

Staff Report  
**REVIEW OF FIRST QUARTER  
MODIFICATION**  
December 18, 2008

***New York State Financial Control Board***

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## I. Overview

First quarter modifications to the city's financial plan are usually technical documents dealing with the current fiscal year and any changes that have occurred since budget adoption. This modification is different. The city wisely recognized that a recession, which we now know started in December 2007, coupled with a credit crisis and turmoil in the financial services industry would lead to a severe local economic downturn.

The city laid out a plan in the November modification to get a head start on dealing with large projected budget gaps in FY 2010 and beyond. The city reduced its tax collections estimate by \$388 million for FY 2009 and by \$1.3 billion in FY 2010. The current modification assumes a mid-year rescission of a seven percent property tax cut and cancellation of the \$400 homeowner rebate program. Additionally, the modification incorporates an expense reduction program that assumes budget savings of \$462 million in FY 2009 and \$1.1 billion in FY 2010. All agencies are affected, with cuts to the Department of Education and the Police Department comprising the largest shares. If all of these actions are implemented, the city projects to finish FY 2009 with a surplus of \$1.8 billion, which would be used to help balance FY 2010. The city projects that the remaining budget gaps would be \$1.3 billion in FY 2010, \$5 billion in FY 2011, and \$4.9 billion in FY 2012.

Since the modification was released, the economic news has worsened. Our review of the city's modification finds that the financial situation is likely to be worse than the city projects. The income loss emanating from the city-centered financial services downturn is likely to have a disproportionately greater impact on city revenues compared with the level of expected job loss. Lower investment earnings by the pension systems will increase the city's contribution over the plan period and beyond. The proposal to offset these investment losses by reducing the amount in the Retiree Health Benefit Trust leaves unresolved the long-term problem of the unfunded liability for these benefits growing from \$64 billion in FY 2008 to over \$88 billion by FY 2012.

We estimate a downward revenue risk of about \$600 million annually in FYs 2009-2011, and about \$400 million in FY 2012. Assuming implementation of the mid-year property tax increase, but not the repeal of the \$400 rebate in FY 2009, we project budget gaps of \$672 million in FY 2009, \$2.3 billion in FY 2010, \$6.4 billion in FY 2011, and \$6.1 billion in FY 2012. It is important to note that this risk assessment does not include an evaluation of the impact of the Governor's Executive Budget, released on December 16, 2008. It includes large reductions in education aid and Medicaid funding anticipated by the city, as well as a reduction in other state aid to the city. The Medicaid reduction could affect the Health and Hospitals Corporation. The proposed reduction in the Aid and Incentives for Municipalities program, if adopted, could cause an addition to our projected gaps of over \$300 million in FY 2009 and beyond. We will do a full evaluation of the impact of the state budget on the city in our March staff report.

In recognition of the grim fiscal forecast, the city, on December 9, 2008, asked agency heads to submit plans for an additional seven percent cut in expenditures totaling \$1.4 billion for FY 2010. The agency heads have been requested to submit two packages, one detailing a five percent reduction program along with a separate package taking an additional two percent reduction. Using this information, the city will develop an agency reduction program that will be included in the preliminary budget for FY 2010.

**NOVEMBER MODIFICATION:  
THE CITY'S OPERATING PROJECTIONS FOR  
FISCAL YEARS 2009-2012**

**TABLE 1** (\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
<b><u>Revenues</u></b>				
Taxes:				
General Property	\$13,743	\$14,701	\$15,642	\$16,388
Other Taxes <sup>a</sup>	21,264	19,865	21,959	23,523
Discretionary Transfers	546	546	--	--
Tax Audit Revenue	680	589	589	589
Tax Reduction Program	832	1,479	1,554	1,615
Sale of Property Tax Liens	38	34	31	31
Miscellaneous Revenues	6,896	6,482	6,526	6,546
Unrestricted Intergovernmental Aid	340	340	340	340
Interfund Revenues	464	425	420	420
Less: Intracity Revenues	(1,607)	(1,447)	(1,446)	(1,446)
Disallowances	(15)	(15)	(15)	(15)
Total City Funds	\$43,181	\$42,999	\$45,600	\$47,991
Federal Categorical Grants	5,816	5,299	5,280	5,290
State Categorical Grants	11,668	11,946	12,805	13,108
Total Revenues	<u>\$60,665</u>	<u>\$60,244</u>	<u>\$63,685</u>	<u>\$66,389</u>
<b><u>Expenditures</u></b>				
Personal Service	\$34,934	\$36,506	\$38,598	\$39,594
Other Than Personal Service	25,520	24,864	25,679	26,355
Debt Service	3,569	2,049	4,817	5,349
NYCTFA Debt Service	225	216	1,114	1,158
Budget Stabilization & Prepayments	(2,276)	(907)	(350)	--
General Reserve	300	300	300	300
Subtotal	\$62,272	\$63,028	\$70,158	\$72,756
Less: Intracity Expenditures	(1,607)	(1,447)	(1,446)	(1,446)
Total Expenditures	<u>\$60,665</u>	<u>\$61,581</u>	<u>\$68,712</u>	<u>\$71,310</u>
Gap To Be Closed	<u>\$0</u>	<u>(\$1,337)</u>	<u>(\$5,027)</u>	<u>(\$4,921)</u>
<sup>a</sup> Allocates NYCTFA debt service to expenditures.				

**CHANGES TO THE CITY'S OPERATING PROJECTIONS FOR  
FISCAL YEARS 2009-2012  
JUNE FINANCIAL PLAN COMPARED TO NOVEMBER MODIFICATION**

**TABLE 2** (\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
<b><u>Revenues</u></b>				
Taxes:				
General Property	(\$1)	(\$2)	(\$3)	(\$4)
Other Taxes <sup>a</sup>	(386)	(1,820)	(1,108)	(1,028)
Discretionary Transfers	0	546	—	—
Tax Audit Revenue	103	10	10	10
Tax Reduction Program	835	260	261	262
Sale of Property Tax Liens	0	0	0	0
Miscellaneous Revenues	196	174	155	153
Unrestricted Intergovernmental Aid	0	0	0	0
Interfund Revenues	1	0	1	1
Less: Intracity Revenues	(69)	6	6	6
Disallowances	0	0	0	0
Total City Funds	\$679	(\$826)	(\$678)	(\$600)
Federal Categorical Grants	450	16	7	8
State Categorical Grants	142	7	2	5
Total Revenues	<u>\$1,271</u>	<u>(\$803)</u>	<u>(\$669)</u>	<u>(\$587)</u>
<b><u>Expenditures</u></b>				
Personal Service	(\$23)	(\$298)	(\$323)	(\$303)
Other Than Personal Service	401	(529)	(503)	(499)
Debt Service	(29)	2	20	22
NYCTFA Debt Service	0	(546)	0	0
Budget Stabilization & Prepayments	991	(445)	0	—
General Reserve	0	0	0	0
Subtotal	\$1,340	(\$1,816)	(\$806)	(\$780)
Less: Intracity Expenditures	(69)	6	6	6
Total Expenditures	<u>\$1,271</u>	<u>(\$1,810)</u>	<u>(\$800)</u>	<u>(\$774)</u>
<b>Gap To Be Closed</b>	<b><u>\$0</u></b>	<b><u>\$1,007</u></b>	<b><u>\$131</u></b>	<b><u>\$187</u></b>
<sup>a</sup> Allocates NYCTFA debt service to expenditures.				



## RISKS TO THE FINANCIAL PLAN

**TABLE 3** (\$ in millions, positive numbers are offsets to risks)

	FY 2009	FY 2010	FY 2011	FY 2012
<b>Stated Financial Plan Gap</b>	<b>\$0</b>	<b>(\$1,337)</b>	<b>(\$5,027)</b>	<b>(\$4,921)</b>
<b>Estimation</b>				
Nonproperty Taxes	(\$450)	(\$425)	(\$300)	\$0
Property Tax	0	(300)	(400)	(500)
Miscellaneous Revenue	125	100	75	75
Uniformed Services Overtime	(91)	(107)	(90)	(90)
<b>Subtotal</b>	<b>(\$416)</b>	<b>(\$732)</b>	<b>(\$715)</b>	<b>(\$515)</b>
<b>Implementation</b>				
Pollution Remediation	\$0	\$0	(\$500)	(\$500)
<b>Subtotal</b>	<b>\$0</b>	<b>\$0</b>	<b>(\$500)</b>	<b>(\$500)</b>
<b>Not in Mayor's Control</b>				
Property Tax Program	(\$256)	\$0	\$0	\$0
Health Insurance Savings	0	(200)	(200)	(200)
<b>Subtotal</b>	<b>(\$256)</b>	<b>(\$200)</b>	<b>(\$200)</b>	<b>(\$200)</b>
<b>Risk Total</b>	<b>(\$672)</b>	<b>(\$932)</b>	<b>(\$1,415)</b>	<b>(\$1,215)</b>
<b>Total FCB Estimated Surplus/(Gap)</b>	<b>(\$672)</b>	<b>(\$2,269)</b>	<b>(\$6,442)</b>	<b>(\$6,136)</b>
Note: The city has set aside \$300 million for a general reserve in each year of the financial plan. This risk assessment does not include any impact of the Governor's executive budget proposal. A full analysis of the impact of the state budget will be in our March 2009 report.				

## **II. Review of the Modification**

With the national economy sinking faster than the city had forecasted, local tax collections, which benefited from the delayed arrival of the downturn to the city, could also fall more steeply than the city expects. The city is planning to augment its weakening tax outlook with the elimination of property tax breaks and implementation of an expenditure reduction program. The current modification assumes a mid-year rescission of a seven percent property tax cut and cancellation of the \$400 homeowner rebate program. Additionally, the modification incorporates an expense reduction program that assumes budget savings of \$462 million in FY 2009 and \$1.1 billion in FY 2010, with cuts to the Department of Education and the Police Department comprising the largest shares. These actions will enable the city to finish FY 2009 with a surplus of \$1.8 billion, which the city proposes to use to help balance FY 2010. The remaining budget gaps are \$1.3 billion in FY 2010, \$5 billion in FY 2011 and \$4.9 billion in FY 2012.

The increasingly dire economic situation could, however, necessitate additional difficult budget balancing measures. We estimate a downward revenue risk of about \$600 million annually in FYs 2009-2011 and about \$400 million in FY 2012. Additionally, the expenditure risks, which are less than \$100 million in FY 2009, increase to about \$300 million in FYs 2010-2012. The FCB projects budget gaps of \$672 million in FY 2009, \$2.3 billion in FY 2010, \$6.4 billion in FY 2011 and \$6.1 billion in FY 2012, assuming the \$1.8 billion of FY 2009 resources are used to reduce FY 2010 expenses.

In recognition of the grim fiscal forecast, the city has recently asked agency heads to submit plans for an additional seven percent cut in expenditures totaling \$1.4 billion for FY 2010. The agency heads have been requested to submit two packages – details of a five percent reduction program along with a two percent program. Using this information, the city will develop an agency reduction program that will be included in the preliminary budget for FY 2010.

