

Staff Report

**NOVEMBER MODIFICATION  
FYs 2011-2014**

December 16, 2010



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## I. Overview

First-quarter modifications to the city's financial plan are usually technical in nature and reflect any changes that have occurred in the current fiscal year since the budget was adopted. In the November Modification to the FYs 2011-14 Financial Plan, the city has chosen to be more aggressive in dealing with the large budget gap projected in FY 2012. It has also chosen to make policy decisions concerning the risk and uncertainty with continued federal education aid.

The November modification includes an agency reduction plan that will save \$584 million in FY 2011, annualizing to \$1 billion in FY 2012. This plan is advanced in FY 2011, even though not needed to balance the current budget, in order to maximize the savings available to help balance the FY 2012 budget. In addition to these savings, the city has determined that a \$600 million reserve created to deal with changes to the pension systems actuarial assumptions and methods would not be needed in FY 2011. The combination of these actions has added almost \$1.2 billion to the Budget Stabilization Account and will be used to lower the FY 2012 budget gap.

Despite the city's continued efforts to reduce agency spending, pressures on the expenditure side continue to outpace the growth in revenues. In the November modification, the city has chosen to reflect a number of areas that will need additional funding in FY 2012, primarily healthcare and pension costs, and education.

The city expects that health insurance expenses will increase progressively by \$126 million in FY 2012 to \$276 million in FY 2014, primarily due to changes made by federal healthcare reform and growth in rates. While the city determined that the pension reserve would not be needed in FY 2011, it now projects that it will need a reserve of \$1 billion in FY 2012 and beyond. The city is awaiting completion of the biannual audit and recommendations from the City Actuary. The \$4 billion now reserved over the next four years may not be sufficient to cover growth in pension costs, but it is also unclear exactly in which fiscal year the changes will have to be implemented.

The city has made a major policy choice of using city funds to replace \$853 million in expiring federal stimulus money. In prior plans, the city had said that the loss of federal funds would require the reduction of 14,000 teaching positions. With the loss of the stimulus funds likely, the city has changed course. The city has not yet developed plans to pay for the additional expense in FY 2012 and beyond making the outyear gaps grow larger. In addition, the biggest issue now facing the Department of Education's budget in FYs 2012-14 is the risk and uncertainty of state aid for education. The city's financial plan assumes growth in state Foundation Aid of over \$700 million in FY 2012, rising to \$1.1 billion by FY 2014. Given the large budget gaps facing the state, this assumption of growth is overly optimistic.

The city's projections are that, after all of the actions proposed in the November modification, FY 2012 would still have a budget gap of almost \$2.4 billion, growing to almost \$5.5 billion by FY 2014. Our review of the plan has identified risks of over \$1

billion in the city's estimate of state aid, as well as the risk, of lower property tax collections and higher costs for overtime. With our risks, the budget gaps faced by the city would be \$3.9 billion in FY 2012, rising to \$7.4 billion by FY 2014. It should be noted that if the assumptions in the city's plan for labor contracts are not achieved, these gaps would be substantially higher. The city, in the FY 2012 preliminary budget and January modification to the financial plan, will have to develop initiatives to close these gaps.

**NOVEMBER MODIFICATION:  
THE CITY'S OPERATING PROJECTIONS FOR  
FISCAL YEARS 2011-2014**

TABLE 1 (\$ in millions)

	FY 2011	FY 2012	FY 2013	FY 2014
<b><u>Revenues</u></b>				
Taxes:				
General Property	\$16,747	\$17,393	\$17,663	\$17,800
Other Taxes	21,574	22,710	23,801	25,016
Tax Audit Revenue	628	645	644	651
Sale of Property Tax Liens	40	40	40	40
Miscellaneous Revenues	7,507	6,950	6,993	7,056
Unrestricted Intergovernmental Aid	14	314	314	314
Interfund Revenues	559	500	493	493
Less: Intracity Revenues	(1,824)	(1,523)	(1,519)	(1,519)
Disallowances	<u>(15)</u>	<u>(15)</u>	<u>(15)</u>	<u>(15)</u>
Total City, IFA & Other Categorical Funds	\$45,230	\$47,014	\$48,414	\$49,836
Federal Categorical Grants	7,871	5,837	5,725	5,712
State Categorical Grants	<u>11,475</u>	<u>12,318</u>	<u>12,518</u>	<u>12,935</u>
<b>Total Revenues</b>	<b><u>\$64,576</u></b>	<b><u>\$65,169</u></b>	<b><u>\$66,657</u></b>	<b><u>\$68,483</u></b>
<b><u>Expenditures</u></b>				
Personal Service	\$36,049	\$36,991	\$38,380	\$39,441
Other Than Personal Service	27,182	26,700	27,640	28,883
General Obligation, Lease & TFA Debt Service	5,354	6,219	6,694	6,956
Budget Stabilization & Prepayments	(2,485)	(1,161)	--	--
General Reserve	<u>300</u>	<u>300</u>	<u>300</u>	<u>300</u>
Subtotal	\$66,400	\$69,049	\$73,014	\$75,580
Less: Intracity Expenditures	<u>(1,824)</u>	<u>(1,523)</u>	<u>(1,519)</u>	<u>(1,519)</u>
<b>Total Expenditures</b>	<b><u>\$64,576</u></b>	<b><u>\$67,526</u></b>	<b><u>\$71,495</u></b>	<b><u>\$74,061</u></b>
<b>Gap To Be Closed</b>	<b><u>\$0</u></b>	<b><u>(\$2,357)</u></b>	<b><u>(\$4,838)</u></b>	<b><u>(\$5,578)</u></b>

**CHANGES TO THE CITY'S OPERATING PROJECTIONS FOR  
FISCAL YEARS 2011-2014  
JULY FINANCIAL PLAN COMPARED TO NOVEMBER MODIFICATION**

TABLE 2 (\$ in millions)

	FY 2011	FY 2012	FY 2013	FY 2014
<b>Revenues</b>				
Taxes:				
General Property	\$7	\$10	\$11	\$11
Other Taxes	70	(56)	(211)	(188)
Tax Audit Revenue	6	24	24	31
Sale of Property Tax Liens	0	0	0	0
Miscellaneous Revenues	360	70	85	100
Unrestricted Intergovernmental Aid	0	0	0	0
Interfund Revenues	1	7	0	0
Less: Intracity Revenues	(208)	(25)	(17)	(17)
Disallowances	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total City, IFA & Other Categorical Funds	\$236	\$30	(\$108)	(\$63)
Federal Categorical Grants	1,058	90	51	45
State Categorical Grants	<u>123</u>	<u>44</u>	<u>31</u>	<u>32</u>
<b>Total Revenues</b>	<b><u>\$1,417</u></b>	<b><u>\$164</u></b>	<b><u>(\$26)</u></b>	<b><u>\$14</u></b>
<b>Expenditures</b>				
Personal Service	(\$413)	\$688	\$659	\$563
Other Than Personal Service	1,015	(163)	23	114
General Obligation, Lease & TFA Debt Service	3	(75)	92	97
Budget Stabilization & Prepayments	1,157	(1,161)	--	--
General Reserve	<u>(137)</u>	<u>0</u>	<u>0</u>	<u>0</u>
Subtotal	\$1,625	(\$711)	\$774	\$774
Less: Intracity Expenditures	<u>(208)</u>	<u>(25)</u>	<u>(17)</u>	<u>(17)</u>
<b>Total Expenditures</b>	<b><u>\$1,417</u></b>	<b><u>(\$736)</u></b>	<b><u>\$757</u></b>	<b><u>\$757</u></b>
<b>Gap To Be Closed</b>	<b><u>\$0</u></b>	<b><u>\$900</u></b>	<b><u>(\$783)</u></b>	<b><u>(\$743)</u></b>



### RISKS TO THE FINANCIAL PLAN

TABLE 3

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

	FY 2011	FY 2012	FY 2013	FY 2014
<b>Stated Financial Plan Gap</b>	<b>\$0</b>	<b>(\$2,357)</b>	<b>(\$4,838)</b>	<b>(\$5,578)</b>
<b>Estimation</b>				
Property Taxes	\$0	(\$300)	(\$250)	(\$200)
Uniformed Services Overtime	(136)	(234)	(234)	(234)
<b>Subtotal</b>	<b>(\$136)</b>	<b>(\$534)</b>	<b>(\$484)</b>	<b>(\$434)</b>
<b>Not in Mayor's Control</b>				
State Foundation Aid for Education	\$0	(\$721)	(\$806)	(\$1,083)
Aid and Incentives for Municipalities	0	(302)	(302)	(302)
<b>Subtotal</b>	<b>\$0</b>	<b>(\$1,023)</b>	<b>(\$1,108)</b>	<b>(\$1,385)</b>
<b>Risk Total</b>	<b>(\$136)</b>	<b>(\$1,557)</b>	<b>(\$1,592)</b>	<b>(\$1,819)</b>
<b>Total FCB Estimated Surplus/(Gap)</b>	<b>(\$136)</b>	<b>(\$3,914)</b>	<b>(\$6,430)</b>	<b>(\$7,397)</b>

## II. Review of the Modification

The November modification to the FYs 2011-14 Financial Plan reflects the city's recent efforts to address its projected budget deficits in the outyears of the plan. The city took steps that will provide a \$1.161 billion surplus in FY 2011 to be used in full to reduce the budget shortfall projected for FY 2012. In one step, the city will release \$600 million in FY 2011 from a reserve fund created to address expected changes in the pension systems' actuarial assumptions and methods. The city now projects that these changes will occur later than FY 2011 and will require additional funding of \$400 million annually in FYs 2012-14. In a second step, the city expects to achieve \$585 million of budgetary savings in FY 2011 from a new agency program it undertook in September. Meanwhile, a \$140 million gain in city-funded revenues has been used to fund various increases in expenditures.

