

Staff Report

**FEBRUARY MODIFICATION
FYs 2012-2016**

March 15, 2012



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I. Overview

The February modification to the FYs 2012-16 Financial Plan and Preliminary Budget for FY 2013 continues to lay out a plan for balanced budgets in both FYs 2012 and 2013. In the November modification, the city relied on a \$1 billion agency reduction program, \$1 billion from the sale of new taxi medallions, and \$1 billion from the further depletion of the Retiree Health Benefits Trust to reduce the projected FY 2013 budget gap to \$2 billion.

In the February modification, the city was able to generate just under a \$1.3 billion surplus in FY 2012. The city recognized routine annual savings, such as a \$500 million write down of prior-year payables and a \$200 million release from the general reserve, which are no longer needed. The city also fine-tuned its debt service projections based on current market conditions to realize savings in all years of the plan. The city was also able to increase its tax revenue forecast due to improved property taxes.

In addition, the city's financial plan reflected significantly less resources allocated to pension costs due to changes to the actuarial assumptions and methods used by the pension system. The city had funded a \$1 billion reserve for each of FYs 2012-16 in anticipation of changes that would increase its pension contribution. However, due to how the City Actuary is proposing to implement the changes, it is now estimated that the city will not need to use all of the reserve, resulting in savings of \$425 million for each of FYs 2012 and 2013, with additional savings in the outyears of the plan. The combination of the FY 2012 surplus, which will be used to prepay FY 2013 debt service, and the savings in FY 2013 allows the city to present a balanced budget.

While the city has presented a reasonable financial plan and preliminary budget, we have concerns that the city will need to address in the executive budget. The city is relying on \$1 billion in additional revenue from the sale of taxi medallions. The state has authorized the city to proceed, but has added a number of requirements on the city to ensure handicapped accessibility. While it is too early to assess a specific risk, it may be overly optimistic to expect that the city will be able to complete the total sale in FY 2013. Some part may slip into FY 2014. The executive budget should realistically assess how much may be achievable in FY 2013.

In addition, we continue our concerns over the drawdown of the Retiree Health Benefits Trust in FY 2013 and the ultimate depletion of the trust in FY 2014. As we have reported in the past, this is a step back from trying to deal with this long-term fiscal problem. We believe the continuing growth in the pay-as-you-go funding for retiree health benefits and not dealing with the unfunded liability will lead to the crowding out of vital services or the inability to live up to the promises made to the city's workforce.

Most importantly, we are concerned that as the nation is pulling out of an economic stall and is back on a moderate growth path, the local economic recovery appears to be flattening. The city has recognized this in its economic forecast. We are concerned, however, that nonproperty tax collections could be even worse than forecasted in both FYs 2012 and 2013 by \$250 million and \$200 million, respectively. Tax collections have been slow through January, primarily in the personal income and

unincorporated business taxes. We are also concerned about the flat economic activity in the city and the \$4.9 billion loss accrued by New York Stock Exchange member firms in the last two quarters of 2011.

In addition, even though property tax collections are strong, the growth reported in the FY 2013 tentative tax roll appears to be slightly overstated and could necessitate a downward revision of the property tax revenue plan when the final tax roll is published in June. The combination of these factors indicate that the city should not expect large unanticipated revenues to appear that would increase the FY 2012 surplus or create a large surplus in FY 2013 to help close the projected \$3 billion FY 2014 budget gap. The current economic conditions also dampen our optimism for large revenue growth in the outyears of the plan.

**FEBRUARY MODIFICATION:
THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2012-2016**

TABLE 1 (\$ in millions)

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
<u>Revenues</u>					
Taxes:					
General Property	\$17,730	\$18,337	\$18,948	\$19,610	\$20,253
Other Taxes	23,650	24,751	25,373	26,643	27,624
Tax Audit Revenue	700	724	706	706	706
Sale of Property Tax Liens	82	46	38	38	38
Miscellaneous Revenues	7,335	7,971	6,944	7,003	7,089
Unrestricted Intergovernmental Aid	25	--	--	--	--
Interfund Revenues	551	509	504	504	504
Less: Intracity Revenues	(1,791)	(1,531)	(1,533)	(1,537)	(1,542)
Disallowances	(15)	(15)	(15)	(15)	(15)
Total City, IFA & Other Categorical Funds	\$48,267	\$50,792	\$50,965	\$52,952	\$54,657
Federal Categorical Grants	7,734	6,592	6,491	6,414	6,412
State Categorical Grants	11,368	11,341	11,449	11,586	11,705
Total Revenues	<u>\$67,369</u>	<u>\$68,725</u>	<u>\$68,905</u>	<u>\$70,952</u>	<u>\$72,774</u>
<u>Expenditures</u>					
Personal Service	\$37,455	\$37,210	\$37,794	\$39,222	\$40,164
Other Than Personal Service	28,438	27,765	28,587	29,320	29,810
General Obligation, Lease & TFA Debt Service	5,612	6,278	6,797	7,163	7,436
Budget Stabilization & Prepayments	(2,445)	(1,297)	--	--	--
General Reserve	100	300	300	300	300
Subtotal	\$69,160	\$70,256	\$73,478	\$76,005	\$77,710
Less: Intracity Expenditures	(1,791)	(1,531)	(1,533)	(1,537)	(1,542)
Total Expenditures	<u>\$67,369</u>	<u>\$68,725</u>	<u>\$71,945</u>	<u>\$74,468</u>	<u>\$76,168</u>
<u>Gap To Be Closed</u>	<u>\$0</u>	<u>\$0</u>	<u>(\$3,040)</u>	<u>(\$3,516)</u>	<u>(\$3,394)</u>

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

TABLE 2 (\$ in millions)

	FY 2012	FY 2013	FY 2014	FY 2015
<u>Revenues</u>				
Taxes:				
General Property	\$166	\$145	\$324	\$556
Other Taxes	(107)	43	13	(15)
Tax Audit Revenue	30	30	30	30
Sale of Property Tax Liens	0	0	0	0
Miscellaneous Revenues	78	36	(7)	(7)
Unrestricted Intergovernmental Aid	0	--	--	--
Interfund Revenues	1	1	1	1
Less: Intracity Revenues	(42)	0	(1)	0
Disallowances	0	0	0	0
Total City, IFA & Other Categorical Funds	\$126	\$255	\$360	\$565
Federal Categorical Grants	\$164	\$6	\$12	\$13
State Categorical Grants	68	156	117	173
Total Revenues	<u>\$358</u>	<u>\$417</u>	<u>\$489</u>	<u>\$751</u>
<u>Expenditures</u>				
Personal Service	(\$387)	(\$344)	(\$304)	(\$656)
Other Than Personal Service	(205)	125	91	108
General Obligation, Lease & TFA Debt Service	(93)	(120)	(85)	(62)
Budget Stabilization & Prepayments	1,285	(1,285)	--	--
General Reserve	(200)	0	0	0
Subtotal	\$400	(\$1,624)	(\$298)	(\$610)
Less: Intracity Expenditures	(42)	0	(1)	0
Total Expenditures	<u>\$358</u>	<u>(\$1,624)</u>	<u>(\$299)</u>	<u>(\$610)</u>
Gap To Be Closed	<u>\$0</u>	<u>\$2,041</u>	<u>\$788</u>	<u>\$1,361</u>

RISKS TO THE FINANCIAL PLAN

TABLE 3 (\$ in millions, positive numbers are offsets to risks)

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Stated Financial Plan Gap	\$0	\$0	(\$3,040)	(\$3,516)	(\$3,394)
Estimation					
Property Tax	\$0	(\$50)	(\$50)	(\$50)	(\$50)
Nonproperty Taxes	(250)	(200)	0	0	0
Uniformed Services Overtime	(29)	(124)	(167)	(196)	(231)
Police Overtime PEG	0	(50)	(50)	(50)	(50)
Subtotal	(\$279)	(\$424)	(\$267)	(\$296)	(\$331)
Not in Mayor's Control					
State Pension Reform	\$0	\$0	\$0	(\$80)	(\$155)
State Medicaid Relief	0	11	65	164	293
Subtotal	\$0	\$11	\$65	\$84	\$138
Implementation					
Bond Refunding Savings	\$0	\$139	\$0	\$0	\$0
Risk Total	(\$279)	(\$274)	(\$202)	(\$212)	(\$193)
Total FCB Estimated Surplus/(Gap)	(\$279)	(\$274)	(\$3,242)	(\$3,728)	(\$3,587)

II. The FYs 2012-16 Financial Plan

At \$68.7 billion, the FY 2013 budget is balanced after several rounds of gap-closing actions. The November modification to the FYs 2012-16 Financial Plan closed a \$2.6 billion gap in the FY 2013 budget. Now, the February modification identified \$1.285 billion of new surplus funds generated in FY 2012 through a reduction of \$927 million in total expenditures coupled with an increase of \$358 million in total revenues. The FY 2012 surplus is being applied to prepay FY 2013 debt service costs.

A significant component of the gap-closing actions involves changes to the actuarial assumptions and methods used by the pension system. The city had funded a \$1 billion reserve for each of FYs 2012-16 in anticipation of changes that would increase its pension contribution. However, due to how the City Actuary is proposing to implement the changes, it is now estimated that the city will not need to use all of the reserve, resulting in savings of \$425 million for each of FYs 2012 and 2013, with additional savings in the outyears of the plan. The \$425 million of savings for FY 2012 is part of the surplus that is being used to prepay FY 2013 expenses.

