

Staff Report

REVIEW OF FY 2011

June 9, 2011



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I. Overview

The city adopted a budget for FY 2011 that was balanced with the use of \$3.6 billion of prior-year surplus resources and \$395 million drawn from its Retiree Health Benefits Trust. The adopted budget contained no projected surplus funds to help deal with the large FY 2012 budget gap. Faced with fiscal concerns and challenges in the outyears of the financial plan, the city set upon managing its FY 2011 finances to build up surplus resources that would be used to help balance FY 2012. Throughout FY 2011, the city has been accumulating a budget surplus that is now estimated at \$3.2 billion. The city expects to use the entire surplus to balance the FY 2012 budget. The fact that the surplus used to balance the FY 2011 budget is greater than the surplus generated in FY 2011 is an indication that revenues were actually less than expenditures. In fact, since FY 2009, the city has been using prior-year surpluses to bridge its budget gaps.

Facing the fiscal stress of a \$3.3 billion budget gap in FY 2012, as stated in the July 2010 financial plan, in addition to budgetary uncertainty resulting from the prospects of an uneven economic recovery and its effect on revenues, as well as the potential impact of the state and federal budgets, the city accelerated its budget practices in FY 2011 to address these concerns. The city acted early in the fiscal year by implementing an agency program, starting with the November modification, that produced more than \$600 million in agency expense savings in FY 2011. Also, by the February modification, the city saw improved revenue collections that raised its estimates by more than \$1 billion. With further measures, the city drew upon resources from the general reserve, prior-year payables, debt service savings, unused pension reserves, and additional federal monies received earlier than anticipated as a result of the enhanced Federal Medical Assistance Percentage. These actions were responsible for building the \$3.2 billion surplus as well as covering an additional \$1 billion in city-funded expenditures.

The city will be entering FY 2012 with a balanced budget and no money set aside to deal with the FY 2013 budget gap. The surplus created in FY 2011 has allowed the city not only to propose a balanced budget in FY 2012, but to largely replace the loss of almost \$1.7 billion in federal and state education aid with city funds. Since this was accomplished with nonrecurring resources, the projected budget gap for FY 2013 is over \$4.8 billion. It will become more and more difficult for the city to manage its budget in an uncertain economic recovery and with the likelihood of further reductions in federal and state aid. The city will have to again act quickly to reduce expenditures and increase revenues to build up a surplus of the magnitude of past years.

**MODIFICATION HISTORY OF
THE CITY'S OPERATING BUDGET FOR FISCAL YEAR 2011**

TABLE 1 (\$ in millions)

	July Financial Plan	November Modification	February Modification	Executive Budget
<u>Revenues</u>				
Taxes				
General Property	\$16,740	\$16,747	\$16,817	\$16,825
Other Taxes	21,504	21,574	22,267	22,253
Tax Audit Revenue	622	628	868	868
Sale of Property Tax Liens	40	40	30	5
Miscellaneous Revenues	7,147	7,507	7,476	7,528
Unrestricted Governmental Aid	14	14	14	14
Interfund Revenues	558	559	559	569
Less: Intracity Revenues	(1,616)	(1,824)	(1,871)	(1,890)
Disallowances	(15)	(15)	(15)	(15)
Total City Funds	<u>\$44,994</u>	<u>\$45,230</u>	<u>\$46,145</u>	<u>\$46,157</u>
Federal Categorical Grants	6,813	7,871	8,197	8,325
State Categorical Grants	11,352	11,475	11,565	11,495
Total Revenues	<u>\$63,159</u>	<u>\$64,576</u>	<u>\$65,907</u>	<u>\$65,977</u>
<u>Expenditures</u>				
Personal Service	\$36,462	\$36,049	\$36,392	\$36,388
Other Than Personal Service	26,167	27,182	26,735	26,831
General Obligation, Lease, & TFA Debt Service	5,351	5,354	5,046	5,037
Budget Stabilization & Discretionary Transfers	(3,642)	(2,485)	(495)	(429)
General Reserve	437	300	100	40
Subtotal	<u>\$64,775</u>	<u>\$66,400</u>	<u>\$67,778</u>	<u>\$67,867</u>
Less: Intracity Expenditures	(1,616)	(1,824)	(1,871)	(1,890)
Total Expenditures	<u>\$63,159</u>	<u>\$64,576</u>	<u>\$65,907</u>	<u>\$65,977</u>
<u>Gap To Be Closed</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

**CHANGES TO THE CITY'S OPERATING BUDGET
FOR FISCAL YEAR 2011 SINCE JULY FINANCIAL PLAN**

TABLE 2

(\$ in millions)

