

Staff Report

**NOVEMBER MODIFICATION
FYs 2012-2015**

December 16, 2011



**NEW YORK STATE
FINANCIAL CONTROL BOARD**

**STAFF OF THE
NEW YORK STATE FINANCIAL CONTROL BOARD**

ACTING EXECUTIVE DIRECTOR

Jeffrey L. Sommer

SENIOR STAFF

Mattie W. Taylor
Administration

Martin Fischman - Acting
*Economic and Revenue
Analysis*

Dennis J. DeLisle
*Expenditure and Covered
Organization Analysis*

Jewel A. Douglas
*Finance and Capital
Analysis*

ANALYTIC STAFF

Sew-Lian Ang
Steven A. Bollon
Iwona Matusiak
Michelle McManus
Jean L. Schwartz
Edward C. Thurston

**ADMINISTRATIVE AND
SUPPORT STAFF**

Barbara Marin
Margaret C. Oliver
Saundra L. Truell

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I. Overview

With a sluggish national recovery and the local economy weakening, the November modification to the FYs 2012-2015 Financial Plan shows the strains on the city's finances. The city has developed a new round of agency reductions that will save \$470 million in FY 2012 and about \$1 billion in FY 2013. Last year at this time the city announced a round of agency actions that allowed the city to add money to the Budget Stabilization Account (BSA) in order to start to deal with the large budget gap projected for FY 2012. Unfortunately, this year the \$470 million is needed in the current fiscal year to offset new agency needs, primarily overtime and other restorations in the uniformed services.

Over the last ten years the city's strategy has been to build up the BSA in a given fiscal year in order to prepay the next year's debt service and other costs. This allowed the city to roll surplus funds to deal with large budget gaps in the next fiscal year. It appears it will be much more difficult for the city to continue that practice. The city, in the November modification, has only \$12 million in the BSA. Historically, by this time of the fiscal year, the city had identified anywhere from \$413 million to over \$2.2 billion of surplus resources to prepay future expenses. Just last year, FY 2011, the city had over \$1.1 billion in the BSA. The amount in the BSA is likely to rise over the course of the year due to actions such as the write-down of prior-year payables and the reduction of the general reserve. Because of uncertainty regarding the direction of the economy, the city planned a very conservative revenue growth path. We believe that most of the city's modest revenue goals are attainable, despite the weakness of the economy. However, we see no upside potential for tax collections leading to a surprise surplus by the end of FY 2012.

There are other pressures that may make it more difficult to build up a surplus in FY 2012 and balance FY 2013. The City Comptroller, on December 7, 2011, released an independent actuarial review of the city's pension funds prepared by the Hay Group. The consultant makes a number of recommendations concerning the actuarial interest rate assumed by the system, as well as demographic changes, which would increase the city's contribution to the pension systems. If all of the consultant's recommendations are approved, we estimate the city's contribution would increase by \$2.2 billion. This is a start of a process that will still require the recommendations of the City Actuary, and the approvals of the individual pension boards and the state legislature. It is not clear at this point if all of the recommendations will be approved, or if other changes mitigating the cost will be recommended, and what fiscal years will be impacted. The city, in anticipation of these recommendations, created a \$1 billion reserve in each of the years of the financial plan.

The FY 2013 budget gap had been projected to be \$4.6 billion. The November modification proposes to reduce this gap to \$2 billion through a combination of measures, including \$1 billion in agency gap-closing actions; \$1 billion in new revenues from the at risk, not-yet approved, sale of taxi medallions; and a \$1 billion drawdown from the Retiree Health Benefits Trust. Our evaluation indicates that the

gap could grow to almost \$3.2 billion in FY 2013, over \$4 billion in FY 2014 and \$5.2 billion in FY 2015.

The city's proposal to deplete the Retiree Health Benefits Trust by removing \$1 billion in both FYs 2013 and 2014 is another troubling sign for the city's finances. The cost of providing post-retirement health benefits to city employees is paid annually on a pay-as-you-go basis. The city, however, is required to report in its financial statements the value of those future benefits earned by current city workers as a liability. This unfunded liability has grown to \$84.5 billion in FY 2012 and has been growing at an average rate of about \$5 billion a year. The city, in FY 2006, created the trust fund and deposited \$2.5 billion in an effort to start to deal with this growing unfunded liability. The city was commended for taking this first step. We have urged the city to develop plans to increase the funding to the trust fund and take actions to reduce the costs of providing these benefits.

We believe that this looming liability on future generations will lead to the crowding out of vital services or the inability of the city to live up to the promises made to its workforce. The funds in the trust fund had grown to over \$3 billion since FY 2006, but over the last two years starting in FY 2010, the city had drawn down the trust by \$1.1 billion to fund investment losses in the pension system. The current proposal will deplete the trust by FY 2014. This is a step back from trying to deal with this long-term fiscal problem. In addition, the use of these nonrecurring revenues, while reducing the outyear gaps, does not solve them. The city still needs to develop plans to deal with the recurring structural deficits that continue year after year.

**NOVEMBER MODIFICATION:
THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2012-2015**

TABLE 1 (\$ in millions)

	FY 2012	FY 2013	FY 2014	FY 2015
<u>Revenues</u>				
Taxes:				
General Property	\$17,564	\$18,192	\$18,624	\$19,054
Other Taxes	23,757	24,708	25,360	26,658
Tax Audit Revenue	670	694	676	676
Sale of Property Tax Liens	82	46	38	38
Miscellaneous Revenues	7,257	7,935	6,951	7,010
Unrestricted Intergovernmental Aid	25	--	--	--
Interfund Revenues	550	508	503	503
Less: Intracity Revenues	(1,749)	(1,531)	(1,532)	(1,537)
Disallowances	(15)	(15)	(15)	(15)
Total City, Capital IFA & Other Categorical Funds	\$48,141	\$50,537	\$50,605	\$52,387
Federal Categorical Grants	7,570	6,586	6,479	6,401
State Categorical Grants	11,300	11,185	11,332	11,413
Total Revenues	<u>\$67,011</u>	<u>\$68,308</u>	<u>\$68,416</u>	<u>\$70,201</u>
<u>Expenditures</u>				
Personal Service	\$37,842	\$37,554	\$38,098	\$39,878
Other Than Personal Service	28,643	27,640	28,496	29,212
General Obligation, Lease & TFA Debt Service	5,705	6,398	6,882	7,225
Budget Stabilization & Prepayments	(3,730)	(12)	--	--
General Reserve	300	300	300	300
Subtotal	\$68,760	\$71,880	\$73,776	\$76,615
Less: Intracity Expenditures	(1,749)	(1,531)	(1,532)	(1,537)
Total Expenditures	<u>\$67,011</u>	<u>\$70,349</u>	<u>\$72,244</u>	<u>\$75,078</u>
Gap To Be Closed	<u>\$0</u>	<u>(\$2,041)</u>	<u>(\$3,828)</u>	<u>(\$4,877)</u>

