

Staff Report
**BUDGETARY PRESSURE FROM
FAST GROWING EXPENSES**
March 22, 2005

New York State Financial Control Board

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I. Overview

Our review of the city's midyear modification to the FYs 2005-09 financial plan finds that FY 2005 will end with a substantial budget surplus. A surge in nonproperty taxes has produced \$1 billion in extra revenues for FY 2005. The city has taken actions to reduce expenditures which will more than offset higher spending for social services and education. This combination allows the city to apply an additional \$1.4 billion to the Budget Stabilization Account for a total of \$2 billion. The larger FY 2005 surplus, which will be used to prepay FY 2006 expenditures, will slightly exceed the surplus that was rolled into FY 2005 from previous years, indicating that the current-year revenues grew at a pace sufficient to meet current-year expenses.

There is a potential for the FY 2005 surplus to be even larger by \$275 million. We estimate that the gain in nonproperty tax revenues and miscellaneous revenues may actually be higher by \$425 million. These positive variances could be partially offset by \$150 million of revenues expected to be received from the sale of city-owned land to the Battery Park City Authority that we continue to hold at risk because we are unsure whether the deal can be completed by the end of FY 2005.

The city has emerged from an economic downturn and now appears to be in the early phase of a solid recovery. An improving local economy, with a long-awaited turnaround in employment and an ongoing boom in the real estate market, is currently producing strong growth in revenues. However, the city faces significant fiscal challenges in the outyears of the plan. The city plans to use all of an estimated \$2 billion FY 2005 surplus, in addition to \$1.7 billion of other gap-closing actions, to address the budget imbalance projected for FY 2006. Even after these actions, the city projects that the budget gap in FY 2007 will be over \$3.7 billion. The financial plan assumes conservative revenue growth in FYs 2006-09 for the property and non-property taxes, as well as miscellaneous revenues. Revenues are weakest in FYs 2006 and 2007 due to the expiration of temporary tax increases and the depletion of one-time resources. Also, because of the city's expectation of rising interest rates, the forecasts for the property transaction taxes, which are currently growing at an accelerated pace, have been constrained in the outyears of the plan. We believe the city's forecast of modest revenue growth is reasonable.

The source of budgetary pressure lies on the expenditure side. Spending in such areas as fringe benefits, pensions, Medicaid, and debt service is projected to rise at a pace that outstrips the growth in tax revenues. Within fringe benefits, it is healthcare costs that make up over half the spending in this category. As the city's required contribution to the pension system continues to rise, the City Actuary is considering proposing a package of actuarial assumptions and methods to the retirement systems later this fiscal year. If proposed and approved, the package will defer some near-term pension costs to later years in the city's financial plan. Escalating Medicaid costs remain a pressing issue, and the city and state are in discussions over actions which may be taken to limit this growth.

The rise in debt service reflects the city's large capital program, which places an emphasis on upgrading and expanding school facilities. In hopes of easing the burden debt service will place on the operating budget, the city is planning to undertake several capital projects that are designed to stimulate economic activity and ultimately expand the revenue base. While this investment strategy has merit, the amount and flow of the new revenue streams are not guaranteed. If the revenues do not materialize as projected, payment of debt service may require displacement of other competing operating needs.

There are other issues that could exacerbate the city's budget imbalance. The city is faced with the prospect of having to fund a portion of a court-mandated multi-billion dollar spending plan for education. With impending appeals, it may be some time before this impact on the city's budget is known. There is also substantial uncertainty regarding the city's assumptions about the cost of wages and salaries. Future labor agreements related to contracts that have expired or are soon to expire could dramatically increase the city's annual operating budgets.

The city plans on using the entire FY 2005 surplus to help balance FY 2006. With the projected large budget gaps reappearing starting in FY 2007 and the large potential risks looming, we encourage the city to take actions at the start of FY 2006 to create a Budget Stabilization Account, and manage the FY 2006 budget in a way that will create a surplus equal to or greater than the current one in order to deal with the high outyear budget gaps.

**JANUARY MODIFICATION:
THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2005-2009**

TABLE 1 (\$ in millions, Before Gap Closing Program)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Revenues					
Taxes:					
General Property	\$11,476	\$12,239	\$13,013	\$13,954	\$14,620
Other Taxes ^a	16,840	16,512	16,798	17,547	18,374
Tax Audit Revenue	523	509	509	509	509
Sale of Property Tax Liens	44	100	47	46	45
Miscellaneous Revenues	6,867	5,417	5,221	5,264	5,295
FY 2004 Discretionary Transfer	400	--	--	--	--
Unrestricted Intergovernmental Aid	562	562	562	562	562
Anticipated State & Federal Actions	0	--	--	--	--
Interfund Revenues	354	347	339	332	332
Less: Intracity Revenues	(1,268)	(1,206)	(1,205)	(1,205)	(1,205)
Disallowances	<u>(15)</u>	<u>(15)</u>	<u>(15)</u>	<u>(15)</u>	<u>(15)</u>
Total City Funds	\$35,783	\$34,465	\$35,269	\$36,994	\$38,517
Federal Categorical Grants	5,522	4,820	4,801	4,790	4,790
Federal-FEMA Insurance Program	1,000	--	--	--	--
State Categorical Grants	<u>8,987</u>	<u>9,054</u>	<u>9,087</u>	<u>9,151</u>	<u>9,192</u>
Total Revenues	<u>\$51,292</u>	<u>\$48,339</u>	<u>\$49,157</u>	<u>\$50,935</u>	<u>\$52,499</u>
Expenditures					
Personal Service	\$26,421	\$27,421	\$27,977	\$28,389	\$28,652
Other Than Personal Service	22,219	21,011	21,397	21,963	22,539
Debt Service	3,202	3,517	4,169	4,509	4,853
MAC Debt Service	130	10	10	10	--
NYCTFA Debt Service	525	956	977	983	988
Budget Stabilization & Prepayments	481	(2,004)	--	--	--
General Reserve	<u>100</u>	<u>300</u>	<u>300</u>	<u>300</u>	<u>300</u>
Subtotal	\$53,078	\$51,211	\$54,830	\$56,154	\$57,332
Less: Intracity Expenditures	<u>(1,268)</u>	<u>(1,206)</u>	<u>(1,205)</u>	<u>(1,205)</u>	<u>(1,205)</u>
Total Expenditures	<u>\$51,810</u>	<u>\$50,005</u>	<u>\$53,625</u>	<u>\$54,949</u>	<u>\$56,127</u>
Gap To Be Closed	<u>(\$518)</u>	<u>(\$1,666)</u>	<u>(\$4,468)</u>	<u>(\$4,014)</u>	<u>(\$3,628)</u>
Gap-Closing Program	518	1,666	750	449	449
Remaining (Gap) / Surplus	<u>\$0</u>	<u>\$0</u>	<u>(\$3,718)</u>	<u>(\$3,565)</u>	<u>(\$3,179)</u>
^a Allocates NYCTFA debt service to expenditures.					

