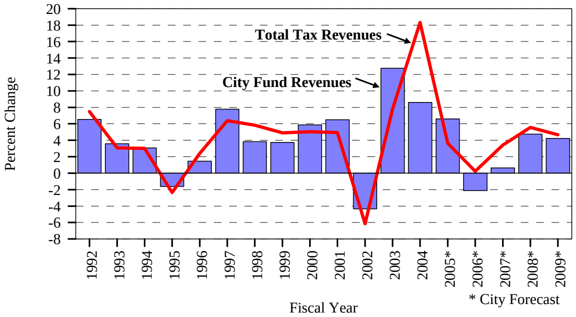
The City has raised its forecasts of City fund revenues as the year has progressed. City fund revenues[1] are now projected to increase by 6.6 percent in FY 2005 (see Graph 2), fueled by a 3.6 percent increase in tax revenues and $1.6 billion in nonrecurring revenue resources.

City fund revenues are projected to decline by 2.1 percent in FY 2006 as most of the nonrecurring resources used in FY 2005 are not replaced, temporary tax increases expire, and tax revenue growth slows in response to an easing pace of economic growth. Tax revenue growth is expected to improve in the later years of the Plan period as the effects of the tax expirations pass.

[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 TFA, and tobacco settlement revenues dedicated to pay debt service on tobacco bonds.

Graph 2

Annual Change in City Fund Revenues and Tax Revenues



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

Major tax revenue trends include the following.

- The February Plan assumes that tax revenues will decline by $548 million between fiscal years 2005 and 2006, in response to expiring temporary taxes that were enacted to help the City balance its budget during the fiscal crisis precipitated by the recession and attack on the World Trade Center.[2]
- The recent tentative real property tax roll for FY 2006 shows that the real estate market remains strong. Assessed values are expected to rise by 6.5 percent in FY 2006, which, when combined with the postponed sale of property liens from FY 2005, results in growth in real property tax revenues of 7 percent. The forecast includes the continuation of the $400 real property tax rebate to homeowners, which reduces collections by $256 million.

  State law requires assessment increases for large residential and commercial properties to be phased in over five years. This has created a pipeline of assessment changes not yet phased in that has reached more than $13 billion in value, the highest level since FY 1991. This pipeline will help support continued revenue growth during the Plan period, with projected average annual gains of 5.9 percent in fiscal years 2007 through 2009.
- The Plan assumes that long-term interest rates will begin to rise later in calendar year 2005, and that activity in the real estate market, especially refinancings, will ease. Revenue from mortgage-recording and real property transfer taxes, which are responsible for about half of the FY 2005 surplus, are expected to decline by more than 30 percent in FY 2006.
- Personal income tax collections are expected to increase by 4.6 percent in FY 2005, boosted by year-to-date strength in estimated payments (due to increased capital gains realizations). Collections are expected to decline in fiscal years 2006 and 2007, reflecting the expiration of the high-income surcharge and a falloff in expected capital gains realizations.

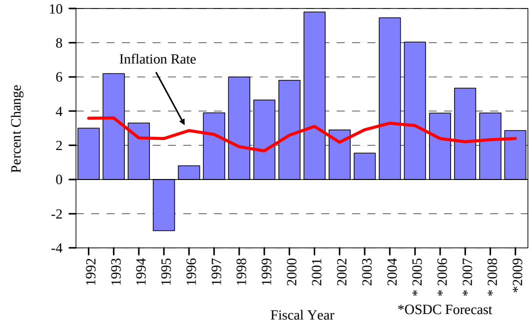
Our review finds that year-to-date strength in nonproperty tax collections will continue into early next year. Real estate transaction taxes will begin to fall next year, though we expect the falloff to occur later than the City forecasts. Overall, we expect tax revenues to be higher by $350 million in each of fiscal years 2005 and 2006. The receipt of $150 million from the sale of property to the Battery Park City Authority will likely be delayed until at least FY 2006.

Expenditure Trends

City-funded spending grew by 9.5 percent in FY 2004, and is projected to grow by 8 percent in FY 2005 (see Graph 3). The February Plan assumes that the rate of expenditure growth will slow to 4 percent, on average, during fiscal years 2006 through 2009. The Plan also assumes, however, that teachers, police officers, and firefighters will reach terms similar to the District Council 37 agreement and that the next round of collective bargaining will be fully funded from productivity savings. The Plan does not take into account the potential for an increase in City education funding pursuant to a CFE court ruling or settlement.