Separately, the November modification provided details of the four-year capital program, reflecting for the first time the cuts announced in June. Despite the stretching out of the capital program, the dollar value of the contracts expected to be entered into annually over the four-year period is larger on average than projects undertaken during the previous ten years. The debt service forecast for FYs 2009-12 changes only marginally from the relatively high levels in the June plan, when the impact of the announced cut in the capital program was initially incorporated.

### **REVENUES**

The city has reduced its tax collections estimate by \$388 million, to \$37.1 billion, since June when the FY 2009 budget was adopted. The outlook for FY 2010 is considerably more negative, with the tax estimate reduced by \$1.3 billion. The city is addressing the downturn in tax collections by proposing to eliminate \$832 million in property tax breaks. With the midyear tax initiatives in the plan, total FY 2009 revenues improve by \$1.27 billion, to \$60.7 billion, and city-funded revenues increase by \$631 million to \$41.6 billion.

The FY 2009 revenue changes in the November modification are summarized in the figure to the right. The two-part \$832 million property tax proposal would rescind a seven percent property tax cut, in the middle of the current fiscal year, to raise \$576 million in FY 2009, with the full-year effect being more than \$1.2 billion in FY 2010 and thereafter. The city also expects to raise \$256 million annually by cancelling the \$400 homeowner rebate program, starting in the current fiscal year.<sup>1</sup> These property tax restorations largely explain why city-funded revenues increase by \$631 million in the plan, even while tax collections have been sinking.

Property Tax Program Restores FY 2009 Revenues (\$ in millions)	
Taxes	(\$388)
Rescind Property Tax Cuts	832
Audit Revenue	100
Miscellaneous Revenue	81
Other	6
<b>City Funds</b>	<b>\$631</b>
Categorical Aid & Other Revenue	639
<b>Total Change in Revenues</b>	<b>\$1,270</b>

Additionally, a very successful audit collections effort is yielding an extra \$100 million, while miscellaneous revenue increased by \$81 million. Categorical grants, which are funded by state, federal and private sources, increased by nearly \$640 million. These grant increases account for about half of the \$1.3 billion improvement in total city revenue.

The city anticipates that the plan-to-plan reduction in tax collections, which is a relatively modest \$388 million in FY 2009, will become more severe in the future because of persistent declines in the business and personal income taxes and the property transactions taxes. Compared with the June plan, tax collections deteriorate by \$1.3 billion in FY 2010 and by more than \$1 billion in each of FYs 2011 and 2012. The weaker tax projections will diminish both city-funded and total revenues by about \$800 million in FY 2010, \$700 million in FY 2011 and \$600 million in FY 2012.

### **The City Faces Up to the Recession**

The current recession, which began in December 2007 with cutbacks in construction and manufacturing, was greatly exacerbated by the abuses in the mortgage industry. The resulting credit crisis and the severe dislocations in the financial services industry appear to be the precursors of a severe local economic downturn. The income loss emanating from the city-centered financial services downturn is likely to have a disproportionately greater impact on city revenues compared with the level of expected job loss. Employment losses in the city could be mitigated by the relatively late arrival of the downturn to the city, because the nation could be starting its recovery by the time the most severe job losses hit the city.

The city's economic plan indicates that the city is facing a severe downturn. National economic growth, as measured by real gross domestic product (GDP), slows to 1.8 percent in CY 2008 and sinks to 0.7 percent in 2009 in the city's economic plan, down from two percent in 2007. National job growth drops to minus 0.1 percent in 2008, and

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<sup>1</sup> With the city council objecting to the midyear cancellation of the homeowner rebate program, this \$256 million revenue restoration is unlikely to happen in FY 2009.

sinks to minus one percent in 2009, down from the positive growth of 1.1 percent that was recorded in 2007. Pretax corporate profits plummet by eight percent in 2008, down from the stagnant 0.7 percent growth of 2007, which followed a four-year surge of double-digit growth rates for business profits.

The downturn that the city foresees for the local economy is considerably more severe than that projected for the nation. Gross city product falls by 10 percent, with this slide stretching out over calendar years 2008 and 2009 and the ensuing recovery might not restore local economic output to its pre-recession peak until beyond 2012. Even though job losses do not hit the city until relatively late in the recession, local job growth slows to 0.4 percent in the city's forecast for 2008, down from the 2.2 percent growth recorded in 2007. Local employment plunges by 3.1 percent in 2009 and continues to fall slightly in 2010, even while national jobs are recovering. Local employment, like gross city product, is unlikely to regain its pre-recessionary level until beyond 2012.

In the third quarter of 2008, a 3.7 percent drop in domestic consumption caused real GDP to fall by 0.5 percent. These negative results indicate that the recession is affecting consumption. The Blue Chip Consensus survey for December sees real GDP growing 1.3 percent in 2008 and declining by 1.1 percent in 2009. This more current consensus outlook is decidedly more negative than the city's earlier forecast, which had GDP on a positive but decelerating growth path in both of these years.

Even though GDP has only recently moved decisively downward, the nation's employment numbers have been sinking steadily since the start of 2008. Through November, 1.9 million jobs have been lost since the start of the recession in December 2007, with two-thirds of these job losses occurring in the last three months. At the start of the downturn the employment losses were concentrated in manufacturing and construction; however, the downturn in jobs is now widespread across the major industry sectors. The city had estimated that the national peak-to-trough private sector job loss would reach 2.4 million but this estimate could soon be exceeded as the recent acceleration in job losses was not known when the city's forecast was prepared. The unemployment rate worsened to 6.7 percent in November, increasing from 6.5 percent in October and up from 4.7 percent one year earlier.

Thus far, the job losses battering the nation are not yet evident in the local employment market. Moreover news reports of massive finance-sector layoffs are only partly reflected in the local employment data. This does not mean that the city will be unaffected by job losses, it just means the onset of the most severe effects of the recession are arriving here about a year later than elsewhere in the nation. The local job market, which is leveling off following a prolonged hiring boom, appears poised to follow the steep declines that have weakened national employment since the start of calendar year 2008.

Unlike the nation, the city's labor market has not yet turned downward even though local job growth has been decelerating since January. By October, local employment growth had virtually disappeared, dropping to 0.2 percent from 1.5 percent in January. The local unemployment rate has increased slightly over the year, to 5.7 percent in October, up from 5.2 percent in the prior year. Despite the late arrival of recession to the city, the locally-centered securities industry is one area that is already

seeing job losses. Compared with the previous year, the securities sector is down by 16,000 jobs, equivalent to a nine percent decline. By the time the bottom is reached, the city estimates that 31,000 Wall Street jobs and a total of 147,000 private sector jobs will have disappeared.

The severity of the local economic downturn is discussed in three recent papers published by the Comptroller of New York City, the Comptroller of New York State and by the Federal Reserve Bank of New York. The City Comptroller's report estimates local private sector job loss at 165,000 of which 35,000 are in the financial services industry.<sup>2</sup> The New York State Comptroller, in a more recent report, puts the private sector job loss somewhat higher, at 175,000.<sup>3</sup> Of these lost jobs, 48,000 are in the financial services industry, which includes 38,000 securities industry jobs. Additionally, this report estimates that the multiplier effect for each lost financial services job would be two city jobs and 1.3 jobs elsewhere in the state.

The Federal Reserve Bank of New York, in its research paper, compares the economic performance of the city, with that of New York State and New Jersey and investigates the present downturn in the context of other recent downturns.<sup>4</sup> The authors expressed greater concern for the income effects of the current financial services downturn than for the employment effects. Another concern is that the weakness observed in the city's finance sector is likely to spread to other sectors and the other areas of the region.

The authors explain why the income effects of the securities industry downturn are relatively more important than the employment effects. "Within the financial sector, the securities industry has assumed an increasingly important role in New York City's economy. Overall, the industry accounted for five percent of total city employment in 2007, or roughly nine times the national average, and almost 25 percent of earnings, the highest share in the city's history. The mean annual salary in 2007 was slightly less than \$400,000. Moreover, each securities job is estimated to generate 2.3 other city jobs . . ." The authors further conclude that the duration of the local employment downtrend could be mitigated by the concurrence of the national and local financial services downturns and because earlier downturns were exacerbated by the transfer of many financial services jobs to lower cost locations outside the city.

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<sup>2</sup> See Frank Braconi "New York City's Changing Economic Picture." Office of the New York City Comptroller (October, 2008).

<sup>3</sup> See Thomas P. DiNapoli and Kenneth B. Bleiwas "The Securities Industry in New York City." Office of the New York State Comptroller (November, 2008).

<sup>4</sup> See Jason Bram, James Orr, and Rae Rosen "Employment in the New York - New Jersey Region: 2008 Review and Outlook." Federal Reserve Bank of New York *Current Issues in Economics and Finance* Volume 14, Number 7 (September/October, 2008).

## Tax Revenue

The city reduced its tax revenue estimate for FY 2009 by \$388 million to prepare for a recession-induced collections slump, as shown in the figure to the right. With the city's financial and real estate sectors bearing the brunt of the downturn, the steepest cuts are in the business and personal income taxes and the real estate transactions taxes. The city has therefore reduced its estimate for personal income tax collections by \$165 million. The general corporation and banking corporation taxes, which have experienced a worrisome upturn in refunds, are

down \$104 million and \$130 million, respectively. The property transfer and the mortgage recording taxes are down by \$33 million and \$76 million, respectively. The hotel tax is down slightly in FY 2009, but more severe revenue cuts are in the plan for the outyears. On the positive side, the sales tax is up by \$83 million. The minor taxes are up over \$40 million, reflecting higher payments in lieu of taxes and income taxes paid by nonresident city employees.

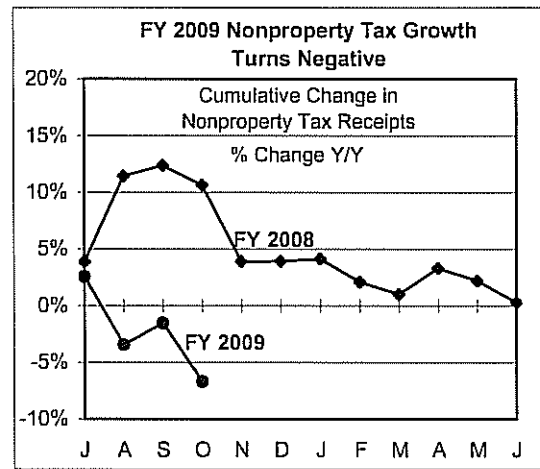
Changes in the FY 2009 Tax Revenue Projections Since Adoption (\$ in millions)	
General Property Tax	(\$1)
Personal Income	(165)
General Corporation	(104)
Banking Corporation	(130)
Property Transfer	(33)
Mortgage Recording	(76)
Hotel	(5)
Sales	83
Other	43
<b>Total Tax Changes</b>	<b>(\$388)</b>

The city has slightly reduced the real property tax, taking FY 2009 collections down by \$1 million. The city's plan has the property tax growing about six percent annually from \$13.8 billion in FY 2009 to \$16.4 billion in FY 2012. However, the city will reevaluate its property tax revenue plan in January, following the release of the tentative tax roll for FY 2010. The city is attempting to squeeze additional revenue out of this tax by rescinding \$832 million in property tax breaks in FY 2009, with the benefit increasing to \$1.5 billion in FY 2010. This extra property tax revenue might well be needed should the assessment report prove to be weaker than anticipated. To alert the city of this contingency, we estimated a property tax risk of \$200 million per year, in our July 2008 report. We now increase this risk to \$300 million in FY 2010, \$400 million in FY 2011 and \$500 million in FY 2012, as shown in Table 3 on page 5. We are also placing at risk \$256 million in FY 2009 due to resistance to the mayor's proposal to rescind the \$400 property tax rebate program.