	November Modification	February Modification	Executive Budget
<u>Revenues</u>			
Taxes			
General Property	\$7	\$70	\$8
Other Taxes	70	693	(14)
Tax Audit Revenue	6	240	0
Sale of Property Tax Liens	0	(10)	(25)
Miscellaneous Revenues	360	(31)	52
Unrestricted Aid	0	0	0
Interfund Revenues	1	0	10
Less: Intracity Revenues	(208)	(47)	(19)
Disallowances	<u>0</u>	<u>0</u>	<u>0</u>
Total City Funds	\$236	\$915	\$12
Federal Categorical Grants	1,058	326	128
State Categorical Grants	<u>123</u>	<u>90</u>	<u>(70)</u>
Total Revenues	<u>\$1,417</u>	<u>\$1,331</u>	<u>\$70</u>
<u>Expenditures</u>			
Personal Service	(\$413)	\$343	(\$4)
Other Than Personal Service	1,015	(447)	96
General Obligation, Lease, & TFA Debt Service	3	(308)	(9)
Budget Stabilization & Discretionary Transfers	1,157	1,990	66
General Reserve	<u>(137)</u>	<u>(200)</u>	<u>(60)</u>
Subtotal	\$1,625	\$1,378	\$89
Less: Intracity Expenditures	<u>(208)</u>	<u>(47)</u>	<u>(19)</u>
Total Expenditures	<u>\$1,417</u>	<u>\$1,331</u>	<u>\$70</u>
<u>Gap To Be Closed</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

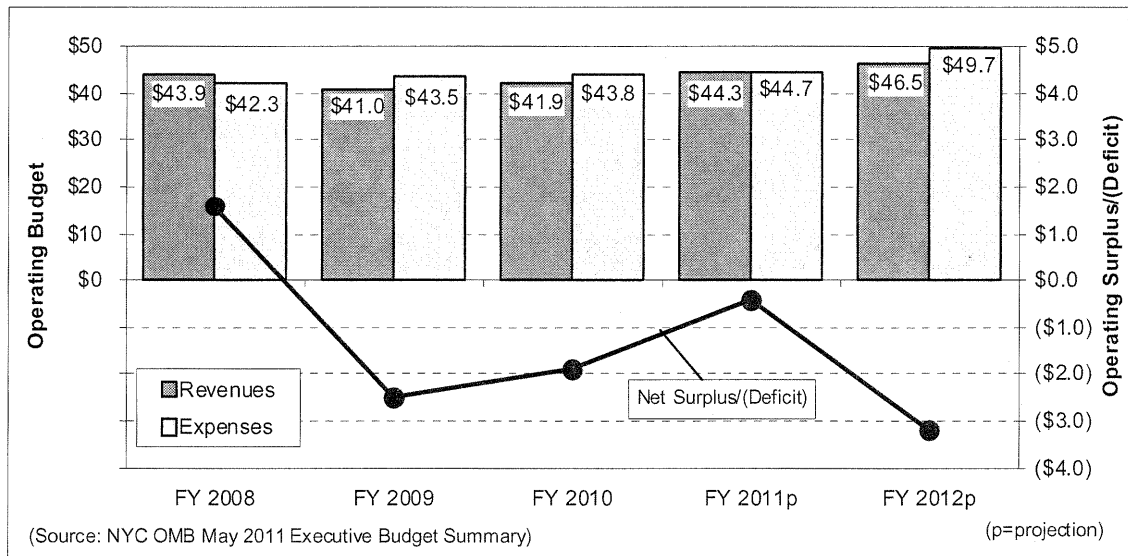
II. Balancing the FY 2011 Budget

The city's FY 2011 total-fund budget of \$66 billion, as presented in the May 2011 modification to the financial plan, includes a budget surplus of \$3.2 billion. On the surface, the surplus seems to indicate that the city is in strong fiscal health. However, a closer analysis reveals that the budget surplus produced in FY 2011 falls \$400 million short of a \$3.6 billion prior-year surplus used to support FY 2011 expenses.¹ Essentially, the FY 2011 budget is balanced with the net use of \$400 million of prior-year surplus funds.

Moreover, since FY 2009 the city has been using prior-year surpluses to bridge its budget gaps. This trend is captured in Chart 1, which shows consumption of budget surpluses correlating to annual city-fund revenue shortfalls of \$2.5 billion, \$1.9 billion, \$0.4 billion and \$3.2 billion in each of FYs 2009-2012, respectively. For FY 2011, city-fund revenues at \$44.3 billion are less than city-fund expenses at \$44.7 billion. The shortfall occurs despite a 5.7 percent growth rate for FY 2011 city-fund revenues that is faster than the 2.1 percent growth rate for city-fund expenses. This is because, coming out of the FY 2009 recession when city-fund revenues fell by 6.8 percent while city-fund expenses grew by 2.7 percent, the base from which revenues is compared is lower than the base for expenses.

**THE CITY HAS BEEN USING PRIOR-YEAR SURPLUSES
TO BRIDGE ITS BUDGET GAPS SINCE FY 2009**

CHART 1 (\$ in billions, city funds)



¹ The city has also drawn down \$395 million from its Retiree Health Benefits Trust to support FY 2011 expenditures.

After nearly catching up in FY 2011, city-fund revenues are projected to grow in FY 2012 at a rate of five percent, lagging the vigorous growth rate for city-fund expenses of 11.2 percent. The city plans to accommodate a \$5 billion jump in city-fund expenses projected for FY 2012 in part by fully depleting the \$3.2 billion FY 2011 surplus to free up resources to fund a pension reserve, and to replace federal and state aid for education. With no surplus available beyond FY 2012 to cover relatively fast growing city-fund expenses, budget deficits of \$4.8 billion, \$5.1 billion and \$5.3 billion are projected for each of FYs 2013-15, respectively. Given the size of the outyear deficits, the city will need to do as it did in FY 2011 and take early actions to address its budgetary stress.