The November modification shows remaining budget gaps totaling \$2.4 billion in FY 2012, \$4.8 billion in FY 2013 and \$5.6 billion in FY 2014, even after accounting for over \$900 billion of recurring savings in each of FYs 2012-14 stemming from the Agency Program. Our evaluation indicates that budget gaps could be larger by \$1.6 billion in each of FYs 2012-13 and \$1.8 billion in FY 2014.

### **REVENUES**

The city increased its FY 2011 revenue estimate by \$1.4 billion, since the July financial plan, to \$64.6 billion. City-funded revenues increase by \$140 million to \$43.3 billion because of stronger tax collections and miscellaneous revenues. The city's new revenue plan includes reductions of the state-funded school tax relief (STAR) program, which will leave high-earning local taxpayers with an extra tax burden.

The FY 2011 revenue changes, which were presented in the November modification, are summarized in the figure to the right.<sup>1</sup> Tax collections improve by \$240 million, but only about \$25 million of this improvement is attributable to economic factors. Most of the extra taxes are a direct consequence of state budget actions, such as tax increases and cuts to the STAR program. The state has recently enacted tax increases that will boost city sales and personal income tax collections by \$52 million in FY 2011, with the effect of the tax increases diminishing to about \$46 million in the outyears. As a result of the state's enacted budget, which modified the STAR program, the city's reimbursement will be lower by \$163 million in FY 2011 with the reductions rising to \$182 million by FY 2014. The city's taxpayers will consequently

<b>FY 2011 Revenue Changes Since July Plan</b> (\$ in millions)	
Taxes	\$240
Miscellaneous Revenue	57
STAR Aid	(163)
Revenue PEGs	<u>6</u>
<b>City Funds</b>	<b>\$140</b>
Categorical Aid and Interfund Revenue	<u>1,277</u>
<b>Total Change in Revenues</b>	<b>\$1,417</b>

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<sup>1</sup> For this analysis, November modification revenues are compared with the July plan, which was restated to include tax program increases to the sales and personal income taxes.

face larger property and personal income tax payments to offset the diminished state aid.

Miscellaneous revenue increased by \$57 million, which is discussed in further detail on page 11. The city is implementing a revenue gap-closing program worth \$6 million, which includes audit initiatives. Categorical aid increased by almost \$1.3 billion. Of this amount, federal grants increased \$1.058 billion, state grants increased \$123 million, while private grants increased \$95 million. Education and social service programs, with federal aid increases of \$266 million and \$184 million, respectively, were major beneficiaries of the extra grant allocations.

Among the city's taxes, the banking corporation, sales, and property transfer taxes registered large gains. Offsetting some of these gains were decreases for the general corporation, mortgage recording, and personal income taxes.

**Tax Revenue**

The city increased its tax revenue estimate for FY 2011 by \$240 million, as shown in the figure to the right. The strongest gains are for the banking corporation and the sales taxes, which increased by \$256 million and \$141 million, respectively. The general corporation tax declined by \$171 million, while the personal income tax is down \$25 million. Real property tax collections increase \$7 million. Among the property transactions taxes, the real property transfer tax is higher by \$41 million, while the mortgage recording tax is down by \$40 million. The hotel tax is up \$15 million. The minor taxes added \$16 million, due to larger income tax payments for nonresident city workers and higher payments in lieu of taxes scheduled for the Industrial Development Agency.

<b>Changes in the FY 2011 Tax Revenue Projections Since July</b>	
(\$ in millions)	
Real Property Tax	\$7
Personal Income	(25)
Sales	141
General Corporation	(171)
Banking Corporation	256
Property Transfer	41
Mortgage Recording	(40)
Hotel	15
Other	16
<b>Total Tax Changes</b>	<b>\$240</b>

The nonproperty taxes, excluding STAR, yield \$20.8 billion in FY 2011, with revenue increasing to \$24.1 billion by FY 2014. Nonproperty tax growth slows from nearly eight percent in FY 2011 to about five percent annually thereafter.

**Real Property Tax**

The city slightly increased its FY 2011 property tax forecast by \$7 million. This increase is a technical correction to offset a corresponding decrease in STAR aid. The city normally conducts a thorough reevaluation of its property tax revenue plan in January after the city's tax assessors release the tentative tax roll for the upcoming fiscal year. However, the city presented a frank overview of the real estate industry in its monthly economic report, indicating that the local real estate market was not yet in recovery. This report leads us to conclude that the city's real estate tax base, which has failed to show any substantial market value growth since FY 2008, could remain stagnant on the FY 2012 tentative tax roll.

In its October economic report, the city describes a local real estate market that is not yet in recovery. In the office sector, a surge in leasing activity led to virtually no net absorption of vacant space, indicating that existing tenants were rushing to renew leases at current low asking rents. Areas in Midtown that were hard hit by the loss of financial services jobs have been saddled with high vacancy rates and falling rents. These areas are unlikely to recover until the financial sector resumes hiring and growth.

In the residential sector, home sales improved by 50 percent in the second quarter of 2010 as buyers rushed their transactions in order to beat the deadline for the now-expired homebuyer tax credit stimulus program. Prices remained weak despite this surge in activity, with buyers preferring lower priced units in older buildings to more expensive newer units. A sharp drop in building permits indicates that little new construction is presently being planned, which could eventually bring the housing supply back into equilibrium.

Because of the size of the property tax, which yields \$16.8 billion in FY 2011, any shortfall of the property tax revenue targets could present the city with major budgetary difficulties in FY 2012 and beyond. Property tax growth in the city's plan slows from 3.8 percent in FY 2012 to 1.5 percent in FY 2013 and 0.8 percent in FY 2014. The city's economic report indicates continued weakness in the markets for both homes and offices. Consequently, the market value growth in the FY 2012 tentative assessment roll could prove to be disappointing, leading to a downward revision of the city's property tax revenue plan. We therefore hold the property tax at risk for \$300 million in FY 2012, \$250 million in FY 2013 and \$200 million in FY 2014, as shown in Table 3 on page 5.

### **Business Taxes**

Collections for this group of taxes, consisting of the general corporation tax, the banking corporation tax and the unincorporated business tax, have been mixed. Bank tax collections have been stronger than the city had projected in its previous revenue plan, while the general corporation tax is not recovering as strongly as projected.

The banking sector has profited greatly from the Federal Reserve's policy of low short-term interest rates and infusions of federal stimulus cash. Still concerned about shoring up bank liquidity, the Fed has renewed its commitment to maintaining low interest rates. Continuing bank profitability has enabled the city to increase its bank tax forecast by \$256 million in FY 2011, \$153 million in FY 2012, \$129 million in FY 2013 and \$143 million in FY 2014. With these increments, the bank tax grows by 13 percent in FY 2011 to \$1.1 billion. Revenue then drops by four percent in FY 2012 and remains fairly stable through FY 2014.

The city reduced its revenue plan for the general corporation tax (GCT) by \$171 million in FY 2011, \$211 million in FY 2012, \$291 million in FY 2013, \$346 million in FY 2014. Despite these reductions, GCT increases from \$2.3 billion in FY 2011 to \$2.9 billion in FY 2014, with growth decelerating from 17 percent in FY 2011 to four percent in FY 2014. The GCT reductions and the decelerating growth path appear to be consistent with the city's new economic forecast of a slower and more gradual economic recovery.

Also, GCT revenues at the start of FY 2011 had been running behind monthly collection goals.

### **Property Transaction Taxes**

The city increased its FY 2011 estimate for the real property transfer tax by \$41 million to \$669 million. The homebuyer tax credit program apparently succeeded in bumping up the long-dormant local real estate market, but it remains to be seen if the upturn will be transitory or permanent. The city's plan calls for growth to drop from nine percent in FY 2011 to two percent in FY 2012, after which growth gradually recovers to seven percent by FY 2014. Previously, this tax had plummeted by 64 percent over three years from a high of \$1.7 billion in FY 2007 to \$615 million in FY 2010.