Since June, the city has taken down its FY 2009 nonproperty tax collection target by \$386 million. The reductions affecting FYs 2010-2012 are far more severe, with cuts of \$1.3 billion, \$1.1 billion, and \$1 billion, respectively. As a result of these cutbacks, nonproperty tax receipts fall from \$23.4 billion in FY 2008 to a projected yield of \$20.6 billion in FY 2009, a staggering one-year decline of \$2.9 billion, or about 12 percent. These taxes decline by an additional seven percent in FY 2010 to reach a low of \$19.1 billion, before recovering with growth of eight percent in FY 2011, and growth of about seven percent in FY 2012 to \$22.1 billion. The end result of this sharp two-year slide followed by a moderate recovery is that the nonproperty taxes will yield \$1.3 billion less revenue in FY 2012 than was collected in FY 2008.

The city's pessimistic tax collection outlook is verified by the appearance of a negative growth trend in current collections data. The figure on page 11 shows that nonproperty tax growth, which had been in a definite downtrend all through FY 2008,

finally slipped below zero early in FY 2009. This figure demonstrates that FY 2008 was a transition from robust tax growth at the start of the year to stagnation by the fiscal year's end. The 12 percent growth recorded in September of the prior year appeared to be a continuation of the double-digit revenue growth which had prevailed for the previous four years. The FY 2008 growth trend fell below four percent by November and continued to slide towards zero. By the end of FY 2008, the nonproperty taxes had increased a mere 0.2 percent, marking a clear transition from robust growth to a weaker period of flat or even sinking tax revenues.



Early results for FY 2009, are pointing to the emergence of a negative growth trend, with collections through October having fallen seven percent below the comparable period of the previous year. Furthermore, with the growth trend sinking progressively lower for the past year, the figure suggests that collections for the balance of FY 2009 could be weaker than the already sluggish results observed at the start of the year. Monthly reports on FY 2009 collections indicate that the real estate transactions taxes are down 34 percent through October, and the business income taxes have been weakening due to surging refund requests. Two taxes that are running strongly ahead of plan thus far in FY 2009 are the personal income and sales taxes, but we expect a much weaker performance for the taxes in the second half of the year.

**Business Taxes.** Since June the city has reduced its revenue plan for the business taxes by \$234 million to \$4.7 billion in FY 2009. Collections for group of taxes, consisting of the general corporation tax, the banking corporation tax and the unincorporated business tax are no longer growing. Revenues fell by 10 percent in FY 2008, and the city projects further declines of 13 percent in FY 2009 and six percent in FY 2010, after which revenue growth returns with increases of eight percent and 11 percent in FYs 2011 and 2012. The banking corporation tax has been hit much harder than the other business taxes by the losses in mortgage-backed assets and the restructuring of the financial service sector. The bank tax, which reached a peak of \$1.2 billion in FY 2007, plummeted by 48 percent in FY 2008 and is projected to fall an additional 18 percent to \$517 million in FY 2009.

An increase in business tax refund issuance is a serious concern. The city has issued \$804 million in business tax refund checks in the ten-month period ending in October, compared with the average of \$246 million in refunds paid during the similar period of the previous three years.<sup>5</sup> The city was not taken completely by surprise by the refund surge as it had already increased the refund set-aside to \$695 million in FY 2009, up from \$586 million in the June plan. However, largely because of the persistence

<sup>5</sup> The surge in refunds was noted by the New York Times in a December 1, 2008 article.

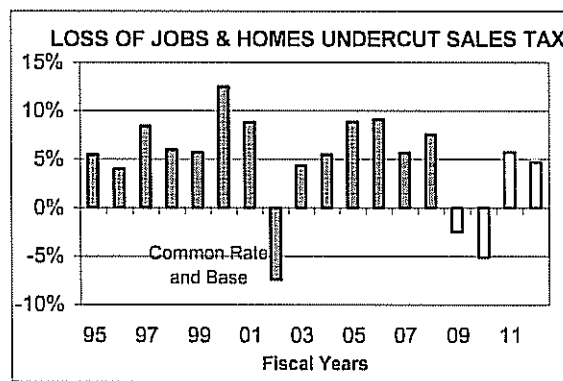
of the refund trend, the city faces a business tax risk of \$150 million in FY 2009 and \$100 million in FY 2010.

**Property Transaction Taxes.** In response to a slowdown in property sales, and the difficulty in obtaining financing, the city has reduced its FY 2009 revenue projection for the two property transactions taxes by \$109 million, compared with the adopted budget. The property transfer and the mortgage recording taxes fell by 23 percent from a record \$3.3 billion in FY 2007 to \$2.5 billion in FY 2008. The city does not foresee any quick recovery for this formerly high-flying revenue source, projecting a decline of 28 percent in FY 2009 and nine percent in FY 2010, after which revenues stage a sluggish recovery with growth of two percent in FY 2011 and seven percent in FY 2012.

Thus far in the first four months of FY 2009, transaction tax collections have dropped by 34 percent compared with the previous year, which is six percentage points more negative than the city's estimate of minus 28 percent. Similarly, the New York State Comptroller has found that in the first half of CY 2008 the volume of single family home sales in the city fell by 30.7 percent while median prices declined by 3.5 percent, for a combined downturn of 34 percent.<sup>6</sup> These numbers suggest that the city's transactions tax estimates are subject to risks of \$150 million in FY 2009 and \$100 million in FY 2010.

**Sales Tax.** Faced with the prospect of job losses spreading beyond the financial sector, and evidence of falling home prices and increasing foreclosures, consumers have cut back on discretionary spending and are likely to pursue this frugal course through the current holiday season and into calendar year 2009. The conservative consumer behavior also reflects the fear of a prolonged recession and anxiety over the condition of the financial markets and their retirement accounts. To make matters worse, there are fewer domestic visitors to the city than last year and the recent appreciation of the dollar may negatively affect spending by international visitors.

All in all, there are numerous reasons for a sharp pullback in personal consumption expenditures, which is why the city expects two years of negative sales tax growth (on a continuing base).<sup>7</sup> As shown in the figure above, the city assumes sales tax revenue will decline by 2.5 percent in FY 2009 and by 5.1 percent in FY 2010 (on a continuing base). With a recovery in the local and national economies in place by 2011,



<sup>6</sup> See Thomas P. DiNapoli "Meltdown: The Housing Crisis and its Impact on New York State's Local Governments." Office of the New York State Comptroller *Local Government Issues in Focus* (November, 2008).

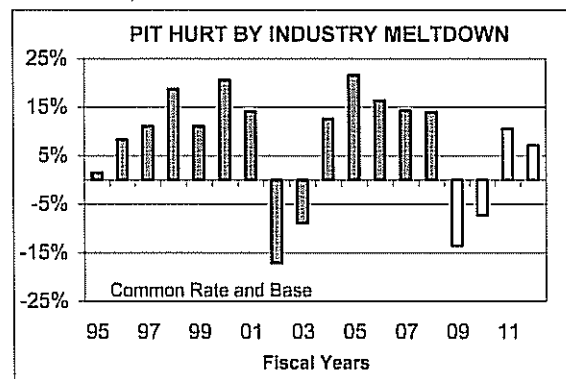
<sup>7</sup> "On a common rate and base" or "on a continuing base" refers to tax collections that have been adjusted to remove the effects of tax programs (and law changes) to focus on the influence of the economy.



sales tax revenue on a common rate and base is anticipated to spurt by 5.7 percent and 4.7 percent in FYs 2011 and 2012, respectively.<sup>8</sup>

From last June's adopted budget to the November modification, the city increased the sales tax forecast for FY 2009 by \$83 million to \$4.7 billion, because of a number of positive factors that boosted sales tax revenue for the past several years, which have, unfortunately, run their course. Such events would include local job gains, large bonus payouts from the securities industry, and record-setting numbers of both domestic and international travelers to the city. Currently, the only "good news" for consumers is the swift and sharp decline in energy prices, which has resulted in lower gas prices and, therefore, relatively more spending money. However, this news is unlikely to significantly shake consumer pessimism given the reverse wealth effects from declining stock portfolios and home valuations, further Wall Street job cuts, tight credit, and rising home delinquency and foreclosure rates. For these reasons, sales tax revenue may fall short of the city's forecast by \$50 million in FY 2009, \$75 million in FY 2010, and \$100 million in FY 2011.

**Personal Income Tax.** Caught in a "perfect storm" of events facing the financial sector—more layoff announcements, extreme equity market volatility, near insolvency of certain banks and insurers, frozen credit markets, recessionary fears and concern that federal efforts, so far, have not stabilized the financial system—the city has adjusted upward its estimate of layoffs (national and local) and downward its estimates of securities industry profits, compensation, and capital gains realizations. Given the scope of the restructuring currently underway in the securities industry (e.g. moving away from the investment banking model) and continued market instability, the FY 2009 personal income tax (PIT) projection was lowered by \$165 million to \$7.4 billion in the November modification, as compared to the adopted budget estimate.



On a continuing base, PIT revenue is projected to turn negative and fall by 13.6 percent in FY 2009 and by an additional 7.3 percent in FY 2010, as seen in the figure above. With a recovery expected by the city in the local and national economies during FYs 2011 and 2012, PIT revenue returns to positive growth of 10.5 percent and 7.1 percent, respectively.<sup>9</sup> Since the financial sector is still in the process of being

<sup>8</sup> Separate from its baseline sales tax forecast, the city presented several options in its gap-closing program to raise sales tax revenue starting in FY 2010 by increasing the local sales tax rate and/or removing the current exemption on the purchase of clothing and footwear. Either type of revenue-raising initiative would have to be approved by the state legislature before enactment.

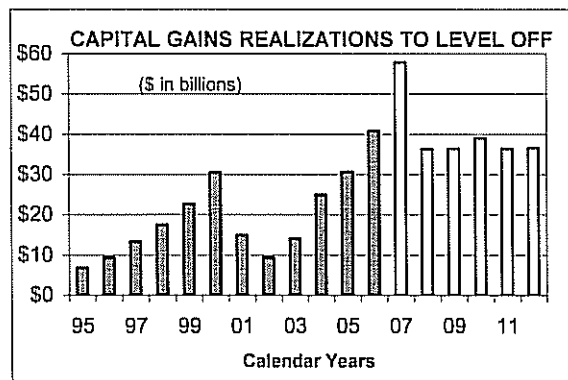
<sup>9</sup> Separate from its baseline PIT forecast, the city presented several options in its gap-closing program to raise PIT revenue starting in FY 2009 by increasing the tax rates for residents at all income levels. For the tax increase to be implemented, state legislation would be required.

recapitalized and restructured (largely by the federal government), amidst a national recession, there is a downside risk to the city's PIT forecast of \$100 million in FY 2009, \$150 million in FY 2010, and \$200 million in FY 2011.