CHANGES IN REVENUES

The city has increased its revenue forecast for FY 2011 by \$2.8 billion, to \$66 billion, since the start of the fiscal year last July. As shown in the figure to the right, city funds increased by about \$1.1 billion, largely due to a \$1 billion improvement in tax collections. The nonproperty taxes, lifted by a recovering economy, increased by \$978 million. A \$51 million increase in property tax revenue is due to lower refund issuance, partly offset by fewer lien sales.

FY 2011 City Funds Increase by \$1.1 Billion Since the July Plan (\$ in millions)	
Property Tax	\$51
Nonproperty Taxes	978
Audit Revenue	246
STAR Aid	(230)
Miscellaneous Revenue	6
City Funds	\$1,051
Categorical Grants	1,756
Other Revenue	11
Total Revenue Increase	\$2,818

A strong audit collection program added \$246 million to city funds. The state reduced the city's allocation of the School Tax Relief program (STAR) by \$230 million. Miscellaneous receipts increased by \$6 million.

Categorical grants increased by \$1.8 billion to \$21.2 billion, with most of the improvement being in federal grants. The state, which funded \$11.5 billion of these program-specific grants, is the largest source of categorical aid. The city also received \$8.3 billion in federal grants and \$1.3 billion in private grants.

Most of the major nonproperty taxes contributed to the \$978 million improvement in tax receipts. The largest gains were for the banking corporation tax, the sales tax, and the real property transfer tax. The acceleration of this last tax is significant in that it indicates the end of a three-year slide in property sales. Some taxes, however, failed to meet expectations and have weakened since July. These declining taxes include the general corporation tax, the mortgage tax and the cigarette tax.

The city recognized most of the extra tax revenue in the February modification and it has not been able to discover any additional upside for tax collections even as the economic recovery gained traction. Increasing budget stress appears to have forced the city to recognize all of its tax collections potential early in the fiscal year in order to avoid the need for additional painful expenditure cuts. In previous years, when the surplus roll was large and layoffs were not yet on the agenda, the city could afford the luxury of conservative revenue projections. Although the current tax revenue projections appear close to the mark, the early recognition of revenue can be risky if collections should weaken late in the fiscal year.

Budget Stress Persists Despite the Economic Recovery

With the economy in recovery, the city has added \$1 billion to taxes in FY 2011, since the July revenue plan. The nonproperty taxes have finally begun to turn upward, registering a year-to-year increase of 11 percent. Despite this very welcome growth, the city budget remains under stress from the 17 percent decline sustained during the recession when the nonproperty taxes fell or remained stagnant for three consecutive years. The net effect of the earlier declines and current growth is that the nonproperty taxes remain eight percent below the pre-recession collections peak.

Another source of budgetary stress is the unsteadiness of the economic recovery, as this exacerbates the risks associated with the city's economic forecasts and its revenue plan. This unsteadiness became apparent when national economic growth abruptly dropped even as job growth was starting to accelerate. Real gross domestic product (GDP) dropped to 1.8 percent in first quarter of calendar year (CY) 2011 from 3.1 percent in the fourth quarter of 2010, revealing the potential for downside economic shocks. The labor market is also unsteady. Private job growth increased to 251,000 in April, capping three months of strong employment. Unfortunately, this pace did not persist and private job growth dropped to 83,000 in May. This unsteady economic growth is making it difficult to predict with any certainty whether the nation's economic recovery will be strong enough to pull the city out of its revenue slump.

The city is responding to budgetary stress in the same way as government entities throughout the nation, by trying to reduce payrolls. The national employment numbers indicate that governments are responding to budget stress by shedding jobs. Since the start of 2011, government employment is down by 125,000 jobs, for the year through May. This downtrend appears to be a continuation of a slide that began in 2009, when 76,000 government jobs disappeared. Government jobs kept falling in 2010 when 233,000 jobs were lost despite a brief uptick caused by temporary census hiring. It is now apparent that government employment is in the midst of a long-term decline in response to the budgetary strains that are persisting long after the end of the recession.

The city is experiencing a similar downtrend in government employment, at all levels, down by 18,000 in April 2011 compared with the previous year. The downturn in government jobs appears to be gathering momentum, as 9,000 jobs disappeared in 2010. This weakening of the government sector in the city actually seems to have begun in 2009 but the job count in that year was propped up by a very successful stimulus-funded summer youth employment program, so that year recorded a slight increase in government jobs.

The city projects that the national economic growth will ease back to 2.7 percent in 2011 from the 2.9 percent growth recorded for 2010. The recent instability of GDP apparently motivated the Blue Chip forecasters to reduce their May consensus forecast for 2011 by 0.2 percentage points to 2.7 percent, which agrees with the city's projection. The city's estimate of 2.8 percent output growth in 2012 is sluggish compared with the consensus forecast of 3.2 percent. National employment growth recovers in 2011 to 1.5 percent in the city's outlook, up strongly from the one percent decline in 2010. The national economy lost 8.8 million jobs from January 2008 through February 2010. In the

15 months since that low point was reached, employment has increased by 1.8 million jobs through May 2011.

Led by a strong finance sector rebound, the local economy as measured by real gross city product (GCP) recovered with a spike of 6.6 percent growth in 2010, rebounding sharply from a nine percent decline during the recession of two preceding years. The city economic plan does not expect any similar strong growth to be repeated in the foreseeable future. Instead, local economic growth stagnates at less than one percent in 2011 and 2012 before increasing gradually in the outyears. Local employment, which added 14,000 jobs in 2010, for an increase of 0.4 percent, is projected to increase by 28,000 jobs in 2011, for a growth rate of 0.8 percent. The plan then expects the job growth rate to languish at 0.8 percent until 2013, before climbing to 1.2 percent in 2014.