The city reduced its mortgage tax plan by \$40 million to \$415 million in FY 2011. This tax grows by about 15 percent annually in the city's plan, increasing from a low of \$366 million in FY 2010 to \$641 million in FY 2014. Despite this impressive recovery, because of the depth of the 77 percent slide in collections, this tax remains far below the FY 2007 revenue peak of \$1.6 billion.

### **Sales Tax**

Based on the strength of current collections, the city raised the FY 2011 estimate of sales tax revenue by \$141 million to \$5.3 billion in the November modification. The city's latest estimate includes the full-year effect of a half a percentage point increase in the local sales tax rate to 4.5 percent and the removal of the local exemption on purchases of clothing and footwear priced at and above \$110, which were both implemented last August. Currently, it is too early to determine whether the degree of spending at both brick-and-mortar and online stores that occurred during the Thanksgiving weekend and Cyber Monday will continue through December and boost sales tax collections.

City sales tax collections (common rate and base) leaped 14.1 percent in the September quarter, on a year-to-year basis, while the state posted a 6.2 percent gain during the same time.<sup>2</sup> Both the city and the state are benefitting from relatively more optimistic consumers who are using some of their discretionary incomes to purchase non-necessities as well as continuing to pay down debt. While vendors are relieved that sales are up compared with last year's holiday season, recent news reports also show that the new sales are largely dependent on store promotions and discounts. Yet, for many households, unemployment, falling home prices, and foreclosures are still barriers to significant post-recession spending. Another support to the sales tax base for the city and state is the large number of tourists visiting the city due in part to the favorable exchange rate with the dollar. During the September quarter, city sales tax collections were also buoyed by its taxation of residential energy because of the hot summer.

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<sup>2</sup> "Continuing base" or "common rate and base" refers to tax collections that have been modified to remove the effects of tax programs and other adjustments to focus on the influence of the economy.

After experiencing two years of declining revenue in FYs 2009 and 2010, the city anticipates sales tax collections (continuing base) will exhibit modest growth of 1.5 percent in FY 2011 and 1.6 percent in FY 2012 on a year-to-year basis. The near-term forecast is supported by several factors including the city's assumptions of small gains in total wages and that tourism will remain at the current high level. A strong rebound in employment and income at the local and national levels starting in calendar year 2012 and gaining traction during the plan period is expected to propel sales tax collections by 5.3 percent in FY 2013 and 4.8 percent in FY 2014. At this early point in FY 2011, the city's sales tax forecast for FY 2011 through FY 2014 appears reasonable.

### **Personal Income Tax**

Compared with the July financial plan, the city slightly reduced the FY 2011 personal income tax (PIT) estimate by \$25 million to \$7.5 billion, but added between \$200 million to \$300 million annually to the forecasts for FYs 2012-14 due to state legislative changes and stronger economic growth expected during the plan period. After calendar year 2011, the city anticipates greater strength and depth in the local and national economic recoveries, which would support job and income gains. Also, in the outyears, it is more likely that the housing market would achieve some measure of price stability and reduce the unsold inventory, which would boost capital gains realizations in 2012.<sup>3</sup> Yet, even with these additional sums, the city is forecasting a modest recovery in PIT revenue by historical standards. After PIT revenue nosedived in FY 2009 and FY 2010 (year-to-year basis, common rate and base), growth in collections is expected to advance by six percent in FY 2011 and 7.6 percent in FY 2012, and slow to 4.5 percent in FY 2013 and 5.7 percent in FY 2014.

Currently, local employment conditions are a major reason for the subdued near-term PIT projection. On a year-to-year basis, private sector companies started hiring people in July, but through October, very few of these new jobs have been in the higher-paying financial activities sector and none so far are in the securities subsector.<sup>4</sup> In terms of finance sector compensation, the city expects salaries and bonus payouts to remain in the \$70 billion range annually from 2009 to 2013 and only reach \$81.1 billion at the end of the forecast period in 2014. Previously, finance sector compensation was in the \$60 billion range in 2004 and 2005, leaped to \$80.9 billion in 2006, and exceeded \$90 billion in both 2007 and 2008. There may be a small increase in the 2010 bonus pool from the prior year, which would be reflected in withholding collections from December 2010 through March 2011, but it is uncertain if the structure of the compensation will again favor stocks over cash and higher base salaries, and if the size will be aligned with the long-term performance of the company.

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<sup>3</sup> The city assumes that the lower federal capital gains tax rate will expire at the end of 2010, causing a spin-up of income into 2010 from 2011. Further changes to personal income tax rates from federal legislation would be reflected in the upcoming financial plan.

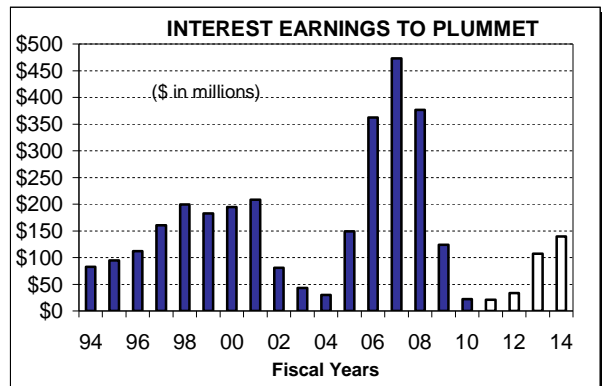
<sup>4</sup> Employment data cited are not seasonally adjusted.

New York Stock Exchange (NYSE) member firms earned \$14.1 billion in profits for the first two quarters of 2010 and faced a tough trading environment at lower volumes in the third quarter. Some financial firms benefitted from reducing loan-loss reserves and advising clients on potential mergers and acquisitions. However, profits for NYSE member firms in 2010 may fall short of the city's estimate of \$20.6 billion if the current difficult trading environment and unease over the domestic economy, Federal Reserve policy, and sovereign debt in the euro zone remain.<sup>5</sup> So far, local banks and bank holding companies have not declared any problems related to holdings of euro zone debt and have resisted calls to repurchase residential mortgage loans that they have either originated or securitized. While federal regulators fill in the details in the Frank-Dodd Act, several firms have taken proactive measures to increase their capital base, close down proprietary trading units and move the traders to other areas.

**Miscellaneous Revenue**

Since adoption, the city has increased the FY 2011 miscellaneous revenue estimate by \$57 million to \$4.4 billion, where additional nonrecurring resources more than offset negative plan-to-plan variances in water and sewer charges, interest income, and rent. If we exclude specific revenue sources that do not exhibit recurring growth and instead focus on the remaining core categories, there is an \$11 million positive plan variance for the core categories, and the expectation of 1.4 percent year-to-year growth in FY 2011 to \$2.6 billion.<sup>6</sup> Over the course of the financial plan, among the core categories, there are sharply lower projections of interest income that are mitigated by the city's anticipation of improvement in charges for services and license revenues. By FY 2014, core category revenue is projected to rise by \$122.1 million to \$2.7 billion, a 4.7 percent gain from FY 2011.

In FY 2010, the city earned \$22.2 million in interest income, as seen in the figure to the right. Based on a model of short-term interest rates and recent actions by the Federal Reserve, the city now assumes that the current ultra-low interest rate environment will prevail much longer than originally thought. As a result, interest earnings will be severely undercut in three out of four years in the financial plan. In the November modification, interest income is forecast at \$21.1 million in FY 2011, \$33.5



<sup>5</sup> The city expects NYSE member firm profits to return to a more sustainable level after 2010 and fluctuate between \$11 billion and \$13 billion during 2011 to 2014.

<sup>6</sup> Core category revenue consists of: licenses (with permits and franchises), charges for services, interest, rent, fines, and a miscellaneous category that is stripped of major nonrecurring actions, tobacco proceeds, housing revenue, and Health and Hospitals Corporation payments. Since water and sewer charges are dedicated to programmatic expenditures and therefore unavailable for gap-closing assistance, they are also excluded from the definition of core category revenue.

million in FY 2012, \$107.2 million in FY 2013, and \$139.8 million in FY 2014.

While interest income is projected to temporarily slump, charges for services revenue is forecast to exceed \$750 million annually in FYs 2011-14, aided by higher passenger and commercial parking rates. Parking meters are forecast by the city to yield \$164.7 million in FY 2011 and increase to \$184.3 million in each of FYs 2012 through 2014. License revenue, averaging over \$500 million from FY 2011 to FY 2014, is expected to be boosted by more construction permits (about \$74 million annually) and cable franchise receipts (about \$130 million annually).

## **EXPENDITURE HIGHLIGHTS**

The FY 2011 budget is balanced with projected expenditures at \$64.6 billion matching revenues. Beyond FY 2011, budget gaps are projected to grow sharply, as expenditures exceed revenues by \$2.4 billion in FY 2012, \$4.8 billion in FY 2013 and \$5.6 billion in FY 2014, reflecting a structural budget imbalance. The budget deficit for FY 2012 was reduced by \$1.161 billion, as this amount of debt service costs is expected to be prepaid in FY 2011 with the use of surplus funds.