In detailing the FY 2013 gap-closing program in the February modification, the city has chosen to recognize routine annual savings for FY 2012, such as a \$500 million write down of prior-year payables and a \$200 million release from the general reserve, which are no longer needed. The city also fine-tuned its debt service projections based on current market conditions and expected financing needs to recognize \$93 million of savings in FY 2012 and \$120 million in FY 2013.

Revenues contribute about \$358 million in extra total funds to the FY 2012 surplus, in the February modification, and an additional \$417 million in FY 2013 to help close the budget gap. Property taxes, which were lifted by recovering property values for a second consecutive year, added much of the extra revenue. However, we think that the flattening of local economic activity could weaken nonproperty tax collections and diminish the contribution of revenues toward building up a current surplus and closing future budget gaps. Furthermore, even though current property tax collections are strong, the growth reported in the FY 2013 tentative tax roll appears to be overstated and could necessitate a downward revision of the property tax revenue plan when the final tax roll is published in June. Among the nonrecurring resources in the latest financial plan, one of the most important is the initiative to sell 2,000 wheelchair-accessible yellow taxicab medallions in FY 2013 to raise \$1 billion. We are concerned that all of the proceeds might not be realized in FY 2013, because of insufficient time for the city to complete the milestones necessary to sell all the taxi medallions.

Even with its gap-closing program, total expenditures are projected to exceed total revenues by \$3 billion in FY 2014, \$3.5 billion in FY 2015 and \$3.4 billion in FY 2016. Over the financial plan years of FYs 2012-16, expenditures are forecasted to grow by 13.2 percent, while revenues are expected to grow by eight percent. The growth in expenditures is being driven primarily by surges in fringe benefits and debt service. In the absence of stronger revenue growth, the city would be forced to pare down expenses in accordance with its priorities, as it has consistently done over the years.

REVENUES IMPROVE SLIGHTLY IN FY 2012

Most of the revenue changes in the February modification for FY 2012 were relatively small. City-funded revenues increased by \$112 million compared with the November modification, as shown in the figure to the right. The increase to total revenue of \$358 million was somewhat larger because of a \$246 million increase in categorical grants. The property tax added \$166 million, but this was largely offset by a \$105 million decline in the nonproperty taxes. Thus, the net improvement in tax revenue was just \$61 million. The increase to city funds was augmented by a \$30 million gain in tax audits and a \$22 million increase in miscellaneous revenue. This pattern of stronger property taxes and unsteady nonproperty taxes, which are augmented by improved audits and miscellaneous receipts, flows through to provide modest revenue gains in FY 2013 and the outyears of the plan.

FY 2012 City Funds Improve by a Slight \$112 Million	
(\$ in millions, change since Nov. plan)	
Property Tax	\$166
Nonproperty Taxes	(105)
Tax Audits	30
STAR Aid	(1)
Miscellaneous Revenue	22
City Funds	\$112
Categorical Aid	246
Total Change in Revenues	\$358

Nonproperty tax collections have been inconsistent thus far in FY 2012 and are down \$105 million. The personal and business income taxes weakened along with the flattening of local economic growth, while property-related taxes and the hotel tax are improving. Since November, the personal income tax is down by \$58 million, while the business taxes are down by \$161 million. Hotel tax revenue is higher by \$70 million because room tax rates, which were set to expire in December 2011, were recently extended. The property transfer taxes are up \$14 million and payments in lieu of property taxes are up \$44 million. The real property tax is up \$166 million due to smaller refund payouts and higher collections on overdue prior year tax bills.

Miscellaneous Revenue

In the February modification, the city's FY 2012 miscellaneous revenue forecast increases modestly by \$22 million from the prior submission to \$4.5 billion. About \$16 million of the \$22 million plan-to-plan variance originates among the core categories of miscellaneous revenue, primarily from additional building and construction permits, and environmental fines.¹ In FY 2012, core category revenue is projected to rise 1.1 percent over the prior year to \$2.7 billion. Yet, over the course of the financial plan, revenue growth accelerates 7.6 percent from FY 2012 to FY 2016, which represents a gain of \$204.1 million to \$2.9 billion by FY 2016. Most of the \$204.1 million planned increase is due to higher short-term interest rates that propel interest earnings from \$17.3 million in FY 2012 to \$156.4 million by FY 2016.

¹ The six core categories are a subset of the city's miscellaneous revenue forecast and consist of: 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.

Among the nonrecurring resources in the latest financial plan, one of the most important is the initiative to sell 2,000 wheelchair-accessible yellow taxicab medallions in FY 2013 to raise \$1 billion. We are concerned that all of the proceeds might not be realized in FY 2013, because of insufficient time for the city to complete the milestones necessary to sell all the taxi medallions. Some of the requirements for the Taxi and Limousine Commission are: (1) to sell permits to for-hire vehicle base stations and licenses to livery cab drivers that allow street hails in a new taxicab system devoted to upper Manhattan and the other boroughs; (2) to produce a market analysis of the new hail licenses for public comment, which includes data on rider demand, enforcement, industry impact, traffic safety, and street congestion; and (3) to develop a comprehensive plan with input from stakeholders to make the city's medallion and for-hire vehicle industry more handicapped accessible over time, which has to be approved by the New York State Department of Transportation.

REVENUE GAINS FLOW THROUGH TO FYS 2013-16

The modest revenue gains in FY 2012 flow through to the city's plan for FY 2013. City funds are higher by \$278 million in FY 2013 compared with the November modification, as shown in the figure to the right. Total revenue is up by \$417 million, because of an expected increase of \$139 million to categorical aid programs.

City Funds Rise \$278 Million in FY 2013 (\$ in millions, change since Nov. plan)	
Property Tax	\$145
Nonproperty Taxes	43
Tax Audits	30
Miscellaneous Revenue	60
City Funds	\$278
Categorical Aid	139
Total Change in Revenues	\$417

The city has increased its tax collection plan for FY 2013 by \$188 million. The property tax, which improved by \$145 million, gained most of the additional revenue in FY 2013 because a favorable assessment report shows that local real estate values climbed for a second consecutive year. Similar to the previous year, the city expects FY 2013 tax audits and miscellaneous revenues to improve by \$30 million and \$60 million, respectively.

The city has increased its nonproperty tax collection plan for FY 2012 by \$43 million. This small change actually consists of large but inconsistent upward and downward adjustments to the individual taxes, as shown in the figure to the right. The largest shifts affected the business taxes. The general corporation and the unincorporated business taxes are down by \$142 million and \$73 million, respectively, whereas the financial corporation taxes increased by \$112 million. The personal income tax is higher by \$28 million but the sales tax is down \$2 million and the utility tax is down \$13 million. The property transactions taxes increased by \$21 million because of an improving real estate market, a factor which also lifted the minor taxes by \$33 million due to rising payments in lieu of property taxes. The hotel tax increased by \$80 million due to the extension of room tax rates.

Nonproperty Tax Outlook for FY 2013 Increases by \$43 Million since Nov. (\$ in millions)	
Nonproperty Taxes	\$43
Personal Income	28
General Corporation	(142)
Banking Corporation	112
Unincorporated Business	(73)
Sales	(2)
Property Transfer	13
Mortgage Recording	8
Utility	(13)
Hotel	80
Minor Taxes	33
Numbers may not add due to rounding.	

Economic Growth Steadies Following a Soft Patch

The nation is pulling out of an economic stall and is back on a moderate growth path. Unfortunately, the local economic recovery appears to be flattening. The city's February economic plan recognizes these new trends with a stronger national forecast and diminished expectations of local growth. The weaker local economic outlook has constrained the city to hold back on increases to its nonproperty revenue plan.

In the city's outlook, national output growth as measured by real gross domestic product (GDP) edges up slowly from 1.7 percent in CY 2011, when the national recovery nearly stalled, to 2.1 percent in 2012, 2.5 percent in 2013, before finally climbing to an above-trend growth rate of 3.4 percent in 2014. Even though these numbers tell of a very sluggish national recovery, this plan is more positive than the November economic plan. The city's current forecast of national jobs is also more positive than its previous employment projection. National jobs grow by 1.3 percent in the city's outlook for 2012, up from actual growth of 1.1 percent in 2011. Job growth improves to 1.7 percent in 2013 and to 1.9 percent in 2014 and 2015, before slipping to 1.6 percent in 2016.

Evidence that the nation is pulling out of a soft patch comes from GDP growth, which accelerated to 3.0 percent in the fourth quarter of 2011, from a too-sluggish 1.8 percent growth rate in the third quarter. Likewise, employment surged by 227,000 in February 2012, making it the third consecutive month with job growth exceeding 200,000. Despite these positive results, the recovery might not yet be self-sustaining, for to keep growth on track, the nation found it necessary to extend payroll tax cuts and emergency jobless benefits through the end of the year.

The local economy is practically flat in the city's plan. Real gross city product (GCP) starts out with less than one percent growth in 2011 and slightly negative growth in 2012. Local output growth remains soft at about two percent annually in 2013-16. Similarly, local job growth falls to 27,000 in 2012 from 33,000 in 2011, before strengthening to 54,000 late in the plan. This pessimistic outlook reflects a preliminary small sample employment survey, which has been superseded by a more comprehensive survey. The revised result shows that local jobs surged by 74,600 in 2011, which is more than twice as high as the preliminary estimate. Another factor behind the local weakness could be the \$4.9 billion in losses that accrued to Wall Street firms in the last two quarters of 2011, while the stock market was negative. Local weakness is also evident in regional data compiled by economists at New York Federal Reserve. Their February report states: "Our Indexes of Economic Coincident Indicators for December show continued growth in activity in New Jersey, but a slight decline in New York State. Activity in New York City remained essentially flat."