**CHANGES TO THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2005-2008
OCTOBER MODIFICATION COMPARED TO JANUARY MODIFICATION**

TABLE 2 (\$ in millions, Before Gap Closing Program)

	FY 2005	FY 2006	FY 2007	FY 2008
Revenues				
Taxes:				
General Property	(\$42)	\$201	\$443	\$573
Other Taxes ^a	587	198	65	0
Tax Audit Revenue	0	1	0	0
Sale of Property Tax Liens	(54)	51	0	0
Miscellaneous Revenues	84	247	124	135
FY 2004 Discretionary Transfer	400	--	--	--
Unrestricted Intergovernmental Aid	0	0	0	0
Anticipated State & Federal Actions	(50)	--	--	--
Interfund Revenues	5	12	8	1
Less: Intracity Revenues	(79)	(76)	(76)	(76)
Disallowances	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total City Funds	\$851	634	564	633
Federal Categorical Grants	565	244	242	241
Federal-FEMA Insurance Program	0	0	0	0
State Categorical Grants	<u>278</u>	<u>460</u>	<u>417</u>	<u>410</u>
Total Revenues	<u>\$1,694</u>	<u>\$1,338</u>	<u>\$1,223</u>	<u>\$1,284</u>
Expenditures				
Personal Service	\$680	\$615	\$482	\$662
Other Than Personal Service	904	882	998	1,196
Debt Service ^b	995	612	101	159
MAC Debt Service	10	10	10	10
NYCTFA Debt Service	(5)	0	0	0
Budget Stabilization & Prepayments	(93)	(2,004)	0	0
General Reserve	<u>(200)</u>	<u>0</u>	<u>0</u>	<u>0</u>
Subtotal	\$2,291	\$115	\$1,591	\$2,027
Less: Intracity Expenditures	<u>(79)</u>	<u>(76)</u>	<u>(76)</u>	<u>(76)</u>
Total Expenditures	<u>\$2,212</u>	<u>\$39</u>	<u>\$1,515</u>	<u>\$1,951</u>
Gap To Be Closed	<u>(\$518)</u>	<u>\$1,299</u>	<u>(\$292)</u>	<u>(\$667)</u>
Gap-Closing Program	518	(1,299)	(1,100)	(1,201)
Remaining (Gap) / Surplus	<u>\$0</u>	<u>\$0</u>	<u>(\$1,392)</u>	<u>(\$1,868)</u>
^a Allocates NYCTFA debt service to expenditures.				
^b Based on the debt service in the current plan, which is presented net of the use of the prior- and current-year surpluses, compared to debt service in the October modification, which was presented net of the use of the current-year surplus only. A restatement of the October modification would result in total-funded debt service being reduced by \$48 million in FY 2005, and increased by \$38 million in FY 2006, \$101 million in FY 2007 and \$159 million in FY 2008.				

RISKS TO THE FINANCIAL PLAN

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

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Stated Financial Plan Gap	\$0	\$0	(\$3,718)	(\$3,565)	(\$3,179)
Estimation					
Uniformed Services Overtime	\$0	(\$99)	(\$118)	(\$118)	(\$118)
Nonproperty Taxes	375	150	0	0	0
Miscellaneous Revenue	50	125	150	150	150
Pensions/Health Insurance	0	(325)	(200)	0	0
Subtotal	\$425	(\$149)	(\$168)	\$32	\$32
Implementation					
Sale of Property to Battery Park City	(\$150)	\$0	\$0	\$0	\$0
Not in Mayor's Control					
Federal Action	\$0	(\$250)	\$0	\$0	\$0
Risk Total	\$275	(\$399)	(\$168)	\$32	\$32
Total FCB Estimated Surplus/(Gap)	\$275	(\$399)	(\$3,886)	(\$3,533)	(\$3,147)
Note: The city has set aside \$100 million in a general reserve in FY 2005 and \$300 million in each subsequent year of the financial plan.					

II. Balancing the FY 2005 Budget

FY 2005 will end with a substantial budget surplus. A surge in nonproperty taxes has produced \$1 billion in extra revenues for FY 2005. The city has taken actions to reduce expenditures which will more than offset higher spending for social services and education. This combination allows the city to apply an additional \$1.4 billion to the budget stabilization account for a total of \$2 billion. The larger FY 2005 surplus, which will be used to prepay FY 2006 expenditures, will slightly exceed the surplus that was rolled into FY 2005 from previous years, indicating that the current-year revenues grew at a pace sufficient to meet current-year expenses.

There is a potential for the FY 2005 surplus to be even larger by \$275 million, as depicted in Table 3 on page 5. We estimate that the gain in nonproperty tax revenues may actually be higher by \$375 million and miscellaneous revenues may exceed projection by \$50 million. These positive variances could be partially offset by \$150 million expected to be received from the sale of city-owned land to the Battery Park City Authority that we continue to hold at risk because we do not have sufficient information to ascertain whether the deal can be completed by the end of FY 2005.

STRONG REVENUE GROWTH IN FY 2005

Since October, the city has increased its estimate of FY 2005 revenues by \$1 billion, as seen in the figure to the right.¹ This reflects both stronger nonproperty tax collections and miscellaneous receipts, offset by relatively small downward adjustments to the real property tax and intergovernmental aid. The nonproperty taxes, which improved by \$990 million are responsible for nearly all of the current-year revenue gains. The property transactions taxes increased by \$357 million in the latest plan and represent the largest component of the improvement in the city's nonproperty tax forecast. Other strong revenue gains were made by the personal income tax, which increased by \$247 million; business income taxes, which gained \$173 million; and the sales tax, which improved by \$77 million. The real property tax estimate declines by \$80 million mainly because of the postponement of a planned tax lien sale and an increase in its refund reserve.

Plan-to-Plan Revenue Changes in FY 2005	
(\$ in millions)	
Real Property Tax	(\$80)
Nonproperty Taxes	990
Intergovernmental Aid	(50)
Miscellaneous Receipts	<u>140</u>
Total City-Fund Revenues	\$1,000

Since October, the city has recognized a net increase of \$140 million in its FY 2005 miscellaneous revenue forecast that largely reflects strength in the core categories and additional nonrecurring resources.² The figure also lists a \$50 million plan-to-plan

¹ The variance excludes governmental and other categorical grants and adds back personal income tax revenue retained for NYC Transitional Finance Authority debt service.

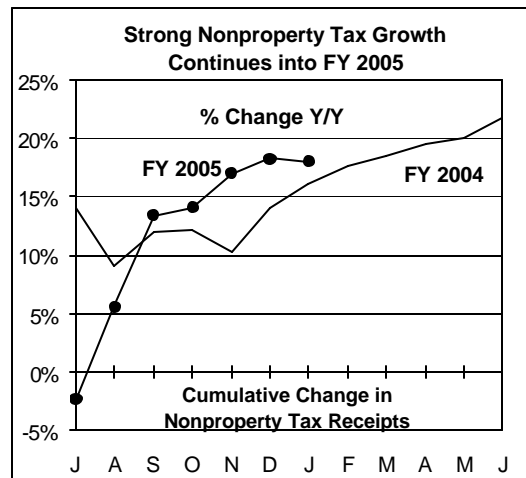
² The "core" categories are responsible for recurring revenue growth and consist of licenses, fees, fines, rent, interest earnings and a residual "miscellaneous" category. They exclude proceeds from the

negative variance in intergovernmental aid. The “loss” in aid refers to \$50 million in anticipated federal aid that will not be forthcoming from the federal government and was subsequently removed from the January modification.

In the core categories, the improvement in the city’s FY 2005 miscellaneous revenue projection primarily affected charges and interest. Charges are projected to grow by \$36 million to \$557 million primarily due to a greater yield from existing fees, particularly a \$15 million increase in city register fees that is related to the higher volume of real estate transactions. The FY 2005 estimate of interest increased by \$34 million to \$96 million because of much more cash available for short-term investment at higher interest rates. There were also smaller gains projected in FY 2005 from building and construction permits, higher franchise revenue, and improved enforcement of quality-of-life violations. The city also expects to generate more nonrecurring resources in FY 2005, primarily from airport rent arrears, higher prices at the recent sale of taxi medallions, and several one-time restitution payments. Based on the pace of current collections, miscellaneous revenue could exceed the city’s forecast by \$50 million.