In this section, we will examine some of the factors contributing to the outyear budget deficits. For example, the city has made a policy choice of using city funds in FYs 2012-2014 to replace \$853 million in expiring federal stimulus money for education. Also, the city has added \$400 million in each of the outyears of the plan to a reserve to fund pension costs, bringing the annual reserve to \$1 billion, in anticipation of major changes to the pension fund's actuarial assumptions and methods. The city also projects health insurance expense will increase by \$126 million in FY 2012, \$195 million in FY 2013 and \$276 million in FY 2014.

To address the multi-billion dollar gaps, the city developed a new Agency Program, with spending cuts and revenue enhancements totaling \$584 million in FY 2011, \$1 billion in FY 2012 and approximately \$900 million annually in FYs 2013 and 2014. The city is also employing actions that minimize the cost of servicing its debt.

### **Program to Eliminate the Gap**

In September 2010, the city asked all agencies to find in their departments recurring spending cuts and revenue increases (if applicable for the agency) that collectively would reduce total city expenditures by about \$800 million in FY 2011 and by approximately \$1.2 billion in FY 2012. According to the November modification, city agencies have targeted more than \$584 million of spending reductions in FY 2011 and more than \$1 billion in FY 2012. The majority of the spending cuts will extend over the life of the financial plan with projected savings of about \$916 million in FY 2012 and \$914 million in FY 2014. It is anticipated that to achieve a number of these saving initiatives, city agencies will need to trim their headcounts through attrition and layoffs resulting in personnel reductions of 2,102 in FY 2011 and growing to 8,264 positions by FY 2012.



The city's Program to Eliminate the Gap (PEG) or Agency Program is presented in Table 4 on page 13. As shown in the table, city agencies have targeted \$529 million of expenditure reductions in FY 2011 and an expected increase in revenue collections in some agencies totaling \$55 million. The PEGs will be substantially greater in the outyears of the financial plan as they are fully implemented. The city projects that the PEGs will produce expenditure savings of \$892 million in FY 2012, \$826 million in FY 2013, and \$816 million in FY 2014. These savings will be increased further by about \$100 million in each of FYs 2012 and 2014, and by \$90 million in FY 2013 from increased revenue collections.

One of the major sources of savings will be in the Department of Education (DOE). The DOE, which is part of the city's major organization's category, is expected to save more than \$215 million in FY 2011. The targeted savings will result by using funds made available from the Education Jobs Bill and restoration of the State Summer Handicapped program, which will both be applied to mitigate the impact of a city tax levy PEG. The DOE will also be enacting a number of other measures such as reducing its supply and travel budgets and decreasing its custodial services, which it contracts out. In FYs 2012 to 2014, the savings will be substantially higher with scheduled headcount reductions from layoffs and attrition. The DOE plans to save more than \$350 million in each of those fiscal years from this action.

**TOTAL AGENCY PROGRAM FOR FYs 2011 - 2014**

TABLE 4

(\$ in millions)

<b>Agency Category</b>	<b>FY 2011</b>	<b>FY 2012</b>	<b>FY 2013</b>	<b>FY 2014</b>
Uniformed Services	(\$94)	(\$182)	(\$129)	(\$103)
Health and Welfare	(97)	(121)	(130)	(130)
Mayoral	(103)	(146)	(128)	(122)
Major Organizations	(231)	(375)	(375)	(375)
Elected Officials	(4)	(7)	(6)	(6)
All Other	0	(61)	(58)	(80)
<b>Total Expense PEG</b>	<b>(\$529)</b>	<b>(\$892)</b>	<b>(\$826)</b>	<b>(\$816)</b>
<b>Total Revenue PEG</b>	<b>(55)</b>	<b>(110)</b>	<b>(90)</b>	<b>(98)</b>
<b>Total Program</b>	<b>(\$584)</b>	<b>(\$1,002)</b>	<b>(\$916)</b>	<b>(\$914)</b>
(Negative) numbers decrease the gap.				

Other notable expense savings come from the city's health and welfare agencies with planned reductions of \$97 million in FY 2011, growing to \$121 million in FY 2012 and to \$130 million in each of FYs 2013 and 2014. The city's health and welfare agencies are comprised of the Administration for Children Services and the Departments of Social Services, Homeless Services, and Health and Mental Hygiene. A large proportion of the health and welfare agencies' expenditure reductions will affect the Department of Social Services' budget. The Department expects cost-containment initiatives to aggregate to nearly \$49 million in FY 2011 from mostly the collection of more than \$32 million in additional revenues from the state and federal governments in the form of food stamps and Medicaid allocations. These initiatives are mostly nonrecurring though. The Department, however, has also identified a number of efficiencies, which will decrease expenditures in the following years of the plan that include overtime cuts, vacating of positions through mostly attrition and changing cost allocation

methodologies. These PEGs are expected to reduce expenditures by \$33 million in FY 2012 and \$41 million in each of FYs 2013 and 2014.

The other three agencies in health and welfare will save an additional \$48 million in FY 2011 combined with reductions coming primarily from the Administration for Children Services and the Department of Health and Mental Hygiene. All three agencies have a variety of cost-cutting programs that include actions such as restructuring departments and reducing contractual services. These initiatives are expected to increase significantly over the course of the financial plan with anticipated savings of \$88 million in FY 2012, and about \$89 million in each of FYs 2013 and 2014.

The city's four uniformed agencies (Police, Fire, Correction, and Sanitation), will produce cost reductions that total about \$94 million in FY 2011 and will grow modestly by FY 2014 to \$103 million. The Police Department anticipates saving a total of \$43 million for FY 2011 with a one-time collection of additional Homeland Security funding totaling \$24 million, which will be used to cover overtime costs related to these types of security activities. It also plans to reduce its civilian headcount by 350 positions through attrition for a savings of almost \$14 million in FY 2011 and will see that savings increase to about \$30 million in each of FYs 2012 to 2014 as the full effect of the headcount reduction is realized. The Department will also realize additional savings of \$12 million for reimbursement of security expenses related to the annual United Nations gathering, and about \$11 million from fleet reductions in FY 2012. These measures will add to the headcount savings obtained in the Department, bringing total savings to \$67 million in FY 2012.

The Sanitation Department has identified cost savings from modifying the supervisor span of control. This action includes headcount reduction of 200 positions, which will create a surplus in personal service expenses related to increased attrition. Further measures in the Department include a decrease in hiring and a freeze in promotions. The Department expects that those savings will increase in each of FYs 2012 to 2014 as the PEG annualizes. Also the Department will realize a waste export and landfill surplus and will reduce its contractual expenses associated with security of its facilities on Sundays and holidays. The total of these savings are expected to reach \$25 million in FY 2011, increase to about \$76 million in FY 2012, mainly because of the landfill surplus, and fall to \$54 million in FY 2013 and \$27 million in FY 2014 as the landfill surplus and the waste export surplus phase out.

The Fire Department is expected to save about \$15 million by redeploying firefighters during the overnight tour and by collecting grants worth more than \$7 million, for a total of about \$23 million in FY 2011, though these are mainly one-time savings. The Department has planned, starting in FY 2012 and recurring thereafter, to increase uniform availability by 1.5 percent by instituting controls on medical leave, light duty and other leaves that will be expected to reduce annual expenses by \$15 million. With other initiatives, the Department plans to reduce its annual budget by \$36 million in FY 2012 and \$31 million in each of FYs 2013 and 2014. Lastly, the Department of Correction will save nearly \$5 million through a number of initiatives in FY 2011 and will see the savings grow to about \$10 million annually in FYs 2012 to 2014.

The city's other Mayoral agencies, which consists of the Departments of Aging, Finance, Transportation, and Parks, citywide services, cultural affairs, housing preservation, and other supporting city agencies, have targeted total savings that are anticipated to approach almost \$103 million in FY 2011. These PEGs will increase to \$146 million in FY 2012, \$128 million in FY 2013 and \$122 million in FY 2014.

As mentioned earlier, many of the savings will come from a reduction in city headcount. The city plans to reduce staffing levels over the next two fiscal years, by 2,102 positions in FY 2011, reaching 8,264 by FY 2012. The detail of the headcount reduction program is shown in Table 5.