State Labor Department data confirm that the city's employment forecast is close to its target, with the city gaining 26,400 jobs, or 0.7 percent, in April, compared with the previous year. Education and health jobs increased by 18,000, while professional and business services jobs expanded by 16,000. The financial services industry, with a gain of 13,000 jobs, is also in the forefront of the expanding labor market. Construction, which declined by 9,000 jobs, has not pulled out of a three-year slump. Also as noted earlier, government jobs are down by 18,000.

Tax Revenues

Since July, the city increased its FY 2011 tax collection plan by about \$1 billion, to an estimated \$38.4 billion. The nonproperty taxes accounted for nearly all of the improvement in total tax collections during the year, as shown in the figure to the right.

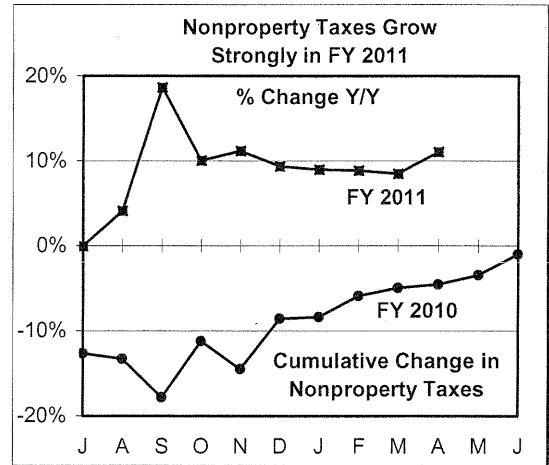
The real property tax improved by \$51 million to \$16.8 billion. To achieve its higher property tax target, the city raised its estimate of prior-year collections and trimmed unneeded funds from its contingency reserve for refunds. These positive reserve changes were partly offset by the postponement of lien sales until FY 2012. Compared with the previous year, the property tax grew by four percent.

FY 2011 Tax Outlook Improves by \$1 Billion Since July Plan (\$ in millions)	
Property Tax	\$51
Nonproperty Taxes	\$978
Personal Income	\$61
Sales	396
General Corporation	(166)
Banking Corporation	422
Unincorporated Business	72
Commercial Rent	37
Property Transfer	100
Mortgage Recording	(31)
Utility	10
Hotel	45
Cigarette	(5)
Other	37
Tax Revenue Increase	\$1,029
Note: Excludes STAR and audit programs.	

The nonproperty taxes improved by \$978 million to \$21.5 billion in FY 2011. The personal income tax increased by \$61 million, while the sales tax is up by a stunning \$396 million. The business taxes present a mixed picture, having both large positive and large negative adjustments. The banking corporation tax and the unincorporated business tax increased by \$422 million and \$72 million, respectively, while the general corporation tax declined by \$166 million. The real estate related taxes also present a mixed picture, with the commercial rent tax up by \$37 million, the real property transfer tax increasing \$100 million, while the mortgage recording tax is down \$31 million. The

hotel tax gained \$45 million, an indication of the strength of tourism. Other taxes are up \$37 million, due to tax collections from city workers residing outside the city, and because of increased payments in lieu of taxes from public benefit agencies such as the Industrial Development Agency and the Economic Development Corporation.

The nonproperty taxes, shifted from negative to positive growth between FYs 2010 and 2011, as the economic recovery and stimulus spending programs began to take hold. The figure to the right, which shows the cumulative growth rates of the city's nonproperty tax collections for the past two fiscal years, shows the nonproperty taxes recovering from a severe downturn. These taxes, which fell by 17 percent in FY 2009, were still in the midst of a steep slide at the start of FY 2010. Fortunately, as shown in the figure, FY 2010 turned out to be a year of transition from the deep drop of 18 percent in September to the far more tolerable decline of one percent at the end of the fiscal year.



Tax collection growth surged to 19 percent in September of FY 2011, which enabled the city to raise its nonproperty tax collection target by \$233 million and increase the collections growth rate to eight percent in the November modification. By December, the collections growth rate had leveled off at 10 percent and the city responded by adding another \$746 million to its February tax plan and raising its nonproperty tax growth target by another three percentage points to 11 percent. This plan had assumed that collections would strengthen as the year progressed along with the strengthening economy. Disappointing business tax collections in March caused the nonproperty tax collections growth to slip to eight percent and gave rise to concerns that the city's February tax plan was too aggressive, and might be in need of a downward adjustment late in the fiscal year. Fortunately, April personal income tax collections were sufficiently strong to lift nonproperty tax growth to 11 percent and make whole the city's revenue plan. In the May revenue plan, the city was able to retain its overall nonproperty tax goal, although it did adjust the individual tax collection targets within this category.

Business Income Taxes. Since the start of FY 2011, the banking corporation and the unincorporated business taxes improved by \$422 million and \$72 million, respectively, while revenues for the general corporation tax declined by \$166 million. Taken together, revenue for this group of taxes climbed 16 percent in FY 2011, compared with the previous year, to \$5.2 billion. Previously, business tax collections had sustained a three-year slide of 25 percent, so despite the current upturn, collections still remain \$780 million below the FY 2007 collections peak of \$6 billion.