**CHANGES TO THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2012-2015
JUNE FINANCIAL PLAN COMPARED TO NOVEMBER MODIFICATION**

TABLE 2 (\$ in millions)

	FY 2012	FY 2013	FY 2014	FY 2015
<u>Revenues</u>				
Taxes:				
General Property	\$21	\$35	\$32	\$32
Other Taxes	5	123	39	(8)
Tax Audit Revenue	10	35	10	10
Sale of Property Tax Liens	0	0	0	0
Miscellaneous Revenues	109	797	(245)	(203)
Unrestricted Intergovernmental Aid	(12)	(12)	(12)	(12)
Interfund Revenues	1	7	2	2
Less: Intracity Revenues	(200)	(5)	(9)	(14)
Disallowances	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total City, Capital IFA & Other Categorical Funds	(\$66)	\$980	(\$183)	(\$193)
Federal Categorical Grants	896	197	164	163
State Categorical Grants	<u>270</u>	<u>95</u>	<u>169</u>	<u>233</u>
Total Revenues	<u>\$1,100</u>	<u>\$1,272</u>	<u>\$150</u>	<u>\$203</u>
<u>Expenditures</u>				
Personal Service	\$603	(\$671)	(\$636)	\$352
Other Than Personal Service	797	(376)	(195)	(140)
General Obligation, Lease & TFA Debt Service	(108)	(255)	(26)	(40)
Budget Stabilization & Prepayments	8	(12)	--	--
General Reserve	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Subtotal	\$1,300	(\$1,314)	(\$857)	\$172
Less: Intracity Expenditures	<u>(200)</u>	<u>(5)</u>	<u>(9)</u>	<u>(14)</u>
Total Expenditures	<u>\$1,100</u>	<u>(\$1,319)</u>	<u>(\$866)</u>	<u>\$158</u>
<u>Gap To Be Closed</u>	<u>\$0</u>	<u>\$2,591</u>	<u>\$1,016</u>	<u>\$45</u>

RISKS TO THE FINANCIAL PLAN

TABLE 3

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

	FY 2012	FY 2013	FY 2014	FY 2015
Stated Financial Plan Gap	\$0	(\$2,041)	(\$3,828)	(\$4,877)
Estimation				
Miscellaneous Revenues	\$25	\$25	\$75	\$75
Uniformed Services Overtime	(16)	(106)	(133)	(162)
Police Overtime PEG	0	(50)	(50)	(50)
Subtotal	\$9	(\$131)	(\$108)	(\$137)
Not in Mayor's Control				
Pension Reform	\$0	\$0	(\$131)	(\$252)
Sale of Taxi Medallions	0	(1,000)	0	0
Subtotal	\$0	(\$1,000)	(\$131)	(\$252)
Risk Total	\$9	(\$1,131)	(\$239)	(\$389)
Total FCB Estimated Surplus/(Gap)	\$9	(\$3,172)	(\$4,067)	(\$5,266)

II. Review of the Modification

Balancing the FY 2012 budget has been a challenging task. The FY 2012 budget has been balanced with the use of a \$3.7 billion prior-year surplus, as well as over \$5 billion in gap-closing actions that were undertaken in prior years, and \$470 million more gap-closing measures implemented in the current modification to the FYs 2012-15 Financial Plan to cover new needs. Moreover, a modest \$12 million budget surplus projected for FY 2012 is by far the smallest allocation to the Budget Stabilization Account (BSA) for the funding of future-year budget balance that has been made by the city over the most recent ten-year period.

A sluggish national economic recovery appears to be suppressing local economic growth. The weak economy could be a side effect of the polarization of the labor market and the scarcity of middle-income jobs. Regional economic data indicate mild declines in activity for the city and the state. Because of uncertainty regarding the direction of the economy, the city planned a very conservative revenue growth path. We believe that most of the city's modest revenue goals are attainable despite the weakness of the economy. However, we see no upside potential for tax collections leading to a surprise surplus at the end of FY 2012.

With the failure of the economy to bounce back from the recession, the budget for FY 2013 remains \$2 billion out of balance. The FY 2013 budget deficit has been reduced from the \$4.6 billion the city had projected last June through a combination of actions, including \$1 billion in agency gap-closing cuts, \$1 billion drawn down from the Retiree Health Benefits Trust (RHBT), and \$1 billion applied from the not-yet approved sale of taxi medallions. Budget gaps also remain in FY 2014 and FY 2015 totaling \$3.8 billion and \$4.9 billion, respectively. Our evaluation indicates that the gaps could be larger by \$1.1 billion in FY 2013, \$239 million in FY 2014 and \$389 million in FY 2015. We hold at risk the \$1 billion of sale proceeds in FY 2013 from the assumed sale of taxi medallions, as implementation is contingent on state approval.

ECONOMIC OUTLOOK

The city's economic plan calls for a weak national recovery, with output growth improving very gradually and with an even slower upturn in employment. The city had to reevaluate its plan when first-quarter Gross Domestic Product (GDP) growth fell to 0.4 percent and when job growth also came to an abrupt halt. Fortunately, national economic growth revived to 1.3 percent in the second quarter, and increased slightly to 2.0 percent in the third quarter, enabling the city to expect the national economy to gradually improve. The city projects that GDP will improve from 1.5 percent in 2011 to 1.8 percent in 2012 while national job growth stagnates at 0.9 percent in 2011 and 1.0 percent in 2012.