**TOTAL CUMULATIVE HEADCOUNT REDUCTION PROGRAM  
FOR FYs 2011 and 2012**

TABLE 5

Agency Category	Fiscal Year 2011			Fiscal Year 2012		
	Attrition	Layoff	Total	Attrition	Layoff	Total
Uniformed Services	576	--	576	791	--	791
Health and Welfare	272	265	537	285	228	513
Mayoral	165	624	789	603	806	1,409
Major Organizations	92	--	92	1,219	4,278	5,497
Elected Officials	108	--	108	54	--	54
<b>Total Reduction</b>	<b>1,213</b>	<b>889</b>	<b>2,102</b>	<b>2,952</b>	<b>5,312</b>	<b>8,264</b>

As shown in the table, the city plans to reduce headcount by leaving open vacated positions and implementing layoffs. About 64 percent of the actions to decrease staffing will stem from the layoff of 5,312 city workers with the majority being pedagogical positions in the DOE. The city expects to reduce its teaching staff by nearly 4,300 in FY 2012 for a savings of \$269 million. The city has faced the difficult choice of reducing teaching staff before but has been able to restore positions slated for layoff. For example, the city faced losing over 14,000 teachers in FY 2010 because of a decrease in state aid but federal stimulus funding allowed the city to save those positions. Recently, the city had planned to reduce DOE pedagogical positions by more than 4,400 in FY 2011 but believes that those positions can be saved from freezing wages in the last round of collective bargaining. However, no contract settlement has been reached between the city and the United Federation of Teachers at this time.

**Department of Education**

From the July financial plan to the November modification, the Department of Education (DOE) increased its forecast expenditure for FY 2011 by over \$99 million to \$18.71 billion, because of a combination of factors. The federal contribution went up by almost \$270 million, most of which was due to the Education Jobs Bill Funding, which made available over \$190 million to the public school system. Additional federal funding is attributable to some post-American Recovery and Reinvestment Act of 2009 adjustments, mainly in the form of Title II D Technology grant, Title I funding and aid to Individual with Disability Education Act. City funding, including other categorical and intracity, decreased by a net \$169 million, mainly in response to a summer memorandum requesting a 2.7 percent cutback in agency spending to help sustain the current-year budget balance and to alleviate budget deficits in the outyears.

In the November modification, the city has made a major policy choice of using city funds to replace \$853 million in expiring federal stimulus money. In prior plans the city had said the loss of federal funds would require the reduction of 14,000 teaching positions. With the loss of the stimulus funds likely, the city has changed course. The city has not yet developed plans to pay for the additional expense in FY 2012 and beyond. The decision has increased the outyear gaps, shown by the remaining budget deficits of \$2.4 billion, \$4.8 billion and \$5.6 billion in FYs 2012-14, respectively. The city, in the FY 2012 preliminary budget and January modification to the financial plan, will have to develop initiatives to close these gaps.

The decision to replace the federal funds with city funds did not protect the DOE from having to share in the city's gap-closing efforts. The DOE's FY 2012 budget is reduced by \$350 million in each of FYs 2012-14 resulting from the response to a four percent agency spending reduction, which is in the form of teachers' layoffs and attrition, as discussed in "Program to Eliminate the Gap" on page 12. It should be noted that the teachers' layoffs and attrition are taking place while the United Federation of Teachers' contract negotiation with the city is still at an impasse and in mediation at the New York State Public Employment Relations Board.

The biggest issue now facing DOE's budget in FYs 2012-14 is the risk and uncertainty of state aid to education. The city's financial plan assumes growth in state Foundation Aid of over \$700 million in FY 2012, rising to \$1.1 billion in FY 2014. Given the large budget gaps facing the state, this assumption of growth is overly optimistic. We are holding the amount assumed for growth at risk and the city will have to plan for what is likely to be actual cuts in state education aid.

### **Uniformed Overtime**

For FY 2011, the November modification projects that the four uniformed agencies (Police, Fire, Correction, and Sanitation) will generate \$761 million in overtime expenditures. The revised budget is an increase of \$38 million above the July financial plan estimates, which is due mainly to additional spending of \$9 million and \$26 million by the Police and Fire Departments, respectively. However, the city estimates that overtime spending will fall to \$663 million in each of FYs 2012 to 2014. The latest overtime budget for the four agencies is presented in Table 6.

### **PROJECTED UNIFORMED SERVICES OVERTIME BUDGET FOR FYs 2011 to 2014**

TABLE 6

(\$ in millions)

<b>City Forecast</b>	<b>FY 2011</b>	<b>FY 2012</b>	<b>FY 2013</b>	<b>FY 2014</b>
Police	\$423	\$367	\$366	\$366
Fire	200	157	157	157
Correction	79	75	75	75
Sanitation	59	64	65	65
<b>Total Overtime</b>	<b>\$761</b>	<b>\$663</b>	<b>\$663</b>	<b>\$663</b>
<b>FCB Projected Overtime</b>	<b>897</b>	<b>897</b>	<b>897</b>	<b>897</b>
<b>Risk to Budget</b>	<b>(\$136)</b>	<b>(\$234)</b>	<b>(\$234)</b>	<b>(\$234)</b>

Note: Totals include uniformed and civilian personnel.

As shown in the table, the Police and Fire Departments anticipate higher spending in FY 2011 than in the outyears of the financial plan. The Police Department has historically outspent the other three agencies in this category by a wide margin accounting for more than half of uniformed overtime expenditures. Much of the overtime expenditures are driven by time consumed in the arrest and transportation process, events (i.e. parades, sporting events, protests, and United Nation's security), and special operations such as Atlas and Impact, which have been very successful in providing extra security for the city following the September 11<sup>th</sup> attacks and preventing crime in high frequency crime areas. It is not unusual for the Department to revise up its projections as the fiscal year progresses, which will further increase expenditures in total.

The Fire Department has also needed to revise its overtime projections as it struggles with an understaffing problem. The Department has been served an injunction that has stopped its ability to hire firefighters due to a lawsuit over the bias found in the testing procedures for new recruits. The legalities of the issue are complex and the city has been instructed to change the test to make it nondiscriminatory before it can resume hiring. The delay in hiring is expected to strain staffing levels in the Department for FY 2011 and drive up overtime costs. In response, the Department has added an additional \$26 million to its budget. However, the Department will be able to offset these higher overtime costs by redeploying personnel assigned to night-time shifts. This cost-containment initiative, which will not extend beyond FY 2011, will offset the overtime increases by \$15 million.

Based on actual overtime expenditures in the four uniformed agencies through November 2010, we estimate that the city will likely spend close to \$900 million by the end of FY 2011, driven primarily by additional funding needed in the Fire Department to compensate for understaffing. We anticipate the risk to the city's budget is \$136 million in FY 2011 and \$234 million in each of FYs 2012 to 2014.

### **Fringe Benefit Costs**

The higher cost of fringe benefits, which includes pension and healthcare costs, has been a major budgetary problem for the city. Under the pressure of these growing expenditures, the city has been forced to address structural imbalances by cutting city services by billions of dollars, trimming its work force, and finding ways to increase revenue collections. The issue at hand is the city's inability to directly control the cost of employee benefits such as pension costs since they are constitutionally guaranteed. In addition, changes to pension benefits have been made by the state independent of collective bargaining agreements. Likewise, the city has recommended cost-saving actions to reduce its employee healthcare costs, like increasing the contribution paid by employees, but such actions are not implemented unilaterally by the city and must be negotiated as part of collective bargaining. The city has not been successful in fully achieving these recommendations.

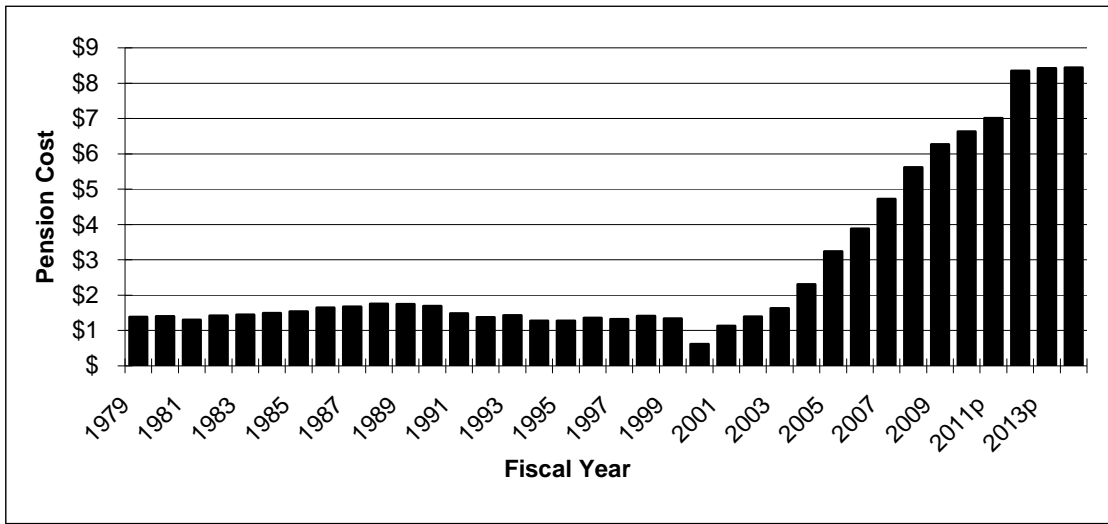
### **Pension Costs**

The city's annual pension cost, with the exception of FY 2011, is expected to remain above \$8 billion (total funds) over the life of the financial plan. As reported in the November modification, the projected pension costs in FYs 2012 to 2014 are approximately \$8.4 billion in each of these fiscal years. The cost is expected to be much less in FY 2011 at around \$7 billion as a result of the removal of \$600 million put into reserve to address a pending change in actuarial assumptions and methods. The cost of employee pension payments has been growing year-over-year above its historical level since FY 2004 and is likely to continue its steep upward climb well into future fiscal years, as shown on Chart 1 on page 18.