Aside from the slow recovery, the city has concerns about exogenous factors that could affect the local economy. The eurozone still provokes jitters, even though agreements have been reached to resolve the crisis. Another threat is that rising oil prices could diminish consumer purchasing power and derail the recovery. The depressed housing market, where the recession started, still remains a concern. Wall Street layoffs could further weaken the local economy. Federal Reserve policies to hold down interest rates are not sustainable in the long run and could affect the local

economy when they are lifted. Finally, federal income tax rules are ripe for reform, and some proposals like a higher capital gains tax rate could weigh down the local economy.

TAX COLLECTIONS SUPPORT MODEST REVENUE GROWTH

Total revenue increases by \$5.4 billion, in the city's plan, to \$72.8 billion in FY 2016 from \$67.4 billion in FY 2012, for growth of eight percent over the plan. City-funded revenue grows by \$6.6 billion, or 14.1 percent, over the plan. City-fund growth achieves 5.8 percent in FY 2013, abruptly slows to 0.4 percent in FY 2014 and then climbs to four percent in FY 2015 and 3.3 percent in FY 2016, as shown in Table 4.

SLOW GROWTH FOR PROPERTY AND NONPROPERTY TAXES

TABLE 4

(percent change, \$ in millions)

	FY 13	FY 14	FY 15	FY 16	FY 12	FY 16	FYs 12-16
Property Tax	3.2%	3.3%	3.5%	3.3%	\$17,812	\$20,291	13.9%
Nonproperty Taxes	4.5	2.6	5.2	3.8	22,860	26,764	17.1
Audits	3.4	(2.4)	0.0	0.0	700	706	1.0
STAR Aid	8.9	(0.2)	0.0	0.0	790	859	8.7
Miscellaneous	0.6	0.6	1.6	2.1	4,422	4,644	5.0
Nonrecurring	1,318.8	(97.7)	(52.0)	(6.6)	76	11	(85.5)
Unrestricted Aid	(100.0)	--	--	--	25	0	(100.0)
Disallowances	0.0	0.0	0.0	0.0	(15)	(15)	0.0
Total City Funds	5.8%	0.4%	4.0%	3.3%	\$46,670	\$53,261	14.1%
Categorical Aid*	(6.5%)	0.0%	0.3%	0.5%	\$20,148	\$19,009	(5.7%)
Interfund Revenue	(7.6)	(1.0)	0.0	0.0	551	504	(8.5)
Total Funds	2.0%	0.3%	3.0%	2.6%	\$67,369	\$72,774	8.0%

*Categorical Aid is the sum of state, federal and other categorical grants. Numbers may not add due to rounding.

The property tax, which grows by 13.9 percent over the plan, increases from \$17.8 billion in FY 2012 to \$20.3 billion in FY 2016. The property tax grows by 3.2 percent in FY 2013 due to two consecutive years of assessment growth. Growth increases slightly to 3.5 percent by FY 2015, as discussed in "Property Values Improve for a Second Year" beginning on page 14.

While the real property tax grows steadily through the plan, the nonproperty taxes show modest but unsteady growth. The nonproperty tax growth plan ranges unsteadily between a low of 2.6 percent in FY 2014 and a high of 5.2 percent in FY 2015, which is similar to the five percent growth achieved in FY 2012. Nevertheless, growth in the plan is down sharply from the 12.6 percent spurt in FY 2011 that marked the start of the recovery. Over the four-year plan period, the nonproperty taxes grow by 17.1 percent from \$22.9 billion in FY 2012 to \$26.8 billion in FY 2016.

Miscellaneous revenue increases by five percent from \$4.4 billion in FY 2012 to \$4.6 billion in FY 2016. Nonrecurring actions of \$1.1 billion are planned for FY 2013 and drop rapidly thereafter. The nonrecurring actions consist primarily of the sale of taxi medallions, which is discussed in greater detail in "Miscellaneous Revenue" beginning on page 7.

Nonproperty Tax Growth Is Slow and Uneven

The nonproperty taxes grow slowly but unsteadily through the plan period. The recovery of the nonproperty taxes started with a 12.6 percent surge in FY 2011 which reflected the recovery of securities industry profits, federal stimulus programs, and the Federal Reserve's efforts to encourage bank lending. Tax growth has since settled down to five percent in FY 2012 and 4.5 percent in FY 2013. The real estate transfer and the hotel taxes are currently among the growth leaders, while the business taxes are showing the least consistent growth pattern. The personal income and sales taxes, which are the largest of the nonproperty taxes, are settling into a moderate but uneven growth path. Overall nonproperty revenue growth drops to 2.6 percent in FY 2014 largely due to poor growth for the personal income tax and the financial corporation tax. Following the pause in FY 2014, growth climbs to 5.2 percent in FY 2015 before slipping back to 3.8 percent in FY 2016.

We think that the nonproperty taxes are at risk for a shortfall of \$250 million in FY 2012 and \$200 million in FY 2013. Collections have been slow in FY 2012 through January, particularly for the personal income and the unincorporated business taxes. We are also concerned about the flat economic activity in the city and the \$4.9 billion loss accrued by New York Stock exchange member firms in the last two quarters of CY 2011.

Business Taxes

The city expects collections for this group of taxes to grow five percent in FY 2012, down from the 18 percent surge in FY 2011, at the start of the upturn. Revenue growth drops to three percent in FY 2013, and to one percent in FY 2014 before accelerating to four percent by FY 2016. If revenues stay close to the slow and unsteady growth path mapped out in the city's plan, collections could surpass the prerecession peak of \$6 billion by FY 2016.

The banking corporation tax, which is the most volatile of the city's taxes, started its bank-bailout-assisted recovery two years earlier than the other business taxes with a steep climb of 75 percent in FY 2009. This climb was followed by a 12 percent decline in FY 2010, but helped by Federal Reserve policies to hold down interest rates, the bank tax bounced back in FY 2011 with a growth spurt of 39 percent. The city's plan has the bank tax falling by one percent in FY 2012, with the downward trajectory continuing for four years until revenue finally turns upward in FY 2016. The negative outlook is a result of concerns about how the banking industry will fare in the era of tighter regulatory oversight and without the support of the Federal Reserve's expansionary monetary policies.

The general corporation tax (GCT) increases slowly through the plan, easing back from the more rapid growth that occurred earlier in the recovery. GCT growth, which soared to 15 percent in FY 2011 and 10 percent in FY 2012, drops to about five percent in FY 2013 and three percent in FY 2014. The earlier growth was fueled by Wall Street profits, which reached \$89 billion over the two-year period of CYs 2009 and 2010. Additional support for this tax came from pretax corporate profits, which surged by 25 percent in CY 2010. More recently, corporate profits growth has declined to four percent

in the third quarter of 2011, a rate that is consistent with the modest GCT revenue growth targets in the city's plan.

The unincorporated business tax (UBT), which grew by seven percent in FY 2011, increases by only three percent in FY 2012. Revenue increases by five percent in FY 2013, after which growth levels off at about four percent in FYs 2014-16.

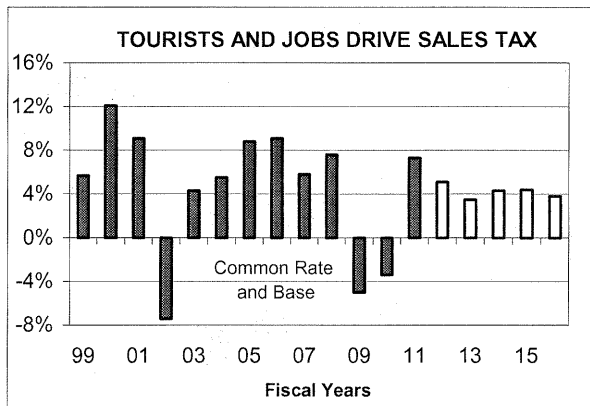
Property Transactions Taxes

The city has increased its estimates for the property transactions taxes by \$14 million in FY 2012 and by \$21 million in FY 2013. Despite this small plan-to-plan change, this group of taxes, consisting of the real property transfer and mortgage recording taxes, grow by 12 percent in FY 2012 to \$1.4 billion. While still impressive, the growth rate is down from 25 percent in FY 2011, which marked the start of the recovery from a three-year slump. The plan projects that growth will slow to eight percent in FY 2013, which is followed by unsteady growth in the outyears.

Sales Tax

Among the recent trends in personal income, consumer confidence, retail sales, stock prices, household debt, and home prices/sales, one fact remains constant--the consumer has shown remarkable resilience in difficult economic times. Despite weak income growth, households reacted positively to heavy promotions in the 2011 holiday season and have continued to spend, although at a slower pace, by either saving less or using credit. In addition, the city estimates that taxable consumption was boosted by a new high of 50.5 million tourists in 2011 and their associated spending of \$32 billion, which had positive effects on the hotel, and leisure and hospitality industries.