Nonproperty Tax Collections

Strong nonproperty tax receipts in the first half of FY 2005 indicate that the growth trend that started in FY 2004 is continuing into FY 2005. As the figure to the right shows, after getting off to a slow start, growth in FY 2005 collections surged to 13 percent in September, gradually accelerating to 18 percent by December. The city projects that a slowdown in property transactions and the planned expiration of some of the temporary tax increases could diminish the FY 2005 nonproperty tax growth rate to six percent by the end of the fiscal year. Although January collections indicate that a slight deceleration is in progress, collections are nevertheless likely to finish FY 2005 about \$375 million ahead of plan.



Nonrecurring Actions and Use of the Prior-Year Surplus

The city generates and uses nonrecurring resources to help achieve budget balance in a fiscal year because of the mismatch between the growth rates of city-fund revenues and expenditures. Nonrecurring resources may take the form of asset sales, debt service savings, and payments from state and federal entities. In the past, the city generated about \$1 billion of one-time resources annually, although this figure exceeded

tobacco Master Settlement Agreement and dedicated revenue streams, such as water and sewer charges, which are restricted in use and therefore cannot provide gap-closing assistance.

\$3 billion in both FYs 2002 and 2003 when the city had to offset the impacts of an economic downturn and the terrorist attacks. In the current plan, the city expects to generate about \$2 billion of nonrecurring resources in FY 2005 and prepay a similar amount of expenses in FY 2006.

Among the initiatives listed in the figure, three actions from state entities represent nearly 80 percent or \$1.6 billion of the \$2 billion of nonrecurring resources that the city plans to generate in FY 2005 to supplement baseline revenues. First, after signing a new lease with the Port Authority to operate Kennedy and LaGuardia airports, the city received \$782 million to settle questions of past underpayment of rent. Second, the court decision that allowed the city to refinance debt issued by the Municipal Assistance Corporation (MAC) in the 1970s will provide \$631 million in budgetary relief in FY 2005. Third, the Battery Park City Authority is expected to provide \$204 million to the city, chiefly from a \$150 million purchase of city-owned land and excess reserves from a debt refinancing. The rest of the list, roughly \$400 million in one-time actions planned by the city, mainly reflects debt service savings, asset sales (such as mortgages, taxi medallions, and property), and proceeds from restitution.

Use of Nonrecurring Resources in FY 2005 (\$ in millions)	
Airport Rental Arrears	\$782
MAC Retention	631
BPCA Revenues	204
Debt Service Savings	171
Asset Sales	104
Sale of Taxi Medallions	98
Other Revenues	83
Resources Generated	\$2,073
Prior-Year Surplus	\$1,923
Current-Year Surplus	(2,004)
Net Surplus Roll	(\$81)
Resources Used	\$1,992

The figure also shows that the city began FY 2005 with \$1.923 billion of resources from FY 2004. The surplus generated in FY 2004 was transferred into FY 2005 by prepaying \$1.923 billion of expenses normally due in FY 2005 in the prior year. In its latest plan, the city believes that it can manage its budget in such a way as to generate \$2.004 billion by the end of FY 2005, which will all be used to prepay FY 2006 expenses in FY 2005. The difference between the inflow into FY 2005 from FY 2004 and the outflow from FY 2005 into FY 2006 is \$81 million.³ We commend the city for managing the FY 2005 budget in a way that created a budget surplus equal to or greater than that in FY 2004. However, there is no provision in the current plan to use any of the surplus to help close the budget gap in FY 2007. The city needs to take actions now to build up the Budget Stabilization Account in FY 2006 for use in FY 2007.

CHANGES IN THE CITY'S FY 2005 EXPENDITURE PROJECTIONS

On the expense side of the budget, there are a number of increases between the FY 2005 October modification and the January modification. The largest adjustment is \$1.4 billion in increased prepayment of certain FY 2006 expenses, using surplus

³ It is a good sign that the net surplus roll is a negative number because it means that the city is using more of the nonrecurring resources generated in a fiscal year to prepay expenses in a subsequent year than for current-year expenditures. In fact, in eight of the last eleven years, the net surplus roll has been negative.

resources projected from FY 2005. There is an increase of \$168 million in Medicaid expenses as well as a \$134 million increase in public assistance costs. Due to an overage in FY 2004 expenses the Department of Education increased its FY 2005 budget by \$84 million to partially cover the recurring implications of the overage. These increases are partially offset by decreases in pension and debt service costs of \$134 million and \$43 million, respectively. In addition, the city has increased its FY 2005 agency program to over \$422 million of which \$300 million has already been implemented.

Medicaid Spending Increases

The percentage of Medicaid costs to the city's total expense budget remains high at an average of over 10 percent per annum throughout the plan. In the January plan, the city estimates that the cost of Medicaid for FY 2005 will be over \$4.9 billion, an increase of \$168 million, or over three percent from the October modification.

The cost to provide Medicaid benefits for the over 2.6 million people enrolled in the program is rising at record levels. In fact, from FY 2000 until FY 2005, the city's Medicaid spending has increased by an average of nine percent. These escalating costs can be attributed mainly to managed care, long-term care and rising pharmaceutical costs. In order to provide relief to the city, the state in late 2004 implemented a phased-in takeover of the city's share of the Family Health Plus program. Beginning January 1, 2005, the state began its takeover of 50 percent of the city's share with a planned takeover of 100 percent of the city's share on January 1, 2006.

While Medicaid represents a large portion of its budget, the city must rely on state and federal cost-containment measures to reduce its share of the cost. The city is anticipating that actions by the state, as discussed in "Medicaid" beginning on page 27, will be implemented in FY 2006 and remain as recurring savings.

Public Assistance Spending Increases

In the January plan, the city forecasts that the cost of Public Assistance (PA) for FY 2005 will be approximately \$2.5 billion, an increase of \$134 million from the October modification. The increase can be attributed mainly to the city's reestimate of the PA caseloads.

Total PA caseloads are calculated from the aggregate of three PA recipient populations: Family Assistance Program (FAP), Safety Net Assistance (SNA), and Safety Net Five-Year Limit (SNA 5-Year). Currently, the number of recipients on PA has risen slightly over the past two years to a FY 2006 projected total of 438,295, as discussed in "Public Assistance" beginning on page 28.

Overtime

Facing a tight budget and mounting pressure to keep expenses in check, the city has made progress in stabilizing the cost of their uniformed agency overtime. The effort has been accomplished through a number of cost containment and savings initiatives,

additional federal homeland security funding and reimbursement for the Republican National Convention (RNC) held in August 2004.

The city has spent, since the beginning of the fiscal year, about \$50 million less than it had spent last year during the same period. It is projected that spending will be reduced by more than \$100 million in total over last year when overtime costs reached \$709 million. We are expecting that the overtime budget will end FY 2005 in balance. The majority of the savings has been realized in the Police Department (NYPD) from \$50 million received for costs associated with last August's RNC event and \$53 million in homeland security funding. The city is also expecting additional homeland security funds of approximately \$30 million in FY 2006.⁴

Other savings in the NYPD can be attributed to the replacement of retired veteran officers with new hires. As senior officers, who average much higher salaries, leave the force, overtime costs decrease because new hires receive a lower pay rate. Further savings and containment are expected to occur due to changes in the arrest procedures.

PROJECTED UNIFORMED OVERTIME RISK FOR FYs 2006 - 2009
(\$ in millions)

TABLE 4

	FY 2006	FY 2007	FY 2008	FY 2009
Police	\$261	\$256	\$256	\$256
Fire	107	122	122	122
Correction	43	44	44	44
Sanitation	67	67	67	67
Total City OT	\$478	\$489	\$489	\$489
FCB Projected	607	607	607	607
Homeland Security	(30)	--	--	--
Projected Risk	\$99	\$118	\$118	\$118

As shown in Table 4, a risk develops in FYs 2006-09. We project a shortfall of \$99 million in FY 2006 and \$118 million in each of the outyears of the financial plan. As the city's overtime projections decrease, the effect is an increase in the projected risk. The city has historically underestimated its overtime costs and increased their estimation with each budget modification based on the current spending level. For example, the city has estimated that overtime costs will total \$579 million in FY 2005, which is \$70 million more than first estimated in the adopted budget. Hence, the risk for the outyears may be reduced as the city increases its estimate and spending stays at the current level.