Graph 3

Changes in City-Funded Expenditures



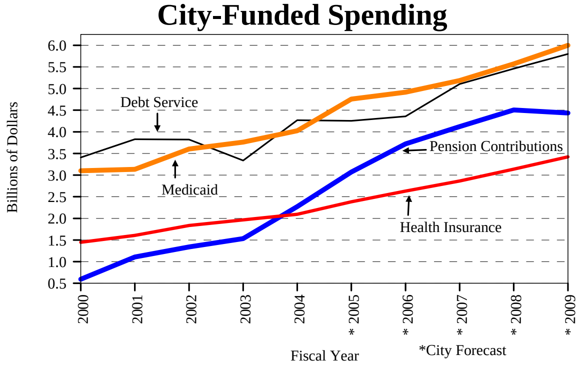
Sources: NYC Comptroller's Office; NYC Office of Management and Budget; OSDC analysis

[2] The expiration of the personal income tax surcharge will reduce tax revenue collections by $230 million, while the expiration of the temporary sales tax rate increase and the permanent reinstatement of the clothing sales tax exemption will reduce collections by $318 million.

The growth in City-funded expenditures is fueled by nondiscretionary spending, but staffing levels have also been rising. Staffing levels grew by 1,200 employees during FY 2004 (adjusted for transfer between agencies), and are projected to increase by another 2,400 during FY 2005. These increases offset about one quarter of the reduction achieved between fiscal years 2001 and 2003.

City-funded spending for Medicaid, debt service, pensions, and health insurance is projected to grow at an average annual rate of 8.8 percent during the Plan period. These costs are projected to account for 52 percent of City fund revenues by FY 2009, compared with 39 percent in FY 2004. Graph 4 shows historical and projected growth in these spending categories.

Graph 4
Trends in Nondiscretionary City-Funded Spending



Sources: NYC Office of Management and Budget; OSDC analysis

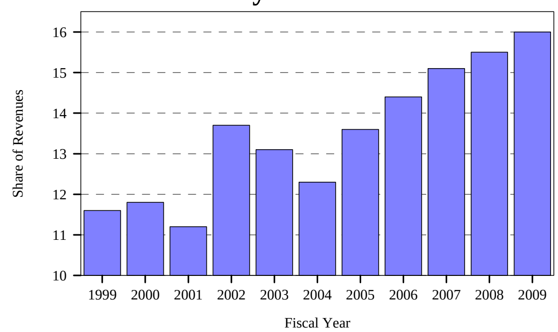
- Pension contributions doubled between fiscal years 2003 and 2005 to reach $3.1 billion, and are projected to peak at $4.5 billion in FY 2008 before declining slightly in FY 2009. The estimates for fiscal years 2008 and 2009 include a reserve of $250 million.

- Debt service costs are projected to remain stable at about $4.3 billion during fiscal years 2005 and 2006, which includes savings of $85 million in FY 2006 from debt restructuring. Debt service costs, however, are projected to increase by over $1.5 billion during the succeeding three years, reaching $5.8 billion in FY 2009. These costs are projected to increase by more than three times the local inflation rate and the debt burden (debt service as a percent of tax revenues and offsetting revenues) will increase from 14.3 percent in FY 2005 to 17.1 percent in FY 2009.

- Medicaid is projected to total $4.9 billion in FY 2006—an increase of $160 million—and then grow at an average annual rate of 6 percent during fiscal years 2006 through 2009, reaching $6 billion by FY 2009.

  City-funded Medicaid expenditures are projected to continue to grow faster than City fund revenues and will consume, on average, 15.2 percent of City fund revenues during fiscal years 2006 through 2009, compared to 12.6 percent during fiscal years 2001 through 2005 (see Graph 5).

Graph 5
City-Funded Medicaid Expenditures as a Share of City Fund Revenues



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

  Most of the growth in Medicaid results from the continued rise in the utilization and cost of prescription drugs, and growing managed care enrollment. These two components are projected to increase by $1.4 billion during the Plan period, and to account for 53 percent of City Medicaid expenditures by FY 2009, up from 38 percent in FY 2005.

- The Health Insurance Plan of Greater New York (HIP) increased health insurance premiums for municipal employees by 10.4 percent in FY 2005, and projects an increase of 8.75 percent in FY 2006. The Plan assumes that health insurance premium rates will increase by 8 percent annually thereafter. The Plan incorporates a recent 17 percent increase in Medicare Part B premiums.