In trying to determine the effects of the securities industry on tax revenue (and other industries), the city's problem is not that its economic and PIT forecasts are too conservative, but that its projections are being overtaken by recent events, such as the 50,000 plus layoff announcement from Citigroup and the latest federal bailout effort also centered on Citigroup. Citigroup is the latest, but probably not the last financial firm to require recapitalization and risk guarantees by the federal government in exchange for equity, due to the possibility of large losses from commercial and residential loans and related securities, and credit default swaps. In its latest forecast, the city expects securities industry layoffs of 31,000 from the fourth quarter of 2007 through the third quarter of 2009. As the layoffs in the securities industry affects the rest of the local economy, the city anticipates total private sector job cuts of 147,000 from the third quarter of 2008 through the fourth quarter of 2009. By 2011, the city hopes for private sector job growth of 1.1 percent or 40,000 jobs from the prior year.

With the expectation of further securities industry layoffs, compensation (including bonuses) is projected to fall 5.6 percent in 2008 to \$91.7 billion and by nearly \$21 billion to \$70.8 billion in 2009, causing total wage income to fall by 7.6 percent in 2009. In 2010, the city anticipates only a small boost in finance sector compensation of 1.5 percent to \$71.9 billion, which supports positive total wage growth of 2.5 percent. For the first time since 1980, New York Stock Exchange (NYSE) member firms may post losses for two straight years in a row that is an actual loss of \$11.3 billion in 2007 and a city estimate of negative \$25.5 billion in 2008, where year-to-date losses total \$20.7 billion for the first two quarters of 2008. By the end of 2009, the city is forecasting NYSE member firms to return to profitability of \$8.7 billion.

The other effect on PIT revenue from persistent stock market volatility and continued retrenchment in the financial sector, besides job losses and reduced compensation, is a sharp falloff in capital gains realizations. Capital gains occur when a financial or physical asset is sold at a higher price than originally purchased. Currently, fear and a lack of confidence among traders and investors is pushing stock market indexes to new lows as housing prices and sales continue to fall. Until the stock market and the residential housing market each reach a "bottom," which would signal movement through the business cycle and the start of national and local economic recoveries, it is not unusual to see pronounced drops in capital gains realizations, as shown in the figure to the right. For example, capital gains realizations fell by \$21.2 billion over two years, from \$30.5 billion in 2000 to \$9.3 billion in 2002, before growing 51.7 percent to \$14.1 billion in 2003. After surging an estimated 41.9 percent in 2007 to a record high of \$57.8 billion, the city projects capital gains realizations will fall by 37.2



percent or \$21.5 billion to \$36.3 billion in 2008. Little sustainable growth is expected during the forecast period from 2008 to 2012, when capital gains realizations are expected to average just under \$37 billion annually.

### **Miscellaneous Revenue**

The city's FY 2009 miscellaneous revenue projection has advanced by \$81 million to \$4.2 billion in the November modification, since the budget was adopted last June. If we exclude those parts of the city's miscellaneous revenue forecast that do not foster long-term growth and budget balance, and focus on the remaining core categories, the total projected increase amounts to \$76 million.<sup>10</sup> Almost three-quarters of the \$76 million improvement in the FY 2009 miscellaneous revenue estimate originates from gains of \$28 million each in charges and fines, with much smaller increases projected for interest earnings, rental income, licenses, and other miscellaneous. Based on historical patterns of growth, miscellaneous revenue could be higher by \$125 million in FY 2009, \$100 million in FY 2010, and \$75 million in each of FYs 2011 and 2012, as shown in Table 3 on page 5.

The positive plan-to-plan variance of \$28 million in charge revenue brings the FY 2009 forecast to \$619 million, and represents increases in the yield from existing fees, new pilot programs, and PEG restorations that primarily effect the Fire Department (e.g. insurance premiums), Department of Corrections (e.g. commissary fees), Department of Housing, Preservation, and Development (e.g. housing fees), and the Department of Transportation (e.g. multi-space meters, pilot program). In the fine category, the FY 2009 forecast was raised by \$28 million to \$776 million based on increased enforcement efforts and inspection activity, and the start of two new programs. First, the city expects more revenue from pursuing code violations related to buildings, parking, the environment, and public health. Second, the city plans to hire an additional 200 traffic agents and 34 supervisors to expand the "Block the Box Violation Initiative" that is anticipated to yield \$74 million annually in each of FYs 2010-12 when fully staffed. The other new program, called "Enterprise Billing and Collections Revenue" is designed to use data mining techniques and improved collection processes to enable payment on outstanding violations, which is forecast to earn the majority of revenue in FY 2010 (\$25 million) and in FY 2011 (\$20 million).

### **EXPENDITURES**

In the November modification, the city projects a balanced budget for FY 2009, with plan-to-plan revenue increases matched by expenditure increases totaling almost \$1.3 billion. The majority of the increase includes \$991 million of surplus funds, which will be used to prepay \$445 million of FY 2010 city debt service costs and provide a grant

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<sup>10</sup> The core categories are licenses, fees or charges, interest, rent, fines, and a residual miscellaneous category (less nonrecurring actions, housing revenue, tobacco proceeds, and payments from the Health and Hospitals Corporation). Dedicated funds such as water and sewer charges are also excluded from the analysis, because they act as an offset to city expenditures and do not assist in achieving budget balance.

of \$546 million to the New York City Transitional Finance Authority to pay debt service in FY 2010.

Small increases in Medical Assistance and Public Assistance totaled \$56 million with another \$275 million in spending increases spread across a number of city agencies. There were also small decreases of \$29 million in debt service costs and \$23 million in personal services.

In response to the Office of Management and Budget's (OMB) request to reduce city-fund spending by 2.5 percent in FY 2009 and five percent in FY 2010, the city proposed new agency programs in addition to the \$1.3 billion reduction in FY 2009 expenses proposed in May 2008. The final reductions being projected in the November modification are \$462 million, or 2.2 percent in FY 2009, and almost \$1.1 billion, or 5.2 percent in FY 2010. On December 9, 2008, OMB requested agencies to develop plans to further reduce city-fund spending in FY 2010 by seven percent, or \$1.4 billion. The reductions are to be proposed in two components, the first being five percent and the second an additional two percent. Both components are to be submitted to OMB by Monday, December 22, 2008.

### **Uniformed Overtime**

Over the last several years, the city has built up multi-billion dollar surpluses that were used, among other things, to prepay expenses and fund a Retiree Health Benefits Trust (RHBT) to address a change in accounting requirements for post employment benefits. However, a severe economic downturn has hit the city hard and has required the city to ask all of its agencies to reduce their expenditures in FYs 2009 and 2010. One budgetary item that has changed little under this directive is overtime spending by the city's uniformed agencies. According to our analysis, collectively, the city's uniformed agencies are already at risk to overspend their overtime budget by the end of FY 2009.

In the FY 2009 Adopted Budget, the city had expected that its four uniformed agencies (Police, Fire, Correction and Sanitation), including both uniformed and civilian personnel, would spend \$672.7 million for the fiscal year. In the November modification, that amount has increased by \$16.3 million and the city now has anticipated that overtime expenditures will total \$689.3 million. Our analysis indicates that based on expenditures through October, the agencies are on track to spend \$780.3 million, or \$91 million over the current budget estimate.

In the FY 2008 Adopted Budget, the city expected \$616.2 million in overtime expenditures; however, that figure was significantly lower than actual expenditures. The city actually spent, by fiscal year end, \$808.9 million with more than half of those expenses accounted for by the Police Department. The Police Department spent \$406.5 million in uniformed overtime and another \$69.2 million for civilian personnel. Additionally, the Department of Correction required extra funding of \$46 million. Much of Police Department overtime is driven by arrests. The court system has a fixed set of personnel in place to deal with the processing of criminals. Police officers must process an arrest from start to finish and at times a bottleneck in the system occurs and the need

for overtime is manifested. The greater the number of arrests, the more overtime is usually required.

FY 2008 was the first time in six years that the city has spent greater than \$800 million to fund its overtime operations. The last year that spending reached that magnitude was in FY 2002, the year in which the September 11<sup>th</sup> attacks occurred and overtime expenses reached \$976 million. Fortunately, the city did receive a good deal of state and federal to help offset the overtime expenses incurred in that year.

Since FY 2002, spending has been in the mid \$700 million range, with the Police Department accounting for much of those expenditures. The help received from the federal government, in the form of Homeland Security grants, has continued in subsequent years, but has gradually diminished each year or become categorical funding, which could only be used for straight time expenses. The city is expected to receive \$4.5 million this fiscal year that can be used for overtime expenses.

As mentioned previously, the city has implemented a cost reduction initiative or what is known as the Program to Eliminate the Gap (PEG) in order to meet the challenges that lie ahead this fiscal year and several years into the future. Table 4 shows that all four uniformed agencies have identified ways to reduce their overall salary budgets with some of the reductions directed to reducing overtime expenditures exclusively. The majority of the reductions in overtime recur throughout the financial plan years.

TABLE 4

**PEG PROGRAMS AFFECTING SALARIES FOR THE UNIFORMED AGENCIES**  
(\$ in thousands)

	FY 2009	FY 2010	FY 2011	FY 2012
<b>Police Dept</b>				
Straight Time	\$27,158	\$63,337	\$72,446	\$45,675
Overtime	--	\$8,000	--	--
<b>Subtotal Police</b>	<b>\$27,158</b>	<b>\$71,337</b>	<b>\$72,446</b>	<b>\$45,675</b>
<b>Fire Dept</b>				
Straight Time	\$18,323	\$16,451	\$14,764	\$14,763
Overtime	7,480	14,961	14,961	14,961
<b>Subtotal Fire</b>	<b>\$25,803</b>	<b>\$31,412</b>	<b>\$29,725</b>	<b>\$29,724</b>
<b>Correction Dept</b>				
Straight Time	\$6,059	\$4,404	\$4,117	(\$1,575)
Overtime	3,373	18,780	19,455	25,270
<b>Subtotal Correction</b>	<b>\$9,432</b>	<b>\$23,184</b>	<b>\$23,572</b>	<b>\$23,695</b>
<b>Sanitation Dept</b>				
Straight Time	\$18,245	\$36,199	\$12,994	\$14,952
Overtime	500	1,000	1,000	1,000
<b>Subtotal Sanitation</b>	<b>\$18,745</b>	<b>\$37,199</b>	<b>\$13,994</b>	<b>\$15,952</b>
<b>Total Straight Time</b>	<b>\$69,785</b>	<b>\$120,391</b>	<b>\$104,321</b>	<b>\$73,815</b>
<b>Total Overtime</b>	<b>11,353</b>	<b>42,741</b>	<b>35,416</b>	<b>41,231</b>
<b>Total PEG Programs</b>	<b>\$81,138</b>	<b>\$163,132</b>	<b>\$139,737</b>	<b>\$115,046</b>
The amounts shown in the table are net of technical adjustments made to the miscellaneous budget for FICA, healthcare costs and other offsets.				