The local economy appears to be weakening in comparison with national output growth. Planned growth of real Gross City Product (GCP) slides from 6.9 percent in 2010 to 1.4 percent in 2011 and to 0.1 percent in FY 2012, before growth slowly improves in the outyears. The city estimates that the local job count will increase by 40,000 new

jobs in 2011. Disappointingly, job growth has been faltering in recent months and may fall short of the city's goal. Similarly, the Federal Reserve's regional economic model shows "mild declines in activity in New York State and New York City, but continued growth in New Jersey."

It is possible that the failure of the economy to bounce back from the recession is an unwelcome side effect of the job polarization of the nation's workforce. In a recent study, Federal Reserve economists point out that middle-income jobs are shrinking as a proportion of the labor force.¹ Most new job offerings are occurring at the extremes, with low-skill jobs growing in tandem with an expanding high-skill jobs sector. Furthermore, the income gap is widening because low-income and middle-income job holders have been getting marginal pay increases, while high income jobholders are getting a much larger share of the pay raises. One implication of this research is that, by exacerbating income and wealth inequalities, the polarization of the workforce is causing social stress that is finding expression in recent street demonstrations. Another implication is that, by blocking the upward mobility of low-income workers, the shrinkage of the middle-income sector could be holding back the nation's economic growth. This could help explain why the current economic recovery has been so lethargic.

Although the city's plan sees interest rates remaining low at least until 2014, it is possible that the European sovereign debt crisis could drive up interest rates throughout the world. In the meantime domestic interest rates remain soft, both because of the Federal Reserve Board's monetary easing strategy and because dollar-denominated securities are still perceived as a safe haven compared with European bonds. However, if evidence suggests that the European credit crunch is spreading to the US, the city may have to raise its interest assumptions and correspondingly take down its already-modest growth plan for the national economy.

In November, the Commerce Department revised third-quarter GDP down from 2.5 percent to 2.0 percent, indicating that the economic recovery is not yet self sustaining. Also, the failure of Congress to reach a consensus on how to control runaway federal deficits could destabilize the still-fragile economic recovery. For these reasons we see no upside potential for tax collections leading to a surprise surplus at the end of FY 2012.

REVENUES

With the economy still in a holding pattern, the city has chosen not to substantially alter its revenue plan in the November modification. Aside from categorical grants, which normally increase as the fiscal year progresses, most revenue shifts were small. City-funded revenue is up by \$94 million in FY 2012 due to small increases in tax collections and miscellaneous revenues. The city increased its FY 2012

¹ Jaison R. Abel and Richard Deitz "Job Polarization in the United States: A Widening Gap and Shrinking Middle," Liberty Street Economics website, November 21, 2011.

revenue estimate by \$1.1 billion, since the June Adopted Budget, to \$67 billion. City-funded revenues increase by \$94 million to \$46.6 billion because of slightly stronger tax collections and miscellaneous revenues.

The FY 2012 revenue changes in the November modification are summarized in the figure to the right. Tax collections improve by \$26 million and audits increase by \$10 million. Miscellaneous revenue is up by \$70 million while intergovernmental aid was re-estimated downward by \$12 million. Categorical aid increased by about \$1 billion. Of this amount, federal grants increased \$896 million, state grants increased \$270 million, while private grants declined by \$161 million.

FY 2012 Revenue Changes Since the Adopted Budget (\$ in millions)	
Taxes	\$26
Audits	10
Miscellaneous Revenue	70
Intergovernmental Aid	(12)
City Funds	\$94
Categorical Aid and Interfund Revenue	1,006
Total Change in Revenues	\$1,100

Among the city's taxes, the real property, banking corporation, sales, and property transfer, had large upward revisions. Offsetting these gains were decreases for the general corporation and personal income taxes. The net effect of these changes is that the city's tax collection forecast increases by \$26 million in FY 2012. In FY 2013, the net improvement in the tax collection forecast is \$158 million.

Tax Revenue

The city increased its tax revenue estimate for FY 2012 by \$26 million, as shown in the figure to the right. The property transfer tax, which improved by \$79, had the largest upward revision. Also increasing strongly were the banking corporation and the sales tax, which increased by \$71 million and \$70 million, respectively. The personal income tax is down \$134 million, while the general corporation tax declined by \$100 million. Real property tax collections increase \$21 million. Reflecting the strong tourist industry, the hotel tax is up \$8 million.

Changes in the FY 2012 Tax Revenue Projections Since June (\$ in millions)	
Real Property Tax	\$21
Personal Income	(134)
Sales	70
General Corporation	(100)
Banking Corporation	71
Unincorporated Business	(1)
Property Transfer	79
Mortgage Recording	8
Utility	3
Cigarette	1
Hotel	8
Total Tax Changes	\$26

The city expects the real property tax to increase by 4.7 percent to \$17.6 billion in FY 2012, after which growth drops to 3.4 percent in FY 2013. These property tax growth estimates are consistent with the 4.2 percent growth rate recorded for FY 2011. The nonproperty taxes increase at the moderate pace of 5.4 percent in FY 2012 to yield \$23 billion. Nonproperty growth then eases back to 3.8 percent in FY 2013. At the start of the recovery in FY 2011, the nonproperty taxes grew at the relatively robust pace of 13 percent. A replay of any similar growth surge in FY 2012 or FY 2013 is unlikely given the current sluggish economy.

While some taxes like the business taxes got off to a slow start in current-year collections, the downside risk appears to be offset by stronger-than-expected collections for the personal income tax and the property transfer taxes.

Business Taxes

Collections for this group of taxes, consisting of the general corporation tax (GCT), the banking corporation tax (BCT) and the unincorporated business tax (UBT), have been decidedly slow thus far in FY 2012. While we agree with the city's prudence in taking down the GCT by \$100 million, we do not yet see sufficient strength in the BCT to warrant the additional \$71 million in the city's revenue plan for this tax.

The three business taxes are slated to grow by eight percent in FY 2012 and by two percent in FY 2013, decelerating from the 18 percent upturn in FY 2011. The declining growth plan for these taxes reflects the weakening growth trend of business profits. National pretax corporate profits, which surged by 25 percent in calendar year (CY) 2010, are averaging just three percent growth for the first three quarters of CY 2011.