The general corporation tax increased by 17 percent in FY 2011 and is slated to increase by 18 percent in FY 2012. It is possible that unsteady business profits could diminish the collections growth of this tax. National pretax corporate profits increased

by 37 percent in 2010 following a slide of 28 percent over the preceding three years. Despite the strong gains in most of 2010, profits dropped slightly at the end of 2010, and by the first quarter of 2011 the profit growth rate slipped to eight percent. The city projects that profits will fall by seven percent in 2011, largely because of a recently enacted federal bonus depreciation rule. The unsteady recovery of business profits bears close monitoring as it can cut short the recovery of this major source of revenue.

Real Estate Transactions Taxes. The two transactions taxes increased by 17 percent in FY 2011 to \$1.2 billion. These taxes are finally emerging from a precipitous three-year slide, during which the transactions taxes fell by \$2.3 billion, or 70 percent. Since the start of FY 2011, the city has increased its estimate for the real property transfer tax by \$100 million while it reduced its estimate for the mortgage recording tax by \$31 million. The residential market started to recover with the activity generated by the now lapsed homebuyer tax credit program. Also, the commercial real estate market became more active because the capital gains tax rate had been scheduled for an imminent increase. Reflecting uncertainty regarding the strength of the real estate market, the city expects collections for these two taxes to climb unsteadily by 11 percent in FY 2012 and by three percent in FY 2013.

Sales Tax. Since the start of FY 2011, the city raised the sales tax estimate by \$396 million to \$5.5 billion in the May modification due to recoveries in the national and local economies, and a record number of tourists in 2010.² In a different context, sales tax collections increased by 6.7 percent from the prior year, on a continuing base, after declining by 5.1 percent in FY 2009 and four percent in FY 2010.³ By the last quarter of 2010, it was clear that consumer spending had resumed due to local job gains, a more positive outlook by households, a rising stock market, and changes in the federal tax code, such as the two percentage point cut in the employee portion of the payroll tax, which increased disposable income. Currently, the income boost has increased purchases of durable and nondurable goods as well as addressed higher gasoline prices.

On a year-to-year basis, the city estimates that taxable consumption in FY 2011 was fostered by solid income gains of 11.9 percent in the financial sector and 4.2 percent in the nonfinancial sector of the local economy in 2010, after compensation in both sectors fell sharply in 2009.⁴ In April 2010, local employment turned the corner and exhibited positive year-over-year growth, while the financial activities sector and securities subsector both added jobs in July 2010. Besides job growth, the other mainstay in the recovery of local consumption was a new high of 48.7 million visitors to the city and the \$31 billion (city estimate) they spent in 2010. Records were also set in 2010 in terms of the number of domestic and higher-spending foreign travelers. The ripple

² The plan-to-plan variance is from the restated FY 2011 adopted budget to the May modification.

³ "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, such as the local sales rate increase that occurred in August 2009.

⁴ The city expects more moderate earnings growth of 5.4 percent in the financial sector and 3.6 percent in the nonfinancial sector of the local economy in 2011.

effects extended to additional jobs in the leisure and hospitality industry, more hotel rooms sold (even with a seven percent year-over-year increase in inventory), and higher daily room rates.

Personal Income Tax. Even though the city's FY 2011 personal income tax (PIT) projection only increased by \$61 million on a \$7.6 billion base by the end of the year, FY 2011 was unusual in terms of the economic and regulatory environment for the financial industry. It represented a transition away from numerous Federal Reserve programs that promoted liquidity and low interest rates, to implementing the Dodd-Frank financial reform law and new investigations of how financial companies serviced residential mortgages. Banks and bank holding companies took advantage of low interest rates to sharply reduce their interest costs, while slowly adding jobs, to earn profits of \$61.4 billion in 2009 and \$27.6 billion in 2010 from trading, investment banking, underwriting, and cutting loan-loss reserves.

Pressure from shareholders and federal regulators interpreting the Dodd-Frank financial reform law forced Wall Street firms to change the structure of bonuses by reducing the amount of cash paid upfront and increasing the number of stock grants and options that vest over time.⁵ The purpose was to encourage employees to better manage risk and focus on longer-term company performance. So far, two unintended consequences of the new compensation policy were higher base salaries for employees that may represent the value of foregone cash bonuses, and that greater stock-based deferred compensation will cause smaller withholding growth during the traditional bonus months of December through March.

As a result of the dexterity of Wall Street firms, the city estimates that the 2010 bonus payout rose by 4.3 percent over the prior year, which lifted finance sector compensation by 11.9 percent, or \$8.6 billion, from 2009. In turn, wage income citywide leaped 6.3 percent to \$280 billion in 2010. On a year-to-year basis and on a common rate and base, PIT revenue soared 11 percent in FY 2011, after having declined in both FY 2009 and FY 2010 by 16.4 percent and 8.2 percent, respectively. FY 2011 PIT revenue benefited from increased taxpayer liability due to generous Wall Street paychecks, citywide employment growth, and a turnaround in nonwage income based on positive capital gains realizations from an appreciation in equity holdings.