Debt Service

Compared to the level in FY 2004, city-funded debt service for FY 2005, net of budget surplus resources, is projected to grow by \$144 million and reach \$4.161 billion. The annual growth in FY 2005 debt service was trimmed by \$43 million since the last

⁴ The latest FY 2006 Federal Budget has recommended that Congress pass legislation that will enhance the current formula for distributing homeland funding to states. If enacted, the city may be receiving increased funding that will offset about 90 percent of overtime costs stemming from initiatives such as Operation Atlas, which costs an estimated \$55 million for FY 2005.

projection in October, primarily as a result of more favorable variable interest rates on the city's debt than initially assumed. The savings reflect a partial offset of \$10 million related to the continued use of city sales tax revenues to fund administrative and monitoring costs that flow through the budget of the Municipal Assistance Corporation, which had been excluded in the previous plan.

City-funded debt service is projected to grow precipitously over the plan years, reaching \$5.7 billion by FY 2009. We discuss this issue in detail in a later section of this report titled "The Need to Contain the Relatively High Debt Service Burden" beginning on page 31.

FY 2005 Agency Program

In April of 2004, the city's Office of Management and Budget created a new Agency Reduction Program of \$324 million for FY 2005. In the January modification the city has increased this program to over \$422 million. This program incorporates many initiatives designed to either reduce spending or increase revenues at the agency level. As shown in the figure to the right, \$300 million of the efforts are considered to be fully implemented, while almost \$123 million have yet to be implemented.

The City's FY 2005 Agency Reduction Program (\$ in millions)		
Department	Implemented	To Be Implemented
Police	(\$82.6)	(\$52.9)
Sanitation	(15.7)	(18.8)
Fire	(11.8)	(12.8)
Transportation	(22.5)	
Correction	(8.5)	(10.7)
Housing Pres.&Dev.	(19.3)	
Finance	(18.1)	
Children's Services	(17.6)	
Citywide Services	(14.1)	
Other	(89.8)	(27.5)
Total	(\$300.0)	(\$122.7)

Note: Negative numbers represent a reduction in the city's budget gap.

The Police Department implemented the largest of the new savings programs. The department was able to achieve a salary savings of \$67.1 million due to the lower costs of a younger workforce. Grants related to the Yellow Alert period, Urban Area Security and Law Enforcement Terrorist Prevention have been awarded and approved by the federal government. The department expects to receive \$52.9 million of these funds in May of this year.

The Administration for Children's Services realized a new savings of \$17.6 million by reestimating the costs of foster care contracts. The foster care population of approximately 20,000 children is projected to decline by seven percent in FY 2005 and by an additional 17 percent in FY 2006. Included in the Other category, the Department of Investigation completed an investigation of property tax assessors and realized a one time estate settlement of an additional \$17.6 million in revenue.

Through quarterly meetings conducted by the Office of Management and Budget, all of the remaining initiatives yet to be implemented are being carefully reviewed and most are on target for implementation during FY 2005. However, there is some concern that due to a higher-than-normal attrition rate within the Department of Correction an expected overtime savings of \$5 million might not be fully achieved.

III. Outlook for Budget Balance in FYs 2006-09

The city has emerged from an economic downturn and now appears to be in the early phase of a solid recovery. An improving local economy, with a long-awaited turnaround in employment and an ongoing boom in the real estate market, is currently producing strong growth in revenues. However, while the city will undoubtedly end the current fiscal year with a substantial budget surplus, it faces significant fiscal challenges in the outyears of the plan. In fact, the city plans to use all of an estimated \$2 billion FY 2005 surplus to address the budget imbalance projected for FY 2006. Even with the use of the surplus and before taking any proposed gap-closing actions, there is an outyear budget gap of \$1.7 billion in FY 2006, which grows to \$4.5 billion in FY 2007, before tapering to \$4 billion in FY 2008 and \$3.6 billion in FY 2009.

The financial plan assumes conservative revenue growth in FYs 2006-09 for the property and non-property taxes as well as miscellaneous revenues. Revenues are weakest in FYs 2006 and 2007 due to the expiration of temporary tax increases and the depletion of one-time resources. Also, because of the city's expectation of rising interest rates, the forecasts for the property transaction taxes, which are currently growing at an accelerated pace, have been constrained in the outyears of the plan. We believe the city's forecast of modest revenue growth is reasonable, but may be exceeded.

The source of budgetary pressure lies on the expenditure side. Spending in such areas as fringe benefits, pensions, Medicaid, and debt service is projected to rise at a rapid pace that outstrips the growth in tax revenues. Within fringe benefits it is healthcare costs, which make up over half the spending in this category, that continues to rise despite the city's efforts to slow down the increases. As the city's required contribution to the pension system continues to rise, the City Actuary is considering proposing a package of actuarial assumptions and methods to the retirement systems later this fiscal year. If approved, the package will defer some near-term pension costs to later in the city's financial plan. Escalating Medicaid costs remain a pressing issue, and the city and state are in discussions over what actions the state can take to limit this growth.

The rise in debt service reflects the city's large capital program, which places an emphasis on upgrading and expanding school facilities. In hopes of easing the burden debt service will place on the operating budget, the city is planning to undertake several capital projects that are designed to stimulate economic activity and ultimately expand the revenue base. While this investment strategy has merit, the amount and flow of the new revenue streams are not guaranteed. If the revenues do not materialize as projected, payment of debt service may require displacement of other competing operating needs.

There are other issues that could exacerbate the city's budget imbalance. The city is faced with the prospect of having to fund a portion of a court-mandated multi-billion dollar spending plan for education. With impending appeals, it may be some time before this impact on the city's budget is known. There is also substantial uncertainty regarding the city's assumptions about the cost of wages and salaries. Future labor

agreements related to contracts that have expired or are soon to be expired could dramatically increase the city's annual operating budgets.

We have quantified budgetary risks totaling \$399 million in FY 2006 and \$168 million in FY 2007 and have identified the potential for a surplus of \$32 million in each of FYs 2008 and 2009. Our evaluation of the risks to the city's financial plan is shown in Table 3 on page 5. The primary risk is the projected savings in pension and healthcare of \$325 million in FY 2006 and \$200 million in FY 2007. At this point the city has provided no detail on how these savings will be achieved. We are also holding at risk the \$250 million in anticipated federal actions. With the growing federal deficit, it is uncertain that the city will receive this gap closing aid. The city is beginning to show progress in its efforts to manage its unformed overtime expenses; however, we believe a risk of \$99 million remains for FY 2006 and \$118 million for each of FYs 2007-09.

Partial offsets to these risks in FY 2006 and FY 2007 include increased nonproperty tax receipts of \$150 million in FY 2006 and continued higher-than-projected miscellaneous revenue of \$125 million in FY 2006 and \$150 million in FY 2007. Based on current data and historical patterns of growth, we believe that miscellaneous revenue could also be higher than the city's forecast by \$150 million in both FYs 2008 and 2009 leading to a surplus of \$32 million in each year. These offsets bring our estimate of the city's budget gap, assuming successful implementation of the gap-closing program, to \$399 million in FY 2006, \$3.9 billion in FY 2007, \$3.5 billion in FY 2008, and \$3.1 billion in FY 2009.

