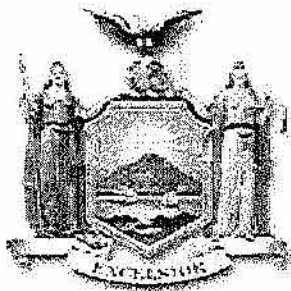


Staff Report

**NOVEMBER MODIFICATION**

**FYs 2010 - 2013**

December 16, 2009



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## I. Overview

The November Modification to the FYs 2010-13 Financial Plan was technical in nature and reflects changes that have occurred since the June adoption of the budget. The city's focus was on the current fiscal year with few adjustments made to the outyear forecast.

Encouraged by signs of a less severe local downturn, the city has begun the process of augmenting its revenue plan, and was able to put \$539 million into the Budget Stabilization Account to start to deal with the previously projected \$4.9 billion FY 2011 budget gap. While most sectors of the local economy are still in decline, a stronger stock market and a recovering financial sector have enabled the city to raise its tax forecast by \$525 million in FY 2010. Despite this improved revenue outlook, total FY 2010 tax revenue remains stagnant at the depressed level achieved in FY 2009, down seven percent from FY 2008.

The strongest projected gains in taxes are from the personal income tax, bank tax, and unincorporated business tax. These taxes greatly benefitted from the recovery of the securities and banking sectors. We expect that there is an upside potential for these taxes in FY 2010 mainly due to extremely high securities industry profits in 2009. The city is wise to wait until later in the fiscal year to determine the exact size of this potential upside. There are still many uncertainties on how the fiscal year will play out. While we expect high bonus payments in the securities industry, it is still difficult to determine what impact federal pressure to control compensation will have on tax collections. Our assessment, at this time, is that nonproperty tax collections could be higher by \$400 million in FY 2010.

While FY 2010 seems to be balanced, the city still faces large budget gaps in FY 2011 and beyond without the over \$5 billion of prior-year surpluses used to balance past budgets. The financial plan shows remaining budget deficits totaling \$4.1 billion in FY 2011, \$4.9 billion in FY 2012, and \$5.6 billion in FY 2013. Our evaluation indicates that the gaps could be higher by \$716 million in FY 2011, \$844 million in FY 2012, and \$969 million in FY 2013. The current year could have an additional surplus of \$324 million. While we see the potential for additional nonproperty tax revenue in each year of the financial plan, we caution that even as the nonproperty taxes gain strength in the unfolding economic recovery, the property tax could lag behind and drag down revenue growth. This will become clearer when the preliminary tax roll is released in January. Our other risks mainly center on the need to reach agreements with labor unions on savings in healthcare and pension costs.

While unable to quantify at this time, the city's FY 2011 budget will probably be impacted by whatever actions the State takes to close its large budget deficit. The impact on the city will remain uncertain until the Governor submits the Executive Budget and the legislature acts. Given the risks and uncertainties, the city was prudent to request that agencies start to prepare plans to reduce expenditures starting in FY 2010 by \$550 million and growing to \$1.2 billion annually in the outyears. We expect that these proposals will be included in the January modification and Preliminary Budget for FY 2011.

**NOVEMBER MODIFICATION:  
THE CITY'S OPERATING PROJECTIONS FOR  
FISCAL YEARS 2010-2013**

TABLE 1 (\$ in millions)

	FY 2010	FY 2011	FY 2012	FY 2013
<b><u>Revenues</u></b>				
<b>Taxes:</b>				
General Property	\$16,016	\$17,100	\$17,690	\$18,078
Other Taxes	19,183	20,316	21,791	23,091
Discretionary Transfers	0	—	—	—
Debt Defeasance	0	—	—	—
Tax Audit Revenue	746	596	595	594
Anticipated Tax Program	0	0	0	0
Sale of Property Tax Liens	48	40	40	40
Miscellaneous Revenues	7,298	6,793	6,833	6,872
Unrestricted Intergovernmental Aid	340	340	340	340
Interfund Revenues	486	453	443	443
Less: Intracity Revenues	(1,768)	(1,565)	(1,568)	(1,572)
Disallowances	(15)	(15)	(15)	(15)
Total City, Capital IFA & Other Cat. Funds	\$42,334	\$44,058	\$46,149	\$47,871
Federal Categorical Grants	7,256	6,454	5,382	5,370
State Categorical Grants	11,518	11,926	12,386	13,059
Total Revenues	<u>\$61,108</u>	<u>\$62,438</u>	<u>\$63,917</u>	<u>\$66,300</u>
<b><u>Expenditures</u></b>				
Personal Service	\$36,634	\$37,049	\$36,980	\$39,011
Other Than Personal Service	25,709	25,760	26,883	27,577
General Obligation, Lease & TFA Debt Service	5,233	5,576	6,225	6,541
General Obligation & TFA Debt Defeasances	(2,726)	—	—	—
Budget Stabilization & Prepayments	(2,274)	(539)	—	—
General Reserve	300	300	300	300
Subtotal	\$62,876	\$68,146	\$70,388	\$73,429
Less: Intracity Expenditures	(1,768)	(1,565)	(1,568)	(1,572)
Total Expenditures	<u>\$61,108</u>	<u>\$66,581</u>	<u>\$68,820</u>	<u>\$71,857</u>
<b><u>Gap To Be Closed</u></b>	<u>\$0</u>	<u>(\$4,143)</u>	<u>(\$4,903)</u>	<u>(\$5,557)</u>

**CHANGES TO THE CITY'S OPERATING PROJECTIONS FOR  
FISCAL YEARS 2010-2013  
JUNE FINANCIAL PLAN COMPARED TO NOVEMBER MODIFICATION**

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

	FY 2010	FY 2011	FY 2012	FY 2013
<b>Revenues</b>				
<b>Taxes:</b>				
General Property	(\$8)	(\$8)	(\$7)	(\$7)
Other Taxes	2,348	885	950	983
Discretionary Transfers	(546)	0	--	--
Debt Defeasance	(382)	0	--	--
Tax Audit Revenue	150	0	0	0
Anticipated Tax Program	(879)	(877)	(943)	(976)
Sale of Property Tax Liens	0	0	0	0
Miscellaneous Revenues	272	49	50	49
Unrestricted Intergovernmental Aid	0	0	0	0
Interfund Revenues	0	0	0	0
Less: Intracity Revenues	(99)	18	18	18
Disallowances	0	0	0	0
Total City, Capital IFA & Other Cat. Funds	\$856	\$67	\$68	\$67
Federal Categorical Grants	656	65	27	26
State Categorical Grants	6	(49)	6	25
<b>Total Revenues</b>	<b>\$1,518</b>	<b>\$83</b>	<b>\$101</b>	<b>\$118</b>
<b>Expenditures</b>				
Personal Service	\$480	\$35	\$4	(\$18)
Other Than Personal Service	644	(14)	14	31
General Obligation, Lease & TFA Debt Service	936	(199)	(26)	11
General Obligation & TFA Debt Defeasances	(413)	--	--	--
Budget Stabilization & Prepayments	(10)	(539)	--	--
General Reserve	0	0	0	0
Subtotal	\$1,617	(\$717)	(\$8)	\$24
Less: Intracity Expenditures	(99)	18	18	18
<b>Total Expenditures</b>	<b>\$1,518</b>	<b>(\$699)</b>	<b>\$10</b>	<b>\$42</b>
<b>Gap To Be Closed</b>	<b>\$0</b>	<b>\$782</b>	<b>\$91</b>	<b>\$76</b>

# RISKS TO THE FINANCIAL PLAN

TABLE 3

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

	FY 2010	FY 2011	FY 2012	FY 2013
<b>Stated Financial Plan Gap</b>	<b>\$0</b>	<b>(\$4,143)</b>	<b>(\$4,903)</b>	<b>(\$5,557)</b>
<b>Estimation</b>				
Nonproperty Taxes	\$400	\$300	\$300	\$300
Property Tax	0	(300)	(400)	(500)
Miscellaneous Revenue	50	125	125	125
Uniformed Services Overtime	(119)	(126)	(124)	(124)
<b>Subtotal</b>	<b>\$331</b>	<b>(\$1)</b>	<b>(\$99)</b>	<b>(\$199)</b>
<b>Implementation</b>				
Pollution Remediation	\$0	(\$176)	(\$176)	(\$176)
<b>Subtotal</b>	<b>\$0</b>	<b>(\$176)</b>	<b>(\$176)</b>	<b>(\$176)</b>
<b>Not in Mayor's Control</b>				
10% Premium Contribution	\$0	(\$357)	(\$388)	(\$418)
Tier V Pension Legislation	19	(182)	(183)	(176)
Aid and Incentives to Municipalities	(26)	0	0	0
<b>Subtotal</b>	<b>(\$7)</b>	<b>(\$539)</b>	<b>(\$569)</b>	<b>(\$594)</b>
<b>Risk Total</b>	<b>\$324</b>	<b>(\$716)</b>	<b>(\$844)</b>	<b>(\$969)</b>
<b>Total FCB Estimated Surplus/(Gap)</b>	<b>\$324</b>	<b>(\$4,859)</b>	<b>(\$5,747)</b>	<b>(\$6,526)</b>
Note: The city has set aside \$300 million in a general reserve in each of FYs 2010-2013				



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

Encouraged by signs of a less severe local downturn, the city has begun the process of augmenting its revenue plan. While most sectors of the local economy are still in decline, a stronger stock market and a recovering financial sector have enabled the city to raise its tax forecast by \$525 million. Despite the improved revenue outlook, total FY 2010 tax revenue remains stagnant at the depressed collection level achieved in FY 2009. Because of the improved outlook for taxes and other revenues, the city increased FY 2010 revenues by \$1.5 billion, but has not yet made any substantive changes to its outyear revenue forecast.