**GROWTH IN TOTAL FUNDED PENSION COSTS FROM FY 1979 to FY 2014**

CHART 1

(\$ in billions, p=projected)



As shown in the chart, from FY 1979 to FY 2004, the city's obligation to fund employee pension payments remained fairly level and never rose above \$2 billion until FY 2004. One of the main causes of the change in this trend was the economic downturn following the September 11<sup>th</sup> attacks, and the 2001 and 2007 recessions, which severely impacted financial markets. The city's pension fund realized unexpected losses of significant magnitude in these periods that drove pension costs higher than their historical levels.

As the chart shows, in each fiscal year following FY 2004, pension costs reached higher and higher levels. From FY 2005 to FY 2010, pension costs more than doubled from \$3.2 billion to \$6.6 billion. In the November modification, the city projects that costs will continue to climb but will level off at around \$8.4 billion in each of FYs 2012 to 2014. These projections are conservative and we expect that pension costs will continue to increase further for a number of reasons. First, we believe that the city's cost estimates reflect its change in labor policy that includes zero funding for the next round of collective bargaining for city employees. Following this two-year wage freeze, the city is assuming wage increases of 1.25 percent. To the extent that future contracts

contain salary increases higher than planned, the city will have to deal with higher budget gaps, not only from the higher salary increase but also from higher growth in pension costs.

Also, the city has funded \$1 billion annually to cover anticipated changes in the pension fund's actuarial assumptions and methods, which may include the lowering of the required rate of return on pension investments. Since the City Actuary has not made any final recommendations, more funding may be required. Lastly, the city may experience further losses on investments in the outyears of the financial plan, which would require additional funding.

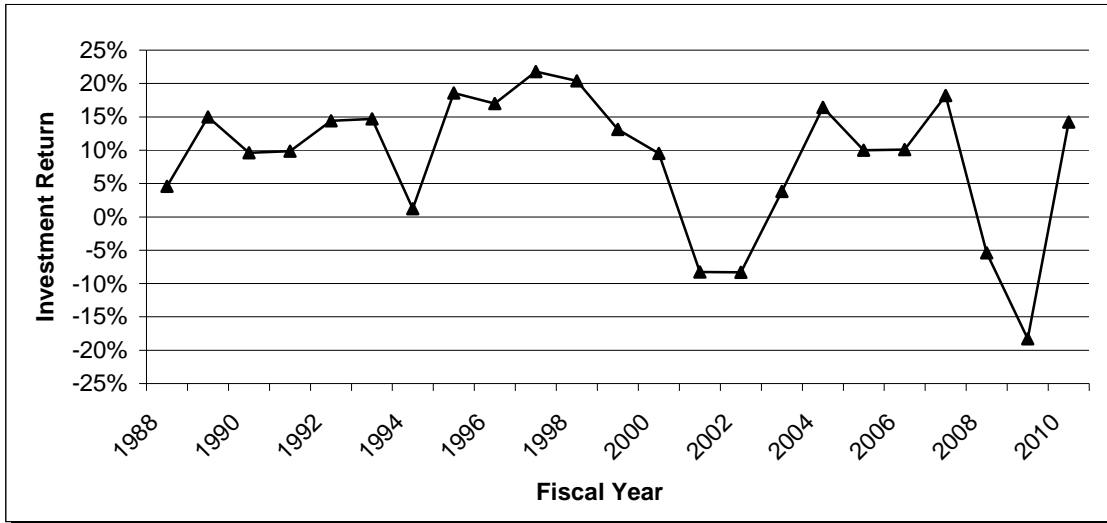
In the years that followed the September 11<sup>th</sup> attacks and the collapse of the Dot Com bubble, the financial markets reeled, pushing down the investment returns of the pension fund into negative territory by 8.3 percent in both FYs 2001 and 2002, as shown in Chart 2 (from available data since 1988). According to the chart, the pension fund had not experienced the magnitude of negative losses, which erased billions of dollars in asset value. Those losses were magnified because the fund must achieve an eight percent return in order to fund the cost of benefits earned by city workers today, which are paid later at retirement. Hence, an 8.3 negative loss actually requires the city to contribute additional funding to cover a 16.3 percent loss. Those losses are required to be funded over a phase-in period, which starts out initially low but becomes increasingly more expensive in later years.<sup>7</sup>

## **PENSION FUND INVESTMENT RETURNS SINCE FISCAL YEAR 1988**

CHART 2

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<sup>7</sup> The city is able to phase in losses over a six-year period at 15 percent for the first four years and 20 percent thereafter with a cumulative phase-in of 15 percent, 30 percent, 45 percent, 60 percent, 80 percent and 100 percent.



After FY 2004, pension costs began to rise substantially in the aftermath of those back-to-back investment losses suffered in FYs 2001 and 2002 as the phase-in began in FY 2003 (there is a two-year lag for the phase-in of investment losses). However, after solid gains in FYs 2004 through 2007, the fund's return was dragged down again in the wake of the December 2007 - June 2009 recession. The downturn was considered to be the worst economic crisis since the Great Depression and investment return fell precipitously by 5.4 percent in FY 2008 and by 18.3 percent in FY 2009.

Subsequently, the fund has recovered after achieving a positive return of 14.2 percent in FY 2010. We expect the positive investment returns to continue throughout FY 2011. The city reports that the pension fund's combined return is nine percent through October 2010. There is always concern that returns may decline. A great deal of uncertainty among investors remains and domestic equity markets have responded similarly to the European banking crisis, momentum of the U.S. recovery, unrest between North and South Korea and the effectiveness of the Federal Reserve's latest quantitative easing program by retreating from recent gains. However, international equity markets and debt markets have performed well supporting the positive outlook on investment returns.

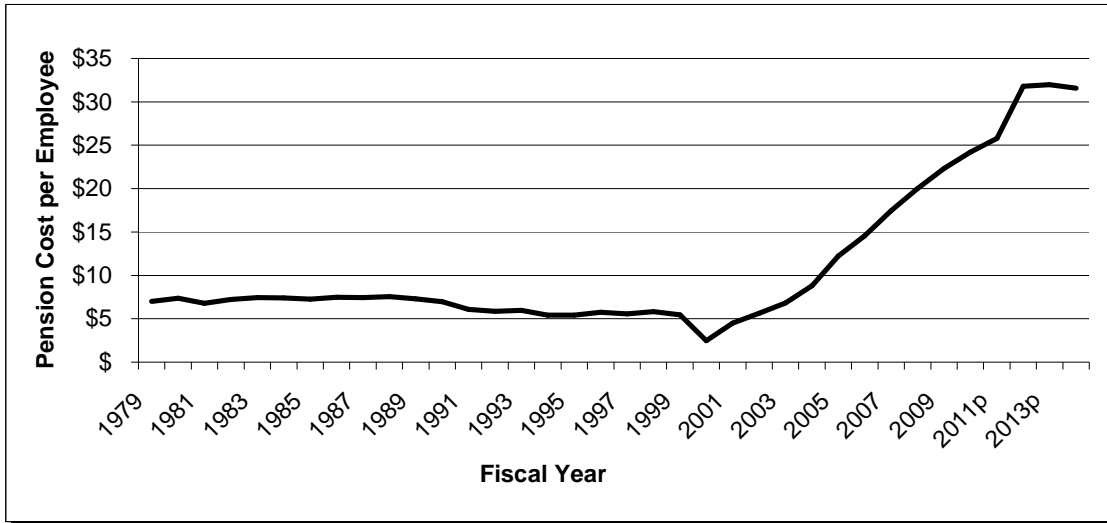
In Chart 3, the cost of paying pension benefits per employee from FY 1979 to projected costs in FY 2014 is shown. Chart 1 on page 18 shows a similar upward climb in expenditures when the pension fund realized unexpected investment losses. In FY 1979, the cost per employee was \$6,998 but that figure has grown by 351 percent to a projected cost of \$31,586 in FY 2014 - an annual growth rate of 4.5 percent - while the projected number of city employees in FY 2014 will be about 70,000 workers greater or 35 percent more than in FY 1979.

**TOTAL FUNDED PENSION COSTS PER EMPLOYEE FROM FY 1979 to FY 2014**

**CHART 3**

(\$ in thousands, p=projected)





However, the increasing cost of pension benefits is not solely a byproduct of investment losses. In recent years there have been a number of other causes that have pushed up costs. In addition to funding investment losses, pension costs have also risen due to salary increases, the Cost of Living Adjustment (COLA), changes in actuarial assumptions such as mortality rates and higher investment fees. Of these, salaries have the strongest effect on pension costs since retirement payments are based upon employee salaries. Salaries paid to city employees have grown rapidly over the years under collective bargaining agreements. Also, overtime generated by employees is calculated as additional salary and is figured into retirement payments. As we have often reported, overtime costs generated by city employees add up considerably each fiscal year. When added to pension costs, the benefit payments can rise significantly in some cases.