The agencies have identified salary expenditure reductions in FY 2009 that total \$81 million, which includes about \$11 million, directed strictly to reduce overtime

expenses. Due to the timing of the expenditure cuts, the city can only recognize a portion of the savings this fiscal year, while the full effects of the expenditure reductions will be realized in FYs 2010 through 2012.

The Police Department, where the bulk of overtime spending occurs, found nearly all its savings in their straight time expenditures. The FY 2009 savings will be realized due to the cancellation of the January 2009 academy class which will achieve gross savings of about \$36 million (after technical adjustments for FICA and healthcare costs to the miscellaneous budget the savings to the Department are \$29 million). In the outyears of the financial plan, the savings are more pronounced. In addition to capturing additional savings from the class cancellation in FY 2009, the Department has also put a cap on the size of the classes scheduled. The Department has two recruit classes each fiscal year with one occurring in July and the other in January. The Department has capped those classes to a maximum size of 2,000 in FYs 2010 through 2012. After similar adjustments to the miscellaneous budget, as mentioned earlier, the savings are substantial. Further, the Police Department has identified savings in civilian headcount and other efficiencies.

Though the Police Department has identified recurring savings in their straight time expenses, no overtime reductions have been proposed. The one item of savings is in FY 2010, which is a federal reimbursement of \$8 million for the last United Nations conference. Each of the other uniformed departments has identified costs savings in both their straight time and overtime expenditures. As shown in Table 4 on page 17, the Fire Department will be able to save more than \$7 million in FY 2009 by reducing both the number of training weeks for new hires and the number of nighttime operational hours in engine companies where ladder companies are fully staffed. Those initiatives will save almost \$15 million in each of FYs 2010 to 2012. Also, the Department of Correction will reduce its overtime expenses by moving city inmates from jails that are operating at full capacity to state jails that are underutilized. This movement of inmates will produce a modest savings of slightly more than \$3 million in FY 2009, but will have a greater effect in the outyears of the financial plan where, as shown in Table 4 on page 17, it will translate into significant savings. Lastly, the Department of Sanitation plans to reduce overtime costs through scheduling efficiencies by \$0.5 million in FY 2009 and by \$1 million for each of the FYs 2010 to 2012.

**PROJECTED RISKS TO UNIFORMED AGENCY'S OVERTIME BUDGET**

TABLE 5

(\$ in millions)				
	FY 2009	FY 2010	FY 2011	FY 2012
Police	\$353.5	\$333.9	\$347.4	\$346.7
Fire	212.5	207.5	205.9	205.2
Correction	58.8	68.3	68.8	69.1
Sanitation	64.5	63.9	68.3	69.3
Total City Projected OT	\$689.3	\$673.6	\$690.4	\$690.3
FCB Projected OT	780.3	780.3	780.3	780.3
Risk	\$ 91.0	\$106.7	\$ 89.9	\$ 90.0

As mentioned earlier, in FY 2009 the city has projected that its four uniformed agencies will spend \$689.3 million for overtime, as shown in Table 5. As first projected in the adopted budget, the city had planned to spend \$16.3 million less or \$672.5 million.

The increase from plan-to-plan is in the Police and Fire Departments and is due to recent collective bargaining agreements and for the allocation of grants. As reported previously, the other departments were able to reduce their budgets or keep them unchanged. However, actual expenditures through October of \$260.1 million indicate that the agencies, collectively, will spend \$780.3 million or \$91 million more than budgeted. The city is reluctant to raise the overtime budget initially at adoption for fear of giving an invitation to increase spending and chooses to incrementally increase the budget with each modification. However, there is usually a deficit that needs to be funded by year end regardless of the budget adjustments. Hence, we will hold at risk \$91 million in FY 2009, \$106.7 million in FY 2010, \$89.9 million in FY 2011 and \$90 million in FY2012.

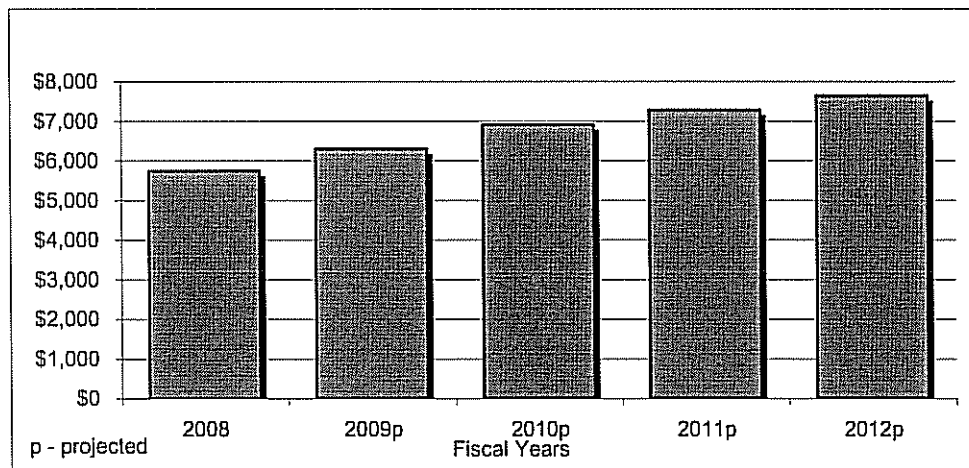
### **Pension Costs**

The financial crisis, which has spread worldwide, has hit the city hard. The crisis has grown rapidly and in a relatively short period of time caused very serious problems for the capital and money markets, the global banking systems, the exchange markets, the commodity markets and a number of economies around the globe. This crisis is far from over and many experts believe that the situation will likely worsen before there are any signs of improvement. The downturn in the U.S. economy has put the city in distress as it tries to manage the impact of the crisis and close substantial multi-billion dollar budget gaps in the coming fiscal years. Adding to this intense pressure is the potential loss of billions of dollars in the value of the assets held by the city's pension systems. Those losses would need to be accounted for and would cause the city's annual pension costs to escalate.

#### **PENSION COSTS EXPECTED TO RISE CONSIDERABLY OVER FYs 2008-12**

CHART 1

(\$ in millions)



In its latest budget modification, the city projects that severe investment losses in the pension systems will result in investment returns falling well below their required rate of return or Actuarial Interest Rate (AIR) of eight percent. The city will be responsible for the losses, which they will phase in over a six-year period starting in FY 2011. As shown in Chart 1, the losses suffered by the pension systems will add to annual pension costs that are expected to climb higher in each year of the financial plan as those losses are phased-in at increasing amounts. The city expects to contribute \$5.7

billion in FY 2008 which will increase substantially by FY 2012 to more than \$7.6 billion or by 33 percent.

The pension systems hold assets that are primarily invested in equity securities (domestic and foreign), but also debt instruments, real estate, private equity, alternative investment vehicles and cash. It is the intention of the pension fund managers to diversify the assets in these different investment classes in order to maximize return and reduce the risk of losses. When investment performance is positive, the assets held by the pension systems will increase in value. Of course, they will decline in value if investments perform poorly. An asset's investment performance below the required rate of return of eight percent equates to a loss that the city must provide funding for. Losses expected in the near term will likely increase the city's annual pension costs, which are phased in over a six-year period. The phasing-in of investment losses and gains smoothes out investment returns over time.

In FY 2007, the systems realized investment gains of 18.2 percent. However, pension returns fell in FY 2008 as the financial crisis adversely affected the markets and investment returns were negative 5.4 percent. In its latest budget modification, the city has allocated a reserve of funds to address an expected eight percent loss for the pension systems in FY 2009. Indeed, investment returns were down in the first quarter of FY 2009 by more than eight percent, and the markets have fallen much further since September, which have reduced the value of the pension assets further. The city has estimated that investment returns are down 20 percent through October. We believe that investment returns are considerably worse and, based on our analysis, estimate that losses through November are closer to 26 percent.

#### LOSSES IN MARKET VALUE OF ASSETS UNDER DIFFERENT ASSUMPTIONS

TABLE 6

(\$ in millions)				
Fiscal Year	Old Value	Return on Assets	Asset Loss	New Value
2009	\$104,729	(8.0%)	(\$ 8,378)	\$ 96,351
2009	\$104,729	(20.0%)	(\$20,946)	\$ 83,783
2009	\$104,729	(25.6%)	(\$26,805)	\$ 77,924

In Table 6, we show the different investment returns discussed earlier. The table details the impact of investment losses on the market value of the pension systems' assets. As mentioned before, the city has set aside reserves to deal with a loss of eight percent but has realized that losses will be greater. The 20 percent loss incurred, as of October 2008, would cause assets to decline by nearly \$21 billion or from \$104.7 billion to \$83.8 billion. We believe that the market value of the systems' assets have fallen even further with an estimated investment loss of 25.6 percent through November 2008. This could result in a loss of \$26.8 billion and reduce the pension systems' assets to \$77.9 billion. It is possible that market conditions could improve and the losses shown here reduced, but it is also possible that things could worsen.



TABLE 7

**ESTIMATED PHASE-IN OF POTENTIAL INVESTMENT LOSSES IN FY 2009**

(\$ in millions)

	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16
Cumulative Phase-in Percentage	15%	30%	45%	60%	80%	100%
FY 09 FCB Projected Phase-In of 25.6% Loss	(\$322)	(\$644)	(\$965)	(\$1,287)	(\$1,716)	(\$2,145)
City Adjustment for FY 09 8.0% Loss	(243)	(447)	(729)	(972)	(1,296)	(1,620)
Over / (Under)	(\$79)	(\$197)	(\$236)	(\$315)	(\$420)	(\$525)
City adjustment for FY 09 has been estimated for FYs 2013 to 2016						

As mentioned earlier, the city is able to phase-in gains and losses over a six-year period in order to smooth out fluctuations in investment returns. Table 7, shown above, shows the potential impact to pension costs if the pension systems suffer a loss of 25.6 percent for the current fiscal year. The systems' assets are required to meet an eight percent return. Any investment return under this figure equates to a loss. Thus, if by fiscal year end the return on assets is a negative return of 25.6 percent, then the actual loss is 33.6 percent. The actual loss phased in over the six-year period starting in FY 2011 will grow during the phase-in, as shown in the table. The city has estimated a fiscal year-end loss of eight percent and has allocated funding to cover this loss. If returns are worse, as in our projection, then the city will need to allocate additional funding as the table shows. However, please note that our analysis of the phase-in does not include the gains and losses from previous years; however, it serves as a general indicator of additional costs the city may be obligated to fund.