PROPERTY TAX PROPELS REVENUE GROWTH

The city's four-year plan projects that city-funded revenue sources will increase from \$34.8 billion in FY 2005 to \$37.4 billion in FY 2009, a gain of \$2.6 billion or 7.5 percent. Table 5 shows that strong and steady property tax growth adds \$3.1 billion, for growth of 27 percent, while the nonproperty taxes follow a less steady course and grow by \$1.1 billion, or six percent. These revenue gains are offset by a decline of nearly \$1.8 billion in one-time resources, which augmented FY 2005 revenues, with virtually no benefit past FY 2006. Total city fund revenues are weakest in FYs 2006 and 2007 mainly because of the depletion of one-time resources, and because of the slowdown in the nonproperty taxes due to expiration of temporary tax increases and an expected downturn in property transactions. These adverse trends at the start of the plan cause revenue growth to be deferred until the last two years of the plan, when both the property and nonproperty taxes move ahead together.

THE CITY EXPECTS REVENUES TO GROW MODERATELY THROUGH FY 2009

TABLE 5

(\$ in millions)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FYs 2005-09 % Change	FYs 2005-09 \$ Change
Property Tax	\$11,688	\$12,498	\$13,221	\$14,162	\$14,826	26.8%	\$3,137
Nonproperty Taxes	17,613	16,871	17,152	17,900	18,729	6.3%	1,115
Miscellaneous	3,136	3,259	3,138	3,175	3,201	2.1%	65
Nonrecurring	1,795	115	0	0	0	(100.0%)	(1,795)
Unrestricted Aid	547	547	547	547	547	0.0%	0
Anticipated State & Federal Aid	0	750	200	100	100	NA	100
Total City Funds	\$34,779	\$34,040	\$34,258	\$35,884	\$37,402	7.5%	\$2,623

Numbers may not add due to rounding.

In contrast to the city’s tax base, the rest of the city-fund revenue sources listed in Table 5, namely miscellaneous revenue, nonrecurring actions, unrestricted aid and anticipated state and federal aid, are not projected to significantly contribute to overall revenue growth. The city’s miscellaneous revenue, less major one-shots, is forecast to grow by only 2.1 percent or \$65 million from FY 2005 to FY 2009. In FYs 2005 and 2006, miscellaneous revenue is projected to grow by \$92 million and \$123 million, respectively, before losing most of the projected increase by FY 2007. In the last two years of the plan, the small gains expected in miscellaneous revenue originate primarily from more water and sewer charges and interest earnings.

Of the two gains, however, only the improvement in interest earnings can help the city achieve budget balance because water and sewer charges are dedicated to paying debt service incurred by the Water Authority for the operation of the water system. Based on past history and current collection activity, we believe the city’s miscellaneous revenue forecast could be higher by \$50 million in FY 2005, \$125 million in FY 2006, and \$150 million in each of FYs 2007-09.

The city expects to generate \$1.8 billion of nonrecurring resources in FY 2005, \$115 million in FY 2006 and as yet undetermined amounts in FYs 2007-09. The largest items proposed for FY 2005 include: airport rent arrears (\$782 million), MAC retention (\$631 million), land sale to the BPCA (\$150 million), and numerous other asset sales (\$202 million). The problem with this approach is that temporary measures are by their very nature unpredictable and unreliable. It is very difficult to anticipate a year or more in advance what the magnitude of nonrecurring resources will be and thus very difficult to develop a four-year financial plan demonstrating that the city will be able to continue to pay for the services it currently provides. We see that the greater the current reliance on one-time measures, the greater the uncertainty about the ability of the city to provide a stable fiscal environment in the years ahead.

In the January plan, unrestricted intergovernmental aid is forecast to remain flat at \$547 million annually during FYs 2005-09. However, the city projects additional assistance from the federal and state governments based on a menu of initiatives that the city submitted, which are designed to either raise revenues or lower programmatic costs. In FY 2006, the city is expecting \$250 million from the federal government and \$500 million from the state government. In FY 2007, the city projects an additional \$200 million in state aid and \$100 million in each of FYs 2008 and 2009. At this early stage in

the budget process for FY 2006, the city's state aid request appears reasonable, but the federal aid target may not be achieved.

Tax Revenue

Following strong growth in FYs 2004 and 2005, city-funded revenues are projected to decline in FY 2006 and increase only slightly in FY 2007, before resuming moderate growth in FYs 2008 and 2009. This pattern of decline followed by a gradual recovery is caused by the nonproperty taxes, which comprise the largest component of revenues. Based on the pace of current collections, the city's nonproperty tax forecast could be higher by \$375 million in FY 2005 and \$150 million in FY 2006. The real property tax, which is in the midst of a prolonged growth phase, grows strongly throughout the plan period, even in FY 2006, when other revenue sources are weakening, as seen in Chart 1. The real estate market's growth in FY 2006 differs from previous years, when it had been led by a rising market for homes and apartments, in that the commercial and office sectors are finally growing strongly along with the residential sector.

THE PROPERTY TAX GROWS STRONGLY EVEN AS THE NONPROPERTY TAXES FALTER IN FY 2006

CHART 1

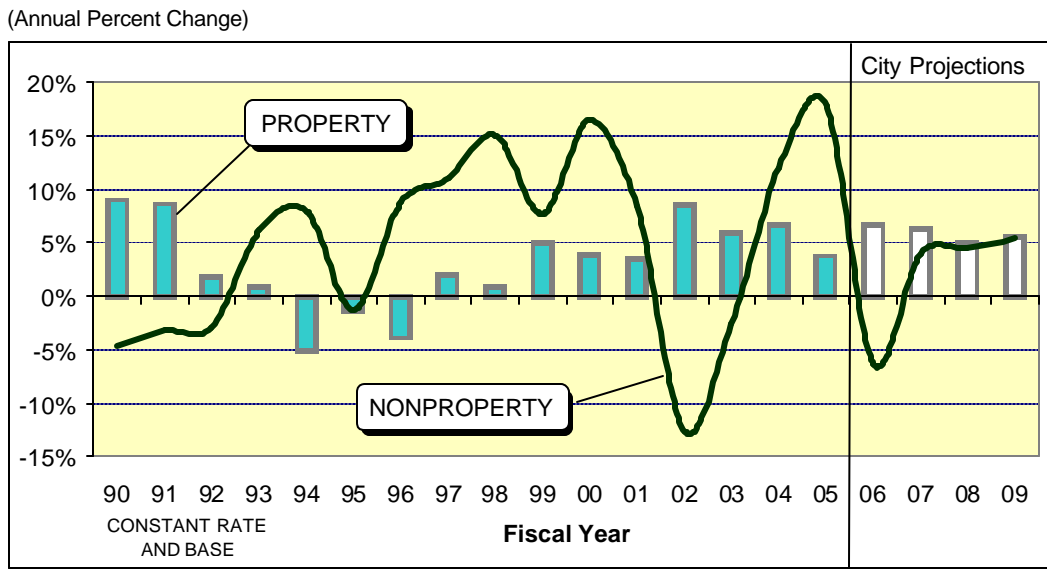


Chart 1 shows actual and planned growth for both property and nonproperty taxes on a continuing base, which is adjusted for tax law changes such as the start and planned expiration of the temporary tax increases. It illustrates the relative volatility of these two revenue sources. Whereas property tax growth tends to run in relatively long cycles, with prolonged periods of moderate growth followed by long periods of slow growth or decline, the nonproperty taxes tend to follow a shorter cycle with more extreme shifts in growth rates.