With the additional \$1.5 billion of revenues, the city funded \$979 million of new operating needs and started to build the Budget Stabilization Account (BSA) with the remaining \$539 million. The BSA will be fully depleted with the prepayment of \$539 million of FY 2011 debt service costs. The financial plan shows remaining budget gaps totaling \$4.1 billion in FY 2011, \$4.9 billion in FY 2012 and \$5.6 billion in FY 2013. Our evaluation indicates that the gaps could be larger by \$716 million in FY 2011, \$844 million in FY 2012 and \$969 million in FY 2013, while the current-year budget could improve further by \$324 million.

Approximately \$600 million of the annual budgetary risks we identified relate to labor savings, which have not yet been achieved. Specifically, the city is seeking long-term recurring savings in healthcare by asking for a 10 percent employee contribution, which no union has agreed to. Additionally, the city is requesting a Tier V in the pension systems for newly hired employees, for which only the United Federation of Teachers union has agreed. Since release of the financial plan, the state legislature passed a pension reform bill that implements the Tier V for newly hired teachers.

To begin to address the multi-billion dollar budget gaps, the city has asked agency heads to identify spending reductions and revenue enhancements to generate \$550 million in budget savings in FY 2010 and \$1.2 billion annually thereafter. A detailed plan will be presented in the January modification and Preliminary Budget for FY 2011.

The city has not called for reductions in its capital program to generate savings to the sizeable and growing debt service expense. However, to address the budget deficits, the city and New York City Transitional Finance Authority have seized opportunities to undertake bond refundings and have incorporated \$200 million of savings for FY 2011 that are generated from refinancings. We believe that the city may be able to achieve additional annual savings, while marginal in nature, by exercising some financing options.

### **REVENUES**

The city increased its revenue estimate by \$1.5 billion to \$61.1 billion, since June when the FY 2010 budget was adopted. City-funded revenues increase by \$746 million to \$40.7 billion, largely due to strengthening tax collections. A stronger stock market and a recovering financial sector have enabled the city to increase its tax estimate by

\$525 million. This improvement brings total FY 2010 tax collections to \$36 billion, which approximately equals the amount collected in FY 2009. All of the gains in tax collections are due to the nonproperty taxes, particularly the business and personal income taxes. For the outyears, the gains in the nonproperty taxes will be linked to the staying power of the recovery in the securities and banking industries.

The FY 2010 revenue changes, which were presented in the November modification, are summarized in the figure to the right. Taxes improve by \$525 million, largely due to stronger business and personal income tax collections. Additionally, an ongoing audit collections effort will yield an extra \$150 million. Miscellaneous revenue increased by \$63 million, largely due to higher fees. The city added \$8 million by reestimating the state-funded School Tax Relief (STAR) program. This aid category is offset by an equivalent reduction in city property taxes, benefitting city homeowners. Categorical grants, which are funded by state, federal and private sources, increased by nearly \$772 million. These grant increases account for about half of the \$1.5 billion improvement in total city revenue.

Wall Street Recovery Lifts FY 2010 Revenues (\$ in millions)	
Taxes	\$525
Audit Revenue	150
Miscellaneous Revenue	63
STAR Aid	8
<b>City Funds</b>	<b>\$746</b>
Categorical Aid	772
<b>Total Change in Revenues</b>	<b>\$1,518</b>

### **Wall Street Recovery Mitigates the Local Recession**

A stronger stock market and the economic stimulus program have sparked a nascent recovery in the city's financial services industry. However, despite the upturn in this sector, local employment and the city's real estate industry are still in decline. The upturn on Wall Street and the resumption of national economic growth have enabled the city to formulate a less severe economic plan. The city added \$533 million to its plan for FY 2010 nonproperty tax collections. But despite the added revenue, the nonproperty taxes are still down 6.5 percent in FY 2010.

The city's economic plan indicates a less severe downturn than had been previously projected. In the city's plan, national output, as measured by gross domestic product (GDP), bottoms out with a decline of 2.5 percent in 2009. This represents a one percentage point improvement compared with the steeper 3.5 percent slide in the city's earlier forecast. The city projects a sluggish recovery, with GDP growth of two percent in 2010, three percent in 2011 and 3.8 percent in 2012. The city does not see any employment growth until 2011, late into the recovery phase. The national job count falls by 3.8 percent in 2009, and continues to fall by an additional 0.7 percent in 2010, even while GDP is staging a recovery.

For the local economy, the city projects job losses of 81,000 (a decline of 2.1 percent) in 2009, followed by 103,000 additional lost jobs (a drop of 2.8 percent) in 2010. Weak projected job growth remains below 50,000 jobs per year throughout the city's plan. As grim as this forecast is, it is far less severe than the city's previous forecast, which had projected that local job losses would reach 328,000.

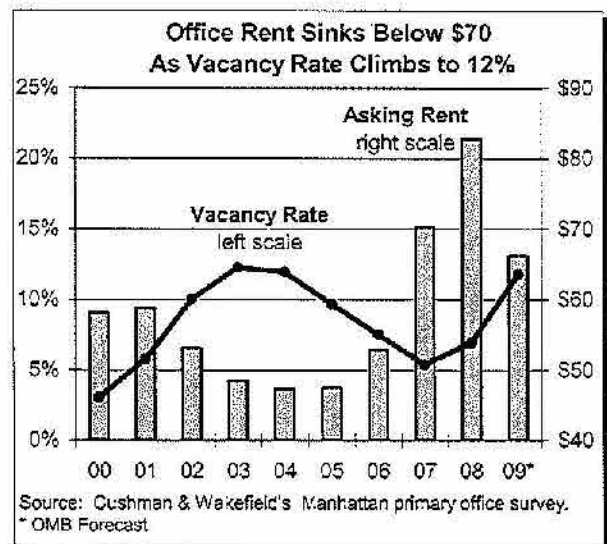
The local economic slide is less severe primarily because of the recovery of the city's financial services industry. The major banks, which had absorbed punishing

losses in mortgage-backed securities and other failed investments, were rescued by federal intervention. The federal intervention sparked a rally on Wall Street, which has produced nearly \$50 billion in profits, in the first three quarters of 2009, for the city-centered securities industry. Dependent as it is on the volatile stock market, the local recovery is narrowly focused and fragile.

The city's labor market is a grave concern. Local employment fell by 110,000 jobs (a decline of 2.9 percent), as of October compared with the previous year. Also as of October, the local unemployment rate increased to 10.3 percent from 6.3 percent in the previous year. Securities jobs are down by about 30,000 since the peak of August 2007; however, the securities industry job count appears to be stabilizing at about 160,000. The leisure and hospitality industry, which had produced jobs at a rate exceeding 10,000 jobs per year in 2007 and 2008, is starting to shed jobs. Despite the downturn in other sectors, jobs are being added in the education and health services industry at the rate of about 16,000 per year.

The real estate industry is another major concern, both nationally and locally. The National Association of Realtors reports that a big sales gain in October, for the nation, marks a continuation of an uptrend established over the past seven months. The real estate recovery is strongly linked to the federal homebuyer tax credit program, which was recently extended until April 2010. Rising mortgage delinquencies, however, threaten to undermine any emerging recovery in both the real estate sector and the banking sector. The Mortgage Bankers Association reports that residential delinquencies increased to a record 9.6 percent in the third quarter of 2009, up from seven percent in the previous year.