Miscellaneous Revenue

Based on the May modification, the core categories of miscellaneous revenue are expected to end FY 2011 up 1.3 percent, or \$34.1 million, to \$2.6 billion from FY 2010.⁶ The focus on the core categories allows an evaluation of the potential for recurring

⁵ In addition to changes in compensation, financial firms have new restrictions on the profitable business activities of proprietary trading and derivatives, and new capital requirements.

⁶ Core category revenue consists of six types of revenue: licenses (with permits and franchises), charges for services, interest, rent, fines, and a miscellaneous category without major nonrecurring actions, tobacco proceeds, housing revenue, and HHC payments. Dedicated funds such as water and sewer charges are also excluded from core category revenue since the funds are unavailable for gap-closing assistance.

revenue growth in the city's miscellaneous revenue forecast, which is not influenced by significant variation in the amount of asset sales and third-party payments received in a year, and collections that are tied to agency expenditures. From the FY 2010 restated adopted budget to the May modification, the projections for the core categories increased by a total of \$9.9 million, which included sizeable reductions in the estimates for interest and fines, and higher revenue primarily from licenses and miscellaneous.

Low interest rates are the main reason the city earned \$22.2 million in FY 2011 from the short-term investment of available funds, which represented \$25.6 million less than first estimated at adoption. Fine revenue fell by \$46.9 million to \$801.6 million in FY 2011, because parking fine receipts were constrained by inclement weather and lower ticket issuance. Among the other four core categories, positive plan variances exceeded \$30 million each in licenses and miscellaneous, and just over \$5 million in both charges for services and rent. Increased collections from construction permits and cable television stood out among the revenue sources that boosted license revenue by \$33.2 million to \$514.1 million in FY 2011. Additional legal settlements and land sales, among a myriad of other activities, were behind the \$38.4 million rise in the projection for the miscellaneous category during FY 2011.

CHANGES IN EXPENDITURES

Facing the fiscal stress of a \$3.3 billion budget gap in FY 2012, as stated in the July 2010 financial plan, in addition to budgetary uncertainty resulting from the prospects of an uneven economic recovery and its affect on revenues, and the potential impact of the state and federal budgets, the city accelerated its budget practices in FY 2011 to address these concerns. The city acted early in the fiscal year by implementing an agency program, starting with the November modification, that produced a total of more than \$600 million in agency expense savings in FY 2011. Also, by the February modification the city saw improved revenue collections that raised its estimates by more than \$1 billion. With further measures, the city drew upon resources from the general reserve, prior-year payables, debt service savings, unused pension reserves, and additional federal monies received earlier than anticipated as a result of the enhanced Federal Medical Assistance Percentage (FMAP). These actions were responsible for building a \$3.2 billion surplus as well as covering an additional \$1 billion in city-funded expenditures. The city plans to use the surplus in full to balance the FY 2012 budget. While FY 2012 is projected to be balanced, multi-billion dollar deficits in FY 2013 and beyond are left to be dealt with, as the growth rate for expenditures outpaces that of revenues.

In addition to building up a \$3.2 billion surplus in FY 2011, the city also managed to cover additional city-funded expenditures of about \$1 billion. As reported in the July 2010 financial plan, city-funded spending, net of prepayments, was projected to be \$43.2 billion but has since been revised up to about \$44.2 billion. Total city-funded expense changes for FY 2011 are presented in the figure to the right. The city projects a total of almost \$4.3 billion in expenditure increase for the fiscal year versus approximately \$3.2 billion of projected spending decrease.

As shown, the city's budget calls for an additional \$4.3 billion of city-funded spending with much of those funds being allocated to the Budget Stabilization Account (BSA). The BSA is a mechanism to account for the use of surplus funds. The city plans to use the total \$3.2 billion of FY 2011 surplus funds to pay FY 2012 expenses, the process of which is discussed in the section titled "Paying Debt Service Costs with Surplus Resources" beginning on page 14. Also, the city addressed agency funding requirements totaling \$631 million and other budgetary adjustments that are expected to add \$417 million. The city made adjustments to its Program to Eliminate the Gap (PEG), adding about \$29 million back to the budget; and additional labor expenses associated with collective bargaining cost around \$4 million more.

In order to build the surplus to pay down FY 2012 expenses, the city drew upon a number of resources totaling more than \$2.6 billion, including prior-year payables, debt service savings, FMAP funds, the general reserve, a pension reserve and other items. Additionally, \$600 million in PEG savings were identified and other adjustments, which include \$8 million collectively in labor and new needs (savings of \$4 million due to healthcare premium reestimate), add to budget reductions.

New Agency Needs and Budgetary Adjustments

As mentioned, the city has budgeted for additional agency spending of about \$631 million with more than half or \$332 million allocated to the city's uniformed agencies. Most of the additional spending is to fund overtime costs, PEG restorations, and higher costs associated with personal service expenses. The Police, Fire and Correction Departments will need approximately \$239 million to cover these costs. Also included is \$93 million, allocated to the Sanitation Department, to cover snow removal costs, which consist mainly of overtime expenses, pertaining to last winter's severe weather. For FY 2011, the city anticipates total overtime spending in its uniformed agencies, for both uniformed and civilian personnel, to total nearly \$938 million. Through April, the city had already spent \$817 million of that budget.