The city anticipates that the two-year growth surge in nonproperty taxes that is expected to peak at 18 percent in FY 2005 will end in FY 2006, when these taxes plummet

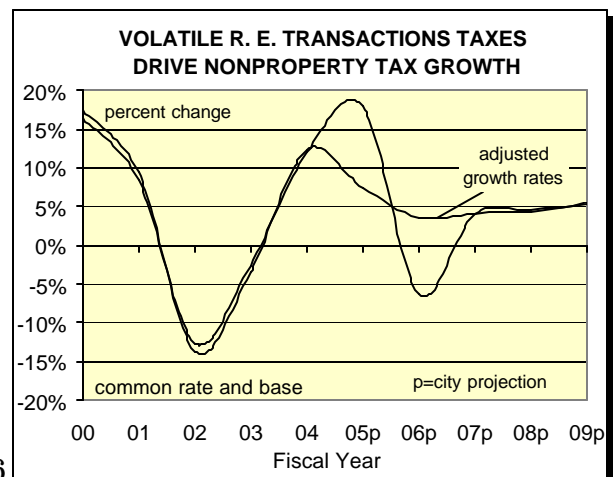
six percent. This expected revenue downturn in FY 2006 is matched by similar slowdowns that occurred in FYs 1995 and 2002, with a less extreme example being FY 1999. Although the factors triggering these revenue reversals may have been different, each followed a sharp upturn in tax revenues. In the most current cycle, the upturn was led by a surge in property transaction taxes that was fueled by a strong real estate market and record-low mortgage interest rates. It is quite possible that a climb in mortgage rates could slow property transactions sufficiently to cause nonproperty tax revenues to fall in FY 2006, with no immediate consequences for real property tax revenues. Long lags in the property assessment process coupled with five-year phase-in rules make it possible for the property tax to continue to grow for several years even after the property sales market has begun to slow down.

Economic Outlook and Nonproperty Taxes

Even though the local economy appears to be in the early phase of a solid recovery, most of the economic indicators do not adequately explain the volatile swings in the nonproperty taxes, which the city projects will surge 18 percent in FY 2005 and then fall by six percent in FY 2006 on a continuing base. For example, real gross city product, which is estimated at 3.7 percent growth in 2004, declines to 2.2 percent in 2006 before accelerating to 4 percent by 2009. It is true that 10,000 local jobs were created in 2004, marking a long-awaited improvement following a three-year job loss of 190,000. Job growth has nevertheless been slow to gain momentum, as 2004 growth amounted to 0.3 percent, but the city projects that job growth will improve to 1.2 percent in 2005, after which growth drops to about one percent annually in 2006-09. The local wage rate, which grew 5.8 percent in 2004, weakens to about four percent in 2005-09.

One notable exception to the moderate growth scenario depicted by the economic indicators is national corporate profits. Profits grew over 13 percent in 2004 and the city projects that profits will soar 35 percent in 2005. Much of this upsurge in profits is linked to the expiration of federal bonus depreciation rules. Normally, such a rule change could be expected to enhance local business taxes, but city revenues had already been sheltered by a depreciation add-back provision from both the negative and the positive consequences of the federal rule changes. City business tax collections could, however, benefit from any profits growth in excess of that resulting from the rule change. Seeing that the pattern of nonproperty tax growth is not readily explainable by any broad-based economic indicators, an adjustment of the data appears to be in order.

Much of the volatility in the nonproperty taxes is being caused by the unusual growth of the real estate transfer and mortgage recording taxes. Adjusting tax collections to remove this source of volatility significantly smoothes out the growth rates, demonstrating that the nonproperty taxes are not quite as volatile as initially presented. The figure to the

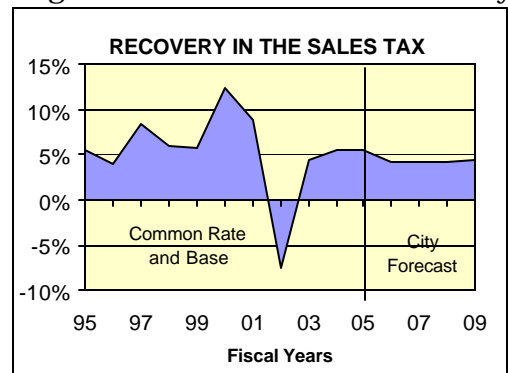


right shows that the adjusted series tracks total nonproperty tax growth fairly closely from FY 2000 until FY 2004. The two series diverge in FY 2005 when the adjusted series that excludes the transactions taxes grows by seven percent instead of soaring by 18 percent as the unadjusted series. Revenue growth slows to four percent for the adjusted series in FY 2006, indicating that the city's plan anticipates that most of the major nonproperty taxes will indeed grow moderately in step with the gradual pace of the current local economic recovery.

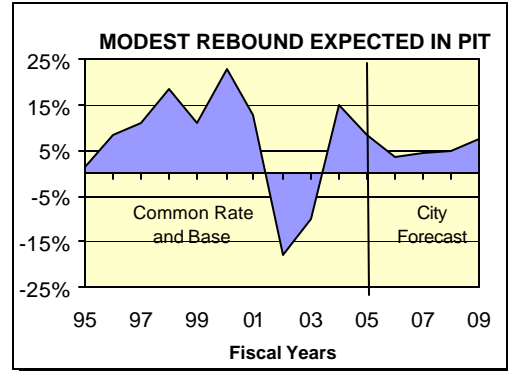
Property Transactions Taxes. A booming real estate market has transformed two relatively small taxes, the real property transfer and mortgage recording taxes, into significant revenue producers for the city. The city expects collections to reach \$1.7 billion in FY 2005, up from \$1.0 billion just two years earlier. The low mortgage rates and the unusually strong demand for city real estate have accelerated these taxes. It is not clear if or when transactions activity will slow down because mortgage rates have been slow to follow the upward path of short-term interest rates and buyers have stayed in the market despite the rising costs of property ownership. The city's plan calls for transactions tax collections to fall to \$1.1 billion in FY 2006 and then climb to \$1.2 billion by FY 2009.

Sales Tax. In contrast to the recent unpredictability of other nonproperty taxes such as the real estate transaction and business income taxes, the sales tax appears to be a model of steadiness and growth. The only slippage in the city's latest sales tax forecast is the projected revenue loss of about \$300 million in FY 2006 from the lapse of the higher tax rate (from 4.125 percent to four percent) and the reimposition of the exemption for clothing and footwear purchases priced under \$110, which are scheduled to take effect in June 2005. As a result of these tax law changes, the city expects sales tax revenue to grow 4.7 percent in FY 2005, decline 3.8 percent in FY 2006, and return to trend growth of over four percent annually during FYs 2007-09.

If we exclude the effects of the tax increases from the city's sales tax forecast, we get a different scenario. This view is focused on the continued growth in wages, modest increases in employment, and a remarkable upswing in the hotel and tourism industry to pre-September 11th levels. On a common rate and base scale that is shown in the figure to the right, sales tax collections are projected to grow 5.6 percent in FY 2005, moderate to 4.2 percent from FY 2006 to FY 2008, and pick up slightly to 4.4 percent by FY 2009. Since reaching a historical low of a 7.4 percent decline in FY 2002 from the combination of the terrorist attacks and economic downturn, sales tax receipts have benefited from steady growth in personal consumption spending that continues despite higher oil prices and incremental increases in short-term interest rates.



Personal Income Tax. Despite the volatility in the personal income tax (PIT) from the scheduled phase-out of the tax increase by FY 2007, the underlying economic fundamentals are in place for long-term sustained growth, absent an external shock from the national economy.⁵ The city anticipates modest employment growth of about one percent annually during the forecast period, but it is the strong turnaround in the sources of taxable income--wages with bonuses (particularly from the finance sector) and positive capital gains realizations--that is driving the PIT forecast. In its latest plan, excluding the distorting effects of the tax increase, the city expects revenue to grow 8.2 percent in FY 2005 after soaring 15.1 percent in FY 2004. As seen in the figure to the right, growth in PIT collections are projected to slow considerably in FY 2006 to 3.6 percent as the local and national economies feel the impact of higher interest rates and the expansion matures. After FY 2006, growth accelerates, coming closer to trend growth of 7.6 percent by FY 2009.