Closer to home, the Manhattan office market is undergoing a stressful period with vacancies climbing and rents falling. As shown in the figure to the right, the office vacancy rate increased to an estimated 12 percent in 2009 from seven percent in 2008. The glut of available space forced down asking rents to about \$66 in 2009 from \$83 in the previous year. These disturbing trends indicate that property assessments could fall and weaken the city's property tax growth plan in FY 2011 and beyond.



The local economic downturn is discussed in a recent paper published by the Federal Reserve Bank of New York. The authors find that the slide in local economic activity may have leveled off in July, following a precipitous fall of 4.9 percent in the 12 months ending June 2009. Despite this hopeful conclusion, the authors express concern that a "downsizing of the area's critical finance sector could pose a major risk to the economic outlook going forward—

particularly for New York City.”<sup>1</sup> It is also possible that the July results were bumped up by the very successful summer youth employment program. Federal stimulus funds were used to place approximately 60,000 youths in temporary summer jobs, in the city and the state, but these jobs disappeared in September.

### **Tax Revenue**

The city increased its tax revenue estimate for FY 2010 by \$525 million, as shown in the figure to the right. The strongest gains are for the personal income tax, which increased by \$292 million, and the banking corporation and the unincorporated business taxes, which improved by \$150 million and \$100 million, respectively. All of these taxes greatly benefitted from the recovery of the securities and banking sectors. Smaller gains of \$20 million were reported for each of the commercial rent and hotel taxes. The minor taxes added \$41 million, mostly due to larger payments in lieu of taxes scheduled for Battery Park City and the Economic Development Corporation.

Changes in the FY 2010 Tax Revenue Projections Since Adoption (\$ in millions)	
General Property Tax	(\$8)
Personal Income	292
Banking Corporation	150
Unincorporated Business	100
Commercial Rent	20
Property Transfer	(47)
Mortgage Recording	(27)
Hotel	20
Utility	(16)
Other	41
<b>Total Tax Changes</b>	<b>\$525</b>

The extra \$525 million that the city added is a first increment to possible future revenue gains that the city will acknowledge as the local recovery widens and becomes more secure. Our analysis indicates a potential for additional nonproperty tax revenue of \$400 million in FY 2010 and \$300 million in each of FYs 2011-2013, as shown on Table 3 on page 4. We caution that even as the nonproperty taxes gain strength in the unfolding economic recovery, the property tax could lag behind and drag down revenue growth. We estimate a property tax risk of \$300 million in FY 2011, \$400 million in FY 2012, and \$500 million in FY 2013. As part of the state's deficit reduction plan to deal with its current fiscal problems, aid to municipalities across the state was reduced. As a result, the city will lose \$26 million in Aid and Incentives to Municipalities in FY 2010. The state believes this reduction may be offset by other state initiatives such as a tax amnesty program.

**Real Property Tax.** The \$8 million reduction in the property tax is a technical correction to offset a corresponding increase in STAR aid, and implies no current downturn in property tax collections. The slippage of property transactions taxes, which fell by \$74 million, could present the city with a far more serious budgetary challenge. The retreat of the transfer and mortgage taxes indicates that the real estate slump is not over and the real property tax could weaken.

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<sup>1</sup> See Jason Bram, James Orr, Robert Rich, Rae Rosen, and Joseph Song "Is the Worst Over? Economic Indexes and the Course of the Recession in New York and New Jersey" Federal Reserve Bank of New York *Current Issues in Economics and Finance* Volume 13, Number 5, September 2009.



Because of the size of the property tax, which yields \$16.1 billion in FY 2010, any shortfall of the property tax revenue targets could present the city with major budgetary difficulties in FY 2011 and beyond. Property tax growth in the city's plan slows from 6.7 percent in FY 2011 to 3.4 percent in FY 2012 and 2.2 percent in FY 2013. However, the city will need to reevaluate its property tax revenue plan in January, following the release of the tentative tax roll for FY 2011. The slowdown in local property transactions coupled with the stress observed in the office market indicate that the assessment report could be weaker than anticipated with negative consequences for future property tax growth.

**Business Taxes.** Collections for this group of taxes, consisting of the general corporation tax, the banking corporation tax and the unincorporated business tax, have benefited from the resurgence of the banking industry, which is gradually returning to profitability, and the securities industry, which has netted nearly \$50 billion in profits in the first three quarters of 2009. Additionally, national pretax corporate profits surged from \$1.246 trillion in the first quarter of 2009 to \$1.493 trillion in the third quarter, for a gain of 20 percent in the half-year period. Thus, the tax base is primed for a recovery of the business taxes.

Since June, the city has increased its revenue plan for the business taxes by \$250 million to \$4.4 billion in FY 2010. Despite this increase, these taxes fall by 16 percent in FY 2010. This decline follows a 10 percent drop in FY 2008 and a further four percent decline in FY 2009. In FY 2011, the city projects a weak recovery with five percent growth, after which revenue growth firms up with increases of 13 percent in FY 2012 and seven percent in FY 2013.

Of all the city's taxes, the banking corporation tax has experienced the most extreme volatility. Bank tax collections reached a peak of \$1.2 billion in FY 2007 with a surge of 86 percent. Revenues abruptly plummeted by 48 percent in FY 2008, when the banking industry was faced with huge losses related to the write-down of mortgage-backed securities. Federal intervention to rescue the large banks enabled bank tax collections to bounce back with a 75 percent spurt in FY 2009. The city projects that this tax will fall by nearly 40 percent in FY 2010, to \$674 million. This weak outlook reflects the great difficulty of forecasting a most unstable and volatile revenue source. Despite its return to profitability, the banking industry is still faced with many difficult challenges. The industry has yet to complete the task of extricating itself from the federal bailout program. The banks may face increased regulatory oversight, and the industry may experience further restructuring and downsizing.

Business tax refund issuance is a serious concern. The city issued an unprecedented \$884 million in business tax refunds in FY 2009. In a continuation of this adverse trend, the city has issued \$149 million in refunds in just the first two months of FY 2010, an amount which matches the accelerated pace of the previous year. If refunds continue at this high level, the city may have to increase its refund reserve and limit its revenue goals for the business taxes. Despite this refund problem, we see the potential for extra revenue from the business taxes.

**Property Transaction Taxes.** The city has reduced its FY 2010 revenue projection for the two property transactions taxes by \$74 million, to \$1 billion. Following a peak

revenue yield of \$3.3 billion in FY 2007, the property transfer and the mortgage recording taxes dropped by 23 percent in FY 2008 and plummeted by an additional 51 percent in FY 2009. The city sees these taxes falling by 19 percent in FY 2010, after which revenues bounce back with growth of 18 percent in FY 2011, nine percent in FY 2012, and 14 percent in FY 2013.

Thus far in the first four months of FY 2010, transaction tax collections have dropped by 50 percent compared with the previous year, which is far more negative than the city's estimate of minus 19 percent. These numbers suggest that the local real estate sector has not yet pulled out of its three-year slide. This ongoing slide puts at risk the already downsized transactions tax revenue targets. More seriously, the shrinkage of these property-related taxes indicates that the city's plan for property tax growth in FYs 2011-2013 may need to be reevaluated.

**Sales Tax.** The FY 2010 sales tax estimate is \$4.8 billion or 4.2 percent year-over-year growth, which includes \$650 million from the sales tax portion of the tax program that was authorized by the state legislature in August.<sup>2</sup> The city's outlook for the sales tax in FY 2010 and the outyears is unchanged from adoption. With the extra revenue provided by the tax program, the city has time to gather more information about consumer spending habits (e.g. holiday shopping season) and the local economy (e.g. job losses and year-end bonus payouts from the securities industry).

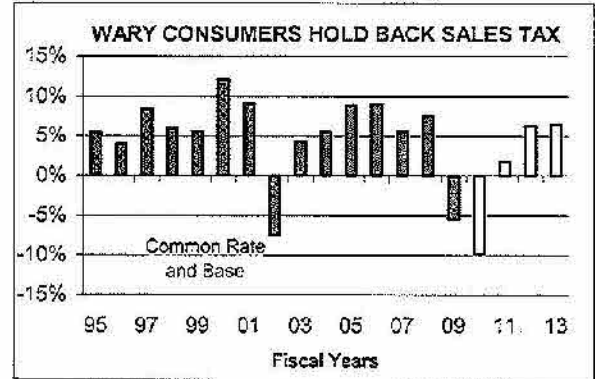
With only one quarter's worth of sales tax collection data, on a common rate and base, September sales tax collections for the city fell by 15.4 percent from the prior year while the state's sales tax receipts declined by 7.9 percent in the same period.<sup>3</sup> Faced with a weak job market, tight credit, sinking home values, rising home delinquencies and foreclosures, consumers have remained focused on paying down debt and purchasing necessities. The recent improvement in consumer spending was largely tied to the federal stimulus package that included the Cash-for-Clunkers program and the \$8,000 tax credit for first-time homebuyers. It remains to be seen whether consumer sentiment will improve and discretionary spending will be sustained without federal programs.