The city did not change the FY 2012 sales tax estimate of \$5.9 billion since the November modification. The FYs 2012-16 sales tax forecast is in line with past fiscal years' performance and is supported by the city's expectation of moderate gains in jobs and income during the plan period. As seen in the figure to the right, sales tax revenue (continuing base, annual percent change) advances by 5.1 percent in FY 2012, slows to 3.5 percent in FY 2013, exceeds four percent in both FYs 2014 and 2015, and settles at 3.8 percent in FY 2016.² After adding an estimated 27,000 jobs in 2012, the city projects that the local economy will create an average of over 46,000 jobs from 2013-16. Anticipating year-to-year



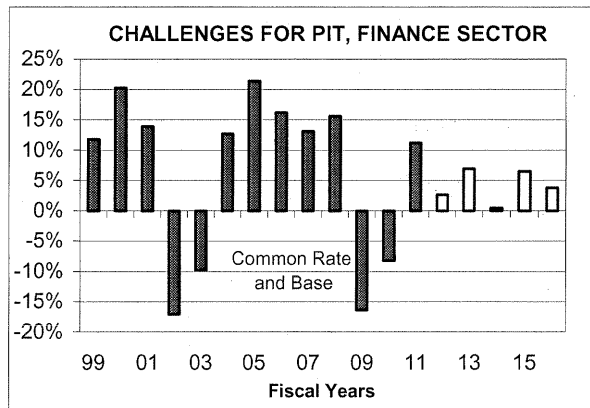
² "Continuing base" or "common rate and base" refers to tax collections that have been modified to remove the effects of tax programs and other adjustments to focus on the influence of the economy.

income growth of 1.1 percent in 2012 to \$294.4 billion, earnings are expected to rise annually thereafter, and record four percent growth in both 2015 and 2016.

Unlike past years where taxable consumption was supported by large payouts from the financial sector, the current recovery is more likely to continue at a measured pace and, therefore, the FYs 2012-16 sales tax forecast is likely to be achieved. However, if there is an unexpected shock to the global economy that causes a significant fall off in tourism or a sustained increase in domestic prices that prompts more frugality from consumers, the city's near-term sales tax forecast may be undercut.

Personal Income Tax

Compared with the prior plan, there are minor changes to the city's latest personal income tax (PIT) forecast for FYs 2012-16 in the context of a tax base that is projected to rise from \$8 billion in FY 2012 to \$9.6 billion in FY 2016. In the city's outlook, total employment and income are expected to exhibit slow but steady growth during the plan period, but job losses in the securities sector that began in 2011 will continue through the forecast period, while industry earnings stagnate at a high level.³ As seen in the figure to the right, PIT collections (continuing base, annual percent change) in the February plan are forecast to grow 2.6 percent in FY 2012, 6.9 percent in FY 2013, 0.5 percent in FY 2014, 6.5 percent in FY 2015, and 3.8 percent in FY 2016.⁴



Judged against historical collections of mostly double-digit gains or losses, the city's current PIT forecast for FYs 2012-16 is not aggressive. However, there are headwinds facing major players in the finance industry that are not easy to resolve, which may negatively impact the forecast. In the February plan, the city adjusted its estimate of the 2011 bonus pool for FY 2012 downward to a 10 percent year-to-year decline, after the report of a \$3 billion loss in the third quarter of 2011 for New York Stock Exchange (NYSE) member firms. The city expects the 2012 bonus pool for FY 2013 to drop eight to ten percent from the prior year. After posting a loss of \$2 billion in the fourth quarter of 2011, NYSE member firms earned \$7.7 billion for the year, compared to the city's estimates of \$13.1 billion in 2011 and \$14 billion in 2012. In light of recent events, the city's 2012 profit estimate may not be achieved if the trading environment remains volatile and investors stay cautious.

³ The city estimates that finance sector compensation reached \$82.9 billion in 2011 and will remain in the \$80 billion range until 2016 when improved business conditions will lift compensation to \$90.3 billion.

⁴ In the city's PIT projections, there is a spin-up in revenue from FY 2014 into FY 2013 from the expiration of the Bush era tax cuts.

Financial firms, to a greater or lesser extent, are having a hard time increasing revenues and profits given the sharp decline in earnings from trading and investment banking, and risk-averse clients. The emphasis is on cutting costs, including jobs and compensation, while firms deal with such issues as: eurozone sovereign debt, higher capital requirements, uncertain domestic fiscal policy, and new rules from the federal government regarding profitable activities. The result is that firms have reduced the amount set aside for compensation, capped cash rewards, and shifted more of the payment into shares that will vest in the future.

Meanwhile, withholding collections fell, on a year-to-year basis, 6.8 percent in December 2011 and 10 percent in January 2012. There is no guarantee that withholding collections in the rest of the bonus period through March will decline by a similar, but not greater, amount. Also, until tax returns for 2011 are filed in the spring, it won't be known if high-income taxpayers recorded capital gains or losses, from selling financial assets and realizing past awards of vested stock.⁵ For these reasons, the city's PIT forecast might be lower by \$150 million in FY 2012 and \$100 million in FY 2013.

Property Values Improve for a Second Year

Market values increased by 3.8 percent on the city's tentative FY 2013 tax roll. This new increase, coming after last year's 2.6 percent increase, indicates that the local real estate market is gradually emerging from its slump. This upturn in market values has enabled the city to project that in FY 2013 property taxes would grow by 3.2 percent to yield \$18.4 billion. We think that the presentation in the current tax roll is not readily comparable to previous tax rolls, because of the inclusion of exempt properties, and that growth appears to be overstated. Our analysis of the tentative roll indicates that the FY 2013 property tax growth could be as low as 2.9 percent, and diminish the tax yield by \$50 million per year in FYs 2013 through 2016, as shown in Table 3 on page 5.

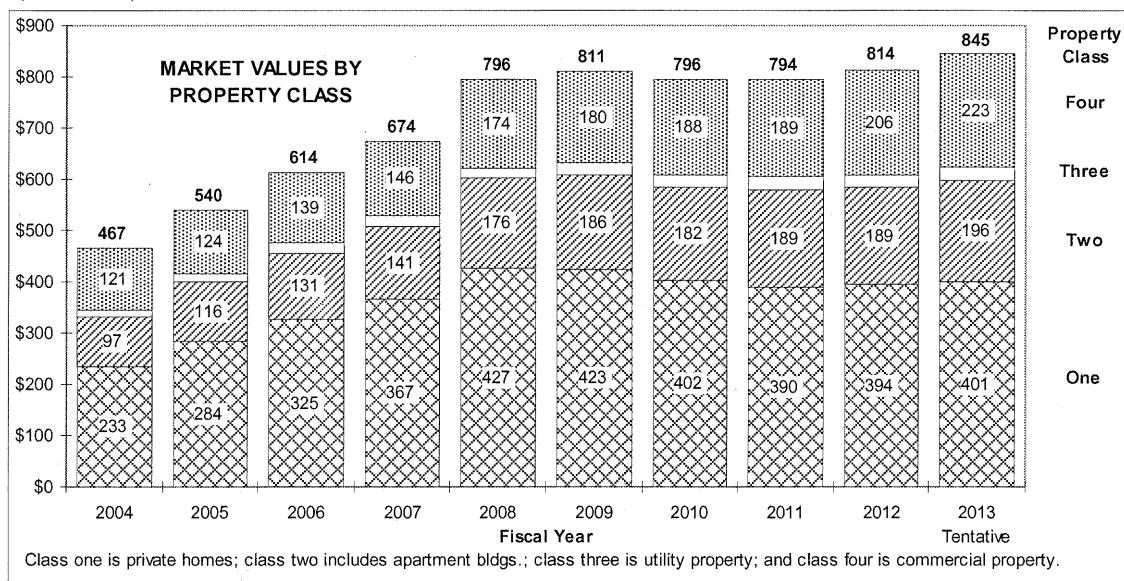
The city's report on the tentative assessment roll for FY 2013 indicates that the market value of all taxable city property increased by 3.8 percent to \$845 billion. This follows a 2.6 percent upturn in FY 2012. Previously, property values had been stagnant at about the \$800 billion level since FY 2008, as shown in Chart 1 on page 15. As welcome as is any sign of recovery, this 3.8 percent growth is modest compared with the 14 percent average annual market value growth achieved from FY 2004 to FY 2008. All property classes added to the overall increase, but growth was strongest for commercial properties. Private home values increased by 1.9 percent to \$401 billion. Residential apartment buildings grew by 3.6 percent to \$196 billion, while commercial properties increased by 7.9 percent to \$223 billion.

⁵ The Standard & Poor's 500-stock index finished 2011 nearly even with its 2010 close and the Dow Jones industrial average ended 2011 with a 5.5 percent gain over the prior year.

MARKET VALUES PULL OUT OF SLUMP WITH SECOND CONSECUTIVE INCREASE

CHART 1

(\$ in billions)



Billable assessments increased 5.7 percent on the tentative roll for FY 2013. The city estimates that by June, corrections to the tentative roll will reduce the billable growth rate on the final tax roll to 4.2 percent, which represents a decline from the 5.2 percent billable growth of the previous year. The weaker billable growth in FY 2013 reflects the five-year phase-in rule that moderates assessment changes for commercial properties and large apartment buildings. The chart shows that FY 2008 had a prerecession market value increase of 18 percent, which helped lift the FY 2012 tax base. In contrast, FY 2013 billable growth is being held down by the flat market values in the tax rolls of FY 2009 through FY 2011. Whatever billable growth occurs in FY 2013 is largely attributable to the upturn in market values in the two most recent tax rolls.

