

Staff Report

REVIEW OF FY 2012

June 7, 2012



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I. Overview

Since the beginning of FY 2012, it was clear that the sluggish national recovery and the weakening local economy would make this fiscal year different than past years. The city has successfully managed its budget to create a projected surplus of \$1.7 billion, which is well short of the \$3.7 billion created in FY 2011 that was used to help balance FY 2012. In past years, the city was able to rely on conservative tax revenue forecasts that, when tax collections came in higher, allowed the city to build up large surpluses. FY 2012 would be different. Taxes added little to the surplus because uncertain and contradictory economic signals did not permit the city to significantly raise its tax collection forecasts.

In the November modification, the city, as it has done in previous years, announced an aggressive agency expense reduction plan that would generate \$470 million in FY 2012 and \$1 billion in FY 2013. Unlike past years, however, the FY 2012 savings were not used to build a surplus. They were needed in the current fiscal year to offset new agency needs, primarily overtime and other restorations in the uniformed services. The city was projecting a surplus of only \$12 million.

In the February modification the city was able to generate just under a \$1.3 billion surplus. The city recognized routine annual savings, such as a \$500 million write-down of prior-year payables and a \$200 million release from the general reserve, which was no longer needed. In addition, the city was able to reduce by \$425 million the amount needed to fund expected changes to the actuarial assumptions and methods used by the pension system. Based on recommendations made by the City Actuary, the city was able to reduce the \$1 billion reserve it had set aside in previous years.

In the May modification, the city increased its projected surplus to \$1.7 billion by using a one-time \$466 million settlement from the contractor on the CityTime automated time keeping system. The city intends to use about \$1.6 billion of the surplus to help prepay FY 2013 expenses and \$124 million to prepay expenses in FY 2014. This surplus has been generated despite the lack of significant help from the economy. Weakening tax collection growth compelled the city to reduce its FY 2012 nonproperty tax forecast in two of the last three plans. The nonproperty taxes increased by \$4 million in November then slipped by \$105 million in February, and fell another \$165 million in May, for a total shortfall of \$266 million since the start of FY 2012. Two consecutive quarters of Wall Street losses at the end of calendar year 2011 weighed heavily on business and personal income tax collections. Our review indicates that this may continue for the rest of the fiscal year and produce another \$150 million shortfall. If we are correct, the city will either have to take additional actions before the close of the year or reduce its projected surplus roll.

The fiscal stress the city has experienced is expected to continue in FY 2013 and beyond, as the city is relying on the drawdown of reserves in the Retiree Health Benefits Trust, as well as \$1 billion in one-time revenue from the sale of taxi medallions, to balance the FY 2013 budget.

**MODIFICATION HISTORY OF
THE CITY'S OPERATING BUDGET FOR FISCAL YEAR 2012**

TABLE 1 (\$ in millions)

	June Financial Plan	November Modification	February Modification	Executive Budget
<u>Revenues</u>				
Taxes				
General Property	\$17,543	\$17,564	\$17,730	\$17,820
Other Taxes	23,752	23,757	23,650	23,486
Tax Audit Revenue	660	670	700	700
Sale of Property Tax Liens	82	82	82	82
Miscellaneous Revenues	5,955	6,225	6,289	6,747
Unrestricted Governmental Aid	37	25	25	25
Less: Intracity Revenues	(1,549)	(1,749)	(1,791)	(1,790)
Disallowances	(15)	(15)	(15)	(15)
Total City Funds	\$46,465	\$46,559	\$46,670	\$47,055
Other Categorical Grants	\$1,193	\$1,032	\$1,046	\$1,036
Interfund Revenues	549	550	551	555
Federal Categorical Grants	6,674	7,570	7,734	7,666
State Categorical Grants	11,030	11,300	11,368	11,312
Total Revenues	\$65,911	\$67,011	\$67,369	\$67,624
<u>Expenditures</u>				
Personal Service	\$37,239	\$37,842	\$37,455	\$37,281
Other Than Personal Service	27,846	28,643	28,438	28,484
General Obligation, Lease & TFA Debt Service	5,813	5,705	5,612	5,623
Budget Stabilization & Discretionary Transfers	(3,738)	(3,730)	(2,445)	(2,014)
General Reserve	300	300	100	40
Subtotal	\$67,460	\$68,760	\$69,160	\$69,414
Less: Intracity Expenditures	(1,549)	(1,749)	(1,791)	(1,790)
Total Expenditures	\$65,911	\$67,011	\$67,369	\$67,624
<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 2012 SINCE JUNE FINANCIAL PLAN**

TABLE 2 (\$ in millions)

	November Modification	February Modification	Executive Budget
<u>Revenues</u>			
Taxes			
General Property	\$21	\$166	\$90
Other Taxes	5	(107)	(164)
Tax Audit Revenue	10	30	0
Sale of Property Tax Liens	0	0	0
Miscellaneous Revenues	270	64	458
Unrestricted Aid	(12)	0	0
Less: Intracity Revenues	(200)	(42)	1
Disallowances	0	0	0
Total City Funds	\$94	\$111	\$385
Other Categorical Grants	(\$161)	\$14	(\$10)
Interfund Revenues	1	1	4
Federal Categorical Grants	896	164	(68)
State Categorical Grants	270	68	(56)
Total Revenues	<u>\$1,100</u>	<u>\$358</u>	<u>\$255</u>
<u>Expenditures</u>			
Personal Service	\$603	(\$387)	(\$174)
Other Than Personal Service	797	(205)	46
General Obligation, Lease & TFA Debt Service	(108)	(93)	11
Budget Stabilization & Discretionary Transfers	8	1,285	431
General Reserve	0	(200)	(60)
Subtotal	\$1,300	\$400	\$254
Less: Intracity Expenditures	(200)	(42)	1
Total Expenditures	<u>\$1,100</u>	<u>\$358</u>	<u>\$255</u>
<u>Gap To Be Closed</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

II. Balancing the FY 2012 Budget

The May modification reflects a \$1.7 billion surplus in FY 2012. In an annual budget process that proved to be anything but routine, the city effectively constrained total spending for FY 2012 to the adopted level and assigned the \$1.7 billion surplus to help balance future-year budgets.