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<sup>2</sup> The tax program was comprised of a business tax conformity package and the following changes to the sales tax: removal of the exemption on purchases of clothing and footwear priced at and above \$110, a rate hike of 0.5 percent, and the city taxation of the transmission and distribution of electricity and natural gas from alternative energy suppliers. The value of the sales tax program is projected at \$745 million in FY 2011, \$790 million in FY 2012, and \$836 million in FY 2013.

<sup>3</sup> "On a continuing base" or "on a common rate and base" refers to tax collections that have been adjusted to remove the effects of tax programs and other adjustments to focus on the influence of the economy.

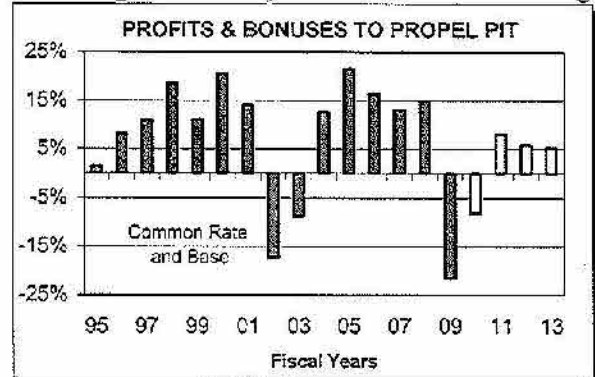
If the extra revenue from the tax program is removed from the city's sales tax forecast, collections on a common rate and base are expected to fall to a negative 9.8 percent in FY 2010 after having slid to a negative 5.5 percent in FY 2009. The figure to the right also shows that the city is anticipating a very weak recovery in FY 2011 of 1.8 percent growth before revenue soars by over six percent in both FYs 2012 and 2013.



The striking improvement in the outyear sales tax forecast is because of the city's assumption of job gains of 14,000 in 2011 and 49,000 in 2012 after job losses of 81,000 in 2009 and 103,000 in 2010. As a result of the new jobs, total wage income is expected to grow 3.3 percent in 2011 and 4.9 percent in 2012 to \$284.7 billion after two years of declining wages in 2009 and 2010. Finance sector compensation, including bonus payouts, is expected to support overall wage income growth starting in 2011 with four percent annual growth after three years of falling earnings from 2008 to 2010. From its lowest point in the forecast period in 2010 to the peak in 2013, finance sector compensation is anticipated to rise by \$12.9 billion, or 18.5 percent, to \$82.7 billion in 2013.

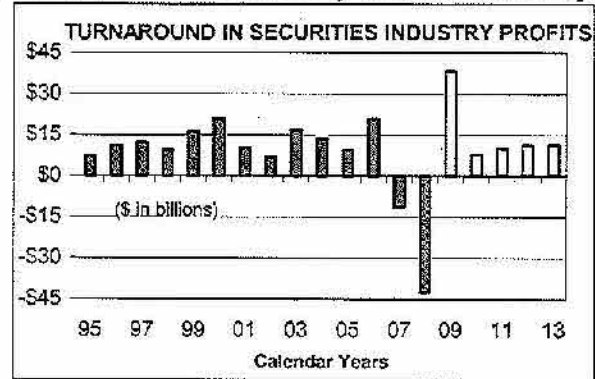
**Personal Income Tax.** Compared with the June financial plan, the city has raised the FY 2010 personal income tax (PIT) estimate by \$292 million to \$6.3 billion and has left the forecast for FYs 2011-13 untouched. The improvement in the FY 2010 PIT estimate is likely due to unprecedented profitability in the securities industry so far in 2009, after the disaster in 2008, rather than from evidence of a revival in either local or national employment. For example, compared with last October, there were 109,900 fewer jobs in the city, where the financial sector shed 32,500 jobs (21,600 from the securities subsector), and 29,400 jobs were lost from the related professional and business services sector.

PIT revenue in FY 2009 plummeted to a negative 21.5 percent, on a continuing base, as firms in the financial industry imploded (i.e. Bear Stearns, Lehman Brothers) when defaults on residential mortgages rose, which led to the freezing up of the credit and debt markets, and the sharp slide in the stock market. As a result, New York Stock Exchange (NYSE) member firms lost \$42.6 billion in 2008. The figure to the right shows the city's latest PIT forecast, on a common rate and base, of a further dive in collections to a negative 8.1 percent in FY 2010, but a rebound in employment and income starting at the



end of 2010 causes positive revenue growth of eight percent in FY 2011, 5.8 percent in FY 2012 and 5.2 percent in FY 2013.<sup>4</sup>

The city projects that profits in the securities industry will reach a record \$38.4 billion in 2009, drop to \$7.8 billion in 2010, and thereafter rise steadily to \$11.4 billion by 2013, as seen in the figure to the right. We believe that the \$292 million plan-to-plan variance can be considered a down payment on further improvements in the PIT forecast for two reasons. First, profits for NYSE member firms for the first three quarters of 2009 total \$49.7 billion. To give us some perspective on profits in the securities industry, the figure to the right shows that for several years profits were under \$10 billion annually, exceeded \$15 billion only four times (1999, 2000, 2003, and 2006) and reached the \$20 billion plateau on two occasions (2000 and 2006). In the past, despite challenging business conditions, employee compensation in the securities industry did not suffer to the same degree as profits due to a desire by firms to retain employees and comply with employment contracts.



However, compensation practices in 2009 will be different than in past years because there are seven companies remaining in the Troubled Asset Relief Program, who face limitations on executive compensation.<sup>5</sup> These firms have constraints on the total amount of employee compensation and on its composition, i.e. the allocation between base salaries, cash bonuses, and stock options tied to long-term company performance. While there are bank holding companies and other financial services firms that have no such restrictions on compensation, because they have paid back the federal government, the total boost to withholding revenue in the December through March period may be less than it otherwise would have been without the restrictions on bonus payouts.

Second, firms in the securities industry, whose balance sheets were not weighed down to the same degree by mortgage- and other asset-backed debt and loans, were able to more quickly get back to the traditional lines of business that include making markets, being primary dealers of government debt, trading, and asset/wealth management.

<sup>4</sup> From peak-to-trough the city expects job losses of 219,000 from the fourth quarter of 2008 to the third quarter of 2010. The financial sector may shed 61,000 jobs from the first quarter of 2008 to the third quarter of 2010, which include job losses of 36,000 from the securities subsector during the same time period. After declining by 10.8 percent in 2009, total wage income is expected by the city to be essentially flat in 2010 at about \$263 billion before growing by 3.3 percent in 2011. Three years of slumping finance sector compensation from 2008 to 2010 undercut total wage earnings until 2011 with an anticipated year-to-year gain of four percent to \$72.6 billion.

<sup>5</sup> Recently, Bank of America and Citigroup announced plans to raise private capital to repay the federal government.



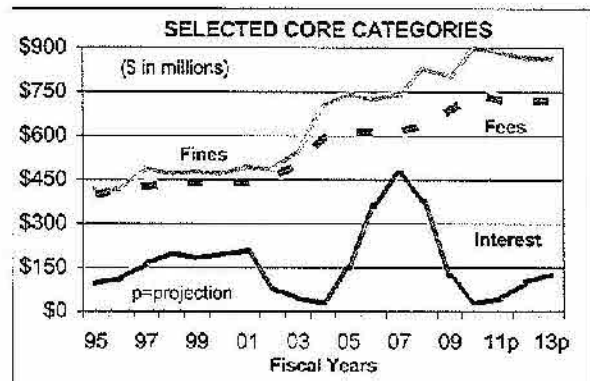
These companies were able to take advantage of a unique set of circumstances in 2009 (that may continue into 2010), which is characterized by fewer competitors, billion-dollar programs created by the Federal Reserve to increase liquidity and encourage lending to businesses and consumers, and very low short-term interest rates that significantly reduced interest costs. All in all, it is likely that finance sector compensation in FY 2010 will exceed the prior year and boost withholding revenue and the final settlement in April. PIT collections may also benefit if capital gains realizations in 2009 turn out to be less negative than the city expects due to the recent appreciation in the stock market.