The city projects that property tax revenue will drop from 5.6 percent in FY 2012 to 3.2 percent in FY 2013 and then slowly climb to 3.5 percent in FY 2015. Much of this shifting growth is due to the city's changing need for contingency reserves. The city has moved a largely unused refund reserve from FY 2012 into FY 2013, lifting tax revenue in FY 2012 and weakening FY 2013 revenue growth. A larger refund reserve could eventually be needed if any large assessment disputes go against the city.

Much of the market value growth recorded for commercial properties reflects the inclusion of many properties like health and education buildings that are normally exempt from paying property taxes. The inclusion of about 1,000 previously exempt properties on the tentative roll indicates that the final roll might need a downward revision for these exempt properties. The city's revenue plan assumes that a 1.5 percent adjustment factor will be sufficient to cover the expected revisions to the final roll. When we attempted to verify the city's correction factor, we estimated that the correction could be as large as 1.8 percent. This larger adjustment translates into a risk of about \$50 million in lower property tax revenue in each of FYs 2013-16, as shown in Table 3 on page 5.

EXPENDITURES

On the face of the financial plan, the city estimates in its February modification total-funded spending of nearly \$67.4 billion in FY 2012. This is an increase of \$358 million over projected spending reported in its November modification. With the FY 2012 budget firmly in balance, the city projects a nearly \$1.3 billion surplus to be used in the prepayment of FY 2013 expenses, and at the same time, it expects to trim total-funded expenditures by \$927 million.

As shown in the figure to right, the city projects greater savings of almost \$1.1 billion before offsetting spending increases are taken into account. The largest portion of this savings is \$425 million, which will come from the reduced cost of changes to the pension fund's actuarial assumptions and methods. Other significant savings will be taken in Other than Personal Service (OTPS) totaling \$289 million and the city will decrease the General Reserve by \$200 million. Also, the city recognized \$93 million in debt service savings that resulted primarily from lower interest expenses and additional budget savings will come from lower spending on fringe benefits and revised costs to intracity funds saving the city \$26 million and \$42 million, respectively.

FY 2012 Expenses November to February Modifications	
Total Funds (\$ in millions)	
Budget Savings	
Pension Changes	(\$425)
Other OTPS	(289)
General Reserve	(200)
Debt Service	(93)
Fringe Benefits	(26)
Intracity Funds	(42)
Total Savings	(\$1,075)
Spending Increases	
Salaries and Wages	\$64
Medical Assistance	60
Public Assistance	24
Total Increases	\$148
Total Net Change	(\$927)
FY 2013 Prepayments	1,285
Total Increase	\$358

However, these savings are expected to be partially offset by anticipated increases in labor costs of \$64 million and higher spending in Medical and Public Assistance totaling \$84 million. The increase in spending will reduce budget savings of \$1.1 billion by \$148 million. With the inclusion of the surplus, total-funded expenditures will increase from \$67 billion to \$67.4 billion, or \$358 million.

In the November modification, the city had reported just \$12 million in surplus funds to be used to prepay FY 2013 expenses. Since then, the city has been able to increase its FY 2013 prepayments to almost \$1.3 billion. Much of the increase in surplus funds will come from reduced city-funded expenditures. As shown in the figure to the right, the city will reduce its reserve by \$500 million used for accrued claims funded in prior years, which is no longer needed. Additionally, the city has forecasted spending less in FY 2012 for expected changes in the actuarial assumptions and methods used by the pension systems. The city had funded a \$1 billion reserve in anticipation of these changes, but due to how the City Actuary is proposing to implement them, the city estimates it will not need to use all of the reserve, thus reducing it by \$425 million.

Growth in Surplus Funds from November to February Plan	
City Funds (\$ in millions)	
November Modification	\$12
Prior Payables Reserve	\$500
Pension Changes	425
General Reserve	200
Tax Revenue Forecast	111
Debt Service	81
HIP Rate Savings	2
Agency Spending	(34)
Surplus Increase	\$1,285
February Modification	\$1,297
Surplus Increase / (Decrease)	

In other actions, the city will reduce the General Reserve, as it routinely does at this time in the fiscal year, adding \$200 million to FY 2012 surplus funds. Also, the city has revised upward its revenue forecast and is now expecting to collect \$111 million more than previously estimated. Of the \$93 million of debt service savings being realized in FY 2012, the city is contributing \$81 million to prepay FY 2013 expenses. Also, it will save an additional \$2 million from lower healthcare costs. However, the city has budgeted for additional agency costs, slightly reducing surplus funds by \$34 million.

For FY 2013, the city projects expenditures to decrease significantly. In the February modification, the city projects that total-funded expenditures in FY 2013 will decrease from \$70.3 billion to \$68.7 billion, which is about \$1.6 billion less than estimated in the November modification. As shown in the figure to the right, much of the decrease between the modifications is from the use of about \$1.3 billion in additional surplus funds rolled into FY 2013 from FY 2012 to prepay expenses. The city is also expecting to reduce a pension reserve by \$425 million due to the changes to actuarial assumptions and methods that will cost less than anticipated. Additionally, the city has fine-tuned its debt service projections based on current market conditions and expected financing needs to realize \$120 million in savings. After the release of the February modification, the city held a refunding bond sale that achieved debt service savings of \$139 million in FY 2013, as shown in Table 3 on page 5. Because the city did not project savings from a new sale of refunding bonds in its current financial plan, these savings will be in addition to the \$120 million reduction. However, the city is projecting higher spending costs in its OTPS expenses totaling \$150 million and \$56 million more is expected to be spent in other budgetary areas.

FY 2013 Expenses November to February Modifications	
Total Funds (\$ in millions)	
Prepayment of Expenses	(\$1,285)
Pension Changes	(425)
Debt Service	(120)
OTPS	150
Other	56
Total Decrease	(\$1,624)

In its November modification, the city had estimated a budget gap of more than \$2 billion for FY 2013. Since then, the city has built up nearly \$1.3 billion of surplus funds in FY 2012 that will be used to prepay FY 2013 expenses, as shown in the figure to the right. Other measures to balance the budget will include reduced pension spending of \$425 million, higher revenue collections of \$278 million, lowered city-funded debt service costs of \$99 million, and healthcare savings of \$42 million. However, the city is anticipating higher agency spending of \$88 million to cover new needs. With the savings generated, the financial plan assumes that FY 2013 will be balanced. Nonetheless, the city does estimate that gaps in FYs 2014 to 2016 will still persist. The February modification assumes gaps of \$3 billion in FY 2014, \$3.5 billion in FY 2015, and \$3.4 billion in FY 2016.

FY 2013 Gap-Closing Actions from November to February Plans	
City Funds (\$ in millions)	
November Mod Gap	(\$2,041)
FY 2012 Prepayment	\$1,285
Pension Changes	425
Revenue Forecast	278
Debt Service	99
HIP Rate Savings	42
Agency Spending	(88)
Total Gap-Closing	\$2,041
February Mod Gap	\$0
Gap (Increase) / Decrease	

PROJECTED GROWTH IN TOTAL-FUNDED EXPENDITURES IN FYs 2012 TO 2016

TABLE 5

(yr/yr percent change, \$ in millions)

	FYs 2012-13	FYs 2013-14	FYs 2014-15	FYs 2015-16	FYs 2012-16	Level in FY 2012	Level in FY 2016
Total Expenditures	2.1%	4.7%	3.5%	2.3%	13.2%	\$66,817	\$75,664
Total PS	(0.5%)	1.6%	3.9%	2.4%	7.5%	\$36,542	\$39,294
Salaries and Wages	(1.6%)	0.3%	(0.2%)	1.1%	(0.4%)	21,333	21,257
Fringe Benefits	0.0%	8.0%	19.9%	6.6%	38.0%	7,333	10,122
Pensions	1.8%	(0.8%)	(1.4%)	1.0%	0.5%	7,875	7,915
Total OTPS	5.3%	8.3%	3.2%	2.1%	20.1%	\$30,276	\$36,370
Public Assistance	(4.5%)	1.5%	0.0%	0.0%	(3.1%)	1,409	1,365
Medicaid	0.7%	2.2%	2.8%	1.5%	7.3%	6,275	6,735
Debt Service	11.9%	8.3%	5.4%	3.8%	32.5%	5,612	7,436
Other OTPS	5.6%	11.0%	2.8%	1.9%	22.7%	16,980	20,834

Note: Excludes interfund and intracity expenditures. Other OTPS adjusted for surplus funds.
Numbers may not add due to rounding.

Over the life of the financial plan, the city has projected total-funded expenditures, excluding interfund and intracity expenditures, to grow from \$66.8 billion in FY 2012 to \$75.7 billion in FY 2016. As shown in Table 5, this is growth of nearly \$8.9 billion, or 13.2 percent. Expenditures are divided between Personal Service (PS) and Other than Personal Service (OTPS). The city is expecting to see growth of 7.5 percent, or about \$2.7 billion, in its PS area. The growth in this budget area is expected to be driven mainly by higher spending in fringe benefits, which will increase by 38 percent over the plan, for an increase of nearly \$2.8 billion. However, while the city estimates that fringe benefits will grow substantially, salaries and wages will fall by \$77 million, or 0.4 percent, and pension costs will remain relatively flat increasing by just \$40 million, or 0.5 percent.

The lower cost in salaries and wages reflects the city's planned headcount reductions, assuming that all its PEG initiatives are implemented as planned. All of the CYs 2006-08 round of collective bargaining contracts will expire in CY 2012. The city has reserves for the funding of undistributed salary increases for these remaining contracts. The reserve also contains funding for wage increases beyond the CYs 2008-10 round of collective bargaining, which is expected to begin three years after that round expires and is assumed to be 1.25 percent.

