

Staff Report

**REVIEW OF FY 2013**

June 6, 2013



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## I. Overview

A review of FY 2013 shows that the city has continued to follow a financial planning process and a strategy that allow it to balance the first two years of its financial plan while trying to reduce the outyear budget gaps. The city has been able to deal with the budget aftermath of September 11<sup>th</sup>, the near collapse of the financial markets, and the damages caused by Hurricane Sandy in an orderly fashion. The strategy has been to propose a budget with revenue assumptions that reflect the volatility of the national and local economies. This conservative approach has allowed the city to minimize its risk during the fiscal year, while maximizing the upside potential of increased revenue. This has been a wise approach given that the city is aware that large outyear gaps exist and reducing them with a prior-year surplus is the least disruptive way to balance the budget.

In addition, the city has used the financial planning process to take early action to either deal with current-year problems or build up a surplus to help reduce the next year's budget deficit. For the last number of years, the city has proposed an agency gap-closing program in the November modification to save roughly \$500 million in the current year and about \$1 billion in the next fiscal year. This approach enabled the city to avoid abrupt mid-year budget reductions, which would be disruptive to the delivery of necessary services.

The FY 2013 adopted budget was balanced using over \$2.4 billion of surplus funds generated in FY 2012. The adopted budget contained a projected surplus of only \$124 million to help balance FY 2014. As the year progressed, the city implemented an agency program that produced \$555 million in resources, wisely deferred \$635 million in revenue expected from the sale of taxi medallions to later years, reduced the general reserve, and wrote down prior-year payables. In addition, the city experienced a surge in revenues, mainly due to an improving local economy and taxpayers advancing transactions due to a threat of potential tax law changes next year, adding a net \$994 million. The city now estimates the FY 2013 surplus at over \$2.1 billion. This has allowed the city to propose a FY 2014 budget that is balanced and contains a projected \$142 million surplus to reduce the FY 2015 deficit. Given recent history, and the fact that we have identified a potential \$165 million of debt service savings attributable to lower interest rates on variable rate debt, the surplus is likely to be higher by the end of the fiscal year.

The outyear budget gaps have been reduced to a projected \$2.2 billion in FY 2015, \$1.9 billion in FY 2016, and \$1.4 billion in FY 2017. The main issues for FY 2014 and beyond are whether the city will continue the current financial management strategy, how it will deal with potential labor contract settlements, and the continuing large growth in healthcare costs. The decisions made on the terms of future labor contract settlements will largely determine whether the financial stability over the plan period remains, or if outyear budget gaps will increase causing potential disruptive service cuts or large revenue increases that could slow the growth of the city's economy.

**MODIFICATION HISTORY OF  
THE CITY'S OPERATING BUDGET FOR FISCAL YEAR 2013**

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

	June Financial Plan	November Modification	January Modification	Executive Budget
<b><u>Revenues</u></b>				
Taxes				
General Property	\$18,371	\$18,384	\$18,394	\$18,494
Other Taxes	24,503	24,571	24,793	25,707
Tax Audit Revenue	724	838	838	1,060
Sale of Property Tax Liens	46	46	46	67
Miscellaneous Revenues	6,949	6,506	6,586	6,359
Less: Intracity Revenues	(1,631)	(1,704)	(1,777)	(1,732)
Disallowances	(15)	(15)	(15)	(15)
<b>Total City Funds</b>	<b>\$48,947</b>	<b>\$48,626</b>	<b>\$48,865</b>	<b>\$49,940</b>
Federal Categorical Grants	\$6,661	\$7,262	\$8,655	\$9,005
State Categorical Grants	11,430	11,566	11,301	11,344
Other Categorical Grants	924	978	981	996
Interfund Revenues	539	538	571	560
<b>Total Revenues</b>	<b>\$68,501</b>	<b>\$68,970</b>	<b>\$70,373</b>	<b>\$71,845</b>
<b><u>Expenditures</u></b>				
Personal Service	\$37,292	\$37,356	\$37,593	\$37,821
Other Than Personal Service	28,706	29,217	29,793	29,992
General Obligation, Lease & TFA Debt Service	6,118	6,108	6,010	5,994
Budget Stabilization & Discretionary Transfers	(2,284)	(2,307)	(1,346)	(270)
General Reserve	300	300	100	40
Subtotal	\$70,132	\$70,674	\$72,150	\$73,577
Less: Intracity Expenditures	(1,631)	(1,704)	(1,777)	(1,732)
<b>Total Expenditures</b>	<b>\$68,501</b>	<b>\$68,970</b>	<b>\$70,373</b>	<b>\$71,845</b>
<b><u>Gap To Be Closed</u></b>	<b><u>\$0</u></b>	<b><u>\$0</u></b>	<b><u>\$0</u></b>	<b><u>\$0</u></b>

**CHANGES TO THE CITY'S OPERATING BUDGET  
FOR FISCAL YEAR 2013 SINCE JUNE FINANCIAL PLAN**

TABLE 2 (\$ in millions)