The business taxes are showing a collections decline of 14 percent through October of FY 2012. Although the collections slowdown is partially attributable to unusually strong collections at the start of the previous fiscal year, it will still be difficult to make up for the unusually slow start of business tax collections in FY 2012. Layoff announcements in the finance sector indicate that the industry has not fully recovered from the financial crisis of 2008, and that weak profits need to be bolstered by shedding personnel and cutting costs.

Property Transaction Taxes

The city increased its FY 2012 estimate for the real property transfer tax by \$79 million to \$853 million. Lifted by the homebuyer tax credit program, the transfer tax pulled out of a three-year slump and climbed 29 percent in FY 2011. Despite the expiration of this program, current collections appear more than adequate to meet the city's growth targets of seven percent in FY 2012 and five percent in FY 2013.

The mortgage recording tax, which was revised upward by \$8 million, has also been recovering strongly. Following a robust 19 percent upturn in FY 2011, this tax is slated to grow 17 percent to \$508 million in FY 2012, and by 11 percent in FY 2013.

Sales Tax

Since the June financial plan, the city has raised the sales tax forecast by \$70 million in FY 2012 and \$84 million in FY 2013 to \$5.9 billion and \$6.1 billion respectively. After soaring by 7.2 percent in FY 2011 (continuing base, year-to-year change), growth in the sales tax is projected to moderate to five percent in FY 2012 and 3.5 percent in FY 2013.² Buttressing the sales tax forecast for FYs 2012 and 2013 is the city's expectation of continued improvement in employment, income, and tourism from 2011 to 2013 (and through 2015). For example, the city expects local job gains of 20,000 to 40,000 annually

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

from 2011 to 2013 and total wage income growth of 5.4 percent to \$310.4 billion over the same three-year period.

While the city's FY 2012 sales tax estimate is not aggressive, it is uncertain whether the momentum generated by consumers over Thanksgiving, where records were set on Black Friday and Cyber Monday, will continue through December. Absent a significant increase in employment, income, or home values, it is not clear if households will still divert more of their savings from paying down debt to funding new purchases. It will also be interesting to see if the prolonged volatility in the financial markets negatively affects high-end consumers, including Wall Street employees, and the record number of domestic and international visitors to the city.

Personal Income Tax

In its first quarter modification, the city lowered the personal income tax (PIT) forecast by \$134 million in FY 2012 and \$100 million in FY 2013, on an \$8 billion base. Bonuses in the securities industry are expected to decline moderately during the forecast period, with some job losses in the securities industry even though the city anticipates gains in total employment from 2011 through 2015. Compared to the prior year, PIT collections, on a common rate and base, are forecast to grow 3.2 percent in FY 2012, six percent in FY 2013, 1.1 percent in FY 2014, and 6.5 percent in FY 2015. Despite its expectation of modest growth, for the PIT at least, the city's forecast might be overtaken by current events in terms of greater job losses and steeper bonus cuts in the securities industry in 2011 and 2012.

New York Stock Exchange (NYSE) member firms earned \$9.6 billion for the first three quarters of 2011. However, profits have steadily eroded during 2011 from a gain of \$9.3 billion in the first quarter to a loss of \$3 billion by the third quarter. It is highly unlikely that NYSE member firms' profits will reach the city's 2011 estimate of \$20 billion, and may end the year in the \$8 billion to \$11 billion range depending if the losses continue into the fourth quarter. The city's 2011 estimate of \$20 billion in securities industry profits reflects a decline of 27.5 percent from earnings of \$27.6 billion by NYSE member firms in 2010.

Yet, the issues that beset financial markets during the summer and put pressure on firms' revenues and profits -- extreme market volatility, and uncertainty over euro-zone sovereign debt and national deficit reduction efforts -- have not gone away. Several financial firms reported positive third quarter earnings that were boosted by an accounting adjustment and the release of reserves, not from trading or deal-making. Banks and bank holding companies are also setting aside more funds for mortgage-related legal costs, higher capital requirements, and to comply with the Dodd-Frank financial reform law.

The challenging environment has hurt firms' business lines, particularly in trading and investment banking, which may lead to considerably lower finance sector compensation than in past years. According to a compensation study reported in the Wall Street Journal, "employees at big Wall Street firms could see annual compensation sink 27% to 30% from a year earlier to the lowest level since the 2008 financial crisis . . ." Furthermore, "bonuses, which constitute a substantial part of many finance workers'

pay, are on track to plunge 35% to 40%, on average, . . . [and that] pay is likely to be hardest hit in areas such as fixed income, which comprises trading in bonds, currencies, and commodities.”³ Although bonus payouts and overall compensation levels will be determined by firms at the end of December 2011 and paid out January through March 2012, it is unclear at this time which scenario will occur -- a higher average payout for fewer workers or overall less compensation.

Miscellaneous Revenue

In the November modification, the miscellaneous revenue forecast increased by \$70 million to \$4.476 billion in FY 2012 and \$1.013 billion to \$5.467 billion in FY 2013, on a plan-to-plan basis. Most of the \$1.013 billion projected gain in FY 2013 is from the sale of 1,500 taxi medallions over three years starting in FY 2013, as detailed in the June 18, 2011 state enabling legislation. We are holding this initiative at risk (see Table 3 on page 5), because implementation is contingent on state approval. Even though preparatory work such as an environmental impact statement is underway, it is unknown when the deliberations will be completed and if there will be changes to the existing enabling legislation. While the city has successfully sold taxi medallions in the past, there is a question whether a deal will be reached in time to sell the taxi medallions in FY 2013.

If we exclude from the city’s miscellaneous revenue forecast initiatives that are one-shots (e.g. taxi medallion sales) or tied to agency expenditures, we are left with sources of recurring revenue growth or “core category revenue.”⁴ In this way, on a plan-to-plan basis, the latest miscellaneous revenue projections increased by \$35 million in FY 2012 and \$11 million in FY 2013, for annual growth of 0.5 percent and 1.7 percent, respectively, to about \$2.7 billion in each year. In FYs 2012 and 2013 (and extending through to FY 2015) projected gains in charges for services, rent, licenses and other miscellaneous were almost offset by declines in interest income and fines.