The city projects that its annual pension cost will hardly grow over the life of the financial plan due to the partial use of a pension reserve, but the overall actual costs to the city for these benefits are significant. In FY 2012, at about \$8 billion, total-funded pension costs consume almost 11.9 cents of every total-funded revenue dollar, and as a percentage of salaries and wages, it accounts for more than 36 percent.

GROWTH IN CITY-FUNDED PENSION COSTS IS HELD FLAT IN FYs 2012 TO 2016

TABLE 6

(\$ in millions, City Funds)

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
June Plan	\$8,259	\$8,405	\$8,284	\$8,529	\$8,529
Release of Reserve	(\$1,000)	(\$1,030)	(\$1,040)	(\$1,050)	(\$1,060)
State Pension Reform	--	--	--	(80)	(155)
Actuarial Assumptions	575	605	539	148	37
Other Adjustments	--	--	--	--	150
Delay in Reform	--	--	131	252	373
Funding Shift	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>
Projected Decrease	(\$420)	(\$420)	(\$365)	(\$725)	(\$650)
February Plan	\$7,839	\$7,985	\$7,919	\$7,804	\$7,879

In Table 6, city-funded pension costs (excluding state, federal and intracity expenses), are shown to be held relatively flat at about \$7.8 billion, growing by just \$40 million from FYs 2012 to 2016. This is because the city expects pension costs to be much lower than its June financial plan estimates. New projections show that pension costs will decline by \$420 million in each of FYs 2012 and 2013, \$365 million in FY 2014, \$725 million in FY 2015, and \$650 million in FY 2016, as shown in the table.

Much of those decreases are due to the release of a \$1 billion pension reserve that was funded to address changes to how pension benefits are calculated and funded. The financial plan assumes that the reserve will not be needed in its entirety. The Office of the Actuary (OA) prepares estimates for the funding of the city's annual pension contribution based on a set of actuarial assumptions and methods. In response to a final independent audit produced by the Hay Group and released in December 2011, the OA has proposed a number of recommendations that revise these assumptions and methods.

The major components of the OA's proposed changes are as follows:

- lowering the Actuarial Interest Rate (AIR) assumption from eight percent to seven percent;
- update mortality tables and modify assumptions of rates for retirement and disability;
- implement a market value restart, which entails resetting the actuarial asset value to the market asset value as of a particular point in time;
- switch the funding method to the Entry Age Normal Cost Method from the currently used Frozen Initial Liability Method, and
- amortize the liabilities recognized by the new funding method over a 22-year period, which is seven more years than under the current method.

In anticipation of expected changes in actuarial assumptions and methods, the city had set aside in reserve \$1 billion annually, as shown in Table 6. However, the OA's proposed recommendations shown above, which include changing funding methods and the amortization period, are now projected to be much less expensive than anticipated.

If the OA's recommendations are ultimately implemented, the city will be able to release the pension reserve and the OA will be able to switch to the alternative funding method and also implement the other proposed method changes. These actions will

offset the cost of the assumption changes over the financial plan period. As shown in Table 6 on page 19, the proposed changes are now expected to cost \$575 million in FY 2012, \$605 million in FY 2013, \$539 million in FY 2014, \$148 million in FY 2015, and only \$37 million in FY 2016. The reduction in the reserve will reduce pension costs by \$425 million in each of FYs 2014 and 2015, and for FYs 2014 to 2016 the city expects to reduce costs even further by \$501 million, \$902 million, and \$1.023 billion, respectively. The reduced spending will be used as gap-closing actions over the life of the financial plan. Without the use of these funds, the city would be forced to take other actions that might include more layoffs, further reductions in city services, or increased revenues.

The OA is currently in the process of presenting the recommendations to each of the five pension systems' Board of Trustees. The trustees of each board have typically approved the OA's proposed recommendations. Following this, the state legislature will need to vote to enact a change in the AIR. If any of these recommendations are not implemented, the amount of monies needed by the city to meet its pension expense would change.

Also, the city has budgeted for savings of \$80 million and \$155 million in FYs 2015 and 2016, respectively, for a new pension reform plan that was proposed by Governor Cuomo in his SFY 2012-13 Executive Budget. The proposal seeks to create a Tier 6 for newly hired state employees and a Tier 5 for newly hired city employees.⁶

Highlights of the Governor's plan as detailed by the city are:

- new nonuniformed employees will work until age 65 to retire and receive a pension,
- all new employees will contribute four to six percent of salary determined by salary level,
- the city and new employees will share the additional cost or savings if pension contributions fall outside a set range,
- new employees can elect for a defined contribution plan that vests in one year with a four percent employer contribution plus an employer match of up to an additional three percent and,
- restrictions on overtime and other items in compensation used to calculate pension benefits will be put in place.

If the reform is enacted by the state legislature, the city will start to see pension savings in FY 2015 of \$80 million and \$155 million in FY 2016.⁷ Preliminary savings over the long term are estimated to be about \$30 billion over the next 30 years. The state has projected, that on a statewide basis, the savings will be \$113 billion, including New York City, over 30 years.

⁶ State legislative enactment is required for the reform to take effect.

⁷ The city will remove \$131 million in FY 2014, \$252 million in FY 2015, and \$373 million in FY 2016 stemming from a reform plan proposed last fiscal year. This will delay projected pension savings by one fiscal year as shown in Table 6 on page 19. For a full discussion of the city's proposed pension reform, see the March 24, 2011 FCB Staff Report starting on page 23.

Fringe benefits paid by the city (not including pension costs), encompass spending on healthcare, payroll tax, unemployment insurance, payments to Supplemental Welfare Funds, and workers' compensation. These costs are expected to total \$7.3 billion in FY 2012 and rise to more than \$10 billion by FY 2016, as seen in Table 5 on page 18. All categories are estimated to increase over the plan period with health insurance being the primary driver of the additional spending. The financial plan reflects estimated spending in healthcare costs for active and retired city workers to increase from about \$4 billion in FY 2012 to almost \$6.7 billion in FY 2016.

As Table 5 on page 18 shows, the cost of fringe benefits is forecasted to grow steeply, especially between FYs 2014 and 2015. But the growth between these two fiscal years reflects the drawdown of the Retiree Health Benefits Trust (RHBT). The financial plan assumes that the RHBT will draw down funds totaling almost \$2.7 billion from FYs 2012 to 2014, with \$672 million in FY 2012 and \$1 billion in each of FYs 2013 and 2014. Following this schedule of drawdowns, the city will deplete the RHBT fully by FY 2014.

As we have reported in the past, we find these actions unfortunate and troubling. The city is relying on these resources to address budget balance in FYs 2012 and 2013 and narrow the gap in FY 2014. This action does nothing to address the structural imbalances that the city faces in the outyears of the financial plan. The use of the RHBT makes a point about the financial stress the city is experiencing. These actions follow the use of \$1.1 billion in RHBT funds to offset pension fund investment losses from prior fiscal years. We are most concerned that by depleting the RHBT, the city leaves the Other Postemployment Benefits (OPEB) liability, now a staggering \$84 billion as of June 30, 2011, completely unfunded. We project that the unfunded OPEB liability will continue to grow at about \$5 billion a year on average exceeding \$100 billion by the end of the financial plan. Even worse, in the long term, the cost of providing pay-as-you-go funding of OPEB expenses will likely become a strain on the budget requiring the further reduction of services or the increasing of revenues in the future. The annual pay-as-you-go OPEB costs are increasing at about \$200 million a year. By FY 2016, they will cost the city more than \$2.7 billion annually and in just ten years an additional \$2 billion will be added to the city's annual cost of providing these benefits.

The city's Other than Personal Service (OTPS) is expected to increase by 20.1 percent, or \$6.1 billion, from FYs 2012 to 2016. Growth is expected in all of the major budgetary areas that comprise OTPS except in Public Assistance, which is projected to decrease by 3.1 percent, or \$44 million, over that period. Behind much of the spending increase in OTPS is higher forecasted growth in debt service expenditures and other OTPS. These two budget areas are projected to increase by 32.5 percent and 22.7 percent, respectively. The growth in spending between these two areas will add about \$5.7 billion more to the city's budget by FY 2016. See the section titled "Framework for Debt Analysis" on page 23 for a detailed discussion on debt service costs.

Elsewhere, the cost for the city's share to fund Medical Assistance expenditures will increase by \$461 million from \$6.3 billion to \$6.7 billion, or 7.3 percent for FYs 2012-16, as shown in Table 5 on page 18. The state had put into place a cap of three percent on growth in Medicaid expenditures in which the state funds any additional spending above the cap. A major initiative in the state's proposed SFY 2012-13 budget is to take over the three percent growth in the local share of Medicaid costs and implement a

phased takeover of local government Medicaid administration expenses. The action will incrementally reduce Medicaid growth starting in SFY 2013-14 from three to two percent and then it will reduce the cap further by an additional one percent annually over the next two fiscal years.

The proposal, if enacted by the state legislature, will negate the growth in the city's Medicaid expenses by SFY 2015. The state takeover of the three percent Medicaid growth factor is projected to save the city \$1.2 billion over five state fiscal years. Savings over the financial plan are expected to be \$11 million in FY 2013, \$65 million in FY 2014, \$164 million in FY 2015, and \$293 million in FY 2016. The city has not included these projected savings in its February modification awaiting state legislative approval, but we see it as a potential upside and have included it as an offset to our risk projections in Table 3 on page 5.