	November Modification	January Modification	Executive Budget
<b><u>Revenues</u></b>			
Taxes			
General Property	\$13	\$10	\$100
Other Taxes	68	222	914
Tax Audit Revenue	114	0	222
Sale of Property Tax Liens	0	0	21
Miscellaneous Revenues	(443)	80	(227)
Less: Intracity Revenues	(73)	(73)	45
Disallowances	0	0	0
<b>Total City Funds</b>	<b>(\$321)</b>	<b>\$239</b>	<b>\$1,075</b>
Federal Categorical Grants	\$601	\$1,393	\$350
State Categorical Grants	136	(265)	43
Other Categorical Grants	54	3	15
Interfund Revenues	(1)	33	(11)
<b>Total Revenues</b>	<b>\$469</b>	<b>\$1,403</b>	<b>\$1,472</b>
<b><u>Expenditures</u></b>			
Personal Service	\$64	\$237	\$228
Other Than Personal Service	511	576	199
General Obligation, Lease & TFA Debt Service	(10)	(98)	(16)
Budget Stabilization & Discretionary Transfers	(23)	961	1,076
General Reserve	0	(200)	(60)
Subtotal	\$542	\$1,476	\$1,427
Less: Intracity Expenditures	(73)	(73)	45
<b>Total Expenditures</b>	<b>\$469</b>	<b>\$1,403</b>	<b>\$1,472</b>
<b><u>Gap To Be Closed</u></b>	<b><u>\$0</u></b>	<b><u>\$0</u></b>	<b><u>\$0</u></b>

## II. Balancing the FY 2013 Budget

The city's FY 2013 total-fund budget of \$72 billion, as presented in the May 2013 modification to the financial plan, includes a budget surplus of \$2.16 billion. At this level, the surplus is about \$280 million short of a \$2.44 billion prior-year surplus used to support FY 2013 expenses.<sup>1</sup> While the city faces mounting costs related to pensions, fringe benefits and debt service that provide a challenge to fiscal stability, there is a strong likelihood that it will end the fiscal year with a larger than forecasted surplus. Indeed, the city has demonstrated a historical pattern of boosting its surplus in its June modification to the current-year budget. For example, over each of the past three fiscal years, the city's surplus edged up by a range of \$370 million to \$711 million between the May modification and the June modification.

The city began FY 2013 with a budget that had already included a surplus of \$124 million. Over the course of the fiscal year, the city augmented the initial surplus by \$2.037 billion, with a net \$994 million attributable to a surge in revenues and \$1.043 billion extracted from expenditure savings. Of these combined revenue enhancements and expenditure cuts, \$555 million was generated from the city's program to eliminate a budget gap that opened early in the fiscal year. Our review of the May modification reveals that the city will likely save an additional \$165 million in FY 2013 debt service costs attributable to lower than projected interest incurred on outstanding variable rate debt, which is needed for future deficit reduction.

The \$2.1 billion surplus already identified has been assigned to prepay \$1.955 billion and \$142 million of FYs 2014 and 2015 debt service costs, respectively, as well as \$64 million of FY 2014 subsidies. With the assignment of \$2.02 billion of the surplus to pay FY 2014 expenses, the city has bridged the gap between recurring revenues and expenditures for that year. Moreover, the city has augmented its funding of the FY 2014 general reserve by \$150 million to deal with unexpected events that may occur. With only \$142 million of the surplus remaining to aid FY 2015, the city is left with a projected budget shortfall for that year of \$2.2 billion. This amount could grow if certain revenues, such as the sale of new taxi medallions, do not materialize, and certain expenses, such as labor contract settlements, are larger than currently provided for.

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<sup>1</sup> The city has also drawn down \$1 billion from its Retiree Health Benefits Trust to support FY 2013 expenditures.



## **CHANGES IN REVENUES**

The city has increased its revenue forecast for FY 2013 by \$3.3 billion, to \$71.8 billion, since the start of the fiscal year. As shown in the figure to the right, city funds are up by \$994 million. The real property tax improved by \$144 million to \$18.6 billion over the year due to increased lien sales and improved collections on prior-year tax bills. The property tax also benefitted from a diminished need for reserves that are set aside for contingencies like delinquency and refunds.

Local nonproperty taxes yielded an extra \$1.2 billion, following a rush by taxpayers to sell assets to beat impending federal tax increases. This revenue spin-up caused a surge in the personal income and the real estate transaction taxes. Much of this extra revenue could be offset by reduced collections in FYs 2014 and 2015. Although the possibility of a spin-up was discussed in our March report, the magnitude of this extraordinary \$1.2 billion collections surge did not become known until April, when the reporting deadline for the personal income tax was reached. Aside from the spin-up, a stronger stock market and improved corporate profits produced stronger business tax collections.

Miscellaneous revenue declined by \$691 million since the June plan primarily due to the deferral of \$635 million in taxi medallion sales into subsequent years.

Audits increased to \$1.1 billion in the current modification from \$724 million at adoption. The entire \$336 million expansion of audits occurred in two installments, with \$114 million added in November and \$222 million added in May. Both increases were credited to the general corporation tax audit program.

Categorical aid from all sources is \$21.3 billion in FY 2013, of which \$11.3 billion is federal aid, \$9 billion is from state programs and \$1 billion is from private sources. Federal grants increased by \$2.3 billion since last June, largely due to the expansion of federal aid to help the city recover from the destruction caused by Hurricane Sandy. The federal government has agreed to furnish an initial installment of \$1.77 billion in aid that could eventually total \$4.5 billion. To begin to tap this resource, the city has submitted a partial action plan that details how it will allocate \$1.5 billion in federal community development block grants for disaster recovery.