### Miscellaneous Revenue

Since adoption, the city has increased the FY 2010 miscellaneous revenue projection by over \$60 million to \$4.4 billion, which represents a fall of 5.6 percent from the prior year. If we exclude those parts of the miscellaneous revenue forecast that do not foster long-term growth and budget balance, and focus on the remaining core categories, miscellaneous revenue is estimated to decline by 0.4 percent on a year-to-year basis to \$2.6 billion in FY 2010 and remain at that level during FYs 2011-13.<sup>6</sup> In the November modification, the \$60 million plan-to-plan variance can be traced to higher tuition and fees at colleges within the City University of New York (CUNY) in each year of FYs 2010-13.

Of the six core categories, only charges and fines are projected to end FY 2010 ahead, while interest income is expected to plunge to levels not seen since FYs 2003 and 2004.<sup>7</sup> The figure below shows the relative scale and importance of these three core categories. Interest income, defined by a target range of 0 to 0.25 percent for the federal funds rate that is set by the Federal Reserve and less cash available for short-term investment, is expected to fall by \$94.3 million, or 76.1 percent, from FY 2009 to \$29.6 million in FY 2010, and increase to \$43.2 million in FY 2011. Only in FY 2013 are interest earnings forecast to exceed the \$100 million mark due to city expectations of higher tax revenue and interest rates.

Augmented by higher college tuition and fees, charge revenue is projected to grow by \$50.4 million, or 7.3 percent, from the prior year to \$737.5 million in FY 2010 and moderate to \$723 million in each of FYs 2011-13. After FY 2010, fee revenue is sustained by CUNY tuition (\$262 million), garage and meter fees (\$152 million), and fire inspections



<sup>6</sup> The core categories are licenses, fees or charges, interest, rent, fines, and a residual miscellaneous category. It excludes nonrecurring resources, tobacco proceeds, and payments from the Health and Hospitals Corporation. Revenues tied to programmatic expenditures, such as water and sewer charges, are also omitted from the analysis because they cannot be used to achieve budget balance.

<sup>7</sup> During FYs 2003-04, interest earnings remained in the \$30 million to \$40 million range.

(\$98 million). Fines are projected to leap by \$97.1 million, or 12.1 percent, in FY 2010 to \$899.3 million on a year-over-year basis and exceed \$863 million annually from FY 2011 to FY 2013. During the plan period from FY 2010 through FY 2013, annual fine revenue is supported by the enforcement of violations related to parking (\$680 million), the environment (\$75 million), health (\$43 million), and a new initiative to collect on outstanding debt with data mining techniques, with an improved process. We expect that as FY 2010 progresses, the projections for the core categories will be increased by \$50 million in FY 2010 and \$125 million in each of FYs 2011-13.

## **EXPENDITURE HIGHLIGHTS**

In the November modification, the city uses the additional \$1.5 billion of revenues it expects to collect in FY 2010 to support \$979 million of new operating needs and to start funding the Budget Stabilization Account (BSA) with the remaining \$539 million, which is allocated to prepay FY 2011 debt service costs. Beyond FY 2010, the city projects budget gaps of \$4.1 billion, \$4.9 billion and \$5.6 billion in FYs 2011-13, respectively. To address these multi-billion dollar gaps, the city has asked agency heads to identify spending cuts and revenue enhancements to generate \$550 million in budget savings in FY 2010 and \$1.2 billion annually thereafter. A detailed plan will be presented in the January modification and preliminary budget for FY 2011.

The city projects costs will rise in the current modification by \$1.5 billion from adoption, as shown in the figure to the right. Driving costs higher are expenditure increases in Other than Personal Service (OTPS), which is projected to rise by \$535 million. A large portion of the projected growth is in the Police and Fire Departments, which account for more than \$170 million of the increase and about \$180 million is accounted for in the Department of Homeless Services, the Department of Health and Mental Hygiene, and Youth and Community Development. The remaining increase in this area is scattered among city agencies like Education, City University, Transportation, and Emergency Management.

FY 2010 Expenditures Rise by \$1.5 Billion (\$ in millions)	
Change in BSA	\$539
OTPS	535
Personal Service	460
Medical & Public Assistance	109
Debt Service	(25)
Other	(100)
<b>Total Expenditure Increase</b>	<b>\$1,518</b>
(Reduce Expenditures) / Increase Expenditures	

Of the \$1.5 billion of expenditure increases, nearly one-third, or \$460 million, is anticipated to be related to extra spending in Personal Service with \$317 million funding higher wage costs, which are driven by collective bargaining settlements. The city also expects to pay more for fringe benefits and has allocated an additional \$143 million to this area while projecting that pension costs will remain flat. The city has also raised its estimates for public assistance spending by \$100 million and medical spending by \$9 million.

Over the life of the financial plan, from FY 2010 to FY 2013, total city expenditures are forecasted to climb by 17.8 percent from \$60.6 billion to \$71.4 billion (excluding intra-city and inter-fund expenditures), which is an average annual growth rate of 5.6 percent, or an increase of \$10.8 billion. Much of this growth is due to increased spending for employee fringe benefits and pension funding. As mentioned,

fringe benefits will jump by \$143 million in FY 2010 and increase significantly from FY 2012 to FY 2013 by \$933 million, or 13.8 percent, though that increase is due to a technical adjustment for the restoration of a planned drawdown of the Retiree Healthcare Benefits Trust in FY 2013. However, while pension costs have been reduced slightly by a cumulative \$141 million from FY 2011 to FY 2013 since the adopted budget, these costs increase by about \$862 million over the life of the plan. The increase in the city's pension bill is the result of investment losses of 5.4 percent in FY 2008 and 18.3 percent in FY 2009. Additionally, changes in the Federal Medical Assistance Percentages (FMAP) rates enacted by the federal government as part of its stimulus package enabled the city to reduce expenditures for Medicaid from October 2009 to December 2011 by \$1.6 billion of which \$850 million was received in FY 2010 and \$295 million in FY 2011. The impact of the federal stimulus funding was of major significance in bringing the FY 2010 budget into balance; however, medical assistance spending is expected to revert to its historical growth rate of three percent after FY 2011 when the stimulus funding ends.

### **Agency Program**

In September 2007, the city asked all agencies to reduce their expenditures by finding recurring spending reductions or revenue increases (if applicable for the agency) in order to address an impending budget shortfall induced by a steep decline in city tax revenues. Since January 2008, the city has targeted recurring total savings of more than \$2.9 billion in FY 2010, about \$3.4 billion in FY 2011, and \$3.3 billion in each of FYs 2012 and 2013, after restorations. Nonetheless, more reductions are necessary as the city faces challenges ahead. In a letter on November 16 to all agency heads, the city is seeking additional savings beyond those already identified to deal with projected multi-billion dollar budget gaps in each of FYs 2011 to 2013.

Although there has been a portion of the city's Program to Eliminate the Gap (PEG) or agency program restored or reversed (\$766 million for FY 2010 and \$202 million in each of FYs 2011 to 2013), many of the PEGs identified have been fully implemented. For example in FY 2010, more than \$256 million of savings have been identified as having been fully implemented, which represents about 19 percent of the nearly \$1.4 billion in core agency PEGs. The city identifies core PEGs as those that exceed \$5 million. Thus, more than half of the nearly \$3 billion worth of PEGs for the fiscal year have effectively reduced the budget.

TABLE 4

**TOTAL AGENCY PROGRAM SINCE JANUARY 2008 FOR FYs 2010-13**  
 (\$ in millions)

Agency Category	FY 2010	FY 2011	FY 2012	FY 2013
Uniformed Services	(\$635)	(\$582)	(\$514)	(\$526)
Health and Welfare	(438)	(428)	(411)	(411)
Mayoral	(434)	(456)	(471)	(475)
Major Organizations	(1,206)	(1,101)	(1,089)	(1,089)
Elected Officials	(43)	(82)	(62)	(62)
All Other	(431)	(441)	(485)	(485)
<b>Total Expense PEG</b>	<b>(\$3,187)</b>	<b>(\$3,070)</b>	<b>(\$3,032)</b>	<b>(\$3,048)</b>
<b>Total Revenue PEG</b>	<b>(543)</b>	<b>(557)</b>	<b>(497)</b>	<b>(495)</b>
<b>Total Program*</b>	<b>(\$3,730)</b>	<b>(\$3,627)</b>	<b>(\$3,529)</b>	<b>(\$3,543)</b>
<b>Restorations</b>	<b>766</b>	<b>202</b>	<b>202</b>	<b>202</b>
<b>Total Agency Savings</b>	<b>(\$2,964)</b>	<b>(\$3,425)</b>	<b>(\$3,327)</b>	<b>(\$3,341)</b>
(Negative) numbers decrease the gap. *Before adjustments for restorations and reversals.				