These types of adjustments are of considerable cost, and relying on strong investment returns to produce large asset gains may not always produce desirable results. While in some years pension fund assets have returned significant gains that have mitigated the impact of past investment losses, those offsets have produced only modest results. Instead, the city has needed to allocate large amounts of resources to address shortfall problems like drawing down the Retiree Healthcare Benefits Trust fund by \$1.1 billion.

As mentioned earlier, the city has projected pension costs that will exceed \$8 billion in each of FYs 2012 to 2014. The estimated costs are much higher than previously anticipated in the July financial plan. According to the November modification, the city will add \$400 million in each fiscal year to a reserve, bringing the annual reserve to \$1 billion, in anticipation of major changes to the fund's actuarial assumptions and methods. The city expects an audit to be completed shortly and the audit is expected to recommend changes to such factors such as the mortality rates and a decrease in the Actuarial Interest Rate (AIR). The reserve was funded in the July financial plan with \$600 million in each fiscal year starting in FY 2011. The funding was removed for FY

2011 because the audit has not yet been completed and changes would not be implemented until FY 2012.

Changing the AIR will have a significant impact on pension costs for the city. The AIR is the rate of interest that pension fund assets are expected to gain in order to fund the benefits paid out to retirees. The city makes a pension contribution each fiscal year to fund the present value of benefits earned by each active city employee. The future value of those retirement benefits earned now are “discounted” to their present value today. The discount factor is the AIR, which is currently eight percent. For example, if an individual needed to have \$100 one year from now and earns simple interest at eight percent, he would need to deposit \$92.59 today. This is the present value of the \$100 discounted at eight percent. At the end of the year, the interest accumulated, added to the initial deposit, would sum to the \$100 needed.

The pension system works in a similar fashion except that the present value is a liability and is the amount that the city must contribute annually to the fund. This present value is known as the normal cost. If the AIR were to decrease from eight percent to 7.5 percent, the impact would be costly. Returning to the previous example, the present value increases as the discount rate becomes smaller, thus the present value of \$100 would increase from \$92.59 to \$93.02. Some estimates suggest that a 50 basis point reduction, which would lower the AIR to 7.5 percent, could cost the city an extra \$750 million to \$1 billion annually. As mentioned earlier, the city had funded a reserve by \$1 billion annually to address such actuarial changes. Nonetheless, costs could be higher than anticipated and would require even more funding.

In addition to the increase in the reserve, the city has also allocated funding to cover higher investment fees. Each of the five actuarial systems hires a large number of portfolio managers to manage the billions of dollars of assets each fund holds. The investment fees for the management of the funds are very costly. For example, the Teachers’ Retirement System (TRS) has 168 portfolio managers. At the end of FY 2009, TRS paid out of investment assets nearly \$102 million in management fees. The city expects to add \$102 million in FY 2012, \$106 million in FY 2013 and \$111 million in FY 2014 to cover added costs for all five actuarial systems. However, the city expects to offset these higher costs with FY 2010 investment gains. As discussed earlier, the city had achieved a combined investment return of 14.2 percent for FY 2010, which is an increase of 2.2 percentage points higher than the city had projected. The gains will be phased in starting in FY 2012 through FY 2014, and will amount to \$45 million, \$90 million and \$130 million, respectively.

### **Other Postemployment Benefits**

The city provides healthcare benefits to retired city workers in addition to employees currently on city payroll. The city expects to spend about \$1.8 billion on Other Postemployment Benefits (OPEB) in FY 2011 for just retirees.<sup>8</sup> The cost of

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<sup>8</sup> FYs 2011 and 2012 OPEB payments exclude the impact of the Retiree Healthcare Benefit Trust fund drawdown of \$395 million and \$672 million, respectively.

providing such benefits to retired workers has become costly to the city. The payments are paid on a pay-as-you-go basis, that is, they are expensed in the current fiscal year and paid out of the city's operating budget. The city estimates that it will need to allocate funds of more than \$2.4 billion by FY 2014 to cover these healthcare benefits. In total, for both retirees and active employees, the city will spend more than \$5 billion in FY 2011 to cover healthcare costs, which also includes payments to employee Supplemental Welfare Funds. The city projects that figure will grow by nearly \$2 billion to around \$6.8 billion in FY 2014.

In accordance with accounting rules, the city must report the value of the benefits earned by current employees and to be paid in the future at retirement, as a liability on its financial statements, though the accounting standard does not require the liability to be funded. The reporting rule was established to make more transparent the liabilities that state and local governments must address in the future. However, the OPEB liability remains mostly unfunded, even though the city had established a trust fund to address it.<sup>9</sup>

The cost of healthcare in the United States has been steadily climbing in recent years as more advanced technology, better treatments, enhanced drug therapies and the like, have increased the longevity of people's lives. Also, the National Healthcare Reform Act will impact premium costs even further in the near future as this new legislation is fully phased in. The city is experiencing the impact of these developments and is feeling the effect of the higher costs associated with them. In response to such trends, it has recently revised its growth rate assumptions for healthcare costs. The city now anticipates that covered medical expenses will grow by 9.5 percent, a 1.5 percentage point increase from its prior expectations. Additionally, it expects to spend more due to extended coverage of children to age 26 from previous cutoffs at ages 19 to 23 for full-time students. The rate adjustments are projected to cost \$7 million in FY 2011, increasing to \$126 million in FY 2012, \$195 million in FY 2013, and \$276 million in FY 2014.

Due to these changes in assumptions and additional expected costs, the city's reported annual OPEB cost and liability will be greatly impacted. The city has estimated that the OPEB liability will increase by more than \$9.4 billion to \$74.9 billion in FY 2010 from \$65.5 billion in FY 2009. We have repeatedly reported that the city's unfunded OPEB liability would grow substantially more than what had been projected due to the city's lower estimate of its healthcare premium growth rate. We had estimated in our July 2009 FCB Staff Report that the unfunded OPEB liability would grow in FY 2010 to \$74.6 billion. We expect that the unfunded liability will continue on this path and will likely grow close to \$100 billion or more by FY 2014. Without major changes in the

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<sup>9</sup> The city took the initiative to form and fund the Retiree Health Benefits Trust with an initial funding of \$1 billion in FY 2006 and followed with another payment of \$1.5 billion in FY 2007. As of June 2010, trust fund assets have grown to more than \$3 billion, after a drawdown of \$82 million to fund pension losses. The city will further draw down the trust by \$395 million and \$672 million in FYs 2011 and 2012, respectively.

structural costs of healthcare and pension benefits, we see no change in the upward trend of these costs. We anticipate that the city's expenditures will continue to increase driven mainly by these budgetary items.

## **RISKS AND OFFSETS**

Our risk evaluation of the city's financial plan is shown in Table 3 on page 5. Based on our evaluation, we estimate that the city could have risks to the financial plan ranging from \$136 million to \$1.8 billion in FYs 2011-14. When we add our risks to the budget gaps stated in the financial plan, we conclude that the budget shortfalls facing the city will total \$3.9 billion in FY 2012, \$6.4 billion in FY 2013 and \$7.4 billion in FY 2014.

The city's October 2010 economic report indicates continued weakness in the markets for both homes and offices. This report leads us to conclude that the city's real estate tax base, which has failed to show any substantial market value growth since FY 2008, could remain stagnant on the FY 2012 tentative tax roll. Disappointing assessment growth could lead to a downward revision of the city's property tax revenue plan. We therefore hold the property tax at risk for \$300 million in FY 2012, \$250 million in FY 2013 and \$200 million in FY 2014.

We also hold at risk overtime expenditures over the life of the financial plan. We estimate that the city is on course to spend \$136 million more in FY 2011 than it has budgeted. The risk is based mainly on spending that has occurred in the Fire Department through November 2010. The Department is dealing with a legal issue concerning its testing procedures and has been blocked from hiring new personnel until the issue is rectified. Based upon FY 2011 actual expenditures, we also risk the outyears of the financial plan by \$234 million in each of FYs 2012 to 2014.

The most substantial risk to the city's budget is state aid, which is not in the Mayor's control. The city is projecting state aid from the Aid and Incentives for Municipalities program as well as increased funding for education from Foundation Aid will total over \$1 billion in each of FYs 2012-14. Given the state's fiscal stress and large budget gaps, the city's projected receipt of such state aid is overly optimistic. As a result, we believe the appropriation of these funds is uncertain and hold at risk \$1 billion in FY 2012, \$1.1 billion in FY 2013 and \$1.4 billion in FY 2014.