State categorical aid has declined by \$86 million since the start of the fiscal year. State education aid was cut in the January plan by \$250 million due to an impasse over teacher evaluations. Whereas outyear education cuts have since been restored, the FY 2013 installment is no longer in the city's plan.

<b>FY 2013 City Funds Increase by \$994 Million Since Adoption</b> (\$ in millions)	
Property Tax	\$144
Nonproperty Taxes	1,200
Audit Revenue	336
STAR Aid	5
Miscellaneous Revenue	(691)
<b>City Funds</b>	<b>\$994</b>
Categorical Aid - Federal	\$2,344
Categorical Aid - State	(86)
Categorical Aid - Private	72
Other Revenue Changes	21
<b>Non-City Funds</b>	<b>\$2,351</b>
<b>Total Revenue Increase</b>	<b>\$3,345</b>

### **Fiscal Uncertainty Drives City Revenues**

The city's economic plan, which had reflected uncertainty since last June, is looking slightly more positive. The largest source of uncertainty centered on the direction of national fiscal policy. Some doubt was resolved with the passage of the tax increases that went into effect at the start of CY 2013. Nevertheless, considerable doubt remains as to how to resolve the spending cuts mandated by the sequester. Fiscal drag resulting from the tighter federal budget is a significant component of the city's economic plan. The city's current forecast suggests that the national economic upturn, while still slow and gradual, will gain traction a little earlier than in the city's previous plan.

The fiscal uncertainties emanating from Washington have left city revenues with a silver lining. Fearing tax increases, many taxpayers put homes and financial assets on the market in order to realize capital gains at the lower tax rates prevailing in 2012, resulting in a spin-up of local income tax collections in FY 2013. Tax collections also benefitted from a rising real estate market, a robust local labor market and a vibrant tourism industry. Finally, a rising stock market generated strong securities industry profits of \$23.9 billion in 2012 up from \$7.7 billion in 2011. Profits remained relatively strong at the start of the current year with reported earnings of \$6.6 billion in the first quarter of 2013, down slightly from \$7.3 billion in the comparable period of the previous year. With this strong start, Wall Street profits are on track to exceed the city's forecast of \$13.4 billion for all of 2013.

Fiscal drag from the tightening federal budget could delay the nation's recovery. The city assumes that the spending cuts related to the sequester represent a new normal and are unlikely to be lifted any time soon. Real gross domestic product (GDP), in the city's plan, slips from a subpar recovery of 2.2 percent in CY 2012 to an even more hesitant growth rate of 1.6 percent in CY 2013. A faster upturn of 2.7 percent finally arrives in 2014, presaging growth that could reach 3.4 percent by 2015. The nation's job growth drops from 2.2 million jobs in 2012 to 1.9 million jobs in 2013 before improving slightly to 2 million in 2014 and to a much more robust growth of 2.7 million jobs in 2015.

The city's outlook for local employment remains robust with 54,000 jobs being added in 2013 after which growth drops gradually to 50,000 by 2015. The city's job growth plan represents a step back from the phenomenal surge of 80,000 new jobs in 2012 and 87,000 jobs in 2011. Employment growth appears to be running ahead of the city's projection of 54,000 new jobs in 2013, as employment growth has averaged 65,000 jobs for the year through April, compared with the comparable period of the previous year. The unemployment rate in the city has been dropping rapidly since the start of 2013, falling from 9.9 percent in January to 7.7 percent in April. This welcome improvement follows a four-year period during which the local unemployment rate remained disturbingly close to nine or ten percent.

Even though employment is strong, wage growth is not, largely because of the disappearance of middle income jobs, as discussed in our report in December, 2012. Also, not all sectors are participating in the upturn, particularly the high-paying securities industry. This sector lost 2,500 jobs in 2012 and employment reports through

April indicate that Wall Street is poised to shed a similar number of jobs in 2013. The weakness of finance employment indicates that finance firms are trying to bulk up profits by squeezing payroll costs. The stalled finance sector could depress local wages and incomes, and slow the city's recovery.

The city's plan expects that a stalled Wall Street sector, together with fiscal drag emanating from the federal budget, will slow the city's economic growth. Gross city product (GCP) growth drops to 1.1 percent in 2013 from 2.3 percent in 2012, after which growth falls to 0.7 percent in 2014. Strong and steady output growth of 2.4 percent resumes in 2015.

### **Tax Revenues**

The city's FY 2013 tax collection plan soared by \$1.3 billion since June, with most of the increase becoming evident only after April receipts were tabulated. The real property tax yielded an extra \$144 million and the nonproperty taxes surged by \$1.2 billion, as shown in the figure to the right. Compared with the previous year, the real property tax grew by 3.4 percent in FY 2013, down from 6.4 percent growth in FY 2012. The nonproperty taxes grew by 10 percent in FY 2013, up from four percent in FY 2012.