The city's mayoral agencies and miscellaneous budget, covering a number of city agencies, have been allocated funds to cover \$140 million of additional spending, which

FY 2011 City-Funded Expenditures (\$ in millions)	
Increase	
BSA	\$3,217
New Needs	631
Budgetary Adjustments	417
PEG Adjustments	29
Labor Costs	4
Total Increase	\$4,298
Decrease	
Budgetary Savings	(\$2,639)
Agency Program	(600)
Labor	(4)
New Need Adjustments	(4)
Total Decrease	(\$3,247)
Total Net Increase	\$1,051

FY 2011 New Agency Needs (\$ in millions)	
Uniformed Services	\$332
Mayoral and Miscellaneous	140
Social Services	110
Citywide Agencies	41
Education	7
Elected Officials	1
Total New Needs	\$631

mainly result from cost reestimates (i.e. licensing agreements for software). Social services agencies, comprised of the Administration of Children's Services, the Department of Social Services, Homeless Services and Health and Mental Hygiene, will need an additional \$110 million to also cover cost reestimates and adjustments for areas such as rental facility funding and higher shelter costs. Other citywide agencies like the Departments of Environmental Protection, Finance, Transportation and Parks together need around \$41 million for costs related to landfill and street repairs. The Department of Education will put \$7 million more into its budget to pay for higher healthcare costs. However, about \$4 million of that has been reversed due to a reestimate in the premium rates paid by the city.

Budgetary adjustments relate to cost increases, decreases or technical adjustments categorized as other than PEGs or new needs. The city has budgeted for \$417 million of increases in this area. Nearly half of this amount, around \$200 million, is for Medical Assistance. The city has added additional money to cover higher coverage costs and has also made technical adjustments to compensate for an earlier recognition of FMAP funding. Other adjustments are for the funding of leases (\$30 million), the Health and Hospitals Corporation (\$24 million), Department of Education and the City University of New York (\$16 million each), other costs or adjustments in social services (\$51 million) and various other departments.

Decreases in Expenditures

In September 2010, the city took the unusual step and asked all agencies to find recurring spending cuts and revenue increases (if applicable to the agency), which would collectively reduce total city expenditures by about \$800 million in FY 2011. This was unusual due to its timing. The city has not asked for agency reductions so early in the budget process. As stated in the May modification, total savings from the program through FY 2011 are expected to reduce expenditures by about \$572 million and increase revenues by about \$62 million, less restored funding of \$29 million and \$9.9 million, respectively. In total, the city has reduced expenditures by \$4.6 billion in FY 2011 since FY 2008 when the agency program was introduced. Those savings have been integral to stabilizing the budget in FY 2012 and reducing gaps in the outyears of the financial plan.

Further, the city has utilized a number of resources to build the FY 2011 surplus. Much of these resources drawn upon are categorized by the city as other adjustments that reduce expenses. The aggregate of these savings is more than \$2.6 billion, as shown in the figure to the right. A large portion of savings stems from the removal of \$600 million in pension reserve to address changes in actuarial assumptions and methods, which will not be needed this fiscal year. The city is also projecting lower pension costs by \$12 million.

FY 2011 Budgetary Savings (\$ in millions)	
Pension	\$612
Social Services	525
Prior-Year Payables	500
General Reserve	396
Debt Service	292
Miscellaneous	162
Other	152
Total Savings	\$2,639

The FY 2011 budget was adjusted to reflect an additional \$516 million that was received earlier than anticipated, as a result of the enhanced FMAP. Additionally, about \$9 million of other savings have been recognized by the Department of Social Services, bringing total expense reductions to \$525 million.

At the close of every fiscal year the city must make allowance for obligations that have been incurred in that year, but not yet discharged. If it is subsequently determined that more funds have been reserved than required, the city may account for the savings as a general reduction in the current year's expenditure level. The May modification recognizes a \$500 million reduction in prior-year payables. This amount is consistent with prior reductions in recent years. Also, the city is required to establish a general reserve of at least \$100 million at the start of each fiscal year. In recent fiscal years, the city has funded the reserve at \$300 million, but in FY 2011, the city allocated an additional \$136 million to the reserve, bringing total funding to \$436 million, as a contingency against the uncertainty of the enhanced FMAP funding being extended. The city has since released \$396 million of the reserve, reducing it to \$40 million. The city has acted appropriately in reducing this reserve, since these monies are being allocated to the BSA, and will be available if any unforeseen problems occur prior to the end of the current fiscal year.

Also, debt service costs have been reduced by \$292 million (excluding \$8 million in PEG savings) and miscellaneous budget expenses have declined by \$162 million reflecting the reestimate of healthcare, fringe benefit and judgment and claims costs. Lastly, the city is drawing on savings from energy, social services, Health and Hospitals Corporation funding, and other departments and budget areas for an additional \$152 million.

Paying Debt Service Costs with Surplus Resources

Over the course of FY 2011, the city and the New York City Transitional Finance Authority (NYCTFA) achieved \$318 million of debt service savings, \$300 million of which are city-funded. The debt service savings represent a component of the city's \$3.2 billion surplus generated in FY 2011. The vast majority of the reduction in debt service was derived from interest savings, as illustrated in the figure to the right.