The city's PEG or agency program is shown in Table 4. As illustrated, the agency heads had targeted more than \$3.7 billion of savings in FY 2010 and more than \$3.5 billion for the remaining years of the financial plan since starting the program in January 2008. Often in the process, the city restores or reverses some of those cuts. For FY 2010, the city has restored almost \$314 million of planned spending cuts in its FY 2010 Adopted Budget and another \$127 million in its November modification. Since January 2008, the city has restored PEGs totaling \$766 million (including \$325 million of prior restorations), reducing the agency program for FY 2010 to about \$2.9 billion, and has restored about \$200 million in cuts to each of FYs 2011 to 2013. Much of the restorations, \$120 million worth, have been redirected back to the Police Department because the department overestimated the savings it could produce from uniformed personnel attrition. The city expects that of the \$120 million to be restored, about one-half will be dedicated to overtime expenditures in the department. The remaining \$7 million is going back to the Department of Correction to meet a delay in planned PEG implementation.

As discussed, the city has asked for additional spending cuts to be identified for its preliminary FY 2011 budget to be released in January. For FY 2010, the city is asking for 1.5 percent in the Department of Education (DOE), two percent for uniformed services, and four percent for all other agencies. The city expects that with these cuts an additional \$550 million will be saved in the current fiscal year. The targets will increase to four percent for the DOE and the uniformed agencies and to eight percent for all other agencies for FY 2011. Those cuts are projected to be worth about \$1.2 billion annually.

#### Uniformed Overtime

For FY 2010, the November modification projects that city-funded expenditures for the four uniformed agencies (Police, Fire, Correction, and Sanitation) will total almost \$7.9 billion, which is 19 percent of city-funded expenditures of \$40.7 billion and 12.5 percent of all-funded expenditures of \$62.9 billion (includes intra-city expenditures). The departments are expected to generate cumulatively more than \$709 million in overtime expenditures, which will account for nine percent of total uniformed agency spending. About 87 percent of all uniformed overtime occurs within the ranks of



uniformed workers like police officers and firefighters. The FY 2010 budget projects total expenditures in this area to be \$615 million and the remaining \$94 million is dedicated to civilian workers. In FY 2009, the city spent \$785 million in total to cover all uniformed (uniformed and civilian) overtime spending. Since FY 2003, the city's uniformed agencies have topped \$700 million in overtime spending with FY 2008 exceeding \$800 million.

TABLE 5

**FYs 2010 to 2013 PROJECTED UNIFORMED SERVICES OVERTIME RISK**

(\$ in millions)

City Forecast	FY 2010	FY 2011	FY 2012	FY 2013
Police	\$373.3	\$390.4	\$390.3	\$390.6
Fire	200.9	182.8	182.6	182.5
Correction	75.3	65.7	66.1	66.1
Sanitation	59.8	64.3	65.3	65.3
<b>Total Overtime</b>	<b>\$709.4</b>	<b>\$703.2</b>	<b>\$704.3</b>	<b>\$704.5</b>
<b>FCB Projected Overtime</b>	<b>\$828.7</b>	<b>\$828.7</b>	<b>\$828.7</b>	<b>\$828.7</b>
<b>Risk to Budget</b>	<b>\$119.4</b>	<b>\$125.5</b>	<b>\$124.4</b>	<b>\$124.2</b>
Note: Totals include uniformed and civilian personnel. Numbers may not add due to rounding.				

In FY 2010, the city projects that the uniformed agencies will spend \$709.4 million in overtime, as shown in Table 5.<sup>8</sup> As first projected in the adopted budget, the city had planned to spend \$25 million less or \$684.4 million. The plan-to-plan increase is in the Fire and Correction Departments. The increase in projections is due to an adjustment in estimates of \$15 million for the Fire Department and a total of \$10 million for the Department of Correction. The Fire Department has raised its overtime estimates due to staffing issues and greater medical leave among its uniformed personnel. However, under union rules, the city has the ability to remove the fifth firefighter from the department's engine companies if the average annual medical leave crosses a certain threshold. Thus, the city will be able to save in future overtime spending.

Also, the Department of Correction reestimated its overtime budget by \$2.6 million and restored two PEG initiatives totaling \$7.4 million due to a delayed implementation. However, actual expenditures through November of \$345.3 million indicate that the agencies, collectively, will spend \$828.7 million or \$119.4 million more than budgeted. The city is reluctant to raise the overtime budget initially at adoption for fear of giving an invitation to increase spending and chooses to incrementally increase the budget with each modification. However, there is usually a deficit that needs to be funded by year end regardless of the budget adjustments. Hence, we will hold at risk \$119.4 million in FY 2010, \$125.5 million in FY 2011, \$124.4 million in FY 2012 and \$124.2 million in FY 2013.

<sup>8</sup> As mentioned in "Agency Program" on page 15, the city restored approximately \$60 million in anticipated overtime savings. This expenditure addition is not reflected in the November modification.

### Pension Costs

In its November modification, the city projects pension costs will remain relatively flat in comparison to adopted budget projections, with only small decreases of \$25 million, \$47 million, and \$69 million in FYs 2011 to 2013, respectively, while keeping FY 2010 the same. While pension costs have been only slightly modified, their ballooning costs, which start at \$6.7 billion in FY 2010 and climb to almost \$7.6 billion in FY 2013 or by about \$862 million or nearly 13 percent, will represent one of the largest growing components in the city's expense budget. Pension costs now represent a little more than 10 percent of the city's total expenditures in FY 2010 and stay at that ratio throughout the financial plan.

Pension costs have climbed in recent years because of investment losses stemming from prior fiscal years, new collective bargaining agreements, union settlements, and actuarial assumption changes. However, unexpected investment losses of 5.4 percent in FY 2008 and 18.29 percent in FY 2009 have caused the majority of the increase. The loss in FY 2008 has hit the city's budget in FY 2010 after a two-year lag in the phase-in and the severe loss suffered in FY 2009 will start to be phased-in in FY 2011, just as the city works to close a reported \$4.1 billion budget shortfall. The city has allocated considerable resources to deal with the losses (i.e. drawing down on the Retiree Health Benefits Trust (RHBT)), enough so that they were able to slightly reduce their estimates this fiscal year, but still they must deal with a growing expenditure they have little control over.

The New York City Retirement Systems (NYCRS) is comprised of the New York City Employees' Retirement System (NYCERS), the Teachers' Retirement System of the City of New York (TRS), the New York City Police Pension Fund, the New York City Fire Department Pension Fund, and the New York City Board of Education Retirement System (BERS). The pension systems hold assets that are primarily invested in equity securities (domestic and foreign), but also hold fixed income assets, real estate, private equity, alternative investment vehicles and cash. An asset's investment performance below the required rate of return of eight percent equates to a loss that the city must fund. Losses below, as well as gains above, eight percent are phased in over a six-year period. The phasing-in of investment losses and gains smoothes out investment returns over time.

For FY 2009, the systems realized an unexpected investment loss of 18.29 percent causing the market value of the assets held by the fund to fall by more than \$19 billion to a market value of \$85.6 billion from \$104.7 billion at the start of the fiscal year. On an actuarial basis, the decline is even more acute with losses totaling \$27.5 billion. The actuarial dollar loss represents the loss of 18.29 percent plus the dollar value of the eight percent required return. Thus, the aggregate return was a negative 26.3 percent. The city's pension system's long-term investment strategy has been to invest more heavily in equities. According to the city, major equity indexes such as the Russell 3000 (domestic equity) and the MSCI EAFE (international equity) were down by 26.6 percent and 31.4 percent, respectively. The economic downturn caused these major markets in FY 2009 to fall precipitously, thus causing much of the loss incurred by the pension fund.

Subsequently, the markets have swung back into positive territory pushing the pension systems' assets up by a considerable margin. We estimate, based upon current market performance from the start of the fiscal year through November 2009, that the pension systems have cumulatively yielded a 15.3 percent return, which is 7.3 percent above its required rate of return or actuarial rate of interest of eight percent. In dollar terms, the market value of the fund's assets has increased from \$85.6 billion to slightly greater than \$99 billion or \$13 billion (on an actuarial basis the increase is \$6.3 billion). Though this is a welcomed upturn, if market performance persists, the phase-in of these gains will not start until FY 2012 and will only be phased in by 15 percent.