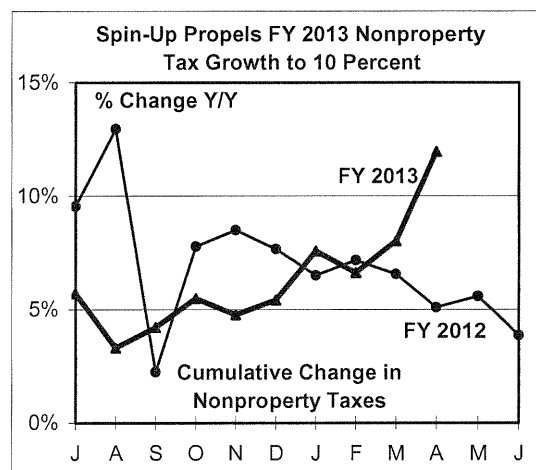
The real property tax improved by \$144 million to \$18.6 billion, since the budget was adopted. Most of the improvement occurred in the May modification, which noted an increase of \$121 million for the property tax. Relatively small improvements of \$10 million and \$13 million were reported in the city's January and November plan modifications, respectively. The extra property tax revenue derives from improved collections and reduced contingency reserves. Lien sales produced \$21 million in extra revenue, while collections on overdue tax bills yielded \$35 million. A drop in delinquency produced \$25 million. Refunds and cancellations reserves, which are set aside to resolve assessment disputes, were lower than the June plan by \$30 million and \$15 million, respectively. A reserve set aside to subsidize the rents of senior citizens and tenants with disabilities proved to be \$25 million more costly than originally projected.

Nonproperty tax collections improved by \$1.2 billion to \$24.9 billion since the start of FY 2013. Nearly all the improvement in the nonproperty taxes was realized in the May modification, with an increase of \$915 million in these taxes. Previously, these taxes improved by \$217 million in the January modification and by \$68 million in the November modification. A strong collection of bank taxes early in the year motivated the small November upturn. In January a large spin-up of tax receipts was anticipated because of a surge in transactions at the end of 2012 to avoid impending tax increases. The true magnitude of the surge in tax collections was not really known until April tax payments were tallied.

<b>FY 2013 Tax Projection</b>	
<b>Is Up \$1.3 Billion Since June Plan</b>	
(\$ in millions)	
<b>Property Tax</b>	<b>\$144</b>
<b>Nonproperty Taxes</b>	<b>\$1,200</b>
Personal Income	\$639
Sales	7
General Corporation	37
Banking Corporation	242
Unincorporated Business	(3)
Commercial Rent	(1)
Property Transfer	144
Mortgage Recording	110
Utility	(23)
Hotel	36
Cigarette	(4)
Other	15
<b>Tax Revenue Increase</b>	<b>\$1,344</b>
Notes: Excludes STAR and audit programs.	
Numbers may not add due to rounding.	

The personal income tax, which was the prime beneficiary of the spin-up, improved by \$639 million since June and accounted for more than half of the \$1.2 billion of the nonproperty tax collections surge. Similarly, the property transfer and mortgage recording taxes, which benefitted from a rush to close on real estate sales in the last quarter of CY 2012, are higher by \$144 million and \$110 million, respectively. A \$242 million improvement of banking corporation tax collections is linked to the Federal Reserve's continued downward pressure on interest rates in order to spur bank lending. Stronger business and finance industry profits drove up general corporation tax receipts by \$37 million, while \$36 million in extra hotel taxes is an indicator of the strength of local tourism. The utility tax, which fell by \$23 million, is one of the few local taxes that failed to improve over FY 2013.

The nonproperty taxes have been increasing for three years since pulling out of the revenue slump of the recession. The figure, 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 2013 has been climbing uncertainly throughout the year. This contrasts with the trend toward slower growth in FY 2012. Through December, it appeared that FY 2013 growth was set to top out at just five percent, which was only slightly better than the final growth rate of four percent at the close of FY 2012. Growth accelerated to eight percent in January as the spin-up began to be felt in stronger personal income tax and property transactions taxes. Another surge occurred in March as the business taxes strengthened. The true magnitude of the spin-up finally became apparent in April as the tax growth rate soared to 12 percent, led by soaring personal income tax receipts. By the end of FY 2013, the city estimates that the tax growth rate will level off at 10 percent, which is far better than the lackluster four percent growth of FY 2012, but not quite as strong as the 13 percent growth rate in FY 2011 at the start of the recovery. The city expects the nonproperty taxes to fall by three percent in FY 2014 as a result of the fiscal drag emanating from Washington and the spin-down of local tax collections from the surge in the current year.



## Sales Tax

Fueled by strong gains in jobs and tourism, and a modest advance in income, the FY 2013 sales tax forecast increased 4.2 percent from the prior year, on a continuing base.<sup>2</sup> Since budget adoption last June, the FY 2013 sales tax estimate hardly changed and is expected to exceed \$6 billion by year's end. Despite a higher payroll tax rate that went into effect in January, households continued to pay down debt, but reduced

<sup>2</sup> "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.

savings to fund purchases and repair property damaged in Hurricane Sandy. While consumer confidence wavered at times during the year, households are benefitting from an improving economy in terms of higher prices for stocks and real estate, and job creation.

One reason for optimism concerns local private sector employment, which rose by 85,000 in 2012 and 94,000 in 2011. The city projects job growth will moderate to a more sustainable level of 54,000 in 2013. Sales tax revenue in FY 2013 also increased because of tourist-based consumption. The city estimated that a record 52 million people visited in 2012 and spent \$36.9 billion. There was also a broader economic impact of \$55.3 billion, which positively influenced hotel occupancy, room rates, and employment in the leisure and hospitality industry. The city believes that in 2012 its share of the overseas tourist market grew to 33 percent, where each percentage point increase in market share represents an additional \$750 million in direct spending by tourists.