The city took aggressive steps in the November modification to address financial stresses that had emerged, which included the implementation of an early agency program to keep FY 2012 balanced. The actions generated the first \$12 million surplus for FY 2012. The February modification identified \$1.285 billion of new surplus funds, with a significant component being \$425 million in freed-up pension reserves. In the May modification, the city has assigned most of a one-time receipt of \$466 million, to settle federal and city investigations into alleged fraud charges in the CityTime automated time keeping system, towards increasing the surplus by \$431 million. Taxes added little to the surplus because uncertain and contradictory economic signals did not permit the city to significantly raise its tax collection estimates. The combined \$1.7 billion surplus will be used to prepay \$64 million of FY 2013 subsidies as well as \$1.664 billion and \$124 million of FYs 2013 and 2014 debt service costs, respectively.

CHANGES IN REVENUES

The city has increased its revenue forecast for FY 2012 by \$1.7 billion, to \$67.6 billion, since the start of the fiscal year. As shown in the figure to the right, city funds are up by \$590 million. Nonrecurring revenue rather than taxes was the most important source of the extra revenue. The real property tax improved by \$278 million to \$17.9 billion over the year due to improved taxpayer compliance and reduced refunds for assessment disputes. Offsetting this gain, the nonproperty tax collections are lower by \$266 million, held down by the halting and unsteady economic recovery. While the business and personal income taxes were mostly down, the taxes linked to the real estate market and the tourist industry tended to be stronger.

FY 2012 City Funds Increase by \$590 Million Since Adoption (\$ in millions)	
Property Tax	\$278
Nonproperty Taxes	(266)
Audit Revenue	40
STAR Aid	(1)
Miscellaneous Revenue	42
Nonrecurring Revenue	509
Intergovernmental Aid	(12)
City Funds	\$590
Categorical Grants	\$1,117
Other Revenue	6
Total Revenue Increase	\$1,713

Nonrecurring revenues added \$509 million, consisting of a \$466 million CityTime settlement and several smaller one-shots, while other miscellaneous revenues gained \$42 million. Audits increased by \$40 million and intergovernmental aid dropped by \$12 million.

Categorical grants increased by \$1.1 billion to \$20 billion, with most of the improvement being in federal grants.¹ The state, which funded \$11.3 billion of these program-specific grants, is the largest source of categorical aid. The city also received \$7.7 billion in federal grants and \$1 billion in private grants. Even though categorical aid has risen compared with the June plan, these grants are down \$131 million compared with actual categorical grants in FY 2011. This marks the second year of declining grants since federal stimulus aid reductions and tight state budgets resulted in sliding grant allocations. Previously, grants declined by \$573 million between FY 2010 and FY 2011.

Unsteady Recovery Holds Down Local Tax Collections

The local economic outlook has been clouded by contradictory signals and inconsistent trends. Local job growth, which appeared to be weak in the July plan, turned out to be exceptionally strong following the March benchmark revisions. The revised job reports put local job growth far out in front of the weak and unsteady national recovery. Contrarily, despite the strength of local jobs, the local unemployment rate has remained high. Even though the improved local jobs picture should certainly be helpful to tax collections, steep Wall Street losses and flat personal incomes held down tax yields. These erratic and contradictory economic reports forced the city to take down FY 2012 nonproperty taxes by \$266 million and weakened the outlook for outyear tax collections.

The city's plan sees a weak and gradual national economic recovery with a painfully slow improvement of the labor market. Real gross domestic product (GDP), in the city's plan, increases slightly from 1.7 percent in calendar year (CY) 2011 to 2.1 percent in 2012. The nation's job growth gradually recovers from 1.5 million jobs in 2011 to two million jobs in both 2012 and 2013, as the unemployment rate slowly recovers from 8.9 percent in 2011 to 8.2 percent in 2012. The plan outlines a flat gross city product in both 2011 and 2012, with slow growth starting in 2013. Employment growth moderates to 50,000 local jobs in 2012 following the very strong 75,000 jobs gained in 2011.

National economic reports have been erratic and have not inspired confidence. GDP growth, which averaged a near-recessionary 1.2 percent over the first three quarters of 2011, finally recovered to three percent in the fourth quarter, but abruptly sank to 1.9 percent in the first quarter of 2012. The unsteady economy and persistent worries emanating from Europe resulted in an unstable stock market. The securities industry lost \$3 billion in the third quarter of 2011 and another \$2 billion in the fourth quarter. Including these losses, New York Stock Exchange member profits for the year totaled a very weak \$7.7 billion in 2011, down from \$27.6 billion earned in 2010. The city consequently reduced its plan for 2012 Wall Street profits to \$10 billion from its earlier forecast of \$14 billion.

¹ After the budget is adopted, grant estimates normally tend to increase with each budget modification and then decline slightly when the comptroller audits the grant allocations.

The labor markets have also been unsteady and unpredictable. Monthly national job counts have shown unsteady albeit positive growth for the 20 consecutive months since October 2010. Job growth, which appeared to be climbing steadily from a low of 54,000 new jobs in May 2011 to a high of 275,000 in January 2012, abruptly began to trend down in the early part of 2012 reaching a low of 69,000 by May. If the May number becomes the new norm, it could undermine the city's forecast of two million new national jobs in 2012.

Local job reports have been strong since recent benchmark revisions to the employer survey showed 2011 job growth to be 75,000, which is more than twice as high as the earlier report of 33,000 jobs.² Local employment has remained strong in the early part of 2012, with an average year-to-year increase of 63,000 jobs through April, but the unemployment rate has, nevertheless, not retreated from the nine percent level that has persisted for the last three years. The city's plan calls for 50,000 new local jobs in 2012, which is a reasonable assumption given the stubbornly high local unemployment rate and the downward trend of national job growth.