**Retiree Health Benefits Trust and Other Post-Employment Benefit Liabilities**

In 2004, the Governmental Accounting Standards Board (GASB) established a set of rules that detailed the reporting of Other Post-Employment Benefits (OPEB), which includes post-employment healthcare costs and other forms of post-employment benefits. The rules are for financial reporting and disclosure only and the city is under no obligation to fund the future cost of the benefits. In response to GASB 43 (*Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans-Issued 4/04*) and GASB 45 (*Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions-Issued 6/04*), the city established the Retiree Health Benefits Trust (RHBT) in FY 2006 with an initial deposit of \$1 billion and allocated another \$1.5 billion in FY 2007, even though it was not required to create or fund the RHBT.

TABLE 8

**CHANGES IN ASSETS HELD BY THE RHBT**

(\$ in thousands)

	Beginning of Year	Net Change	End of Year
FY 2006	\$1,000,000	\$1,332	\$1,001,332
FY 2007	\$1,001,332	\$1,594,000	\$2,595,332
FY 2008	\$2,595,332	\$590,807	\$3,186,139

As shown in Table 8, the city's initial funding of \$1 billion in FY 2006 to the RHBT has grown to nearly \$3.2 billion in FY 2008 because of additional funding allocations in FYs 2007 and 2008 of \$1.5 billion and \$460 million, respectively, and

investment income totaling more than \$144 million with net adjustments for employer contributions and administration fees paid.

As discussed in the pension section of this report (starting on page 19), the pension systems' total investment loss is considerable for FY 2008 and thus far for FY 2009 and the city has put in reserve significant funds to deal with the added expenses. To mitigate the negative impact, the city has planned to apply slightly above \$1.1 billion previously allocated to the trust fund to pay retiree healthcare costs to offset the investment losses in FYs 2010 to 2012. As stated in the November budget modification, the city expects to reduce the RHBT by \$82 million in FY 2010, \$395 million in FY 2011 and \$672 million in FY 2012. If the need to use that allocation of funds remains in FY 2010, the city's planned usage of \$82 million would be at least covered by interest earned by the trust. Beyond FY 2010 though, the funds deposited into the trust fund in the last couple of fiscal years would most certainly be reduced.

In creating the trust fund in FY 2006, the city recognized \$53.5 billion of long-term liability for OPEB on its balance sheet. That figure has since grown to \$63.7 billion in FY 2008. There is no cash flow consequence for the city's budget since the liability is not required to be funded at this time. However, this unfunded liability, known as the Unfunded Actuarial Accrued Liability (UAAL), will continue to grow substantially.

As presented in Table 9, the UAAL for FY 2006 was \$53.5 billion after adjustments for a normal cost or required annual contribution that would be paid if the city had implemented the plan. Additional adjustments are made for interest income that would have been collected on the fully funded assets and another adjustment is made for pay-as-you-go OPEB expenses that are paid through the trust fund. Also, as shown in the table, the UAAL had been reduced in FYs 2006 and 2007 by \$2.5 billion in trust fund allocations.

The beginning year UAAL is adjusted from the preliminary year end UAAL for average growth in healthcare costs, Medicare and Medicare Part B premiums and welfare fund contributions for active and retired plan members. Based on our analysis using city data, we have assumed an average yearly growth rate of healthcare costs for both active and retired members, of about nine percent. The current national trend assumption for the near-term has been for healthcare costs, in particular premiums and hospital care, to grow at an average rate of about 10 percent. As of the latest actuarial audit, there are a total of 517,457 members that are eligible or are receiving OPEB benefits.

#### SUMMARY OF UNFUNDED ACTUARIAL ACCRUED LIABILITY

TABLE 9

(\$ in millions)

	FY 2006	FY 2007	FY 2008
UAAL at Beginning of Year	\$50,523	\$55,059	\$59,522
Normal Cost (Required Annual Contribution)	3,002	3,262	3,133
<b>Subtotal</b>	<b>\$53,525</b>	<b>\$58,321</b>	<b>\$62,655</b>
Interest @ 4%	2,141	2,333	2,506
Pay-As-You-Go OPEB	(1,183)	(1,410)	(1,431)
RHBT Contribution	(1,000)	(1,500)	--
<b>Preliminary UAAL at End of Year</b>	<b>\$53,483</b>	<b>\$57,744</b>	<b>\$63,730</b>

As shown in Table 10, we have projected for each of the financial plan years the possible increase in the UAAL. The UAAL is projected to grow from almost \$68.8 billion in FY 2009 to nearly \$89 billion in FY 2012. As the table details, the city pays its OPEB costs by funding the trust on a pay-as-you-go basis. For FY 2009, the city anticipates payments of almost \$1.6 billion, when in FY 2012, the payments are expected to decrease to about \$1.4 billion. According to our analysis, in paying the annual OPEB cost, the city is recording a shortfall in the true cost of OPEB. In FY 2009, the total projected cost of funding OPEB is the normal cost of \$3.2 billion plus interest on unfunded assets of \$2.7 billion, an aggregate sum of about \$5.9 billion. Thus, the city is funding just 26 percent of what is the projected annual OPEB cost. This equates to a funding shortfall of almost \$4.4 billion. Under the same methodology, the funding shortfall on an annual basis grows to more than \$5.7 billion by FY 2012, with total OPEB funding of about 20 percent.

The FY 2009 Adopted Budget reported a prepayment of \$460 million to OPEB in FY 2009. Because the city utilizes the RHBT as a conduit for OPEB payments, this prepayment increased the OPEB cost in FY 2008 by \$460 million to more than \$1.9 billion, reduced the OPEB cost in FY 2009 to about \$1.1 billion and subsequently increased the RHBT by \$460 million. Because the \$460 million was transferred from the BSA to RHBT as a technical adjustment for the purpose of the FY 2009 prepayment, we have chosen to ignore this budgetary measure for this analysis.

**TABLE 10** **SUMMARY OF PROJECTED UNFUNDED ACTUARIAL ACCRUED LIABILITY**  
(\$ in millions)

	FY 2009p	FY 2010p	FY 2011p	FY 2012p
UAAL at Beginning of Year	\$64,402	\$69,966	\$76,201	\$83,197
Normal Cost	3,235	3,364	3,498	3,638
<b>Subtotal</b>	<b>\$67,637</b>	<b>\$73,330</b>	<b>\$79,700</b>	<b>\$86,836</b>
Interest @ 4%	2,705	2,933	3,188	3,473
Pay-As-You-Go OPEB	(1,561)	(1,617)	(1,501)	(1,404)
RHBT Contribution	--	--	--	--
<b>UAAL at End of Year</b>	<b>\$68,781</b>	<b>\$74,646</b>	<b>\$81,387</b>	<b>\$88,905</b>
Note: Numbers may not add due to rounding. p=projected				

As the city deals in the years ahead with multi-billion dollar budget gaps it is apparent from our analysis that the OPEB liability will continue to grow larger. At the July 2008 FCB annual meeting, the three private board members urged the city to develop a plan to either fund this serious growing liability or reduce the costs of these benefits. The current modification does neither.

### Department of Education

The November modification to the FY 2009 Adopted Budget decreases funding for the Department of Education (DOE) by \$180 million bringing its budget to \$17.6 billion. This is still over \$600 million more than the FY 2008 close. The decrease in city spending is part of the city's agency program. The main component of this decrease is over \$122 million in General Education and School Leadership. Other reductions in spending estimates were mostly in support services with Central Administration decreasing almost \$26 million. In FY 2010, the Department's expense reductions total \$392 million, of which over \$385 million is due to the city's agency program. The

reductions are spread across 19 initiatives, the largest being an Other Than Personal Service (OTPS) reduction in the schools yielding approximately \$256 million. An OTPS reduction in Central Administration totals almost \$22 million.

TABLE 11

**DOE EXPENSE CHANGES BETWEEN PLANS**  
(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
November PS	\$12,448	\$12,876	\$13,982	\$14,087
Adopted PS	12,495	12,962	14,068	14,172
Increase/(Decrease)	(47)	(86)	(86)	(85)
November OTPS	\$5,128	\$5,420	\$5,814	\$6,040
Adopted OTPS	5,260	5,726	6,120	6,346
Increase/(Decrease)	(132)	(306)	(306)	(306)
November Total	\$17,576	\$18,296	\$19,797	\$20,127
Adopted Total	17,756	18,688	20,188	20,518
Increase/(Decrease)	(180)	(392)	(391)	(391)

As shown in Table 11, in FYs 2010–12, the Department estimates spending to grow from \$18.3 billion in FY 2010 to \$20.1 billion in FY 2012, or a ten percent growth. In FY 2009, city funds comprise \$7.2 billion or 41 percent of the Department’s budget, while the state’s share is \$8.5 billion or 48 percent. The balance of the education budget is comprised of \$1.8 billion in federal aid, \$11 million in intra-city funds and \$51 million in other categorical funds.

It is important to note that the Governor had requested a reduction of \$255 million in education aid to the city in FY 2009 as part of the state’s General Fund Gap Closing Proposals. The legislature did not act on these proposals. It is expected as the state deals with its own large budget deficit, significant reductions in state aid to education are likely in FY 2010.

### **Collective Bargaining and Labor**

Since the release of the adopted budget, the city has been active in negotiating contracts with most of its labor unions and has reached tentative agreements with almost all of them. Having agreed to contracts in August with the Patrolmen’s Benevolent Association (PBA), in October with the Correction Officers’ Benevolent Association (COBA) and in November with District Council 37 (DC 37), the city is up to date with its largest union contracts. While there are some smaller contracts still to be resolved, the city has committed to salary increases with most unions through FYs 2009 to 2011.

In the labor agreements reached this fiscal year, the city has agreed to raise salaries by four percent in each year of the contracts (the PBA is four years and COBA and DC 37 are both two years). In recent years, the most contentious negotiations were usually with the PBA, with their contract prior to the one just reached ending up in arbitration. Their latest contract was the first reached in regular negotiations since 1994. The biggest gain in the contract for the union was the increase in the starting salary for

rookie police officers. Effective from August 2009, new recruits start at \$41,975, a significant raise over the last few years when a lower salary resulted in recruitment problems for the Department. The higher salary is expected to attract a greater number of recruits. Additional compensation in the PBA contract was in the form of longevity and holiday pay and night shift differential. Vacation enhancements and changes to the funding of welfare funds were included in the COBA contract while the contract with DC 37 centered around salary increases only.

The latest contract agreements will push expenditures higher over the course of the financial plan, while at the same time significant budget gaps remain to be closed. It is important to note that the collective bargaining agreements negotiated with the city's unions produced few cost saving measures or productivity enhancements. While in the past the city had suggested ideas like creating a fifth pension tier for new hires and healthcare premium payments for future retirees, no such actions have materialized. With few cost-containment or productivity measures taking place, the impact on expenditures will go beyond increases in salaries; it will also increase the city's pension costs. Further, healthcare costs have been climbing higher than the rate of inflation and will climb to more than \$2 billion by FY 2012.