As mentioned, the city is using the RHBT to offset investment losses. The city is also relying on the creation of a Tier V for all newly hired city employees that will yield recurring annual pension cost savings. In a recent development, the state legislature has passed the Governor's pension reform bill, which contains provisions that implement a Tier V agreement between the city and the United Federation of Teachers. The new tier will apply to all new hires and will require a 10-year vesting, employee contributions of 4.85 percent for the first 27 years of service and 1.85 percent thereafter, and a set annual return of seven percent on annuity accounts, which is 1.25 percent lower than before. The new tier is expected to yield pension cost savings of \$19 million in FY 2010, \$18 million in FY 2011, \$17 million in FY 2012, and \$24 million in FY 2013. The city projects that by FY 2019 total annual savings will be more than \$64 million. However, the city has no such agreements in place with its other major city unions, such as Police, Fire, and DC 37.<sup>9</sup>

### **Retiree Health Benefits Trust**

The Government Accounting Standards Board (GASB) established a set of new accounting rules in 2004 that require state and local governments to make more transparent to the public the total projected costs of paying Other Postemployment Benefits (OPEB) for current and retired employees by recognizing the liability on their balance sheet. In response, the city recognized a total liability of more than \$50.5 billion of future unfunded benefit payments and established the Retiree Health Benefits Trust to begin to address this growing liability.

As shown in the figure to the right, assets held in the RHBT have grown to \$3.1 billion in FY 2009 from an initial contribution of \$1 billion in FY 2006, another contribution totaling \$1.5 billion in FY 2007 and the accumulation of earned income on investments. Also, the city prepaid OPEB expenditures with \$460 million and \$225 million of surplus funds in FYs 2008 and 2009, respectively. However, in FY 2009, deductions of trust fund assets (which mainly consist of benefit payments) exceeded employer contributions

<b>RHBT Asset Changes FYs 2006-09</b> (\$ in millions)			
	Beginning of Year	Net Change	End of Year
FY 06	\$1,000	\$1	\$1,001
FY 07	\$1,001	\$1,594	\$2,595
FY 08	\$2,595	\$591	\$3,186
FY 09	\$3,186	(\$83)	\$3,103

<sup>9</sup> There may be future savings in the Police and Fire pension systems due to the Governor's veto of legislation allowing new hires to join the more lucrative Tier II of the pension system.

resulting in a decline of \$83 million in assets from the previous fiscal year. The reason for the decline in dollar value is twofold: the prepayment of \$460 million in FY 2008, which reduced the OPEB contribution made by the city to the trust fund in FY 2009 and changes in the assumptions on healthcare growth factors and attrition rates.

Upon the recognition of more than \$50.5 billion of unfunded OPEB liabilities, the city set forth to produce annual valuations to determine the changes in the OPEB liability in accordance with GASB rules, though GASB explicitly requires only the recognition of the liability. Unlike the city's pension plan, which requires annual employer contributions and an actuarial valuation, the city pays its OPEB costs as a pay-as-you-go expense through the RHBT.

#### SUMMARY OF UNFUNDED ACTUARIAL ACCRUED LIABILITY

TABLE 6 (\$ in millions)

	FY 2006	FY 2007	FY 2008	FY 2009
UAAL at Beginning of Fiscal Year	\$50,523	\$55,059	\$59,522	\$61,959
Normal Cost (Required Annual Contribution)	3,002	3,262	3,133	2,663
<b>Subtotal</b>	<b>\$53,525</b>	<b>\$58,321</b>	<b>\$62,655</b>	<b>\$64,622</b>
Interest @ 4%	2,141	2,333	2,506	2,585
OPEB Expense	(1,183)	(1,410)	(1,431)	(1,458)
RHBT Trust Contribution	(1,000)	(1,500)	0	0
OPEB Prepayment	0	0	(460)	(225)
<b>Subtotal</b>	<b>\$53,483</b>	<b>\$57,744</b>	<b>\$63,270</b>	<b>\$65,524</b>
Adjustments	1,576	1,778	(1,311)	0
<b>UAAL at End of Fiscal Year</b>	<b>\$55,059</b>	<b>\$59,522</b>	<b>\$61,959</b>	<b>\$65,524</b>

As presented in Table 6, the Unfunded Actuarial Accrued Liability (UAAL) for FY 2006 was \$53.5 billion after the normal cost or annual contribution the city would be required to make. Additional adjustments are made for interest income of four percent that would have been earned on the fully funded liability and reductions are made for pay-as-you-go OPEB expenses that are paid through the trust fund. Also, the UAAL has been reduced in FYs 2006 and 2007 by \$2.5 billion by trust fund contributions and prepayments of \$685 million in FYs 2008 and 2009. The UAAL is also adjusted for refinements, changes in Medicare Part B premium assumptions, collective bargaining, and other changes in valuation assumptions.

As shown in the table, the city reports that the UAAL has grown by \$15 billion to \$65.5 billion from \$50.5 billion, or nearly 30 percent, since the beginning of FY 2006 to the end of FY 2009. Though this is an alarming rate of growth, there is no consequence to the city's budget since the liability is not required to be funded at this time. However, this unfunded liability will continue to grow substantially and will eventually need to be addressed at a future interval. To put the numbers in perspective, the unfunded OPEB liability, which is now \$65.5 billion, exceeds total city expenditures for FY 2010 of \$62.9 billion by \$2.6 billion.

Further, at a 30 percent growth rate over the next four fiscal years, from FY 2009 to FY 2012, the UAAL would likely increase to about \$85 billion. We estimate that it will likely be much higher due to the growing cost of healthcare. The city actuary's FY 2009 OPEB valuation reflects a growth rate of nine percent for Pre-Medicare plans, six percent



for Medicare plans, and nine percent for Part B premiums. However, their projected growth rates fall to five percent in future fiscal years, which could be considered conservative given historical trends. Nevertheless, the city is not alone in its targets. According to a July 2009 report from the Center for State and Local Government Excellence, all actuarial reports for state retirement healthcare plans assume medical inflation will decline from the current level of 10 percent to 14 percent to a rate of four percent to five percent.

Unlike city employee pension benefits, which are fully protected by state law, the city does have the collective bargaining power to negotiate for reducing their OPEB payments. The city has made strides in one of these areas with the modification of the New York City Health Benefits Program. The city and the Municipal Labor Committee have agreed on a proposal to charge covered employees and retirees co-payments for certain medical services, which are expected to produce savings of \$200 million in each of FYs 2010 and 2011 and recurring annual savings of \$150 million thereafter. The city has also proposed in the adopted financial plan a 10 percent premium health insurance contribution. The savings of \$357 million were originally scheduled for FY 2010 but are now projected to start in FY 2011. The savings are expected to continue in subsequent fiscal years but no agreement has been made with city employees on this cost-containment initiative.

### **TRIMMING DEBT SERVICE COSTS AT THE MARGIN**

Debt service costs for the city and the New York City Transitional Finance Authority (NYCTFA) that will be paid from the city's tax revenues are projected to rise from \$4.6 billion in FY 2010 to \$6.5 billion in FY 2013, for an average annual growth rate of 12.1 percent. As illustrated in the figure to the right, debt service costs as a percent of tax revenues will increase from 12.9 percent in FY 2010 to 15.6 percent in FY 2013. Compared to the forecast made last June, the current debt service projections, which are net of prepayments, are lower in each of FYs 2010-12 by \$25 million, \$200 million and \$26 million, respectively, but higher in FY 2013 by \$11 million.

City and NYCTFA Debt Service as Percentage of Tax Revenue (\$ in millions)			
FY	Debt Service	Tax Revenue	Debt Service as Percent of Tax Revenue
2010	\$4,640	\$35,993	12.9%
2011	5,576	38,052	14.7%
2012	6,225	40,116	15.5%
2013	6,541	41,803	15.6%

While debt service is driven by the sale of bonds to support capital spending, bond refinancings and surplus revenues are used to reduce this expense. Indeed, the \$200 million reduction in FY 2011 debt service costs is being generated by the sale of refunding bonds. Meanwhile, debt service in FY 2010 has already been lowered by \$659 million to reflect the early retirement and defeasance of debt. This is different from the \$4.1 billion prepayment of FY 2010 debt service costs from surplus funds, which we continue to represent as a FY 2010 expense. The current plan also recognizes the materialization of a \$539 million surplus in FY 2010 that is deposited into the Budget Stabilization Account to be used to prepay FY 2011 debt service costs. Additionally, the city is taking other actions that may help to trim debt service at the margin.

### **Extended Authorization for the Sale of NYCTFA Bonds**

The sale of NYCTFA tax revenue bonds for general capital purposes had been used as a transitory component of the city's capital financing program from FY 1997 until FY 2007 when the NYCTFA exhausted a statutory \$13.5 billion bonding capacity. In July 2009, the NYCTFA received legislative authorization to issue additional debt to support the city's general capital program. The recent legislation permits the NYCTFA to have outstanding \$13.5 billion of future tax secured bonds, which are backed by the city's personal income and sales taxes. In addition, the NYCTFA is authorized to exceed this threshold provided that the amount of additional bonds, combined with outstanding general obligation (g.o.) debt, does not exceed the debt limit for the city. As of July 1, 2009, the city's debt limit was \$74.9 billion and the debt-incurring margin was \$27.7 billion.