FY 2011 City and NYCTFA Debt Service Savings (\$ in millions)			
	Adopted Budget	May Modification	Change
G.O./Lease Debt	\$3,863	\$3,925	\$62
G.O. Variable Rate Debt	272	27	(245)
Short-term Interest	75	0	(75)
NYCTFA Debt	1,141	1,081	(60)
Total-Funded	\$5,351	\$5,033	(\$318)
Less NonCity Funding	(\$236)	(\$218)	\$18
City-Funded	\$5,115	\$4,815	(\$300)

The city and the NYCTFA incurred approximately \$5 billion of debt service expenses for FY 2011, \$4.8 billion of which was payable from the city's tax revenues and \$218 million was supported by noncity funds. However, of the \$4.8 billion FY 2011 city-funded debt service costs, \$3.3 billion was paid from a budget surplus that was generated in FY 2010. Similarly, the city plans to use \$3.1 billion of the total \$3.2 billion surplus generated in FY 2011 to pay FY 2012 debt service costs.

The payment of debt service costs with surplus resources has become an integral instrument in managing the city's budget. In compliance with Generally Accepted Accounting Principles, the city is not allowed to carry over current-year resources to pay future-year expenses. Therefore, the city is compelled to use its surplus resources in the year they are generated. As part of its multi-year budget management, the city has developed the practice of allocating surplus resources to prepay debt service costs and

provide grants to authorities and covered organizations for later use, as means of taking early actions to address projected future-year financial pressures. This practice facilitates fiscal stability, as surpluses are being used to maintain future budget balance during difficult economic times instead of supporting higher levels of current-year spending that would not be sustainable.

Of the city's total \$3.2 billion budget surplus generated in FY 2011, \$2.3 billion will prepay FY 2012 city debt service costs and \$790 million will be used to provide a grant to the NYCTFA to pay its FY 2012 debt service costs, while \$164 million will be used to provide an advance cash subsidy to the Public Library system. In this way, the surplus is being used to balance the FY 2012 budget.

Debt service is a natural choice for prepayment because the cost is quantifiable in that the vast majority is generated from debt that has been undertaken already and has fixed repayment terms. In executing the prepayment of FY 2012 city debt service costs, the city will transfer the surplus resources to the General Debt Service Fund (GDSF) before the end of the current fiscal year. With the deposit into the GDSF, the city will reduce the real property tax levy for FY 2012 debt service costs.

A consideration in allocating the budget surplus to prepay city debt service costs is the potential for reduced flexibility in the undertaking of refunding bond sales. For example, the city often undertakes refunding bond sales where debt service savings are achieved in one year by deferring principal payments.⁷ The prepayment of debt service costs reduces the pool of outstanding bonds to allow for principal deferral. This may limit the city's ability to maximize refunding savings.

Use of the surplus to provide a grant to the NYCTFA is a tool that provides the city flexibility in managing its funding sources. Debt service for the NYCTFA is paid from city personal income tax (PIT). In receiving a grant from the city, the NYCTFA reduces its use of PIT to pay its debt service costs. Moreover, the city retains the amount of PIT that the NYCTFA does not require. As a result, the equivalent amount of PIT is available for city operating expenses, which means less real property tax revenue is required to cover operating expenses.

In deciding how much surplus to apply in providing a grant to the NYCTFA, a factor that is considered is the need to manage the limit on the city's real property tax levy for operating expenses, excluding debt service costs. The city levies the real property tax to cover the difference between total operating expenses and the amount of revenues estimated to be received from all other sources. However, the levying of the real property tax for operating expenses is subject to a constitutional limit of 2.5 percent of the five-year average of the full value of real estate.⁸ Over the past ten years, the

⁷ The city typically undertakes this practice without increasing debt service costs in any year over the life of the refunding bonds.

⁸ Separately, the city levies the real property tax to cover debt service costs on general obligation bonds. The city has unlimited taxing authority to provide for its debt service payments. However, there is a constitutional limit on the amount of general obligation debt that can be outstanding, which is 10 percent of the five-year average full value of real estate in the city

operating levy has come close to the limit on several occasions. In fact, the unused operating margin has been as low as \$33 million in FY 2006. Providing a grant to the NYCTFA to free up PIT revenue to use for operating expenses is a tool that the city uses to manage its operating levy.

In analyzing the true cost of borrowing, we use debt service costs before prepayments and grants. For FY 2011, the full city-funded debt service cost is \$4.8 billion, which represents 12.1 percent of tax revenues. As can be seen in the figure to the right, the FY 2011 debt service ratio was trimmed from an estimated 13.1 percent of tax revenues since the start of the fiscal year, benefiting from \$300 million of savings combined with \$1 billion of additional tax revenues that materialized. Nonetheless, the debt service burden is greater than the 11 percent and 11.5 percent experienced in FYs 2009 and 2010, respectively.

City-Funded Debt Service as Percent of Tax Revenues			
	(\$ in billions)		
	Adopted Budget	May Modification	Change
City-Funded DS	\$5.115	\$4.815	(\$0.300)
Tax Revenues	38.906	39.951	1.045
City-Funded DS as % of Tax Revenues	13.1%	12.1%	

Glossary of Acronyms

BSA	Budget Stabilization Account
CY	Calendar Year
FCB	Financial Control Board
FMAP	Federal Medical Assistance Percentage
FY	Fiscal Year
GCP	Gross City Product
GDP	Gross Domestic Product
GDSF	General Debt Service Fund
G.O. Bonds	General Obligation Bonds
HHC	Health and Hospitals Corporation
NYCTFA	New York City Transitional Finance Authority
PEG	Program to Eliminate the Gap
PIT	Personal Income Tax
STAR	School Tax Relief program