Tax Revenues

Since June 2011, the city increased its FY 2012 tax collection plan by a very slight \$12 million, to an estimated \$40.6 billion. Weak nonproperty taxes erased virtually all the collection gains of the real property tax, as shown in the figure to the right. The weakness since the start of the year has diminished but not eliminated year-to-year nonproperty tax growth. Compared with the previous year, the nonproperty taxes grew by four percent, down from 13 percent growth in FY 2011. The property tax grew by six percent in FY 2012, up from four percent growth in FY 2011.

FY 2012 Tax Projection	
Increased Slightly Since June Plan	
(\$ in millions)	
Property Tax	\$278
Nonproperty Taxes	(\$266)
Personal Income	(\$205)
Sales	38
General Corporation	(249)
Banking Corporation	59
Unincorporated Business	(161)
Commercial Rent	5
Property Transfer	136
Mortgage Recording	16
Utility	(22)
Hotel	80
Cigarette	(2)
Other	39
Tax Revenue Increase	\$12
Note: Excludes STAR and audit programs.	

The real property tax improved by \$278 million to \$17.9 billion, since the June plan. The extra revenue derives from improved collections and reduced contingency reserves. Property tax collections for the current year are \$34 million greater than was anticipated in June, while collections from delinquent prior-year bills are higher by \$50 million. Refunds and cancellations resulting largely from assessment complaints were lower than the June plan by \$155 million and \$29 million, respectively. At the start of the current fiscal year, the city enlarged its lien sale forecast to \$82 million by rescheduling nearly all lien sales from FY 2011 to FY 2012. Through April, the city has generated \$57 million from lien sales, leaving \$25 million uncollected as of yet. One more lien sale before the close of the fiscal year is estimated to yield sufficient revenue to prevent a

² Subsequent data from the Quarterly Census of Employment and Wages indicate that the estimate of 75,000 new local jobs in 2011 might be overstated and could be scaled back in a future revision.

shortfall in this revenue source. Aside from the extra revenue directly generated by lien sales, the threat of impending lien sales is an important reason why the city's property tax delinquency rate is less than two percent of the levy.

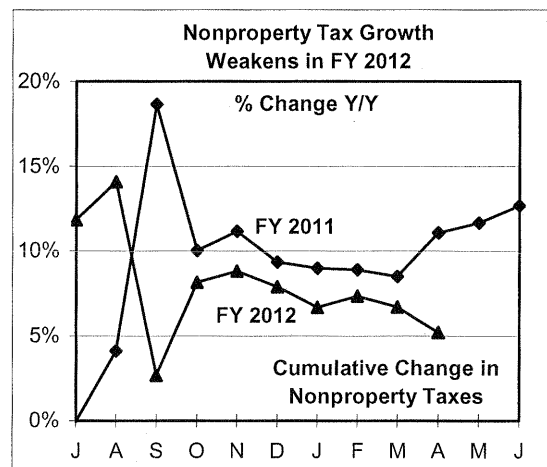
Nonproperty tax collections slipped by \$266 million to \$22.7 billion since the start of FY 2012. While the business and personal income taxes were mostly down, the taxes linked to the real estate market and the tourist industry tended to be stronger. The personal income tax fell by \$205 million. The general corporation tax slid by \$249 million and the unincorporated business tax fell \$161 million. The banking corporation tax, out of step with the other business taxes, increased by \$59 million. Three real estate related taxes are all stronger, with the commercial rent tax up by \$5 million, the real property transfer tax increasing \$136 million, and the mortgage recording tax higher by \$16 million. An influx of tourists lifted the sales tax by \$38 million and the hotel tax by \$80 million.

Other taxes are up \$39 million, due to increased PILOTs (payments in lieu of taxes) from public benefit agencies such as the Economic Development Corporation, the Industrial Development Agency and Battery Park City. Although Battery Park City's PILOT is higher by \$17 million in comparison with the June plan, revenues are down by \$22 million when compared with FY 2011 receipts. Another PILOT, which also dropped, is that of the World Trade Center.

Weakening tax collection growth has compelled the city to reduce its FY 2012 nonproperty tax forecast in two of the last three plans. The nonproperty taxes increased by \$4 million in the November modification, then slipped by \$105 million in the February modification, and fell another \$165 million in the May modification, for a total shortfall of \$266 million since the start of FY 2012. Two consecutive quarters of Wall Street losses at the end of calendar year 2011 weighed heavily on business and personal income tax collections and was the most serious reason for the slippage of the tax estimates. Fortunately, the downward trend was moderated by improving collections for taxes linked to the city's real estate market and the tourism sector.

The nonproperty taxes have been increasing for two years since pulling out of a three-year slump with flat or declining revenues. The figure at the right, which shows the cumulative growth rates of the city's nonproperty tax collections for the past two fiscal years, indicates that collections growth in FY 2012 has been running behind the stronger growth of the previous year. The gap between FY 2012 growth and the stronger growth of FY 2011, which had been showing a steady but small growth deficit since October, abruptly widened in April. In contrast to FY 2011

when growth accelerated in April, tax growth in FY 2012 slowed from seven percent growth in March to five percent in April due to disappointing business and personal income tax receipts during that key collection month. By the end of FY 2012, the city



estimates that the tax growth rate will settle to 4.2 percent, down sharply from the prior year's growth of 13 percent. We estimate that growth could drop as low as 3.5 percent resulting in a shortfall risk of \$150 million. The personal income tax is at risk for \$100 million and business tax refunds are at risk for \$50 million.