Some of the additional funds are projected to arise from higher college tuition at the City University of New York, Fire Department fees, parking meters, airport rent from the Port Authority, Department of Transportation franchises, cable revenue, and other smaller initiatives. On the downside, the decision by the Federal Reserve to keep the target range for the federal funds rate at 0 to 0.25 percent at least through mid-2013 has reduced the city’s interest income forecast to \$20 million (on average) from FY 2010 through FY 2014. Lastly, changes in the amount and type of parking tickets being issued are likely to be permanent and result in less fine revenue during the plan period despite more income from adjudications at the Office of Administrative Trials and Hearings.

³ Brett Philbin and Melissa Korn, “Wall Street Pay Hits a Wall,” The Wall Street Journal online November 28, 2011.

⁴ Core category revenue consists of six types of revenue: licenses (with permits and franchises), charges for services, interest, rent, fines, and a miscellaneous category without major nonrecurring actions, tobacco proceeds, housing revenue, and HHC payments. Dedicated funds such as water and sewer charges are also excluded from core category revenue since the funds are unavailable for gap-closing assistance.

Excluding the taxi medallion sale, given historical collection activity and the city's ability to devise initiatives with recurring value, we believe that miscellaneous revenue could be higher than the city's forecast by \$25 million in each of FYs 2012 and 2013 and by \$75 million in both FYs 2014 and 2015.

EXPENDITURES: CHANGES IN THE FINANCIAL PLAN SINCE JUNE

In an unsteady economic environment that has yet to see a solid recovery take hold, the city projects FY 2012 total-funded expenditures to increase by \$1.1 billion, as reported in its November modification. While the city has kept FY 2012 in balance by implementing further agency actions, as part of its Program to Eliminate the Gap (PEG), it has also dealt with a FY 2013 budget gap of more than \$4.6 billion, as reported in its June plan. The city addressed this by seeking even larger agency cuts of \$1 billion in FY 2013, an additional \$1 billion from the not yet approved sale of taxi medallions and continuing to drain the Retiree Health Benefits Trust (RHBT) by a further \$1 billion. The city also plans to use an additional \$1 billion from the RHBT to help close the FY 2014 gap. These actions will deplete the RHBT, while the Other Postemployment Benefits (OPEB) unfunded liability reaches \$84.5 billion and continues to grow. Even after these actions are taken, the city still must address a more than \$2 billion projected budget gap that remains in FY 2013 and over \$3.8 billion in FY 2014.

As the fiscal year progresses, developments may occur that will make it more difficult to increase the FY 2012 surplus and balance FY 2013. The City Comptroller, on December 7, 2011 released an independent actuarial review of the city's pension funds prepared by the Hay Group. The results of the report detail a number of actuarial change recommendations. It is expected that the Actuary will present his final recommendations to the systems' individual Board of Trustees for proposed changes to the actuarial assumptions and methods used to calculate the city's annual pension contribution.

The most prevalent change recommendation in the Hay Group report is the reduction of the Actuarial Interest Rate (AIR) that is currently set at eight percent. The report estimates the AIR fall into a range between 6.5 and 7.5 percent. However, their recommendation is to set it at seven percent. According to cost estimates provided in the report, the annual cost of reducing the AIR by one full percentage point would be more than \$2.1 billion. The other recommended changes will add another \$500 million to the cost, making the total cost more than \$2.6 billion. However, the city's share will be \$2.2 billion or about \$400 million less, due to its cost-sharing agreements with other non-actuarial systems. This is a start of a process that will require the recommendations of the City Actuary, and the approvals of the individual pension boards and the state legislature. It is not clear at this point if all of the recommendations will be approved, or if other recommendations will be made mitigating the cost, and what fiscal years will be impacted. Prudently, in anticipation of these recommendations, the city created a \$1 billion reserve in each of the years of the financial plan. The city will need to address this in the mid-year modification for FY 2012 and the FY 2013 preliminary budget.

The November modification for FY 2012 estimates total-funded spending will rise from \$65.9 billion to \$67 billion. As shown in the figure to the right, the city's expenditures will increase primarily in three budgetary areas, Other Than Personal Service (OTPS), Salaries and Wages, and Fringe Benefits, by a total of \$1.5 billion. Also, the plan assumes a net difference in the Budget Stabilization Account (BSA) of \$8 million.

FY 2012 November Modification	
Total Funds (\$ in millions)	
Increase	
OTPS	\$887
Salaries and Wages	570
Fringe Benefits	48
BSA	8
Total Increase	\$1,513
Decrease	
Intracity Expenses	(\$200)
Debt Service	(108)
Other Expense Savings	(102)
Medical Assistance	(2)
Total Decrease	(\$412)
Total Net Increase	\$1,101

The additional spending is offset by \$412 million in savings, as shown, for a net increase of \$1.1 billion. Of this amount, \$108 million is expected to come from debt service savings and \$102 million will come from off-setting reductions in OTPS, Salaries and Wages, and Fringe Benefits. Most of these savings will come from OTPS totaling \$87 million. Of this amount, about half will be from the miscellaneous budget with the reduction of \$36 million in state building aid. Also, the Department of Education (DOE) will have reduced OTPS costs of almost \$25 million.

OTPS (excluding debt service and Medical and Public Assistance) is expected to add \$887 million to total-funded expenditures, as shown in the accompanying figure. The majority of the additional expenses, \$349 million or about 39 percent, are categorized as being Mayoral Agencies. A number of city agencies, such as Housing Preservation, Cultural Affairs, the Departments of Finance, Environmental Protection, Transportation, Parks and Aging and city-wide services, make up this budgetary area. Of the increased spending in this area, the highest is in Housing Preservation with added expenses of \$193 million. The next two largest component increases are Health and Welfare and uniformed services, which total \$422 million. Of this total, the Police Department is expected to require about one-third of the new needs, or \$133 million.

Other Than Personal Service	
Total Funds (\$ in millions)	
Mayoral Agencies	\$349
Health and Welfare	213
Uniformed Services	209
All Other Agencies	93
Major Organizations	15
Elected Officials	8
Total OTPS	\$887

The city has also allocated additional funds of \$570 million to cover new needs in Salaries and Wages. The majority of these funds, as shown in the figure to the right, will cover expected higher costs of \$371 million in the uniformed services area. The Police Department will require about \$226 million to fund a structural deficit of \$112 million in Personal Service (PS) and an additional \$102 million to restore previously targeted agency savings. The restorations include \$50 million of proposed overtime savings and \$40 million from uniformed attrition. In addition, the city must fund \$6.3 million of additional overtime related to the Occupy Wall Street protest. The Departments of Correction and Sanitation will also require added funds to cover new needs totaling \$81 million and as part of Major Organizations, the DOE and the City

Salaries and Wages	
Total Funds (\$ in millions)	
Uniformed Services	\$371
Major Organizations	95
Mayoral Agencies	54
Health and Welfare	33
Elected Officials	13
All Other Agencies	4
Total Salaries	\$570

University of New York are expecting added costs of \$49 million and \$46 million, respectively.