## **MANAGING DEBT SERVICE COSTS**

The November Modification to the Financial Plan for FYs 2011-14 reflects the city's effort to manage debt service costs without downsizing its capital program, as it addresses the financial stresses in its operating budget. Debt service costs for the city and the New York City Transitional Finance Authority (NYCTFA) that are backed by the city's tax revenues are projected to rise from \$5.35 billion in FY 2011 to \$6.96 billion in FY 2014, for an average annual growth rate of 9.1 percent. As illustrated in the figure to the right, debt service costs as a percent of tax revenues will increase from 13.7 percent in FY 2011 to 16.0 percent in FY 2014. Compared to the forecast in the July financial plan, the current debt service projections, which are net of prepayments, are lower in each of FYs 2011-12 by \$1 million and \$75 million, respectively, but higher in each of FYs 2013-14 by \$92 million and \$97 million, respectively.

<u>FY</u>	<u>Debt Service</u>	<u>Tax Revenue</u>	<u>Debt Service as Percent of Tax Revenue</u>
2011	\$5,350	\$38,989	13.7%
2012	6,219	40,788	15.2%
2013	6,694	42,148	15.9%
2014	6,956	43,507	16.0%

While city and NYCTFA debt service costs are paid primarily from tax revenues, relatively small sums of noncity funds are available to provide support. As can be seen in the figure to the right, these sources total \$258 million in FY 2011, \$505 million in FY 2012, \$284 million in FY 2013 and \$282 million in FY 2014. The amounts of noncity funds that have been earmarked to pay debt service costs have increased in the November modification by \$21 million in FY 2011, \$267 million in FY 2012, and \$47 million in each of FYs 2013 and 2014. The surge in FY 2012 reflects an assignment of \$220 million of building aid revenues to specifically pay city debt service costs related to school construction. An analysis of the city-funded only debt service costs shows that the burden as a percentage of tax revenues is lower at 13.1 percent in FY 2011, 14.0 percent in FY 2012, 15.2 percent in FY 2013 and 15.3 percent in FY 2014.

	<u>FY</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
State		\$14	\$13	\$13	\$13
State Building Aid		0	220	0	0
Federal Subsidy:					
G.O. BABs		59	69	69	69
NYCTFA BABs/QSCBs		58	78	78	78
Swap Receipts & Other		127	125	124	122
<b>Total</b>		<b>\$258</b>	<b>\$505</b>	<b>\$284</b>	<b>\$282</b>

Debt service costs are driven by the sale of bonds to support capital commitments. The aggregate size of the capital program has not changed substantially, as an increase in projected capital contracts for FYs 2011-14 in the most recent financial plan is driven mainly by a deferral of commitments from FY 2010. While the city has not trimmed its capital program as a means to generate budgetary savings, it continues to manage the associated financing program to minimize debt service costs.

The management efforts are illustrated in a review of the changes in debt service costs since the July financial plan. The \$75 million reduction of FY 2012 debt service costs reflects the city's effort to produce savings to help close the budget gap.

Specifically, the city achieved \$139 million of debt service savings in FY 2012 from two sales of refunding bonds during FY 2011 totaling \$1.263 billion. The savings were captured by refinancing high coupon bonds with lower coupon bonds and by deferring some principal payments in FY 2012. It should be noted that even with the deferral of FY 2012 principal payments, the sales resulted in the refunding bonds having a shorter average life than the refunded bonds.

The November modification includes some actions that serve to increase debt service costs in each of FYs 2012-14. Upon close analysis, some of the additional debt service costs are being offset by associated revenues and others may not materialize, as can be seen in the following examples.

Debt service costs are projected to increase by a net \$12 million in FY 2012 and \$16 million in each of FYs 2013-14 due to an upside in capital borrowing in FY 2011. The NYCTFA projects selling a total of \$3.6 billion of tax revenue bonds in FY 2011 to fund the city's capital program, which reflects an increase of \$575 million compared to the forecast made in July. However, projected general obligation (g.o.) borrowing for the city's capital program, at \$2.7 billion, is lower in FY 2011 than previously forecasted by \$350 million. The \$225 million net larger borrowing amount will be used to support the cash flow for commitments with the balance being deposited into the restricted cash account.

The borrowing assumption for FY 2011 has increased at a time when municipal bond sales nationwide have surged, with the expiration of the federal Build America Bond (BAB) and the Qualified School Construction Bond (QSCB) programs looming. The November modification reflects the city's sale in the current fiscal year of \$925 million of g.o. bonds for capital purposes including \$775 million of BABs, and the NYCTFA's sale of \$1.85 billion of revenue bonds including \$1.3 billion of BABs and \$147 million of QSCBs. Both the BAB and the QSCB programs have proven to be beneficial to issuers.

The BAB and QSCB programs were created by the American Recovery and Reinvestment Act of 2009 and are scheduled to expire on December 31, 2010. With BABs, state and local governments have been authorized to issue taxable bonds to finance capital expenditures for which they otherwise would sell tax-exempt bonds. With QSCBs, state and local governments have been authorized to issue taxable bonds to finance school construction projects for which they otherwise would sell tax-exempt bonds. State and local governments receive a direct federal subsidy payment of 35 percent and 100 percent of the total coupon interest paid for BABs and QSCBs, respectively. For both the city and the NYCTFA, the taxable interest costs have been lower than the financial plan assumptions for tax-exempt costs, even before application of the federal interest subsidy.

To date, the city has sold \$3.5 billion of BABs, while the NYCTFA has sold \$3.0 billion of BABs and \$397 million of QSCBs. The city expects to receive subsidy payments totaling \$1.349 billion over the life of its BABs, with \$59 million scheduled for FY 2011, and \$69 million for each of FYs 2012-14. The NYCTFA expects to receive subsidy payments totaling \$1.547 billion over the life of its BABs and QSCBs, with \$58

million scheduled for FY 2011, and \$78 million for each of FYs 2012-14. The subsidy revenues as a noncity funding source should be considered in conjunction with the higher debt service costs stemming from the net increase in borrowing for the current fiscal year.

Another action that has the effect of increasing debt service costs in the November modification relates to the projected sale of bonds by the Hudson Yards Infrastructure Corporation (HYIC). The November modification incorporates the projected sale of \$1 billion of bonds by HYIC and raises city payments by \$32.5 million in FY 2012 and \$65 million in each of FYs 2013-14.

HYIC was created in FY 2005 as a not-for-profit local development corporation to finance certain infrastructure improvements in the Hudson Yards area on the West Side of Manhattan. HYIC has been authorized by the city council to sell \$3 billion of bonds to finance an extension of the Number 7 subway line from Times Square to a new terminal at 34<sup>th</sup> Street and 11<sup>th</sup> Avenue as well as the groundwork for commercial and residential development at the Eastern Rail Yards. HYIC sold \$2 billion of the \$3 billion authorization in December 2006.

The principal on HYIC bonds will be paid from revenues generated by new development in the area, mostly in the form of payments in lieu of property taxes. Meanwhile, the city guarantees the interest payments on HYIC bonds out of its operating budget to the extent HYIC revenues are insufficient to pay the interest. Additionally, the city agrees to pass on to HYIC the amount of real estate property taxes it collects on new development in the Hudson Yards area. To date, HYIC revenues have been sufficient to pay the full annual interest costs. It is possible that HYIC revenues will also be sufficient to cover additional interest costs of \$23 million in FY 2012 and \$56 million in each of FYs 2013-14 from the \$1 billion of bonds projected to be sold, as the bond proceeds will support new development that will generate supplemental revenues. The projected \$9 million increase in tax equivalency payments for each of FYs 2012-14 that will be passed on to HYIC by the city will be paid from an equal increase in revenue receipts for the city.

## Glossary of Acronyms

<b>AIR</b>	Actuarial Interest Rate
<b>ARRA</b>	American Recovery and Reinvestment Act
<b>BABs</b>	Build America Bonds
<b>COLA</b>	Cost of Living Adjustment
<b>CY</b>	Calendar Year
<b>DOE</b>	Department of Education
<b>FCB</b>	Financial Control Board
<b>FY</b>	Fiscal Year
<b>GCT</b>	General Corporation Tax
<b>G.O. Bonds</b>	General Obligation Bonds
<b>HYIC</b>	Hudson Yards Infrastructure Corporation
<b>IFA</b>	Interfund Agreement
<b>IGA</b>	Intergovernmental Aid
<b>NYCTFA</b>	New York City Transitional Finance Authority
<b>NYSE</b>	New York Stock Exchange
<b>OPEB</b>	Other Postemployment Benefits
<b>OT</b>	Overtime
<b>OTPS</b>	Other than Personal Service
<b>QSCBs</b>	Qualified School Construction Bonds
<b>PEG</b>	Program to Eliminate the Gap
<b>PIT</b>	Personal Income Tax
<b>PS</b>	Personal Service
<b>STAR</b>	School Tax Relief
<b>TRS</b>	Teachers' Retirement System of the City of New York
<b>UFT</b>	United Federation of Teachers