### **Personal Income Tax**

In FY 2013 the city estimates that personal income tax collections leaped 13.4 percent, on a continuing base, largely due to taxpayers shifting income and transactions that generate capital gains into 2012 from 2013 in order to avoid higher federal taxes. These actions caused a spike in personal income tax revenue in FY 2013 at the expense of collections in FY 2014, and possibly FY 2015. In addition to the movement of wage and nonwage income into 2012, FY 2013 also benefitted from robust job growth and improvements in nonfinance sector wages.

The spin-up in FY 2013 was first estimated by the city at \$180 million, but the latest projection is \$540 million on a personal income tax base of \$9.1 billion. To put this event into perspective, extension payments submitted by city residents by the fourth week of April 2013 were \$1.27 billion. Historically, for the same time frame, extension payments ranged from \$300 million to \$800 million during FYs 2009-12, but reached \$1.24 billion by the fourth week of April in FY 2008. Besides extension payments, withholding collections were amplified by the movement of compensation to the end of 2012, which included cash and deferred stock from bonuses, and commissions from real estate transactions.

While taxpayers were adjusting their behavior to lower their liability, New York Stock Exchange member firms appeared to be reaching back to better days, and earned \$23.9 billion in 2012, which represented \$16.2 billion more than was earned in 2011. Yet, these firms are still under pressure to lower costs, which may include more layoffs, and increase revenues, now that the mortgage refinance boom is losing steam. In addition, there were several issues in FY 2013 that will also influence subsequent fiscal years, which included: higher capital requirements, more federal regulation, mortgage-related litigation, instability in the eurozone, and an exit strategy by the Federal Reserve.

### **Miscellaneous Revenue**

The city's FY 2013 miscellaneous revenue estimate declined by \$691.3 million to \$4.6 billion in the May modification since the start of the year, and fell 11.8 percent from

FY 2012. Most of the \$691.3 million variance can be traced to fewer nonrecurring resources used in FY 2013 than planned at adoption, when the sale of taxi medallions was part of the FY 2013 miscellaneous revenue forecast.<sup>3</sup> In a separate issue, the city determined that the amount of revenue lost due to Hurricane Sandy was \$51 million, which reduced collections from fines, parking meters, and towing.

Yet, if we focus on areas within miscellaneous revenue that sponsor recurring growth, then the FY 2013 forecast for the six core categories increased by \$58.3 million to \$2.8 billion within the year, despite slippage in the projections for fees, fines, and interest.<sup>4</sup> Among these three core categories, the largest intra-year drop was \$30.1 million in charges for services to \$856.7 million. The projected decrease was spread among numerous agencies despite extra proceeds from housing fees. On a positive note in FY 2013, license revenue was up \$25.5 million to \$576.7 million, largely due to more construction permits. Additional rent from city-owned residential and commercial properties, along with legal settlements and property sales, helped boost collections in the rental income and miscellaneous categories, respectively.

## **EXPENDITURES**

Our review of FY 2013 points to how the city addressed its fiscal challenges, while at the same time maintaining its ability to produce surplus funds. For FY 2013, the city used \$2.4 billion in surplus funds from FY 2012 to achieve a balanced adopted budget. With most of those surplus funds used to prepay FY 2013 debt service, the adopted budget projected just \$124 million of surplus funds. As FY 2013 moved forward, the city faced a number of issues. In October, a hurricane of historical proportions swept through the city and much of the northeast causing billions of dollars in damage. In addition, a court order stopped the sale of 2,000 new taxi medallions and deferred the revenue expected to be collected in FY 2013 to FYs 2014-17. Further troubles occurred when failure to reach an agreement on a teacher evaluation plan resulted in the loss of state education aid. Even with these fiscal challenges, the city was able to build up more surplus funds in FY 2013. Moreover, the city will be able to start FY 2014 with a projected surplus and also allocate extra funds to the general reserve to deal with any unexpected events that may occur in the fiscal year.

At the release of the November modification, the city faced a setback. Due to a legal challenge, an expected sale of new taxi medallions, which was projected to yield

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<sup>3</sup> Even though the proposal to sell taxi medallions was a FY 2013 initiative, ongoing litigation over the state law that allowed the sale of 2,000 handicapped accessible taxi medallions and borough taxis, has caused the asset sales to be shifted into FYs 2014-17. The city expects to succeed on appeal, and raise \$300 million in FY 2014, \$400 million in FY 2015, \$360 million in FY 2016, and \$400 million in FY 2017 from the medallions.

<sup>4</sup> Core category revenue consists of six types of revenue: licenses, 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.

\$635 million in FY 2013 and was part of the FY 2013 gap-closing actions, was deferred to the outyears of the financial plan. On top of this, additional agency spending of \$135 million was required. With a budget gap to contend with, the city took actions quickly by implementing an early gap-closing program of \$555 million. This is the second consecutive fiscal year in which such early gap-closing actions were needed to address an unexpected budget shortfall in a current fiscal year. What is more, around the same time the city was faced with extensive damage following Hurricane Sandy. While the cost of damage was just beginning to be tallied and would eventually be quantified at about \$4.5 billion, a strong cash balance of about \$5 billion allowed the city to immediately respond with a massive cleanup, repair, and rebuilding effort.