Additional funding of overtime and PEG restorations has also increased the budget of the Fire Department. The Department is projecting a new overtime need that will require funding of \$41 million and in addition, the city is restoring prior targeted savings worth \$24 million. In total, the Department has budgeted for increased overtime expenditures of \$79 million. For FY 2012, the November modification projects that all four uniformed agencies (Police, Fire, Correction, and Sanitation) will cumulatively spend \$1 billion in overtime expenditures for both uniformed and civilian personnel. Uniformed overtime now accounts for 88 percent of total citywide overtime of \$1,135 million.

The November modification for overtime is \$285 million above the June plan estimates with all four agencies requiring further funding for new needs. The Police Department will require the most funding totaling \$183 million, which includes the restorations discussed earlier. The November modification's overtime budget for the four agencies is presented in Table 4.

PROJECTED UNIFORMED SERVICES OVERTIME BUDGET FOR FYs 2012 to 2015

TABLE 4

(\$ in millions)

Department	FY 2012	FY 2013	FY 2014	FY 2015
Police	\$559	\$496	\$493	\$493
Fire	274	261	235	208
Correction	95	70	70	69
Sanitation	72	68	68	68
Total Overtime	\$1,000	\$894	\$867	\$838
FCB Projected Overtime	1,016	1,000	1,000	1,000
Risk to Budget	\$16	\$106	\$133	\$162
Note: Totals include uniformed and civilian personnel. Numbers may not add due to rounding.				

The Fire Department's additional overtime needs relate to an understaffing issue, which involves an injunction stopping its ability to hire firefighters. The injunction was issued as a result of a lawsuit that has found bias in the testing procedures for new recruits. The legalities of the issue are complex and the city has been instructed to change the test to make it nondiscriminatory before it can resume hiring. The delay in hiring has strained staffing levels in the Department and driven up overtime costs.

Based on actual overtime expenditures of \$339 million in the four uniformed agencies through October 2011, we estimate that the city will likely spend close to \$1,016 million by the end of FY 2011. The city has taken the unusual step of funding its annual overtime needs early in the budget process, following a pattern of asking for agency reductions also early in the fiscal year. However, based on our estimates, we hold at risk \$16 million in FY 2012, \$106 million in FY 2013, \$133 million in FY 2014 and \$162 million in FY 2015.

Also contributing to higher expenditures in FY 2012 are costs related to Fringe Benefits (excluding pension costs, which are expected to remain unchanged) that are anticipated to be higher by nearly \$48 million, as shown in the figure to the right. The increases are expected mainly in two areas, Mayoral Agencies and the miscellaneous budget. The Department of Transportation is responsible for the bulk of the added spending in Mayoral Agencies with new needs of \$14 million. The miscellaneous budget is expected to increase by a total of \$15 million, driven mostly by a nearly \$11 million increase in health insurance costs.

Fringe Benefits	
Total Funds (\$ in millions)	
Mayoral Agencies	\$17.0
Miscellaneous Budget	15.0
Major Organizations	8.0
Uniformed Services	6.0
All Other Agencies	0.5
Health and Welfare	0.5
Elected Officials	0.5
Total Fringe Benefits	\$47.5

On a city-funded basis, spending is expected to increase by a far less amount than total-funded expenditures from plan to plan. The city projects city-funded expenditures to increase to \$46.6 billion from \$46.5 billion, or around \$94 million. In total, city-funded expenditures increase by almost \$500 million in FY 2012 but are offset by agency savings of about \$400 million as part of the latest PEG. The \$400 million in expense savings is combined with about \$70 million in new or enhanced agency revenues for a total FY 2012 PEG of \$470 million. This PEG is in addition to the more than \$5 billion already targeted in prior programs. However, unlike prior years where spending cuts and debt service savings were used to build the BSA and help to balance budgets in future fiscal years, these measures were needed in the November modification to cover new needs in FY 2012.

The PEG or agency program is presented in Table 5. As shown in the table, city agencies have targeted \$470 million of reductions in FY 2012, which includes spending cuts and higher revenue collections. The PEG is higher in FY 2013 with projected savings of more than \$1 billion. However, those savings decline in each of FYs 2014 and 2015 by about \$400 million, with many PEGs being nonrecurring. Total nonrecurring PEGs or "one-shots," and those initiatives that were greatly reduced in value, total more than \$342 million over the life of the financial plan.

TOTAL AGENCY PROGRAM FOR FYs 2012 - 2015

TABLE 5

(\$ in millions)

Agency Category	FY 2012	FY 2013	FY 2014	FY 2015
Uniformed Services	(\$53)	(\$184)	(\$126)	(\$128)
Health and Welfare	(114)	(60)	(86)	(61)
Mayoral	(93)	(167)	(129)	(131)
Major Organizations	(149)	(305)	(185)	(193)
Elected Officials	(5)	(19)	(15)	(15)
Debt Service	(56)	(229)	(30)	(44)
Other	--	(56)	(56)	(56)
Total Agency Program	(\$470)	(\$1,020)	(\$627)	(\$628)
Includes both expense and revenue PEGs. (Negative) numbers decrease the gap.				

One of the major sources of savings will be in the Department of Education (DOE). The DOE, which is part of the city's Major Organization's category, is expected to save \$147 million in FY 2012, as shown in the figure to the right. The targeted savings in FY 2012 will result from a number of different initiatives with the largest being a reduction in contractual obligations totaling \$62 million. Other savings will be in the form of a state revenue reestimate, which will enable the DOE to collect more money earmarked for Pre-K. Additionally, the Department has found a number of efficiencies in OTPS and PS of \$25 million. Also, the DOE has found savings of \$12 million in food services, although this will be a one-shot for the fiscal year.