In its latest budget modification, the city expects that Salaries and Wages will rise from \$21.9 billion in FY 2008 to \$24.5 billion in FY 2012, or nearly 12 percent. The city has set aside funding for the contracts that have been agreed upon thus far and awaits their ratification by union members. The PBA contract which was recently ratified will cost \$210 million in FY 2009, \$287 million in FY 2010, \$311 million in FY 2011 and \$315 million in FY 2012. The remaining contracts still need to be agreed to by union members.

As mentioned previously, pension costs are affected by salary increases that drive up the cost of providing retiree benefits. For example, when police officers retire, they are paid benefits based on their average salary for the last three years on the job including overtime pay. In the latest contract with the PBA, the top pay excluding overtime will reach almost \$92,000 and with overtime would likely climb over \$100,000. Annual pension costs or the annual contribution made by the city to the pension systems are the present value of future benefit payments expected to be paid when a police officer retires. Hence, the city will be required to fund those higher future retirement benefits today.

#### **FYs 2009 and 2010 New Agency Programs**

In September 2008, the Office of Management and Budget (OMB) requested that all city agencies submit an expense reduction program for city-funded expenses of 2.5 percent in FY 2009 and five percent in FY 2010. The final reductions being proposed in the November modification are \$462 million, or 2.2 percent in FY 2009, and almost \$1.1 billion, or 5.2 percent in FY 2010. These expenditure reductions are in addition to a \$1.3 billion reduction in FY 2009 expenses proposed in May 2008. As shown in Table 12 on page 26, the FY 2009 program consists of \$382 million in expense reductions and \$80 million in increased revenues. Of these amounts approximately \$391 million or 84.8 percent are of a recurring nature. The FY 2010 agency program consists of \$867 million

in expense reductions and \$216 million in increased revenues. Of these amounts approximately \$1 billion or 91.7 percent are of a recurring nature.

On December 9, 2008, OMB requested agencies to develop plans to further reduce city-fund spending in FY 2010 by seven percent, or \$1.4 billion. The reductions are to be proposed in two components, the first being five percent and the second an additional two percent. Both components are to be submitted to OMB by Monday, December 22, 2008.

In FY 2009, the Department of Education has the largest amount of savings with approximately \$180 million and in FY 2010 the savings total over \$385 million. These savings are spread across a number of individual initiatives which are discussed in more detail in "Department of Education" on page 23 of this report.

### THE CITY'S FY 2009 AND FY 2010 AGENCY PROGRAMS

TABLE 12 (\$ in millions)

<u>Department</u>	<u>FY 2009</u>		<u>FY 2010</u>	
	<u>Expenditures</u>	<u>Revenues</u>	<u>Expenditures</u>	<u>Revenues</u>
Education	(\$180.5)	—	(\$385.4)	—
Police	(35.1)	(10.3)	(91.0)	(76.2)
Fire	(26.2)	(5.5)	(32.4)	(29.5)
Sanitation	(18.8)	(6.2)	(37.2)	(29.8)
Children's Services	(19.3)	—	(38.4)	—
Social Services	(15.3)	—	(29.9)	—
Transportation	(8.2)	(3.8)	(13.9)	(8.4)
Health & Mental Hygiene	(6.6)	(3.6)	(14.3)	(3.9)
Correction	(9.4)	—	(31.6)	—
Homeless Services	(7.9)	—	(15.3)	—
Finance	4.0	(11.6)	0.5	(10.4)
Parks & Recreation	(4.2)	(2.5)	(9.0)	(4.2)
Youth & Community Dev	(5.3)	(0.4)	(9.1)	—
Procurement Savings	—	—	(55.5)	—
Fleet Reduction	—	—	(20.0)	—
Other Agencies	(48.7)	(36.2)	(84.2)	(54.0)
<b>Total</b>	<b>(\$381.5)</b>	<b>(\$80.1)</b>	<b>(\$866.7)</b>	<b>(\$216.4)</b>

Note: Negative numbers represent a reduction in the city's budget gap.

The Police Department plans to reduce expenses by slightly more than \$35 million in FY 2009 which will result from various uniformed and civilian headcount reductions. For more detail on these cuts see "Uniformed Overtime" on page 16 of this report. In FY 2010, the Department projects \$91 million in expense reductions which again are mostly due to uniformed and civilian headcount reductions. On the revenue side the Department expects to collect over \$10 million in additional funds in FY 2009. The largest component of this increase is \$2 million raised by hiring an additional 200 traffic agents and 34 supervisors to expand the Block the Box violation initiative. In FY 2010 these additional agents are expected to raise over \$60 million.

Expense reductions in the Fire Department (FDNY) in FY 2009 are slightly over \$26 million. Of this amount, approximately \$12 million is in additional non-Medicaid ambulance payment collections. Over \$4 million will be realized by the reduction of nighttime operational hours at five engine companies in firehouses where the ladder

companies will be fully staffed. The reduction in the length of the Firefighter Training Academy from 23 to 18 weeks will save an additional \$3 million. In FY 2010 the reduction in the nighttime hours for five engine companies will reduce expenses by almost \$9 million, the additional EMS collections will bring in almost \$7 million and the reduction of the Training Academy will save \$6 million. The Department's total savings in FY 2010 are forecasted to be approximately \$32 million. The FDNY expects to raise additional revenue of over \$5 million in FY 2009 due to additional collections from the two percent tax on fire insurance premiums assessed on insurers based outside of the city. In FY 2010 additional revenues of over \$29 million are projected of which \$21 million will be raised by increasing the tax on insurers based outside of the city from two percent to four percent. This increase must be approved by the state legislature.

The Department of Sanitation plans to reduce expenses by \$19 million in FY 2009, of which \$6 million will be realized through the reduction in funding for the majority of the outreach and education programs run through the Bureau of Waste Prevention, Reuse and Recycling. Expense reductions are expected to increase to over \$37 million in FY 2010. The largest portion of this will be a result of revised cost estimates for core waste disposable activities. In FY 2009 the Department projects increased revenues of over \$6 million due mostly to over \$5 million in grant funding from the State Department of Environmental Conservation. Sanitation expects almost \$30 million in additional revenues in FY 2010. Over half of this amount, or \$16 million, will be raised by proposed legislation imposing a five cent fee to encourage consumers to switch from plastic bags to biodegradable or reusable bags.

The Administration for Children's Services (ACS) is forecasting expense reductions of over \$19 million in FY 2009 and over \$38 million in FY 2010. In FY 2009 the largest savings will be \$5 million due to a 10 percent reduction in payments to institutions and schools for children with unique needs placed by ACS and the Department of Education. Almost \$4 million will be saved because Child Protective Level I Supervisors will now carry a full complement of cases, focusing on more complex investigations. Of the FY 2010 savings, the reduction of payments for children with unique needs will save \$10 million, while an additional expense reduction of almost \$9 million will be realized through increased child care co-payments for non-public assistance families.

In FY 2009, over \$48 million in expense reductions and \$36 million in revenue increases will be spread across a number of city agencies. In FY 2010 these agencies are forecasted to save \$84 million and raise \$54 million in additional revenues. Also in FY 2010 various procurement savings are expected, totaling over \$55 million, while \$20 million in savings will be due to the reduction in the number of the city's fleet vehicles.

## **RISKS AND OFFSETS**

Our evaluation of the city's financial plan is shown in Table 3 on page 5. We project a decrease in non-property tax revenue of \$450 million in FY 2009, \$425 million in FY 2010 and \$300 million in FY 2011. We also project shortfalls in property tax revenue of \$300 million in FY 2010, \$400 million in FY 2011 and \$500 million in FY 2012. We estimate that uniformed overtime costs, based on our analysis and historical growth

rates, will exceed what the city has budgeted by \$91 million in FY 2009, \$107 million in FY 2010, \$90 million in FY 2011 and \$90 million in FY 2012. As a potential offset to these risks, we project miscellaneous revenue, based on historical patterns of growth, to be higher by \$125 million in FY 2009, \$100 million in FY 2010, and \$75 million in each of FYs 2011 and 2012.

The city has budgeted funds in the financial plan assuming that the \$400 homeowner rebate program would be rescinded in FY 2009. If approval from the city council for this action is not received in FY 2009, revenues for that year will be reduced by \$256 million. The city hopes to achieve health insurance savings of \$200 million beginning in FY 2010 and continuing throughout the life of the plan. Negotiations are in the early stages with the Municipal Labor Council, thus there are no details available as to how these savings will be realized. The city is to begin funding pollution remediation projects in FY 2011 in its expense budget instead of the capital budget. The city estimates this could cost up to \$500 million annually. The funding is not included in the current financial plan.

We now estimate that the city will have a possible budget gap of \$672 million in FY 2009, almost \$2.3 billion in FY 2010, over \$6.4 billion in FY 2011, and over \$6.1 billion in FY 2012.

### **THE SIZE OF THE CAPITAL PROGRAM WILL REMAIN ABOVE AVERAGE**

The city's four-year capital plan for FYs 2009-12 totals \$38.7 billion of which \$30.6 billion is city funded and \$8.1 billion is funded by non-city sources, including the state and federal governments. The city-funded commitments include \$23.2 billion of contracts that are supported by city general obligation (g.o.) bonds and \$7.4 billion that are supported by Water Authority revenue bonds, as shown in the figure to the right. Given the very serious fiscal problems threatening the city, in the prior capital plan, the four-year g.o.-funded program was stretched out over five years to reduce debt service costs to levels the city believe it will be able to afford. A review of the current Four-Year Capital Plan for FYs 2009-2012 shows that, despite the prior deferral, city-funded capital commitments are projected to remain above the average level of commitments undertaken annually during the previous ten years, even after adjusting for inflation.

The Capital Plan for FYs 2009-12 (\$ in billions)	
	November Modification
City Funded:	
G.O.	\$23.2
Water Authority	7.4
Subtotal	\$30.6
Noncity Funded	8.1
<b>Total</b>	<b>\$38.7</b>

Debt service costs that will be paid from city tax revenues, before prepayments are made, are estimated to increase annually from \$4.3 billion in FY 2009 to \$6.5 billion in FY 2012, only changing marginally from the June financial plan. As a share of tax revenues, the debt service burden will rise from 11.7 percent in FY 2009 to 15.4 percent in FY 2012. Meanwhile, debt service on Water Authority revenue bonds, sold to support city environmental protection projects and backed by water usage fees paid by city residents, is forecasted to increase from \$1.1 billion in FY 2009 to \$1.6 billion in FY 2012.