In the January modification, another issue developed. An impasse between the United Federation of Teachers (UFT) and the city over a teacher evaluation plan resulted in the forfeiture of extra education aid from the state. The state was to give an increase in education aid to each city school district that reached an agreement with its teachers' union on an evaluation plan by the state mandated date. The city and UFT had failed to meet this deadline, which made the city ineligible for a funding increase of \$250 million in FY 2013. This loss of aid would be baselined for the life of the financial plan. To replace the loss of state aid, the Department of Education (DOE) took a number of nonrecurring actions in FY 2013 and identified recurring actions over the life of the financial plan that would address the loss starting in FY 2014. The actions included the attrition of pedagogical positions.<sup>5</sup>

In new developments, the state has set a new deadline for submission of an evaluation plan. Since an agreement on a plan between the city and UFT was not reached, a binding arbitration process was initiated, presided over by the State Education Department, and the state imposed a plan on June 1, 2013. Under these new terms and as long as the evaluation plan is implemented, the city will remain eligible for annual state education aid increases; thus the state will restore funding to the outyears of the financial plan starting in FY 2014.

Also in the January modification, the costs associated with Hurricane Sandy for cleanup, overtime, and rebuilding were tabulated. The city estimates total damage at nearly \$4.5 billion, which is expected to be fully covered by federal funds. In spite of the loss of state education aid, deferred revenue from the sale of new taxi medallions, and cash outlays for Sandy, the city's fiscal picture improved greatly. The city was able to build up additional surplus funds of \$961 million. To produce much of the extra surplus, the city applied reserves no longer needed from its general reserve and had written down prior-year payables, which added \$200 million and \$500 million, respectively. Also, higher projected revenue added \$239 million.

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<sup>5</sup> A description of the DOE actions can be read in the March 14, 2013 FCB Staff Report starting on page 21. Since the January modification, the state has restored most of the education funding for FY 2014 and beyond. Based on these state actions, the city will restore for FY 2014 1,842 teaching and 224 part-time positions, plus 101 non-teaching titles that were to be reduced.

In the May modification, the city projects an additional \$1.1 billion of surplus funds will come from a higher than expected tax revenue forecast plus extra audit revenue. With the surge in revenue, the city now projects a significantly higher surplus of nearly \$2.2 billion for FY 2013, an increase of more than \$2 billion over the FY 2013 adopted budget projection. The much higher surplus will allow the city to prepay FY 2014 debt service and also start a surplus in FY 2014 of \$142 million. The city has also prudently allocated an additional \$150 million to its FY 2014 general reserve on top of the \$300 million already budgeted. This will position the city to deal with any unforeseen issues in FY 2014 (e.g. unreimbursed costs related to Hurricane Sandy).

In the figure to the right, we examine in greater detail how the city built up additional surplus funds in FY 2013. As shown, the adopted budget assumed just \$124 million of surplus funds. The city's FY 2013 tax collection is expected to improve significantly by \$1.3 billion. Higher estimates have also been made for tax audits that are expected to add \$336 million. However, the deferred sale of 2,000 new taxi medallions has shifted \$635 million out of \$1.46 billion of total proceeds to the outyears of the financial plan. Also, the city estimates that its nontax revenue will decrease by \$152 million. To offset some of this revenue loss, the city initiated another gap-closing program. The revenue component of this action is projected to increase agency revenue collection by \$109 million. The impact of the deferred taxi revenue and the decline in nontax revenue produce a net revenue increase of \$994 million, as shown in the figure.

<b>FY 2013 Surplus Funds</b> City Funds (\$ in millions)	
<b>Beginning Surplus</b>	<b>\$124</b>
<b>Revenue – Inc / (Dec)</b>	
Tax Forecast	\$1,336
Tax Audit	336
PEG	109
Nontax	(152)
Taxi Medallions	(635)
<b>Subtotal</b>	<b>\$994</b>
<b>Expense – Inc / (Dec)</b>	
Prior Payables/Reserve	(\$760)
PEG	(446)
Miscellaneous	(120)
Debt Service	(64)
Agency New Needs	223
Pension Costs	124
<b>Subtotal</b>	<b>(\$1,043)</b>
<b>Surplus Increase</b>	<b>\$2,037</b>
<b>Ending Surplus</b>	<b>\$2,161</b>

On the expense side, routine savings of \$760 million make up the bulk of funds contributing to additional surplus funds. The city wrote down \$500 million for claims from prior periods (known as prior-year payables) and reduced by \$260 million the general reserve. Notable, is the city's ability to manage a number of fiscal difficulties in FY 2013 and still be able to designate these funds to the surplus. Other expenditure savings contributing to the increase of the surplus total \$120 million. The city recognized \$11 million from a reduction to its healthcare premium rate, \$97 million for energy cost savings, and \$12 million in other miscellaneous expense savings. Also, debt service is expected to decline by \$64 million.<sup>6</sup> However, new spending needs in citywide agencies of \$223 million and higher pension costs of \$124 million, associated with the latest valuation update made by the City Actuary, will reduce the total savings to a net \$1.043 billion.

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<sup>6</sup> The reduction of \$64 million does not account for additional debt service savings that were included as part of the city's agency program. With the inclusion of the additional savings, city-funded debt service costs declined by \$70 million. For a full discussion of debt service costs refer to "Debt Service Savings" starting on page 14.



As mentioned earlier, the city experienced a budget shortfall of \$555 million in the November modification, which was dealt with by implementing an early agency program or Program to Eliminate the Gap (PEG). The city's PEG has been an effective gap-closing tool. In FY 2013, the PEG totaled \$555 million, which is comprised of higher revenue collection of \$109 million and \$446 million of spending cuts. The PEG was reduced slightly to \$537 million due to restorations and is preceded by earlier PEGs dating back to before FY 2008. In total, the PEG has reduced FY 2013 expenditures by \$6.3 billion.