Business Income Taxes. Since the start of FY 2012, the general corporation tax (GCT) slid by \$249 million and the unincorporated business tax (UBT) fell \$161 million, while revenues for the banking corporation tax (BCT) increased by \$59 million. Wall Street losses in the last two quarters of CY 2011 caused the revenue slippage, but some of the lost revenue was made up by a rebound of nonfinancial businesses. The weakening of collections caused business tax revenue growth to drop to two percent in FY 2012 from 18 percent in FY 2011. Together, the business taxes earned an estimated \$5.4 billion in FY 2012, which remains \$600 million below the FY 2007 collections peak of \$6 billion.

The GCT, the largest of the business taxes, grew nine percent in FY 2012, down from 15 percent growth in FY 2011. The city expects growth of this tax to diminish to about two percent in FY 2013 due to unsteady business profits. National pretax corporate profits grew by only four percent in CY 2011, down from the brisk 25 percent growth of 2010. The city projects that corporate profit growth will sink to under two percent in 2012, while securities industry profits will increase from \$7.7 billion in 2011 to \$10 billion in 2012. These extremely modest profit targets are capable of supporting slow business tax growth in the years ahead.

Two encouraging reports show that profits have started to turn upward. In the first quarter of 2012, Wall Street firms reported profits of \$7.3 billion, while national corporate profits climbed 15 percent. These higher profits could generate stronger business tax revenues in FY 2013.

We note a trend of higher refund payouts for the GCT and the UBT. If this unsettling trend continues through the accrual period at the close of the fiscal year, FY 2012 business tax collections could be at risk for \$50 million.

Real Estate Transactions Taxes. The two transactions taxes grew by 16 percent in FY 2012 to \$1.4 billion. This strong growth follows the even stronger increase of 25 percent in FY 2011. Despite this strong recovery, tax receipts remain depressed, a lingering after-effect of the precipitous three-year 70 percent slide that occurred during the recession. Since the start of FY 2012, the city has increased its estimates for the real property transfer tax by \$136 million and the mortgage recording tax by \$16 million. Low residential mortgage rates are finally activating the residential market following the lull that resulted from the cessation of the homebuyer tax credit program. The city expects collections growth for these two taxes to ease back to 8.5 percent in FY 2013.

Sales Tax. In the May modification, the city's FY 2012 sales tax estimate advanced by 4.4 percent from the prior year on a continuing base, and reflected an

increase of \$38 million to \$5.8 billion since adoption.³ Put into perspective, the projected growth in FY 2012 collections is modest given economic conditions (e.g. private sector job gains) and recent collection history. On a common rate and base, sales tax revenue leaped 7.3 percent on a year-to-year basis in FY 2011 after collections dropped in both FYs 2009 and 2010 by five and 3.4 percent, respectively.

In this transition period from recession to recovery, households continue to deleverage, and spending is restrained by lackluster income growth, volatility in the stock market, and higher commodity prices. Besides households, the city estimates that taxable consumption in FY 2012 was boosted by a new high of 50.6 million tourists in 2011 and their direct spending of \$32.5 billion. The additional spending had positive effects on retail sales, employment in the leisure and hospitality industry, and hotel occupancy and room rates, even with an increase in inventory. During FY 2012, the ongoing turmoil in the euro zone did not appear to affect tourism.

Personal Income Tax. During the course of FY 2012, one of the main influences on personal income tax collections was the changing condition of the financial industry. With increasing urgency, financial firms cut costs, including compensation and headcount, to make up for lower revenues and profits, due to volatility in the capital markets and the euro zone. Particularly hard hit were the usual profit centers of trading and investment banking, as well as fewer initial public offerings and mergers and acquisitions. In this climate, New York Stock Exchange member firms recorded profits of \$12.6 billion for the first two quarters and a loss of \$4.9 billion for the last two quarters of 2011. While some banks increased lending and reduced loan-loss reserves, the industry faced possible debt default in the euro zone, higher capital requirements, uncertain domestic fiscal policy, mortgage-related litigation, and new rules as the Dodd-Frank law is implemented.

Consequently, the city's FY 2012 personal income tax (PIT) estimate declined by \$205 million to \$8 billion by the end of the year. On a continuing base, PIT collections grew by only 2.4 percent in FY 2012 from the prior year. Given the pace of current collections, including higher refunds, we estimate that PIT revenue in FY 2012 could be lower than the city's projection by \$100 million. It is also possible that the stage is being set for a better performance by collections in FY 2013.

Overall, the results for FY 2012 would have been worse if not for unexpectedly strong local job gains in 2011, cuts in bonuses that were not as deep as they could have been, and the vesting of prior-year stock awards. Despite layoffs in the securities industry, private sector employment jumped by 55,400 jobs from December 2010 to December 2011. In addition, the city estimates that bonus payouts in the private sector declined by 15 percent year-to-year in 2011. While it is likely that bonuses in the securities industry fell by a larger magnitude, the decline would still be from a much higher level than in the nonfinance sector.

³ "Continuing base" or "common rate and base" are terms that describe tax collections adjusted for the effects of tax programs, etc. to focus on the influence of the economy.

Miscellaneous Revenue

The city's FY 2012 miscellaneous revenue estimate jumped by \$551.4 million to \$5 billion from the adopted budget to the May modification, and soared by 13 percent from the prior year. Unfortunately, most of the \$551.4 million variance can be traced to a \$508.9 million surge in nonrecurring resources, led by the \$466 million CityTime settlement. Yet, if we dig deeper, and focus on areas within miscellaneous revenue that sponsor recurring growth, then the FY 2012 projections for the six core categories increased by \$95.5 million within the year.⁴ Compared to FY 2011, core category revenue increased by 2.8 percent, and the improvement was evident in varying degrees in five of the six core categories.

During FY 2012, the projection for interest income declined, because the Federal Reserve decided to keep the federal funds rate at 0 to 0.25 percent through late 2014. The forecast for interest earnings fell by \$16.2 million in FY 2012, from \$33.5 million at adoption to \$17.3 million in the latest modification. Among the other five core categories, some of the sources of additional revenue were cable franchises, building permits, community college tuition, housing fees, and airport rent (the minimum rent was reset). Even though the projection for parking fines fell by \$34.6 million to \$568.8 million by the May modification, as a diversion of resources caused fewer tickets to be issued, surpluses in building, health, and environmental fines caused the fine category of \$820.2 million to be \$5.8 million ahead by the end of the fiscal year.