Department of Education (\$ in millions)		
Expense PEG	FY 2012	FY 2013
Building Aid Debt Service	--	(\$100)
Medicaid Revenue	--	(50)
Contract Reduction	(\$62)	(54)
State Revenue Reestimate	(38)	(62)
OTPS Efficiencies	(20)	(20)
Food Service	(12)	--
Leases	(10)	(10)
PS Efficiencies	(5)	(5)
Total PEGs	(\$147)	(\$301)

For FY 2013, the targeted savings will more than double with total expected budget reductions of \$301 million. As shown in the figure, the two major sources of the larger PEG are a nonrecurring use of \$100 million of state building aid revenue to pay school construction debt service costs and the other is from enhanced claiming processes and procedures for Medicaid revenue, which will generate \$50 million more in federal reimbursements annually. However, the total DOE PEGs are sharply reduced in FYs 2014 and 2015 to \$180 million and \$189 million, respectively, with no additional state building aid revenue and the elimination of savings tied to efficiencies.

Other notable expense savings come from the city's Health and Welfare agencies with planned reductions of \$114 million in FY 2012 where most of the savings are taken by the Administration for Children Services (ACS) and the Department of Social Services (DSS). The two agencies have combined targeted savings of \$99 million with ACS collecting a one-time amount of \$36 million related to an increase in the federally negotiated fringe reimbursement rate and \$17 million for a revenue settlement associated with prior claims. Without these two PEGs, the savings are greatly reduced over the life of the financial plan. In FYs 2013 to 2015, the agency has targeted only \$8 million in total savings. DSS is also claiming a one-time PEG of \$37 million related to an increase in the federally negotiated fringe reimbursement rate that will be taken in FY 2012. However, the Department will sell seven of its buildings anticipating collection of \$25 million, which will be taken as a PEG in FY 2014 raising its targeted savings in that year.

The city's four uniformed agencies (Police, Fire, Correction, and Sanitation) will produce cost reductions that total about \$53 million in FY 2012, grow to \$184 million in FY 2013, but decline to \$126 million and \$128 million in FYs 2014 and 2015, respectively. These expected savings come mainly from the Police Department in the outyears of the plan. The Police Department anticipates saving a total of only \$8 million for FY 2012, but has targeted overtime savings, which were restored for FY 2012, of \$50 million annually starting in FY 2013. However, we are concerned as to whether these savings will materialize given past restorations of overtime cost-containment initiatives and the

continued increase in annual overtime spending by the Department. Given these conditions, we hold at risk this proposed savings initiative.

The city's other Mayoral agencies, which consist of the Departments of Finance, Transportation, Parks, Citywide Services, Cultural Affairs, Housing Preservation, and other supporting city agencies, have targeted total savings of \$93 million in FY 2012. These PEGs will increase to \$167 million in FY 2013, but will fall to \$129 million in FY 2014 and \$131 million in FY 2015.

As part of the PEGs, the city plans to reduce staffing levels over the next two fiscal years by a total of 1,215 as shown in Table 6. The majority of the headcount reduction will be achieved by way of attrition with 202 positions expected to be left vacant in FY 2012. The level of attrition is expected to increase substantially in FY 2013 to 898 positions.

The November modification also assumes that a total of 317 positions will be eliminated by layoffs. The majority of these headcount cuts will occur in the Mayoral Agencies, particularly in Cultural Affairs and the Department of Transportation.

TOTAL AGENCY HEADCOUNT REDUCTION PROGRAM FOR FYs 2012 and 2013

TABLE 6

Agency Category	Fiscal Year 2012			Fiscal Year 2013		
	Attrition	Layoff	Total	Attrition	Layoff	Total
Uniformed Services	(80)	--	(80)	(457)	--	(457)
Health and Welfare	34	(34)	--	(28)	(41)	(69)
Mayoral	(149)	(211)	(360)	(399)	(272)	(671)
Elected Officials	(7)	(4)	(11)	(14)	(4)	(18)
Total Reduction	(202)	(249)	(451)	(898)	(317)	(1,215)

(Negative) numbers decrease the headcount.

To address the more than \$2 billion budget gap in FY 2013, it is likely that the city will seek additional agency cuts and further headcount reductions. However, the process of implementing such gap-closing measures is likely to become much harder. In prior fiscal years, the city had been able to build up surplus funds to close structural deficits, but for FY 2012, the budget contains only \$12 million of projected surplus funds to be used to prepay debt service expense.

In order to reduce the gaps in FYs 2013 and 2014, the city has chosen to continue to drain the RHBT, which was formed in FY 2006 to fund future OPEB earned by current city workers. The cost of providing OPEB to retirees is paid annually by the city but according to accounting rules it must report the value of those future benefits earned by current city workers as a liability. The OPEB liability reported by the city has grown steeply since FY 2006 to \$84.5 billion in FY 2012 and will continue to grow much higher far into the future. The funds in the RHBT had grown to more than \$3 billion since it was formed, but over the last two fiscal years, starting in FY 2010, the city had drawn down the RHBT by \$1.1 billion to fund investment losses in the pension system in FYs 2008 and 2009. Unfortunately, the city did not plan to replenish these funds after strong investment performance in FYs 2010 and 2011. Moreover, the November modification reports that the remaining \$2 billion in the RHBT will be fully drained by FY 2014 and used as a one-shot source to reduce outyear budget gaps.

Debt Service Costs

The city's gap-closing program that is subsumed in the November Modification to the Financial Plan for FYs 2012-15 includes a reduction in debt service costs for the city and the New York City Transitional Finance Authority (NYCTFA) totaling \$56 million in FY 2012, \$229 million in FY 2013, \$30 million in FY 2014 and \$44 million in FY 2015. The gap-closing items that are generating debt service savings are city-funded. Separately, the city switched the funding source for \$100 million of debt service from city funds to state funds. An assignment in FY 2013 of \$100 million of state building aid revenues to specifically pay debt service costs related to school construction allows the city to cut its funding for debt service by an equivalent amount. The reduction in city-funded expenditures is reflected as a gap-closing item under the Department of Education instead of debt service.