With savings anticipated from the PEG, higher projected revenue collection, and other expenditure savings, the May modification estimates additional surplus funds of more than \$2 billion. The total surplus of \$2.2 billion, which includes a surplus of \$124 million from FY 2012, will be used to prepay FY 2014 debt service and library subsidies. The city will also increase the general reserve in FY 2014 by \$150 million, bringing the reserve to \$450 million. We remain cautious of the city's fiscal condition over the life of the financial plan. In the current modification, FY 2014 will be balanced using the FY 2013 surplus plus \$31 million of surplus funds from FY 2012. Also factored in is \$1 billion of PEGs. The city is projecting just \$142 million of additional surplus funds to address a FY 2015 budget shortfall that stands at \$2.2 billion. Although FY 2013 started with only \$124 million in surplus funds and the city was able to build up the funds to balance FY 2014, the city will have to again manage the budget in a way to build up a surplus to deal with projected outyear budget gaps.

For FY 2014, the city remains committed to using the remaining \$1 billion of reserve funds from the Retiree Health Benefits Trust fund, which leaves the retiree health benefits liability of more than \$88 billion completely unfunded and which is expected to continue to grow by about \$5 billion each fiscal year. Furthermore, the city will need to address two major issues in FY 2014, the sale of new taxi medallions that may or may not take place, and potential new contract agreements with its labor unions. Currently, there are no new labor contracts between the city and its workforce. For any new labor deals, the city is assuming no retroactive payments and a wage freeze for the first three years of a five-year contract deal with wage increases of 1.25 percent in the last two years of the contract.

## **Debt Service Savings**

In the city's May modification, debt service cost for FY 2013 was revised downward by \$16 million compared to the January modification. Including these savings, the projected debt service for the city and the New York City Transitional Finance Authority (NYCTFA) has been reduced by a total \$124 million over the course of the fiscal year to \$6 billion. The amount of debt service cost being paid from the city's tax revenues is reduced by \$70 million to \$5.64 billion, and categorical noncity funds serving to offset the remaining \$358 million are lower by \$54 million, as shown in the figure to the right.<sup>7</sup> We believe that at the current projected level there is an upside potential for debt service savings of roughly \$165 million that will result from the recognition of interest savings on the city's variable rate general obligation (g.o.) debt.

FY 2013 City and NYCTFA Debt Service Savings (\$ in millions)			
	Adopted Budget	May Modification	Savings
City	\$4,314	\$4,252	(\$62)
NYCTFA	1,804	1,742	(62)
<b>Total-Funded</b>	<b>\$6,118</b>	<b>\$5,994</b>	<b>(\$124)</b>
NonCity Offset	(\$412)	(\$358)	\$54
<b>City-Funded</b>	<b>\$5,706</b>	<b>\$5,636</b>	<b>(\$70)</b>

In the May modification, the city has deviated from its past practice of recognizing interest savings on its outstanding variable rate g.o. bonds. Typically, the city makes conservative assumptions in forecasting interest costs on variable rate instruments, and then recognizes the savings in the financial plan as they are realized. Interest on 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 upper limits set as high as 25 percent in some cases.<sup>8</sup> The FY 2013 Adopted Budget assumed variable rates of 2.45 percent on tax-exempt and 4.50 percent on taxable city g.o. debt for costs totaling \$178 million; and the current modification applies a similarly conservative interest rate assumption to a larger outstanding amount for costs totaling \$182 million. Meanwhile, in citing the attractiveness of variable rate debt, the city in its current Message of the Mayor notes that short-term interest rates relating to city and NYCTFA floating rate debt have been 0.20 percent on average for tax-exempt and 0.60 percent for taxable bonds outstanding during FY 2013. Applying these actual rates to the \$7.3 billion of city variable rate bonds upon which the financial plan projection is based, we calculate that variable rate interest costs in FY 2013 could be substantially lower than that included in the modification by approximately \$165 million.<sup>9</sup>

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<sup>7</sup> The relatively small noncity-funded component of debt service is comprised of swap receipts, state budget aid and federal subsidies.

<sup>8</sup> Statutorily, the amount of variable rate debt that the city may carry cannot exceed 25 percent of the constitutional debt authority for g.o. bonds. With \$7.96 billion of outstanding variable rate debt, the city is well within its current variable rate debt limit of \$19.21 billion.

<sup>9</sup> Approximately three-quarters of the actual variable rate interest costs for FY 2013 on NYCTFA bonds have been recognized in the May modification.