EXPENDITURES

For FY 2012, the annual budget process proved to be anything but routine for the city. The November modification made clear the city's financial stress with the implementation of an early agency program, which was needed to keep FY 2012 in balance. The city identified only \$12 million of surplus funds, which could be used to prepay FY 2013 expenses. Moreover, the city's decision to deplete the Retiree Health Benefits Trust, to help close budget gaps in FYs 2013 and 2014, was another troubling sign of its fiscal stress. On the revenue side, the city's announcement to raise one-time additional revenue by selling more taxi medallions was met with lawsuits.

The February modification showed improved budget projections with the addition of nearly \$1.3 billion in surplus funds. The modification included a number of key proposals for the short-term, as well as for the outyears, of the financial plan. The city included changes the City Actuary recommended to pension assumptions and methods, which allowed the city to free up more than \$400 million from the \$1 billion reserve it had set up in previous years. The outyears included two proposals put forth by the Governor, which have since been signed into law. One proposal was to reform

⁴ 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.

both the city and state pension funds for newly hired employees and the other was to cap the growth in the city's share of Medicaid costs. In the May modification, the city has identified an additional \$431 million in surplus funds, which brings the total FY 2012 surplus to more than \$1.7 billion. These additional funds come mainly from a one-time payment to settle federal and city investigations in the CityTime automated time keeping system. The majority of the surplus will be used to prepay FY 2013 debt service expense and subsidies.

The May modification projects FY 2012 total-funded expenditures of \$67.6 billion, which is \$1.7 billion higher than originally estimated in the FY 2012 Adopted Budget. The increase is due entirely to the buildup of surplus funds during FY 2012. Net of FY 2013 prepayments, FY 2012 expenses are projected to decrease by \$11 million. On a city-funded basis, the city expects an increase in expenditures of \$590 million. The May modification anticipates city-funded spending of \$47.1 billion as compared to an adopted budget estimate of \$46.5 billion at the start of the fiscal year.

As shown in the figure to the right, projected city-funded spending is expected to decrease by \$744 million in FY 2012. Budget estimates show that agency spending will grow across every agency category with the exception of Major Organizations. These projections include the impact of prepayments and Program to Eliminate the Gap (PEG) (expense only). Over the course of the fiscal year, most of this additional spending was required in uniformed services with new needs of \$325 million. Of that amount, \$218 million was allocated to the Police Department. Elsewhere, Mayoral agencies, Health and Welfare Services, and Offices of Elected Officials, also sought increased funding totaling \$83 million. The Major Organizations category, comprised of the Department of Education (DOE), the City University of New York, and the Health and Hospitals Corporation, reduced spending by \$158 million, which was mostly attributed to a \$147 million PEG identified by the DOE. In Other Budget Areas, the increase of \$340 million primarily reflects the prepayment of future years' expenses with the \$1.7 billion of surplus funds generated in FY 2012 that is partially offset by the release of general reserves, write-down of prior-year payables, reductions in pension costs and miscellaneous expenses, and debt service savings. After adjusting for the impact of prepayments and the FY 2012 expense PEG, the May modification estimates FY 2012 city-funded expenses will actually decline by \$744 million.

FY 2012 City-Funded Expenditures Net of Prepayments and PEG (\$ in millions)	
Agency	
Other Budget Areas	\$340
Uniformed Services	325
Mayoral	50
Health and Welfare	27
Elected Officials	6
Major Organizations	(158)
Total Agency Increase	\$590
FYs 2013-14	
Prepayments	(\$1,728)
FY 2012 PEGs (Expense)	394
Total Net Decrease	(\$744)

The city started FY 2012 with more than \$3.7 billion in prepaid expenses that came from FY 2011 surplus funds. However, no additional funds were left available that could be used to prepay FY 2013 expenses. Earlier in the fiscal year, the city faced difficult financial issues, such as having to use an agency program to offset additional funding needs that would keep the fiscal year in balance, as opposed to using the savings to build up a surplus. However, the city was still able to produce a surplus as the fiscal year progressed. As the figure to the right shows, higher revenue plus a major legal settlement, coupled with budget saving actions, and an agency program produced a more than \$1.7 billion surplus.

As shown in the figure to the right, during the fiscal year the city took a number of cost reduction measures to reduce city-funded expenditures. It also expects to collect \$520 million in additional revenues due mostly to a \$466 million legal settlement. As in other fiscal years, it has become routine for the city to build up surplus funds by taking down its prior-year payables for past period claims and the general reserve. Following this pattern, the city reduced both by \$500 million and \$260 million, respectively. In a separate action, the city adjusted down its annual pension expense by a net \$417 million. The projected downward adjustment is due to the release of a \$1 billion pension reserve that was initially funded to address proposed changes to how pension benefits are calculated and funded. The May financial plan now assumes that this reserve is not needed in its entirety.

FY 2012 Surplus Funds	
City Funds (\$ in millions)	
Revenue – (Inc / (Dec))	
CityTime Settlement	\$466
Tax	39
Miscellaneous	15
Subtotal	\$520
Expense – (Inc / (Dec))	
Prior-Year Payables	(\$500)
Pensions	(417)
General Reserve	(260)
Debt Service	(58)
HIP Rate Savings	(2)
Agency Expenses	483
Judgments and Claims	10
Subtotal	(\$744)
Agency Program	(464)
Total Surplus	\$1,728

The Office of Actuary (OA) has proposed a number of changes based on the recommendations made in an independent audit by the Hay Group, which was completed and presented in December 2011. The OA's package of recommended changes includes lowering the Actuarial Interest Rate (AIR) assumption from eight percent to seven percent, using an alternative new funding method, establishing the unfunded liabilities for the new method, amortizing the liabilities recognized by the new funding method over a longer period, implementing a market value restart, updating mortality tables, and modifying assumptions of rates for retirement and disability.