When debt service from all funding sources, including city tax revenues, swap receipts, state building aid and federal subsidies, is compared on a plan-to-plan basis, it is lower than the forecast in the June financial plan by \$108 million in FY 2012, \$255 million in FY 2013, \$26 million in FY 2014 and \$40 million in FY 2015. The vast majority of the reductions in debt service costs for FYs 2012 and 2013 reflect the recognition of interest savings on long-term securities that have been issued, as interest rates continue to be at historic lows. Additionally, the city has lowered its interest rate assumptions on the short-term borrowing it projects to undertake in FY 2013 to meet cash flow needs. Prudently, the city and NYCTFA continue to assume conservative interest rates in projecting future debt service costs, given that rates could increase suddenly and dramatically for any number of reasons, including the European crisis.

With the plan-to-plan reductions, debt service from all funding sources, net of prepayments, is projected to increase from \$5.7 billion in FY 2012, to \$6.4 billion in FY 2013, \$6.9 billion in FY 2014 and \$7.2 billion in FY 2015, for an average annual growth rate of 8.2 percent.⁵ Such escalating debt service costs are a function of the city's large capital program and are contributing to the projected budget deficits of \$2 billion in FY 2013, \$3.8 billion in FY 2014 and \$4.9 billion in FY 2015, as increasingly more resources have to be assigned to make the annual debt service payments. As illustrated in the figure to the right, debt service costs as a percent of tax revenues will jump by two full percentage points, from 13.6 percent in FY 2012 to 15.6 percent in FY 2015, as the 8.2 percent average annual growth for debt service is more than double the 3.3 percent rate for tax revenues.

City and NYCTFA Debt Service as Percentage of Tax Revenue (\$ in millions)			
FY	Debt Service	Tax Revenue	Debt Service as Percent of Tax Revenue
2012	\$5,705	\$42,073	13.6%
2013	6,398	43,640	14.7%
2014	6,882	44,698	15.4%
2015	7,225	46,426	15.6%

The plan assumes that the city will generate a budget surplus of \$12 million in FY 2012 that will be used to prepay FY 2013 debt service costs. This means that only \$12

⁵ The relatively small noncity funding component of debt service costs decreases from \$479 million in FY 2012, to \$389 million in FY 2013, \$317 million in FY 2014 and \$313 million in FY 2015.

million of the above-mentioned \$108 million debt service savings from FY 2012 will be used to support FY 2013 debt service costs. The additional \$96 million of debt service savings has been allocated to balancing the FY 2012 budget, as current-year expenses have surged while the economy is faltering. A review of the October/November financial plan modifications for the most recent ten-year period reveals that \$12 million is by far the smallest allocation to the Budget Stabilization Account (BSA) that the city has made to prepay debt service costs at this time of the fiscal year.

FUNDING IN THE BSA FOR DEBT SERVICE PREPAYMENT IS NEGLIGIBLE IN THE CURRENT MODIFICATION RELATIVE TO COMPARABLE MODIFICATIONS

CHART 1

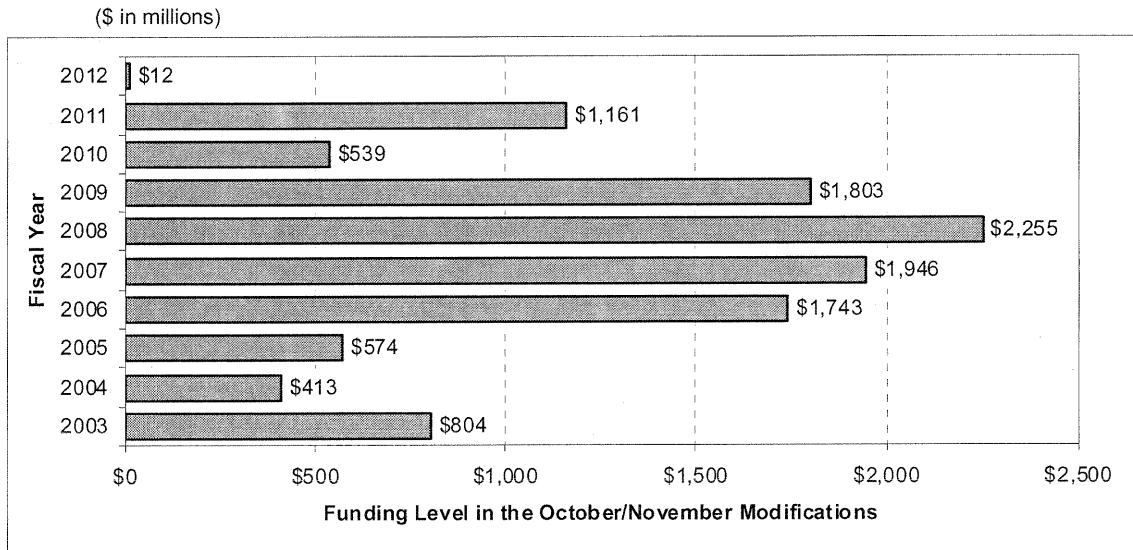


Chart 1 illustrates that historically by this time of the fiscal year the city had identified anywhere from \$413 million to \$2.255 billion of surplus resources to be used to prepay future expenses. In fact, the \$2.255 billion surplus identified in the October 2007 Financial Plan Modification was large enough to be assigned for use in FY 2008 to prepay debt service costs totaling \$1.905 billion for FY 2009 and \$350 million for FY 2010. Had \$2.255 billion of surplus resources been available in the current plan to prepay FY 2013 debt service, the \$2 billion budget gap would not exist.

Glossary of Acronyms

ACS	Administration for Children Services
AIR	Actuarial Interest Rate
BCT	Banking Corporation Tax
BSA	Budget Stabilization Account
CY	Calendar Year
DOE	Department of Education
DSS	Department of Social Services
FCB	Financial Control Board
FY	Fiscal Year
GCP	Gross City Product
GCT	General Corporation Tax
GDP	Gross Domestic Product
HHC	Health and Hospitals Corporation
NYCTFA	New York City Transitional Finance Authority
NYSE	New York Stock Exchange
OPEB	Other Postemployment Benefits
OT	Overtime
OTPS	Other than Personal Service
PEG	Program to Eliminate the Gap
PIT	Personal Income Tax
PS	Personal Service
RHBT	Retiree Health Benefits Trust
UBT	Unincorporated Business Tax