- After declining by half during fiscal years 1996 through 2003, the public assistance caseload has been rising slowly. Last year, the caseload grew for the first time in eight years, and the Plan assumes that the caseload will rise by another 1 percent, to 436,295 persons, by the end of FY 2006. The City's cost of this program will total $534 million in FY 2006, which is slightly more than the FY 2005 level.

Other Issues

The following issues 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 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 in operating aid to City schools to ensure that the New York City public school system receives funding necessary to provide a sound basic education. The panel also recommended that the State provide the City with $9.2 billion over five years for capital projects. The panel stated that the State Legislature should determine how these costs are split between the State and the City, but that the burden placed on the City could not be arbitrary or unreasonable.

The Governor's executive budget suggests creating a statewide Sound Basic Education fund (SBE) that would be supported with proceeds from eight currently authorized video lottery terminals and eight new terminals, five of which would be located in New York City. The DOB estimates that these terminals will generate $325 million statewide for the 2005-06 school year and $2 billion by 2010-11. New York City would receive 60 percent of the proceeds in the SBE fund, or an estimated $195 million in FY 2006.

Combining that with a required 40 percent match from the City, and projected increases in regular State education aid and federal aid, the DOB estimates that the City would receive an additional $4.7 billion over the next five years. To address the capital needs of the City's public school system, the Governor has proposed raising the TFA statutory bonding authority by $2.8 billion.

On February 14, 2005, the State Supreme Court affirmed the panel's recommendations and ordered the State to implement a funding plan that would provide the City's schools with $5.6 billion in operating aid over four years and $9.2 billion in capital funding over five years. The Governor plans to appeal this ruling.

If the Court of Appeals upholds the lower court ruling, and if the State Legislature requires the City to contribute 40 percent of the cost of the settlement as recommended by the Governor, we estimate that New York City would be required to increase education funding above the estimates in the February Plan by $525 million in FY 2006, $1 billion in FY 2007, $1.7 billion in FY 2008, and $2.2 billion in FY 2009.

Collective Bargaining

In April 2004, the City reached an agreement with District Council 37, which represents most civilian employees. The agreement provided employees with a lump sum payment of $1,000 and a wage increase of 5.1 percent over the course of fiscal years 2004 and 2005. The February Plan assumes that all City employees will agree to similar terms, but teachers, police officers, and firefighters are seeking larger wage increases. Each additional 1 percent increase for these employees would raise 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 Uniformed Firefighters Association (UFA). The City and the PBA recently concluded binding arbitration hearings and an impasse award is anticipated by the end of March 2005, although the City and the PBA could still reach an agreement. The PERB recently awarded the MTA's police officers a 23 percent wage increase over a four-year period—more than twice the average annual wage increase offered to the City's police officers. The MTA intends to appeal the PERB's ruling. Mediation between the City and the UFA is ongoing.

The PERB also found that an impasse exists in the negotiations between the City and the United Federation of Teachers, and mediation efforts have begun. If mediation fails, the PERB could appoint a fact-finding panel whose recommendations would be nonbinding.

The February Plan assumes that wage increases for all employees will be limited to 2 percent in

FY 2005, and that these costs will be funded with productivity savings. District Council 37 agreed to reduce starting salaries to help fund its labor agreement, but these savings will not be enough. The City intends 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 Plan further assumes that any wage increases granted after the current round of negotiations are completed will be funded entirely with productivity savings. Wage increases at the projected inflation rate without offsetting productivity savings would widen the projected budget gaps by $280 million in FY 2006, $800 million in FY 2007, $1.3 billion in FY 2008, and $1.8 billion 2009.

Hudson Yard Infrastructure Corporation

The Hudson Yards Infrastructure Corporation (HYIC), a City-created local development corporation, plans to issue $3 billion in bonds to finance the extension of the No. 7 subway line and other infrastructure improvements to spur private investment on the far West Side of Manhattan.

HYIC would incur debt service costs beginning in 2005, but development is not projected to generate sufficient revenues to cover the interest costs until at least 2015. The City Council has expressed its support of a City undertaking to pay, subject to an annual appropriation, the interest on HYIC bonds to the extent that project revenues are insufficient to cover these costs. While the City estimates the interest cost at nearly $1 billion through 2015, there is no limit on the City's liability. Repayment of principal would begin in 2018 assuming the project generates sufficient revenues.