After the release of the Hay Group audit, which was presented to the city and the Board of Trustees for each of the five pension systems, the OA published new assumptions and methods for each system that detailed the proposed changes and updates to demographics, mortality tables, rates of retirement and disability, economic forecasts, funding methods, AIR, etc. The change proposals currently sit with each Board awaiting approval, although actions such as the market value restart are within the purview of the OA. The trustees of each Board have typically approved the OA's proposed recommendations.⁵ However, some of the changes also need to be approved

⁵ The latest information available confirms that the Board of Trustees' of the New York City Employees' Retirement System, the New York City Teachers' Retirement System, and the New York City

by the state legislature (i.e. lowering the AIR and establishing the use of a new funding method). The city needs to submit legislation and get the approval of the legislature and the Governor before the end of the current legislative session.

While we remain cautious over the long term regarding the ultimate cost of the changes, we believe that in the near term, the proposed pension changes warrant no risk to the city's budget. If the OA's recommendations are ultimately implemented, the city will be able to release the pension reserve and the OA will be able to switch to the alternative funding method and also implement the other proposed changes. These actions will offset the cost of the assumption changes over the financial plan period. If, however, the alternative funding method and change to the AIR are not implemented and just some of the changes are, then there exists no downside risk since funding is in place to cover any changes made.

The city has also estimated savings of \$58 million in debt service and \$2 million in healthcare costs associated with the rates paid for the Health Insurance Plan of New York (HIP).⁶ Also, additional agency spending of \$483 million and \$10 million for Judgment and Claims has been budgeted. The additional agency spending is due mostly to new needs required in the uniformed services area. The Police Department was allocated most of these additional funds to address Personal Service costs and to restore an overtime cost-containment measure that is not expected to materialize. The Correction, Fire, and Sanitation Departments also had to address funding shortages that are mainly overtime related as well.

Since the adopted budget, the city has added almost \$300 million to cover the cost of additional overtime spending in these four departments. The city estimates that the uniformed agencies will spend more than \$1 billion in overtime for FY 2012. We have warned repeatedly that the growth in overtime spending would top \$1 billion and eventually pose a risk to city finances. The city was required in November to take corrective actions, in part due to additional overtime needs, to keep the fiscal year in balance. Although the city has now allocated enough money to cover these expenses in FY 2012 and no risk of underfunding overtime spending is present, the city must address this spending issue as it faces multi-billion dollar budget gaps in the outyears of the financial plan. Nonetheless, the city has continued to identify agency PEGs that are expected to produce cost savings and higher revenues totaling \$464 million. In the aggregate, these budgetary actions produced a more than \$1.7 billion surplus that will be used to prepay FYs 2013 and 2014 expenses.

Since the release of the February modification, two important proposals, which greatly affect the city in the outyears of the financial plan, have been signed into law. In

Board of Education Retirement System have approved the OA's package of recommendations. The other two boards still need to approve the recommendations.

⁶ Debt service savings of \$58 million exclude \$56 million of debt service savings related to the city's PEG identified in the November modification. Including the PEG savings, city-funded debt service costs were reduced by \$114 million compared to the start of the fiscal year, which is discussed in "Debt Service Savings" beginning on page 15.

the first proposal, the state has enacted pension reform by creating a Tier 6, which covers all new state and city employees hired on or after April 1, 2012. Highlights of the reform (as stated for city employees) are:

- new nonuniformed employees will work until age 63 in order to retire and receive a pension and will contribute three to six percent of salary for their entire careers;
- new uniformed employees will contribute three percent of their salaries for the first 25 years of service, after 22 years, they can retire at 50 percent pension calculated as the average of the last five years of service, those who retire with 25 years of service receive cost of living adjustments of up to three percent annually;
- all new employees will have their benefits determined on the basis of average salary for the final five years of service, with limits on salary growth;
- all new nonuniformed employees will vest after 10 years of service;
- a readjustment of the pension multiplier will be implemented;
- the state will prefund any pension enhancers to alleviate the city of additional pension costs;
- a voluntary and portable defined contribution plan will be made an option for nonunion employees with annual salaries of \$75,000 and above; and
- restrictions on overtime and other items in compensation used to calculate pension benefits will be put in place.

The savings from the reform do not begin until FY 2015. The preliminary savings estimate for the city over the first five years is \$300 million and over the next 30 years is \$21 billion. The state projects that total savings for the next 30 years for all counties, including the city, will be more than \$82 billion.

The second important piece of legislation will allow the state to take over the three percent growth in the city's share of Medicaid costs and eventually take over administration expenses. This measure will incrementally reduce Medicaid growth starting in SFY 2013-14 from three to two percent and then it will reduce the cap further by an additional one percent annually over the next two fiscal years. The state takeover of the three percent Medicaid growth factor is projected to save the city \$11 million in FY 2013, \$65 million in FY 2014, \$164 million in FY 2015, and \$293 million in FY 2016.

DEBT SERVICE SAVINGS

The city and the New York City Transitional Finance Authority (NYCTFA) incurred approximately \$5.62 billion of debt service expenses for FY 2012, \$5.16 billion of which were paid from the city's tax revenues, and categorical noncity funds served to offset the remaining \$457 million. Over the course of FY 2012, the city and the NYCTFA achieved \$193 million of debt service savings, with city funding being reduced by \$114 million and the noncity offset being reduced by \$79 million, as illustrated in the figure to the right and will be detailed in this section of the report.