With the NYCTFA's ongoing authorization to execute bond sales, the city now includes NYCTFA debt service costs in the financial plan. We have always incorporated these costs in our assessment of the full debt service to be paid from tax revenues.

The rationale for having the NYCTFA resume issuance of debt to support the city's capital program is that NYCTFA revenue bonds have a higher credit rating than city g.o. bonds, which has led to interest savings on past sales. The NYCTFA bonds are rated AAA by the Standard and Poor's Corporation, Aa2 by Moody's Investors Service and AA+ by Fitch Ratings. This compares to the AA, Aa3 and AA- ratings for city g.o. bonds from the three rating agencies, respectively.

The current financial plan assumes that the city will sell \$11.5 billion of g.o. bonds while the NYCTFA will sell \$11.3 billion of tax revenue bonds in FYs 2010-13 to fund capital expenditures. The debt service projections on these bonds assume the same interest rates will apply to the city and the NYCTFA bonds. The city historically has used conservative assumptions when projecting debt service costs to allow for the vagaries of the financial market. Debt service costs are calculated using a flat rate of 5.78 percent to 6.78 percent for bonds issued in FYs 2010-13. To the extent that actual rates are lower than projected, this would temper the increase in debt service costs for the outyears of the plan. In fact, a decline in interest costs could offset the \$11 million plan-to-plan increase in the debt service projection for FY 2013 that is based on an expectation of lower interest earnings on bond proceeds.

### **The Sale of Build America Bonds**

To minimize interest costs, the city and the NYCTFA have taken advantage of the Build America Bond (BAB) program created by the American Recovery and Reinvestment Act of 2009. The program authorizes state and local governments to issue BABs as taxable bonds in 2009 and 2010 to finance any capital expenditures for which they otherwise would issue tax-exempt bonds. State and local governments receive a direct federal subsidy payment of 35 percent of the total coupon interest paid to the BAB investors.

The city has sold \$800 million of BABs, while the NYCTFA has sold \$690 million. The city expects subsidy savings of \$259 million over the 25-year life of its BABs and the

NYCTFA expects savings of \$292 million over the 30-year life of its BABs. For the BABs sold by both the city and the NYCTFA, the taxable interest rates were lower than the financial plan assumptions for tax-exempt rates even before application of the federal interest subsidy. The BABs have been well received in the market and there is discussion of the probable extension of the federal authorization beyond 2010. The current financial plan includes no provision for future sales of BABs by the city and NYCTFA. However, since the release of the plan, the city has come to market with an additional \$561 million of BABs. Continued substitution of such sales for traditional tax-exempt bonds will yield budgetary savings.

#### **GASB 49**

The city is required to include the annual cost of pollution remediation in its expense budget instead of the capital budget beginning in FY 2011. The current financial plan does not reflect this requirement. The Financial Control Board had granted the city's request for a deferral of budgetary implementation of Statement 49 of the Government Accounting Standards Board (GASB), which requires government entities to account for specific pollution remediation costs in their expense budgets starting in FY 2009. The city had requested the deferral because implementation means that the city, unlike most other municipalities, cannot support operating expenditures with bond proceeds in accordance with the Financial Emergency Act, and the city needed more time to interpret and implement the new accounting standard. The deferral expires at the end of FY 2010. Accordingly, we have shown budgetary risks of \$176 million for each of FYs 2011-13, as that was the expenditure for pollution remediation in FY 2009 that was supported by g.o. bond proceeds as noted in the Comprehensive Annual Financial Report of the Comptroller (CAFR) for FY 2009.<sup>10</sup>

While these risks serve to exacerbate the city's outyear budget deficits, one would expect that capital spending will be lower by equivalent annual amounts starting in FY 2011. With commensurate annual reductions in borrowing, debt service costs will decrease. However, the debt service impact of cumulative reductions in borrowing will not be realized to any substantial degree until years beyond the plan.

#### **RISKS AND OFFSETS**

Our risk evaluation of the city's financial plan is shown in Table 3 on page 4. We project additional nonproperty tax revenue of \$400 million in FY 2010 and \$300 million in each of FYs 2011-13. We caution that even as the nonproperty taxes gain strength in the unfolding economic recovery, the property tax could lag behind and drag down revenue growth. We see a property tax risk of \$300 million in FY 2011, \$400 million in FY 2012, and \$500 million in FY 2013.

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<sup>10</sup> Additionally, \$60 million of proceeds from the sale of New York City Municipal Water Finance Authority revenue bonds were used to support pollution remediation related to environmental protection projects. Water Authority expenses are paid from user fees and are not a component of the city's operating budget.

We estimate that miscellaneous revenue may be higher than the city's plan by \$50 million in FY 2010 and \$125 million in each of FYs 2011 through 2013. We estimate that uniformed services overtime, based on our analysis and historical growth rates, will exceed what the city has budgeted by \$119 million in FY 2010, \$126 million in FY 2011 and \$124 million in each of FYs 2012 and 2013.

Additionally, the city has not allocated funding to cover operating expenditures for pollution remediation for each of FYs 2011-13. The CAFR identified such expense at \$176 million for FY 2009, when the city was allowed to issue bonds for this purpose. Beginning in FY 2011, the city is required to fund pollution remediation in its operating budget, as previously explained in the section of our report titled "GASB 49" beginning on page 23.

Meanwhile, the city is proposing that a 10 percent healthcare contribution be made by active and retired city workers. This proposal will add savings to those already agreed upon from a restructuring of the health plan. Since this proposal will need approval from the city's organized labor, we hold at risk \$357 million in FY 2011, \$386 million in FY 2012, and \$418 million in FY 2013. As mentioned in "Pension Costs" starting on page 18, in a recent development, a pension reform bill that the state legislature has just passed implements a Tier V for newly hired teachers. The creation of this new tier follows an agreement reached between the city and the United Federation of Teachers. The benefits of the new tier are expected to materialize as the city starts to hire more teachers with projected savings of \$19 million in FY 2010, growing to \$24 million by FY 2013. However, the city has no such agreements in place with its other major city unions, such as Police, Fire, and DC 37. Based on the uncertainty that additional agreements can be reached with these other unions, we hold at risk the residual planned savings from this action, which were initially projected to be \$200 million annually.

As part of the state's deficit reduction plan to deal with its current fiscal problems, aid to municipalities across the state was reduced. As a result, the city will lose \$26 million in Aid and Incentives for Municipalities in FY 2010. The state believes this reduction may be offset by other state initiatives such as a tax amnesty program.

Based on our risk evaluation, we estimate that the city could have additional resources of \$324 million in FY 2010, but additional expenses of \$716 million, \$844 million, and \$969 million in FYs 2011-13, respectively, that add to the city's multi-billion dollar budget gaps. We project the city is facing budget gaps estimated at \$4.9 billion in FY 2011, \$5.7 billion in FY 2012 and \$6.5 billion in FY 2013.

## **Glossary of Acronyms**

<b>AIM</b>	Aid and Incentives for Municipalities
<b>BABs</b>	Build America Bonds
<b>BSA</b>	Budget Stabilization Account
<b>BERS</b>	Board of Education Retirement System
<b>CAFR</b>	Comprehensive Annual Financial Report of the Comptroller
<b>CUNY</b>	City University of New York
<b>CY</b>	Calendar Year
<b>DOE</b>	Department of Education
<b>DC 37</b>	District Council 37
<b>FCB</b>	Financial Control Board
<b>FMAP</b>	Federal Medical Assistance Percentages
<b>FY</b>	Fiscal Year
<b>GASB</b>	Government Accounting Standards Board
<b>GDP</b>	Gross Domestic Product
<b>G.O. Bonds</b>	General Obligation Bonds
<b>NYCERS</b>	New York City Employees' Retirement System
<b>NYCRS</b>	New York City Retirement Systems
<b>NYCTFA</b>	New York City Transitional Finance Authority
<b>NYSE</b>	New York Stock Exchange
<b>OPEB</b>	Other Postemployment Benefits
<b>OT</b>	Overtime
<b>OTPS</b>	Other than Personal Service
<b>PBA</b>	Patrolmen's Benevolent Association
<b>PEG</b>	Program to Eliminate the Gap
<b>PIT</b>	Personal Income Tax
<b>PS</b>	Personal Service
<b>RHBT</b>	Retiree Health Benefits Trust

<b>STAR</b>	School Tax Relief program
<b>TRS</b>	Teachers' Retirement System
<b>UAAL</b>	Unfunded Actuarial Accrued Liability