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

The TFA's enabling act authorizes the TFA to invest in obligations that may be legally purchased by the City pursuant to the General Municipal Law (GML). In addition, the enabling act contains provisions for the TFA to enter into certain contracts with its bondholders as to, among other things, investments. The purchase of low-rated HYIC bonds is not authorized under the GML, but the City contends that the TFA is not subject to this restriction because it intends to amend the TFA indenture to permit such a purchase. At a minimum, a purchase of HYIC bonds would also require the TFA's Board of Directors to amend its investment guidelines because the current guidelines only permit investment in high-rated bonds.

Such a purchase, if required, would adversely affect the City's budget because the revenues used to purchase these bonds, which are generated by the City's personal income tax (PIT), would otherwise flow to the City. Moreover, the authority to contract with bondholders as to investments, we believe, was intended primarily to enable the bondholders to protect their interests and mitigate their risks. We do not believe that the enabling act was intended to permit the TFA, by agreement with its bondholders, to expand the TFA's investment powers by taking excess PIT monies, otherwise payable to the City, to purchase obligations issued for projects not within the City's capital program.

The use of the TFA as a credit enhancement was not expressly authorized by the Legislature and we believe its use for projects outside the City's capital program was never contemplated by the State Legislature and is inappropriate. The TFA was specifically created to help the City fund its capital plan during a transition period as it approached its debt limit and later to assist the City "in financing its capital program."

The rating agencies have yet to rate HYIC bonds or comment on the potential impact on the City's or the TFA's credit ratings from the TFA's puchase of HYIC bonds. HYIC debt could be viewed as City-supported debt because the City intends to fund the interest costs as long as revenues are insufficient to cover these costs and because the TFA, if called upon, would use City PIT revenues to purchase up to $750 million of HYIC bonds. This could negatively impact the City's credit rating, and effectively adds to the City's "debt" burden. Under the current plan, the MTA would be responsible for No. 7 line extension cost overruns, potentially placing further strains on this authority.

Department of Education Overspending

In FY 2004, the Department of Education exceeded its budget by $236 million, which was revealed during the year-end close. To address the recurring implications of this development, the City has increased its funding by $56 million and the department plans to use $140 million of the $311 million increase in State aid. The department also will adopt the City's financial management system in place of its own accounting system.

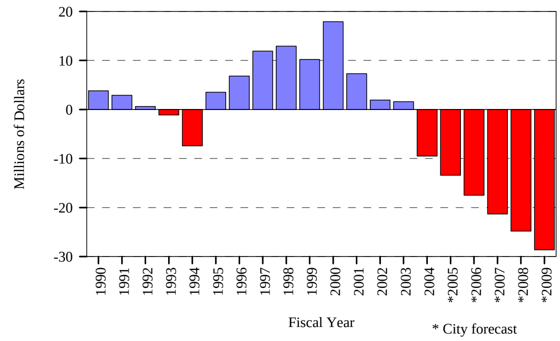
Off-Track Betting Corporation

The Off-Track Betting Corporation (OTB) was established by State law in 1970 as a public benefit corporation to operate a system of off-track betting parlors in New York City. It provides legalized pari-mutuel wagering that generates a stream of revenue for New York City, the State, and the horse racing and breeding industries. The OTB passes along to New York City both the revenues from a mandated 5 percent surcharge on winning wagers, and its residual revenues.[3]

Surcharge revenues have remained relatively flat since FY 1996, at about $17 million, while the OTB experienced an operating loss (i.e., negative residuals) of $9.5 million in FY 2004—its first loss in a decade (see Graph 6). The Corporation's

Graph 6

Residual Revenues



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

finances have continued to deteriorate and a residual loss of $13 million is projected for FY 2005. Unless steps are taken to stem the losses, we estimate that operating losses will nearly equal surcharge revenues in FY 2006, and will exceed surcharge revenues by more than $10 million in FY 2009, which could require the City to subsidize OTB operations.

Ten-Year Capital Plan

The Mayor has proposed a $60.8 billion preliminary ten-year capital plan for fiscal years 2006 through 2015. The plan would devote more than $28 billion to restore assets to a state of good repair, mainly in the areas of schools, bridges and highways; $18 billion for program expansion, mainly for new schools, water supply, and housing; and over $14 billion for replacement of existing capital assets, mainly water pollution control systems and computer equipment.

This plan restores 91 percent, or $9.9 billion, of cuts the City previously made to the portion of these programs funded with City revenues, as a way of slowing down the growth in debt service costs. The cost of these restorations is reflected in the February Plan's debt service estimates.

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

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