While carrying floating rate securities reduces the cost of financing for the city and the NYCTFA, it is important to note that certain events can trigger increased variable rate costs. One such event would be a limitation on or an elimination of the federal tax exemption for municipal bond interest, as part of the various IRS tax code changes being considered. Indeed, the President's proposed FFY 2014 budget imposes a 28 percent tax-benefit cap on tax-exempt interest, applicable to variable as well as fixed rate bonds. Moreover, this provision could be made to apply to existing tax-exempt securities, not just new issuances. Such an unprecedented move would result in higher interest rates that investors would demand of municipal borrowers in general to purchase their bonds. To minimize its variable rate exposure, the city and NYCTFA use conservative assumptions in budgeting expenses related to such instruments.<sup>10</sup>

The federal government has set a precedent in altering its funding in support of municipal infrastructure investment. Indeed, the May modification reflects scheduled nationwide cuts in interest subsidies for direct-pay bonds as part of the federal across-the-board automatic spending cuts, known as sequestration, that went into effect in March. Under the sequestration guidelines, interest subsidies payable to the city and the NYCTFA related to taxable Build America Bonds, Recovery Zone Development Bonds and Qualified School Construction Bonds are cut by 8.7 percent from March 1, 2013 through October 1, 2013 and 7.3 percent thereafter.<sup>11</sup> The partial-year impact for FY 2013 on the direct-pay bonds totaling \$4.4 billion for the city and \$4.1 billion for the NYCTFA is nominal at \$2 million, given that most of the subsidies for the city's fiscal year had been received already, but increases to \$17 million in FY 2014. The federal cut in the subsidies has triggered an uncertainty, causing some other jurisdictions to refund these affected taxable bonds with tax-exempt securities. The city has not announced any such refunding.

Through the May modification, the city and NYCTFA have sold a combined \$3.7 billion of traditional refunding bonds in FY 2013. The majority of the bonds were sold at a high premium, as investors are willing to pay considerably above par in exchange for receiving relatively high coupons of four and five percent. This allowed for the net proceeds to retire a larger \$4.1 billion of bonds. Even at relatively high coupons, the refundings have generated \$567 million in savings over the life of the bonds, with most of the savings occurring in the plan years, as recognized in the May modification, and no dissaving in any year. Additionally, with some prices reaching over 120, reflecting the high coupons, the yields being realized represent historical lows. For example, the 20-year yield on the October 2012 city g.o. bond sale at 3.18 percent was the lowest since FY 1981, when we began keeping record, in both absolute terms and relative to the corresponding Bond Buyer 20-Bond Index. Correspondingly, the net present value of

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<sup>10</sup> In projecting variable rate interest costs for the outyears of the current plan, the city used various interest rate assumptions, some of which are as high as six percent. The city reviews its assumptions regularly and makes revisions to keep them conservative relative to prevailing interest rates.

<sup>11</sup> The taxable interest expense was subsidized by the federal government at a rate of 35 percent for the Build America Bonds, 45 percent for the Recovery Zone Development Bonds and 100 percent for the Qualified School Construction Bonds.

the refunding savings has been averaging over 12 percent of the refunded bonds.<sup>12</sup> Meanwhile, the high coupon bonds are potential candidates for future refundings.

Given investors' interest, a significant portion of the new money bonds sold in FY 2013 by the city and NYCTFA has also been high premium bonds. The four and five percent on these premium bonds still fall below the flat 6.28 percent and 6.08 percent used in the financial plan for the projection of future city and NYCTFA debt service costs, respectively. A by-product of the premium bonds is that less bonds need to be sold to support capital spending, which offsets the cost of the above-market-rate coupons on premium bonds that are used in the calculation of actual debt service costs. In fact, in the city's long-term financing program, the combined sale of bonds in FY 2013 totaling \$4.61 billion is less than capital spending totaling \$5.05 billion, with the drawdown of restricted cash from surplus net proceeds making up the difference. As an alternative, the premium could be used to support higher levels of capital spending for the city, effectively foregoing debt service savings.<sup>13</sup>

With a lift in tax revenue collection projected for FY 2013 in the May modification, the debt service burden has improved over the course of the fiscal year. As can be seen in the figure to the right, the FY 2013 debt service ratio declined from an estimated 13.1 percent of tax revenues since the start of the fiscal year, benefiting more from \$1.7 billion of additional tax revenues that materialized than the \$70 million of city-funded savings. Adding the potential \$165 million of debt service savings on variable rate securities, the burden could drop further to 12.1 percent. Nonetheless, compared to recent years, the debt service burden is continuing on an upward trajectory, increasing from 11.0 percent in FY 2009 to 11.8 percent in FY 2011, and possibly 12.1 percent in FY 2013.

FY 2013 City-Funded Debt Service as Percent of Tax Revenues (\$ in millions)			
	Adopted Budget	May Modification	Change
City-Funded DS	\$5,706	\$5,636	(\$70)
Tax Revenues	43,644	45,328	1,684
City-Funded DS as % of Tax Revenues	13.1%	12.4%	

<sup>12</sup> As a guideline, the city has established three percent as the minimum level for net present value savings as a ratio of the refunded bonds.

<sup>13</sup> The city has recently published its Ten-Year Capital Strategy for FYs 2014-23, which we will review in detail in our July 2013 report.

## **Glossary of Acronyms**

<b>CPI</b>	Consumer Price Index
<b>CY</b>	Calendar Year
<b>DOE</b>	Department of Education
<b>FCB</b>	Financial Control Board
<b>FFY</b>	Federal Fiscal Year
<b>FY</b>	Fiscal Year
<b>GCP</b>	Gross City Product
<b>GDP</b>	Gross Domestic Product
<b>G.O. Bonds</b>	General Obligation Bonds
<b>HHC</b>	Health and Hospitals Corporation
<b>IRS</b>	Internal Revenue Service
<b>LIBOR</b>	London Interbank Offered Rate
<b>NYCTFA</b>	New York City Transitional Finance Authority
<b>PEG</b>	Program to Eliminate the Gap
<b>STAR</b>	School Tax Relief Program
<b>UFT</b>	United Federation of Teachers