FY 2012 City and NYCTFA Debt Service Savings (\$ in millions)			
	Adopted Budget	May Modification	Change
City	\$4,248	\$4,098	(\$150)
NYCTFA	1,565	1,522	(43)
Total-Funded	\$5,813	\$5,620	(\$193)
NonCity Offset	(\$536)	(\$457)	\$79
City-Funded	\$5,277	\$5,163	(\$114)

Coming into the fiscal year, most of the debt service costs for FY 2012 were related to fixed rate securities, as depicted in Table 3. Even new debt expected to be incurred in FY 2012 was assumed to have fixed rate interest in the adopted budget. During the fiscal year, both the city and NYCTFA took advantage of historically low market interest rates to refund outstanding high coupon bonds with lower coupon securities. However, most of the interest rate savings from these sales benefited FY 2013. The debt service costs for FY 2012 had already reflected refunding benefits, as the two entities had refinanced some existing debt in FY 2011 that exacted \$187 million of savings for FY 2012. Over the course of the current fiscal year, the city and the NYCTFA were able to lower debt service costs for FY 2012 by \$193 million through interest savings primarily on the smaller components, such as variable rate debt, swap agreements, as well as leases and other financial commitments.

DEBT SERVICE COST IS COMPRISED MOSTLY OF FIXED RATE SECURITIES AS CALCULATED USING THE FY 2012 ADOPTED BUDGET

TABLE 3

(\$ in millions)	
City Debt Service	
Fixed Rate Principal	\$1,883
Fixed Rate Interest	1,729
Variable Rate Principal	108
Variable Rate Interest	107
Swap Payments	107
LOC/Remarketing Fees	43
Leases & Other Financial Commitments	280
Interest Earnings and Adjustments	(9)
Total City Debt Service	\$4,248
NYCTFA Debt Service	
Fixed Rate Principal	\$508
Fixed Rate Interest	810
Variable Rate Principal	83
Variable Rate Interest	155
Net Other Expenses	9
Total NYCTFA Debt Service	\$1,565
Total City & NYCTFA Debt Service	\$5,813

The vast majority of debt service represents payments of principal and interest on bonds issued by the city and NYCTFA for city capital projects. The city has \$42.4 billion of general obligation (g.o.) bonds outstanding at the end of FY 2012, \$34.7 billion of which are fixed rate bonds and \$7.7 billion are floating rate bonds. Currently, the fixed rate bonds carry a weighted average interest rate of 5.22 percent, with interest costs in FY 2012 totaling \$1.73 billion. Interest rates on the adjustable rate bonds could be determined in various modes, or could be based solely on specific indices such as the London Interbank Offered Rate (LIBOR) and the Consumer Price Index (CPI), with upward limits set as high as 25 percent in some cases.⁷ In the present low interest rate climate, the city paid short-term rates of 0.25 percent on average for its tax-exempt floating rate debt and 1.5 percent for its taxable floating rate debt in FY 2012. The city makes conservative assumptions in forecasting interest costs on variable rate instruments, and then recognizes the savings as they are realized. The FY 2012 Adopted Budget assumed variable rate interest costs on g.o. bonds totaling \$107 million; the current modification projects the actual costs will be half this amount at \$53 million, for a savings of \$54 million.

Given the inherent nature of variable rate debt, the city in past years entered into several swap agreements in an attempt to hedge some of this exposure. In such agreements, the city made arrangements with a number of financial institutions to exchange interest payments for a specific time range and a notional amount of money associated with certain variable rate bonds. The FY 2012 Adopted Budget assumed city swap payments totaling \$107 million; the current plan projects the actual costs will be less than half this amount at \$47 million, for a savings of \$60 million. The corresponding swap receipts act as an offset to debt service costs and have similarly been reduced from a projected \$122 million at budget adoption to \$46 million, or by \$76 million.

The city has outstanding a notional \$902 million of swap contracts that have synthetically converted floating rate debt to fixed rate. For these types of contracts, the counterparty agrees to pay the city a floating rate based on LIBOR, and the city agrees to pay the counterparty a fixed rate that is set when the swap is entered into. Similarly, a notional \$94 million of city swap contracts have converted CPI-based floating rate debt to fixed rate. While swaps are entered into in order to hedge variable rate exposure, they carry risks. Here, the risk exists that the city's variable rate receipts from the counterparty will not equal the variable rate payments on the related bonds if they are based on different indices.

The city also has outstanding a notional \$1.04 billion of basis swap contracts. With this type of contract, the counterparty agrees to pay the city a LIBOR-based floating rate, and the city agrees to pay the counterparty a floating rate based on the SIFMA Municipal Swap Index. There is the risk of a mismatch between the SIFMA used to hedge its exposure and the rate received based on LIBOR. Additionally, a change in

⁷ Statutorily, the amount of variable rate debt that the city may carry cannot exceed 20 percent of the constitutional debt authority for g.o. bonds. With \$7.7 billion of outstanding variable rate debt, the city is well within its current variable rate debt limit of \$15.2 billion.

federal tax rates or laws would alter the relationship between the tax-exempt-based SIFMA and the taxable-based LIBOR.

There are other inherent risks in swaps. For example, there is the risk that the counterparty will default under its agreement. The counterparties for the city's swap contracts include: JPMorgan Chase Bank, N.A.; Merrill Lynch Capital Services Inc.; Morgan Stanley Capital Services Inc.; UBS AG; and Wells Fargo Bank, National Association. The obligations for Merrill Lynch Capital Services and Morgan Stanley Capital Services are guaranteed by Merrill Lynch and Co., Inc. and Morgan Stanley, respectively. The city had a contract with Lehman Brothers Derivative Products that was terminated as a result of the bankruptcy filing of Lehman Brothers Holdings Inc. in 2008. In this case, at the time of the termination, it was the city that had owed a termination value of roughly \$619,000, which it has since paid.

The city calculates on a quarterly basis the net amount it would owe or be owed if all of the transactions were terminated on that date. For March 31, 2012, it was determined that the city would have owed a total approximating \$176 million. The city's swap contracts have provisions that limit the counterparties from optionally ending the agreements when the city owes termination payments. It should be noted that the city last entered into a swap agreement in February 2005 and that the scheduled termination dates of its outstanding agreements range from August 1, 2014 to December 1, 2033. The city, however, continues to issue adjustable rate bonds, increasing this exposure with the ultimate goal of minimizing its interest expense.