The three revenue sources that originate from Wall Street-related activity--securities industry profits, finance sector compensation, and capital gains realizations--can make or break the personal income tax. In its latest plan, summarized in Table 6, we see improvement in all three areas. Based on a pick-up in business activity such as mergers and acquisitions and initial public offerings at the end of 2004, the city raised its forecast of securities industry profits in 2005 to \$14.4 billion, a gain of 12.5 percent from the \$12.8 billion that was estimated to have been earned in 2004. Assuming that there is a gradual increase in interest rates and not a sudden spike, the city forecasts that profits will rise steadily from \$14.7 billion in 2006 to \$18.2 billion by 2009.

⁵ Effective for tax years 2003-05, which impacts FYs 2004-06, two upper income brackets with new tax rates and a tax table benefit recapture provision were established for single filers (\$100,000), joint filers (\$150,000), and head of household filers (\$125,000) and a \$500,000 bracket for all filers.

THE CITY HAS RAISED ITS EXPECTATIONS OF WALL STREET-RELATED ACTIVITY

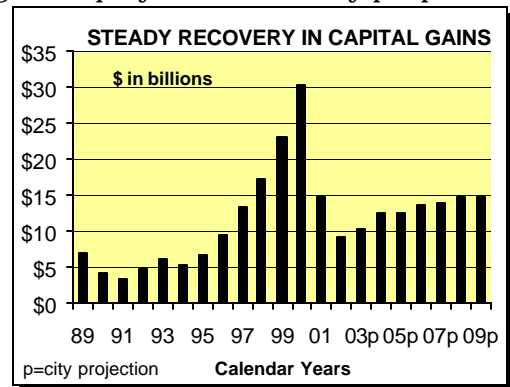
TABLE 6

(\$ in billions, comparison with October Modification forecast)

	2004		2005		2006	
	Old	New	Old	New	Old	New
Securities Industry Profits	\$12.8	\$12.8	\$13.5	\$14.4	\$14.3	\$14.7
Finance Sector Salaries	\$58.9	\$59.4	\$59.4	\$63.0	\$61.7	\$64.8
Realized Capital Gains	\$10.2	\$12.5	\$10.7	\$12.5	\$11.2	\$13.6
Year-to-Year Changes	2005		2006		2007	
Securities Industry Profits	12.5%		2.1%		2.7%	
Finance Sector Salaries	6.1%		2.9%		3.0%	
Realized Capital Gains	0.0%		8.4%		3.0%	

Healthy securities industry profits in a year often signal strong growth in the salaries and bonus payouts for the finance sector in the following January through March quarter, which is evidenced in higher withholding revenue in the PIT. One of the biggest changes in the city's more positive outlook can be seen in higher finance sector compensation, which is projected to increase by \$3.6 billion from the prior forecast to total \$63 billion in 2005. Finance sector compensation is projected to grow 6.1 percent from 2004 to 2005 when it reaches \$63 billion, and continues to climb by about three percent annually, finally reaching \$74.4 billion in 2009. However, during the forecast period, the city does not anticipate a sizeable increase in securities employment as well.

Over the past few years, the low interest rate environment engendered by the Federal Reserve Board was a boon to the housing and equity markets. Many people saw their physical and financial assets appreciate sharply and realized significant capital gains when the assets were sold. As seen in the figure, the city believes that capital gains realizations grew 12.1 percent in 2003 and 20 percent in 2004 to reach \$12.5 billion in 2004. After a brief pause in 2005, capital gains realizations are projected to remain positive and slowly grow to nearly \$15 billion by 2008. If this scenario were to occur, capital gains would have improved to the point where the revenues were in 2001.



Over the long term, we can see from the figure that capital gains realizations have risen and fallen quite sharply, in just a year's time, on numerous occasions. It is not unheard of for capital gains realization to fall by over forty or fifty percent in a year. In fact, that is what happened in 1990, 2001 and 2002. On the other hand, collections soared by thirty to forty percent annually in 1992 and from 1995 through 2000. In trying to find the middle ground, the city's capital gains forecast is reasonable.

Business Income Taxes. The city expects this group of taxes, which includes the general corporation (GCT), the banking corporation (BCT) and the unincorporated business taxes (UBT), to slow down to three percent growth in FY 2006 from about 10 percent in FY 2005. Growth gradually accelerates to five percent by FY 2009, with most

of this growth likely to come from the GCT and the UBT. BCT revenue, however, which doubled in FY 2004 and is forecast to grow more than six percent in FY 2005, is expected to show no additional growth in FYs 2006-09.

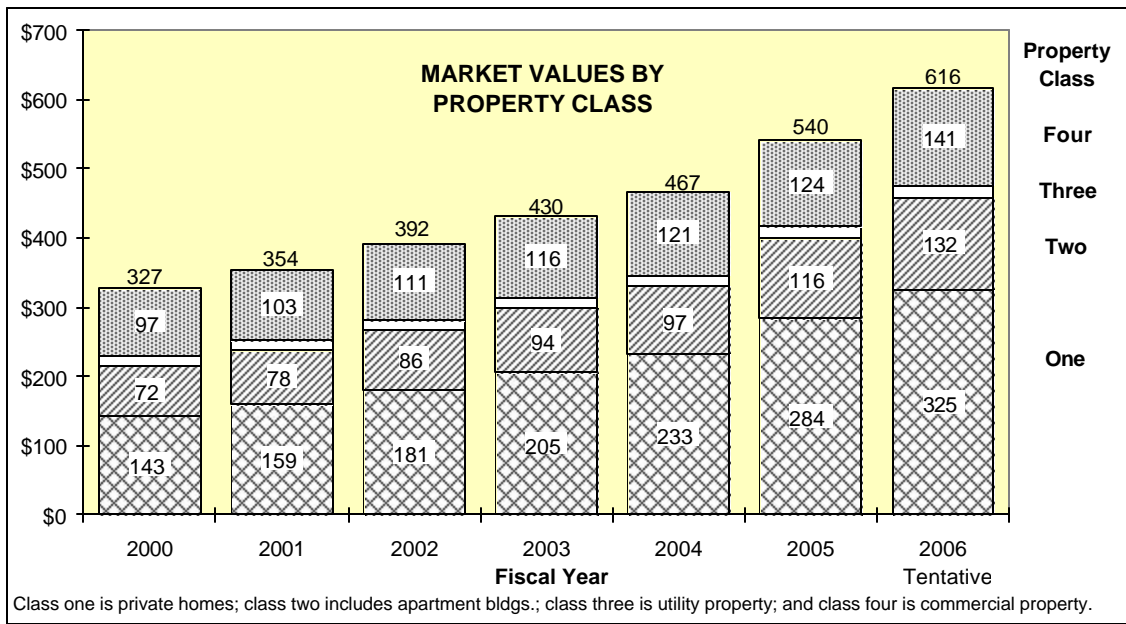
Real Property Tax Grows Strongly

Because property values have been increasing, the city expects the property tax to grow seven percent in FY 2006 to nearly \$12.5 billion. Revenues continue to grow steadily at about six percent per year through FY 2009, when collections yield nearly \$15 billion. Market values of city properties on the tentative tax roll are up by 14 percent, with strong growth reported for most types of property. The rapidly rising tax base has enabled the city to return over \$270 million, which represents a small portion of the \$2 billion generated annually by the recent 18.5 percent real estate tax increase, in \$400 rebate checks to eligible owners of homes and apartments.