The February modification reflects the continuation of the Program to Eliminate the Gap (PEG) that was initiated in the November modification. The program is mainly the same with only minor downward adjustments. The city expects to reduce its FY 2012 PEG to \$465 million, which is just \$5 million lower than the November modification. The savings grow on an annualized basis to more than \$1 billion in FY 2013, but are reduced substantially in FYs 2014 to 2016 to \$626 million, \$627 million and \$537 million, respectively.⁸ The city's PEG, starting in FY 2008 when the first PEG was implemented, has produced significant annual savings and has contributed greatly to balancing the city's budgets for these fiscal years. Through FY 2011, the city has reduced agency expenditures by \$618 million in FY 2008, \$1.6 billion in FY 2009, \$3.5 billion in FY 2010, and \$4.6 billion in FY 2011. The city expects these savings to grow even higher in FYs 2012 and 2013 with savings of \$5.4 billion and \$6.2 billion, respectively.

Overtime spending in the city's four uniformed agencies is projected to exceed \$1 billion for FY 2012, but decrease to \$910 million in FY 2013, \$866 million in FY 2014, \$838 million in FY 2015, and \$802 million in FY 2016. The February modification increases overtime spending over the November modification by just \$4.4 million for FY 2012. In FYs 2013 to 2016, the projected budget remains relatively the same. Since the June plan, the city has raised its estimated spending by almost \$300 million in FY 2012 and by about \$250 million in FY 2013, \$209 million in FY 2014, and \$181 million in FY 2015. As a percentage of total citywide overtime expenditures, total uniformed overtime spending accounts for about 88 percent in FY 2012.

⁸ For a detailed review of the Program to Eliminate the Gap, see the December 16, 2011 FCB Staff Report, starting on page 15.

As shown in the figure to the right, we project the following cost and risk estimates for uniformed services overtime over the life of the financial plan. Based on fiscal-year-to-date actual spending of \$603 million through January 2012, the city is on track to spend \$1.034 billion. We will hold at risk \$29 million in FY 2012, increasing to \$124 million in FY 2013, \$167 million in FY 2014, \$196 million in FY 2015, and \$231 million in FY 2016, as shown in the figure and in Table 3 on page 5. We believe that the risks will fall over the life of the plan as the city increases its spending estimates.

Overtime Estimates and Risk (\$ in millions)		
Fiscal Year	City Estimate*	Budget Risk**
2012	\$1,004	(\$29)
2013	\$910	(\$124)
2014	\$866	(\$167)
2015	\$838	(\$196)
2016	\$802	(\$231)
* Uniformed and Civilian Personnel		
**(Negative) numbers increase gap		

FRAMEWORK FOR DEBT ANALYSIS

Among the many services that the city provides, its investment in capital improvements is essential to facilitating a strong economy. The city's capital program covers infrastructure work for such areas as streets, highways, bridges, and water and sewer systems; and public works for such areas as school buildings, police and fire stations, waste disposal systems, hospitals, correctional facilities, housing, government office buildings, libraries, and economic development. Its capital budget, which is supported primarily by borrowed funds, is distinct from its operating budget. However, the capital debt is repaid from current revenues in the operating budget. Accordingly, the capital program has to compete with other expense budget items, such as labor and social services, as the city determines its own priorities given limited resources.

Since FY 1981, the first year the city achieved a budget that was balanced in accordance with generally accepted accounting principles (GAAP), through the end of FY 2011, the city borrowed \$67.7 billion in the form of general obligation (g.o.) bonds to fund its capital program. Additionally, the Municipal Assistance Corporation for the City of New York (MAC) sold \$2.4 billion of bonds through FY 1985, when its statutory authorization to raise new funds for city capital purposes expired; and the New York City Transitional Finance Authority (NYCTFA) borrowed \$20.7 billion from FY 1998 in the form of revenue bonds to support citywide public works. The combined \$90.7 billion of bonded debt was backed by city tax revenues. At the end of FY 2011, \$60.9 billion of this debt was outstanding.⁹

⁹ Additionally, the New York City Municipal Water Finance Authority was created in 1985 to issue bonds on an ongoing basis to finance capital investment in the city's water and sewer system, which are supported by user fees, not tax revenues. \$30 billion of such bonds have been sold, with \$26.5 billion remaining outstanding through FY 2011.

The current financial plan for FYs 2012-16 assumes that the city and the NYCTFA will sell \$24.5 billion of tax-supported bonds to fund existing capital contracts and a portion of the new commitments that will be entered into during this period.¹⁰ As illustrated in the figure to the right, with the additional borrowing, outstanding debt will climb each year from \$63.5 billion at the end of FY 2012 to \$70.1 billion at the end of FY 2016. As projected in the current financial plan, servicing the outstanding debt will represent \$5.6 billion of the city's FY 2012 operating expenditures and grow incrementally to \$7.4 billion by FY 2016. A review in this section of several fiscal indicators will provide a framework for which to gauge the financial impact of the city's debt program.

Fiscal Year	2012	2013	2014	2015	2016
(\$ in billions)					
G.O. and NYCTFA					
Bond Issuances	\$5.325	\$5.000	\$5.140	\$4.800	\$4.280
Outstanding Debt	\$63.453	\$65.470	\$67.602	\$69.158	\$70.090
Debt Service	\$5.612	\$6.278	\$6.797	\$7.163	\$7.436

Outstanding Debt Analysis

While quite large, the debt loads for the city and the NYCTFA fall within their respective legal limits, as the city has diversified its debt capacity but without providing a meaningful threshold for the combined tax-supported debt. Originally, the amount of outstanding city g.o. debt and capital contract liabilities to be funded by g.o. debt was restricted constitutionally to ten percent of the five-year average full value of taxable city real estate. MAC, which was created in 1975 to help the city recover from its fiscal crisis by providing proceeds from the sale of securities to pay off the city's accumulated budget deficits and short-term debt as well as to restart the city's capital program, exhausted its debt limit in FY 1985. To augment the city's debt capacity, the NYCTFA was created in 1997 by the state legislature to raise funds for the capital program. The NYCTFA's statutory debt limit has increased incrementally to \$13.5 billion of outstanding debt. Additionally, the NYCTFA is permitted to exceed this limit providing that the extra debt, combined with the amount of outstanding g.o. debt, does not exceed the debt limit for the city.¹¹ The portion of NYCTFA outstanding debt that exceeds \$13.5 billion grows from \$4.1 billion in FY 2011 to \$11.3 billion in FY 2015, which is calculated as part of the debt subject to the general limit.

In its latest annual statement of debt affordability that was published in May 2011, the city estimated that its constitutional debt-incurring power would hold steady at \$76 billion to \$77 billion for each of FYs 2011-15.¹² As such, it was determined that the city had an unused debt margin of \$21 billion in FY 2011 that would decline to \$15

¹⁰ The current financial plan projects that such capital commitments expected to be entered into during FYs 2012-16 will total \$21.3 billion.

¹¹ Theoretically, if the statutory debt limit is reached with the sale of NYCTFA bonds, the city could still issue g.o. bonds under the constitutional debt limit since that limit would exclude outstanding NYCTFA bonds.

¹² The legislation creating the NYCTFA requires the city to produce an annual statement of debt affordability.

billion in FY 2014, then increase to \$16 billion in FY 2015, which is illustrated in Table 7.¹³ The fact that there is that much remaining debt incurring power reflects the exclusion from the calculation of \$13.5 billion of NYCTFA outstanding debt. Having two discreet debt limits has increased the overall bonding capacity; but the current levels if fully exercised would generate untenable financial conditions. A single threshold for a combined tax-supported debt provides a more useful tool for safeguarding against an unmanageable debt load.

EXCESS DEBT-INCURRING POWER UNDER THE STATUTORY DEBT LIMIT

TABLE 7

(\$ in billions)

Fiscal Year	2011	2012	2013	2014	2015
Total City Debt-Incurring Power Under General Debt Limit	\$76.224	\$76.146	\$77.338	\$76.540	\$77.297
G.O. Debt Subject to Debt Limit	\$41.541	\$41.814	\$42.102	\$42.389	\$42.376
NYCTFA Debt Outstanding					
Above \$13.5 Billion	4.124	6.307	8.073	9.808	11.290
Contracts and Other Liabilities	<u>9.515</u>	<u>10.303</u>	<u>10.308</u>	<u>9.396</u>	<u>7.960</u>
Total Indebtedness	\$55.180	\$58.424	\$60.483	\$61.593	\$61.626
Debt Margin	\$21.045	\$17.721	\$16.855	\$14.947	\$15.670

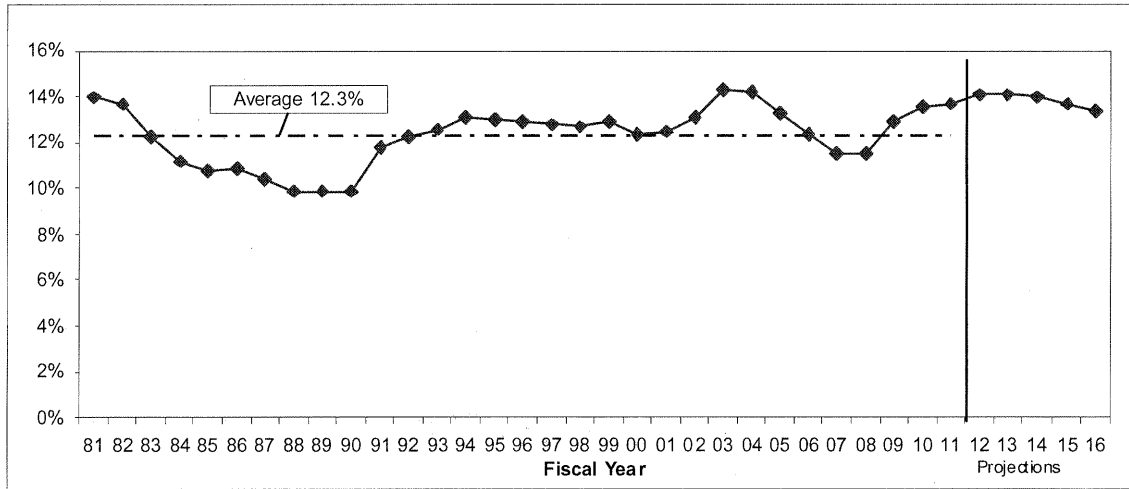
Note: Numbers may not add due to rounding.