## The Four-Year Capital Plan for FYs 2009-2012

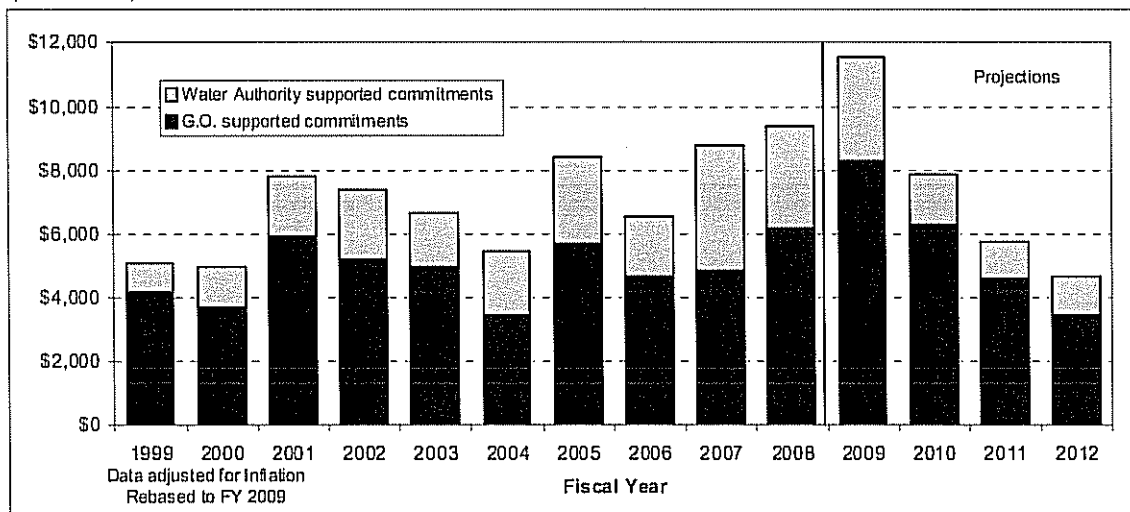
To put the size of the capital plan into context, we compared the prior ten fiscal years of actual city-funded capital commitments to those projected in the four-year plan. In our analysis, we reviewed city-funded capital commitments based on constant dollar amounts that were adjusted for the effects of inflation and rebased to FY 2009. As Chart 2 illustrates, projected city-funded capital commitments will peak in FY 2009 at \$11.5 billion, which is \$2 billion more than the value of the largest amount of commitments ever undertaken in a fiscal year. Thereafter, commitments are projected to decline annually to \$7.8 billion in FY 2010 and \$5.8 billion in FY 2011, before falling to \$4.6 billion in FY 2012 – the lowest value undertaken over the past ten years. Total city-funded commitments projected for FYs 2009-12 average \$7.45 billion annually, which is about \$400 million higher compared to the average of \$7.04 billion for FYs 1999-2008.

The city has set an ambitious target for city-funded commitments in FY 2009 at \$11.5 billion. The fact is that while the city entered into a record high inflation-adjusted amount of capital contracts in FY 2008 at \$9.4 billion, this quantity represents a \$1.5 billion shortfall from the planned level. If the city were to fall short of its target for FY 2009, it is likely that the projects that are not undertaken would be contracted in the outyears of the plan. Under this scenario, commitments could be more evenly distributed over the four years.

### **PROJECTED CITY-FUNDED CAPITAL COMMITMENTS FOR FYs 2009-12 WILL AVERAGE MORE THAN THE LEVELS THAT EXISTED IN FYs 1999-2008**

CHART 2

(\$ In millions)



Of the total amount of city-funded commitments forecasted to be undertaken during FYs 2009-12, 76 percent are funded with city g.o. bonds and 24 percent are funded with Water Authority revenue bonds.<sup>11</sup> G.O. bonds will support the expansion,

<sup>11</sup> The city no longer may utilize the New York City Transitional Finance Authority (NYCTFA) as a source of financing for its general capital program. As of FY 2007, the NYCTFA exhausted its statutory debt capacity. However, the NYCTFA has an additional \$9.4 billion of debt capacity to be used solely for state-funded education capital projects. The bonds, Building Aid Revenue Bonds or BARBs, are secured by state

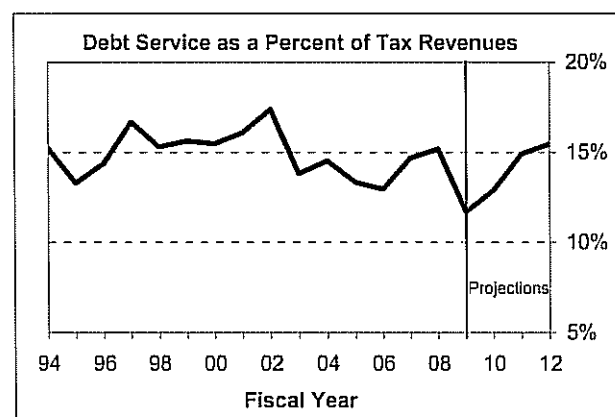
repair and replacement of buildings, equipment, vehicles and roads for functional areas such as education, transportation, mass transit, housing, public safety, general and business services, hospital, health, social services, sanitation, cultural, as well as recreation. G.O.-funded commitments are projected at \$8.3 billion for FY 2009, \$6.3 billion for FY 2010, \$4.6 billion for FY 2011 and \$3.4 billion for FY 2012.

The four-year commitments for the Department of Education rebased at \$4.2 billion represent the largest share of g.o. funding at 19 percent even after \$736 million were deferred from FYs 2009-12 to FY 2013. Excluding education, for which the city does not provide an itemization of individual projects, the ambitious targeted amount of g.o.-funded contracts to be entered into in FY 2009 includes such big ticket items as construction of a new police training facility and citywide economic development initiatives.

Commitments for environmental protection projects covering the functional areas of water mains, water pollution control, water supply, sewers and equipment are financed with proceeds from the sale of Water Authority revenue bonds and are projected at \$3.3 billion in FY 2009, \$1.6 billion in FY 2010, \$1.2 billion in FY 2011 and \$1.2 billion in FY 2012. Over the last two fiscal years, commitments for the Department of Environmental Protection (DEP) were high, due to large sums of resources committed toward the water main system for construction of a full-scale filtration plant for the Croton watershed as well as an ultraviolet light disinfectant facility for the Catskill and Delaware watersheds. The size of contracts expected to be undertaken in FY 2009 will be similarly high, reflecting a concentration on protection and upkeep of the city's source water supply and distribution systems as well as upgrades to the Newton Creek water pollution facility and combined sewer overflow abatement facilities citywide.

### **Debt Service Impact of Capital Program**

The fiscal impact of the city-funded capital program is manifested in the form of annual debt service costs on the bond issuances. For bonds backed by tax revenues – city g.o. bonds and revenue bonds previously sold by the New York City Transitional Finance Authority (NYCTFA) for general capital projects – debt service costs are projected to increase from \$4.3 billion in FY 2009 to \$4.8 billion in FY 2010, \$5.9 billion in FY 2011 and \$6.5 billion in FY 2012. At \$4.3 billion, debt service will absorb what is a historically low 11.7 percent of tax revenues, as shown in the figure to the right. The debt service level for FY 2009 reflects a



building aid payable to the city and assigned to the NYCTFA. The NYCTFA has sold \$2.62 billion of BARBs to date.

reduction that resulted from an early retirement of debt.<sup>12</sup> The debt service burden is expected to increase to 12.9 percent in FY 2010, 14.9 percent in FY 2011 and 15.4 percent in FY 2012, remaining within what has been the norm for the past fifteen years.

The projected levels for city and NYCTFA debt service costs have changed only marginally since the adopted budget. Since June, debt service is lower by \$29 million in FY 2009, and higher by \$2 million in FY 2010, \$20 million in FY 2011 and \$22 million in FY 2012. The major item that contributed to the reduction in debt service for FY 2009 is the assumption that the city will not have to make a previously scheduled \$27 million interest payment on \$2 billion of bonds issued by the Hudson Yards Infrastructure Corporation (HYIC) to finance infrastructure development on Manhattan's far West Side, including the extension of the No. 7 subway line. With higher-than-expected revenue income, HYIC is able to make its interest payments on the bonds in FY 2009 without assistance from the city.

The increases in debt service for FYs 2010-12 reflect higher financing assumptions stemming from adverse financial market conditions. Over the past couple of months, marketwide interest rates for both fixed rate and variable rate debt have been volatile, at times climbing steeply. At the time of the city's October 17<sup>th</sup> bond sale, the last sale before release of the current financial plan, the Bond Buyer 20-Bond GO Index registered a 52-week high at 6.01 percent, exceeding the next highest yield by 54 basis points. The 20-year yield on the city's g.o. bond sale was 6.40 percent, which is the highest 20-year yield over the past twelve years. Given this experience, the city raised the interest rate assumption by 50 to 100 basis points on g.o. bonds to be issued in the remaining months of the fiscal year and in FY 2010.

For variable rate obligations, interest rates had been moving in different directions depending on the indices they are pegged to, which resulted in the city paying more than it received on derivative contracts. The current plan projects that for FY 2009 the city will pay out \$113 million on its swaps while receiving \$95 million, for a net loss of \$18 million. As of September 30, 2008, the notional value of the city's swaps, were they to be terminated, was negative \$94 million. Beyond FY 2009, the plan assumes swap receipts will exceed payouts.

Separately, the Water Authority projects annual debt service on the bonds it sells to finance city environmental projects will grow at an average annual rate of 13 percent, from \$1.1 billion in FY 2009 to \$1.3 billion in FY 2010, \$1.5 billion in FY 2011 and \$1.6 billion in FY 2012. The New York City Water Board levies water and sewer usage charges to pay the debt service on Water Authority bonds.

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<sup>12</sup> This early retirement of debt was explained in the section "Debt Service Transactions" in the FCB May 2007 staff report.

## **Glossary of Acronyms**

<b>ACS</b>	Administration for Children's Services
<b>AIR</b>	Actuarial Interest Rate
<b>BSA</b>	Budget Stabilization Account
<b>CPI</b>	Consumer Price Index
<b>COBA</b>	Correction Officers' Benevolent Association
<b>CY</b>	Calendar Year
<b>DC 37</b>	District Council 37
<b>DEP</b>	Department of Environmental Protection
<b>DOE</b>	Department of Education
<b>EMS</b>	Emergency Medical Service
<b>FCB</b>	Financial Control Board
<b>FDNY</b>	Fire Department
<b>FEA</b>	Financial Emergency Act for The City of New York
<b>FICA</b>	Federal Insurance Contributions Act
<b>FY</b>	Fiscal Year
<b>GASB</b>	Governmental Accounting Standards Board
<b>GCP</b>	Gross City Product
<b>GDP</b>	Gross Domestic Product
<b>G.O. Bonds</b>	General Obligation Bonds
<b>HHC</b>	Health and Hospitals Corporation
<b>HYIC</b>	Hudson Yards Infrastructure Corporation
<b>NYSE</b>	New York Stock Exchange
<b>NYCHA</b>	New York City Housing Authority
<b>NYCRS</b>	New York City Retirement Systems
<b>NYCTFA</b>	New York City Transitional Finance Authority
<b>OMB</b>	Office of Management and Budget
<b>OPEB</b>	Other Post-Employment Benefits

<b>OT</b>	Overtime
<b>OTPS</b>	Other than Personal Service
<b>PBA</b>	Patrolmen's Benevolent Association
<b>PEG</b>	Program to Eliminate the GAP
<b>PIT</b>	Personal Income Tax
<b>PS</b>	Personal Service
<b>RHBT</b>	Retiree Health Benefits Trust
<b>UAAL</b>	Unfunded Actuarial Accrued Liability