The NYCTFA is projected to have \$20.9 billion of tax revenue bonds outstanding at the end of FY 2012, \$17.6 billion of which are fixed rate and \$3.3 billion are floating rate bonds. The NYCTFA does not have any swap contracts related to its variable rate debt. Compared to the adopted budget, the current modified budget for FY 2012 reflects a combined reduction in debt service costs for the NYCTFA of \$43 million, attributable mostly to variable rate savings and lower than projected interest costs on its fixed rate debt that were issued over the present fiscal year. In forecasting its variable rate interest cost for the FY 2012 Adopted Budget, the NYCTFA provided a sizeable cushion to minimize debt service risks. In general, the interest rates that the NYCTFA pays are more favorable than those on city g.o., as NYCTFA bonds have higher credit ratings.

The current financial plan reflects two sales of capital financing tax revenue bonds by the NYCTFA in FY 2012, totaling \$1.8 billion. For the second offering of \$900 million, the NYCTFA is paying coupons in excess of market yields in exchange for receiving a substantial \$110 million of premium above the principal, satisfying investor preferences in this historically low interest rate climate.

Debt service includes a relatively small allocation for lease payments and other financial commitments made by the city as backing for bonds issued through conduits to fund specific city capital improvements. Over the course of FY 2012, the city's allocation for such costs was reduced by \$38 million, bringing the projected payments to \$242 million.

As the forecast for FY 2012 debt service improved over the fiscal year, so too did the projection for city tax revenues. For FY 2012, debt service funded by city tax revenues is \$5.2 billion, which represents 12.3 percent of tax revenues. As can be seen in the figure to the right, the FY 2012 debt service ratio was trimmed from an

FY 2012 City-Funded Debt Service as Percent of Tax Revenues (\$ in millions)			
	Adopted Budget	May Modification	Change
City-Funded DS	\$5,277	\$5,163	(\$114)
Tax Revenues	42,037	42,088	51
City-Funded DS as % of Tax Revenues	12.6%	12.3%	

estimated 12.6 percent of tax revenues since the start of the fiscal year, benefiting from the \$114 million of savings combined with \$51 million of additional tax revenues that materialized. Nonetheless, compared to recent years, the debt service burden is continuing on an upward trajectory, increasing from 11 percent in FY 2009 to 11.5 percent in FY 2010, 11.8 percent in FY 2011, and now 12.3 percent in FY 2012.

Tobacco Bonds. As a tangential matter, there are ongoing discussions nationwide about the outlook of bonds that are backed by tobacco revenues, as tobacco consumption has been declining in recent years. The Tobacco Settlement Asset Securitization Corporation (TSASC), which is a component unit of the city, was created to issue bonds secured by the city's 3.4 percent share of the nationwide settlement with American tobacco companies and to use the proceeds to fund city capital projects. A purchase agreement between the city and TSASC pledges 37.4 percent of the tobacco settlement revenues through FY 2024 to be used annually for TSASC's debt service and operating expenses, with the residual 62.6 percent flowing to the city. The city is not liable for TSASC's debt and the debt service costs are not reflected in the plan.

Coming into FY 2012, TSASC had \$1.26 billion of bonds left outstanding. The first required principal payment of \$284 million on the issuance amount is in FY 2022, while interest payments are required to be made semi-annually. However, TSASC has made advanced principal payments of \$19.9 million in FY 2006, \$16.7 million in FY 2007, \$19.3 million in FY 2008, \$23.9 million in FY 2009, \$8.4 million in FY 2010 and \$5 million in FY 2011, totaling \$93.2 million, toward the FY 2022 maturity. As can be seen, the principal payments have decreased in recent years, reflective of the fact that receipts of tobacco settlement revenues have declined. Indeed, tobacco settlement revenues averaged \$213 million in FYs 2006-09, and then dropped to \$185.6 million in FY 2010 and \$184.5 million in FY 2011. The tobacco revenues are a function of tobacco sales, which have been decelerating in America. Additionally, the tobacco companies that are party to this settlement have been withholding disputed portions of the payments while they litigate their claim that they are at an unfair disadvantage against those tobacco companies that are not party to the agreement.

Currently, TSASC calculates that its share of the forecasted nationwide settlement revenues will total \$187 million in FY 2012 and roughly \$198 million in each of FYs 2013-16. Of these receipts, it expects to retain \$71 million in FY 2012 and \$74 million in each of FYs 2013-16 to pay its debt service and administrative costs. On the \$1.26 billion of outstanding debt, TSASC has a mandatory interest payment of approximately \$63 million in FY 2012, which would diminish in succeeding years upon any advance payment of principal.

Glossary of Acronyms

AIR	Actuarial Interest Rate
BCT	Banking Corporation Tax
BSA	Budget Stabilization Account
CPI	Consumer Price Index
CY	Calendar Year
DOE	Department of Education
FCB	Financial Control Board
FY	Fiscal Year
GCT	General Corporation Tax
GCP	Gross City Product
GDP	Gross Domestic Product
G.O. Bonds	General Obligation Bonds
CPI	Consumer Price Index
HHC	Health and Hospitals Corporation
HIP	Health Insurance Plan of New York
LIBOR	London Interbank Offered Rate
LOC	Letter of Credit
NYCTFA	New York City Transitional Finance Authority
OA	Office of Actuary
PEG	Program to Eliminate the Gap
PILOTs	Payments in Lieu of Taxes
PIT	Personal Income Tax
SIFMA	Securities Industry and Financial Markets Association
SFY	State Fiscal Year
STAR	School Tax Relief program
TSASC	Tobacco Settlement Asset Securitization Corporation
UBT	Unincorporated Business Taxes