In assessing the manageability of the combined debt for the city and NYCTFA, we performed a time series analysis of the debt to local personal income ratio, as income is an indicator of the economic vitality of the city. Such an analysis reveals that the debt as a percent of income is expected to hover at 14.1 percent in FYs 2012 and 2013, then decrease to 14 percent in FY 2014, 13.7 percent in FY 2015 and to 13.4 percent in FY 2016, as the growth rate for income is projected to be faster at 3.9 percent relative to the 2.5 percent for debt. Relating this forecast to historical trends, a 31-year review of debt to income, using 1981 as the start date, illustrates that the ratio ranged from a low of 9.9 percent in each of FYs 1988-90 to a high of 14.3 percent in FY 2003, when the city was in the midst of an economic downturn. During the 31-year period, the ratio averaged 12.3 percent and had only exceeded 14 percent twice—in FYs 2003 and 2004, as illustrated in Chart 2 on page 26. Accordingly, the projections for outstanding debt indicate a heavier than average debt burden for the local economy that easily could become a major challenge to manage if there is a sudden economic drop-off.

¹³ Since the May 2011 publication of the statement of debt affordability, projections for outstanding debt have changed slightly, ranging from a decrease of \$460 million in FY 2012 to an increase of \$139 million in FY 2015.

PROJECTIONS FOR OUTSTANDING DEBT REPRESENT A HEAVIER THAN AVERAGE PERCENTAGE OF LOCAL PERSONAL INCOME

CHART 2



Debt Service Analysis

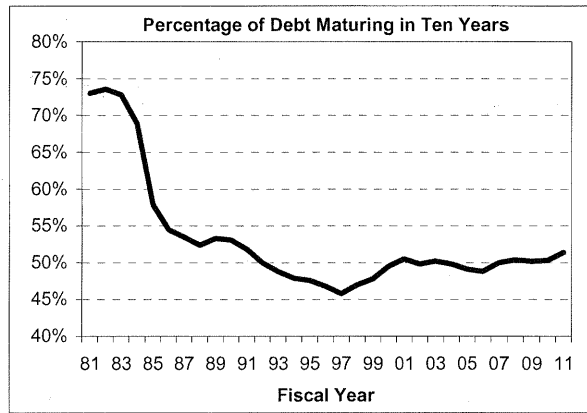
To evaluate the fiscal implications of the size of the outstanding debt, we consider the impact of the annual payment of principal plus interest on the operating budget. Over the past 31-year period, city tax-supported debt service costs have grown at an average annual rate of 3.3 percent, with growth for the last 10-year period leveling off at 2.8 percent.¹⁴ The current financial plan forecasts that debt service will pick up speed, advancing at 32.5 percent between FYs 2012 and 2016, or an average annual rate of 7.3 percent, as presented in the figure to the right.¹⁵ For its part, NYCTFA will increase from representing 27 percent of total debt service costs in FY 2012 to 32 percent in FY 2016, reflecting an average annual growth rate of 11.8 percent.

City & NYCTFA Debt Service as a Percentage of Tax Revenues (\$ in billions)					
FY	Debt Service			Tax Revenues	Debt Service Burden
	City	NYCTFA	Total		
2012	\$4.102	\$1.510	\$5.612	\$42.162	13.3%
2013	4.559	1.719	6.278	43.858	14.3
2014	4.822	1.975	6.797	45.065	15.1
2015	4.990	2.173	7.163	46.997	15.2
2016	5.080	2.356	7.436	48.621	15.3
Average Annual Growth	5.5%	11.8%	7.3%	3.6%	

¹⁴ We exclude the impact of the use of budget surpluses to prepay future-year debt service.

¹⁵ In forecasting its debt service costs, the city uses conservative interest rate assumptions. Currently, market rates are unusually depressed due to U.S. monetary policies, resulting in the realization of interest savings on actual debt incurred by the city and NYCTFA, which are recognized incrementally in each financial plan. Indeed, the current financial plan modification when compared to the November 2011 modification reflects \$93 million in debt service savings in FY 2012, \$120 million in FY 2013, \$85 million in FY 2014, \$62 million in FY 2015 and \$33 million in FY 2016, most of which represent interest savings. In applying conservative interest rate assumptions, the city is making credible debt service projections for when interest rates normalize.

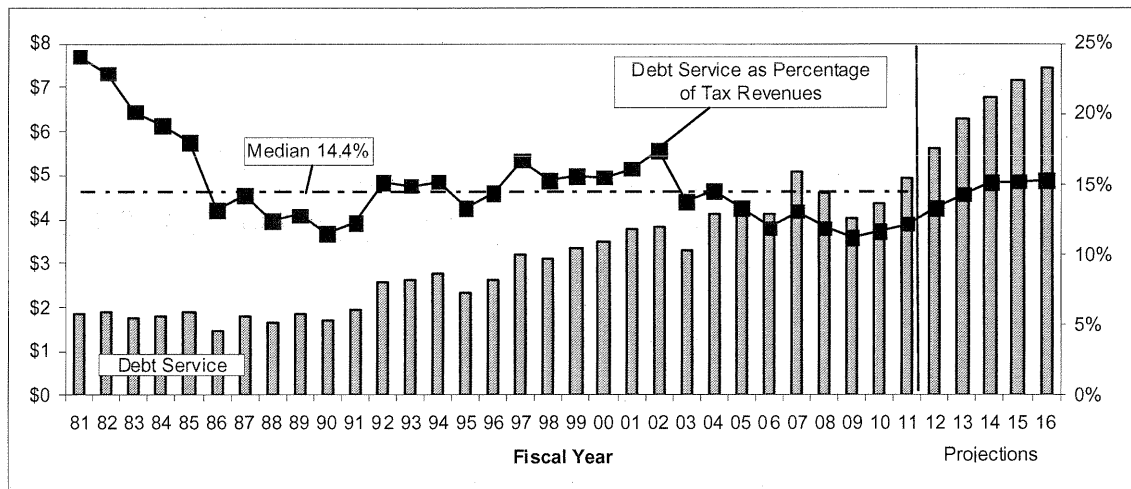
Debt service is forecasted to consume 13.3 percent of tax revenues in FY 2012, a year in which the budget is balanced. However, surging at the swift average annual rate of 7.3 percent compared to 3.6 percent for tax revenues, debt service is forecasted to absorb 14.3 percent of taxes in FY 2013, 15.1 percent in FY 2014, 15.2 percent in FY 2015 and 15.3 percent in FY 2016, as shown in Chart 3. For a comparison to the historical norm, we traced the 31-year history of debt service to tax revenues and observed that, upon sequencing the ratios, the median burden was 14.4 percent.¹⁶ The current forecast of the debt service burden for FYs 2012-16 surpasses the historical norm in three of the five years, as can be seen in the chart. The extremely high debt service burden in the earlier years correlates with the short maturity structure of bonds sold in the early 1980s, which is depicted in the figure above.



DEBT SERVICE AS A PERCENTAGE OF TAX REVENUES IS EXPECTED TO CLIMB ABOVE THE HISTORICAL NORM

CHART 3

(\$ in billions)



The city has demonstrated in the past that it could handle an above-median debt service burden by virtue of continuously balancing its budgets over a 31-year period. In years when the city experienced budgetary pressures, it was forced to adjust the allocation of its resources in accordance with its own priorities. In the current financial plan, total expenditures exceed total revenues by over \$3 billion for each of FYs 2014-16,

¹⁶ Using the median instead of the average gives less weight to the disproportionately high debt service burden for FYs 1981-85, when the city had just regained market access after its fiscal crisis of the 1970s.

the years for which the projected debt service burden exceeds the median. In the absence of revenue increases, expenses would have to be pared down for the achievement of budget balance. Faced with expenditure pressures, the city would have to make a judgment on whether the value of its capital program merits displacement of other essential services.

Glossary of Acronyms

AIR	Actuarial Interest Rate
CY	Calendar Year
DOE	Department of Education
FCB	Financial Control Board
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GCP	Gross City Product
GCT	General Corporation Tax
GDP	Gross Domestic Product
G.O. Bonds	General Obligation Bonds
HHC	Health and Hospitals Corporation
MAC	Municipal Assistance Corporation
NYCTFA	New York City Transitional Finance Authority
NYSE	New York Stock Exchange
OA	Office of Actuary
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
SFY	State Fiscal Year
STAR	School Tax Relief program
UBT	Unincorporated Business Tax