RESIDENTIAL PROPERTIES CONTINUE STRONG GROWTH TREND BUT COMMERCIAL PROPERTY GROWTH SURGE IS A NEW PHENOMENON

CHART 2

(\$ in billions)



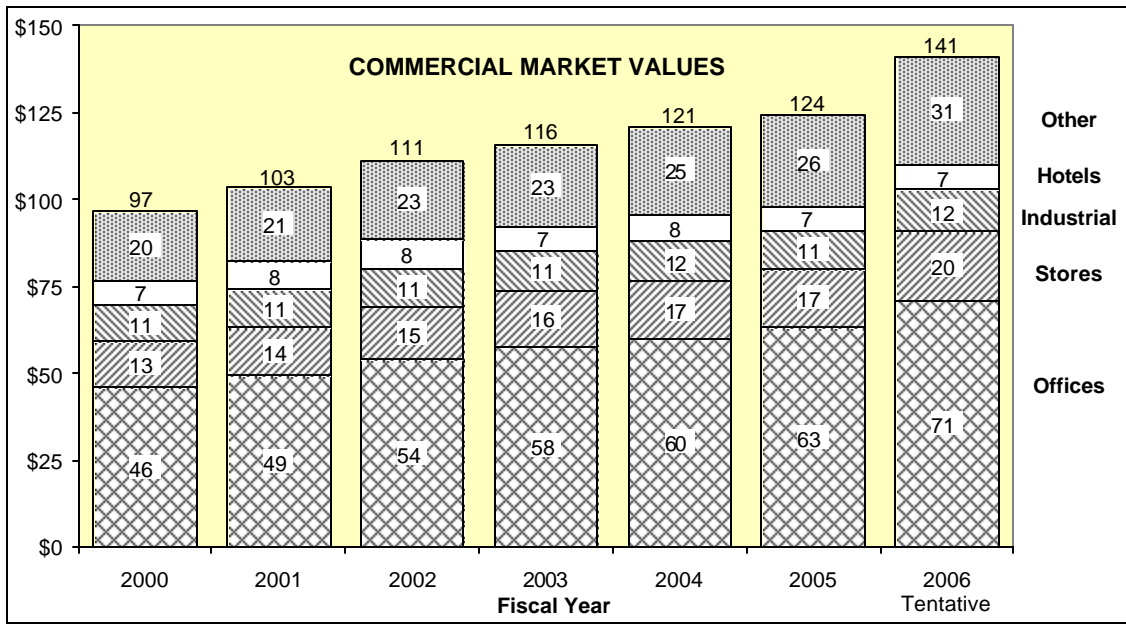
The city’s recent report on the tentative assessment roll for FY 2006 describes how each segment of the real estate market has been participating in the real estate boom. Chart 2, which depicts the growth in market values on the city’s tax rolls since the beginning of the decade, shows that the strong growth in FY 2006 was distributed fairly evenly across most kinds of properties. Market values increased a total of 14 percent to \$616 billion in FY 2006 from \$540 billion the previous year, with private homes growing by 15 percent to \$325 billion, residential apartment buildings increasing 14 percent to \$132 billion, and commercial properties up 13 percent to \$141 billion.

The strong growth of the two residential property classes is a continuation of a pattern that has persisted for the last five years. The appreciation in commercial

properties, however, is a new phenomenon that was not evident in previous assessment reports. For example, the value of private homes nearly doubled from \$143 billion in FY 2000 to \$284 billion in FY 2005, for a five-year average growth rate of 15 percent, which is equal to the current FY 2006 growth rate. Similarly, apartment buildings increased from \$72 billion in FY 2000 to \$116 billion in FY 2005 for an average growth rate of 10 percent per year, which is not very much slower than the current 14 percent growth. Far slower growth, however, was seen for commercial properties, which increased from \$97 billion in FY 2000 to \$124 billion in FY 2005, for a five-year trend growth of just five percent per year. Thus, the 13 percent increase reported for FY 2006 represents a dramatic upturn in the market value trend of the commercial real estate sector.

OFFICES ARE THE LARGEST SEGMENT OF COMMERCIAL MARKET, BUT STORES AND OTHER PROPERTY TYPES GREW FASTER

CHART 3 (\$ in billions)

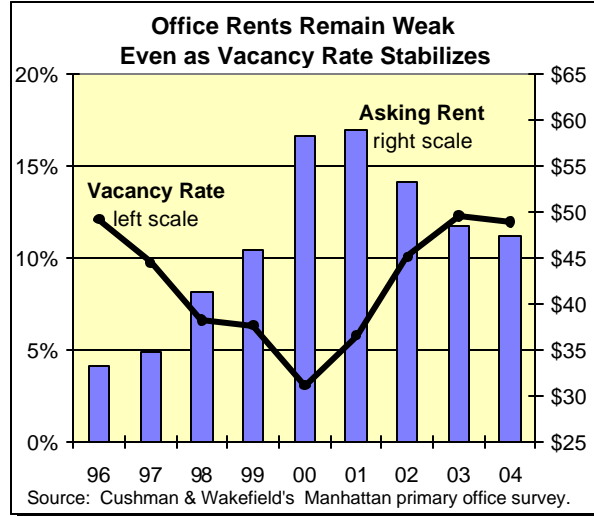


Although most segments of the commercial market grew strongly in FY 2006, the continued growth of this sector depends greatly on the office market. Chart 3, which shows the market values of the major segments of the commercial market since FY 2000, indicates that office property while not the fastest growing segment of this market is by far the largest component of commercial real estate in the city. Stores, for example, with 17 percent growth and some of the smaller segments of the commercial market with a combined growth rate of nearly 20 percent did better than offices, which grew 12 percent in FY 2006.

Even though offices are not the fastest growing segment of the market, the significance of this sector is its great size. Office buildings, with a market value of \$71 billion in FY 2006, comprise about half the \$141 billion value of all commercial properties on the FY 2006 tax roll. Moreover, with FY 2006 growth of \$8 billion, offices accounted for nearly half of the \$17 billion market value increase of the entire

commercial sector. The 12 percent spurt in office market values in FY 2006 appears to be related more to a generalized rush to acquire real estate, than to any great improvement in the income producing capability of these buildings.

One supporting factor is that even though office vacancies have improved slightly, asking rents have not yet turned upward. The figure to the right shows that office vacancy rate, which had climbed from 3 percent in the year 2000 to above 12 percent in 2003, eased back to below 12 percent in 2004. The weakness in vacancy rates caused office rents to fall by \$12 from \$59 per square foot in 2001 to \$47 in 2004. Consequently, since vacancy rates are up and asking rents are down, the sharp upward revaluation of office buildings cannot be explained by any underlying improvement in the operating incomes of the buildings in this sector.



In a rising market, city assessors can revalue commercial properties upward, even if cash flows are not improving, by assigning new capitalization rates. The city estimates capitalization rates, for each type of income-producing property in each neighborhood of the city, by comparing building cash flows to the sales prices achieved by properties that were sold. These capitalization rates enable the city to assess a building's value from the income stream that it generates.

The figure to the right summarizes the recent changes to the city's capitalization rate schedule for Manhattan office properties. The FY 2006 capitalization rate schedule shifted by an average of 11 percent for the highest rated office properties and by 12 percent for lower-rated buildings. The significance of this shift in capitalization rates is that the asset value of office buildings increased much faster than the income producing capacity of these same buildings. Thus, there could well be some element of speculative buying behind the recent 12 percent surge in office market values.

Fiscal Year	Class A Buildings	Class B Buildings
2006	8.72%	9.26%
2005	9.65%	10.39%
Change	10.71%	12.12%

Source: Tentative Assessment Roll Guidelines of the NYC Dept. of Finance.

To the extent that commercial property values are climbing for speculative rather than for investment reasons, the outlook for commercial real estate contains an element of risk. Fortunately, the city takes a conservative position that most of the commercial property tax base growth in FYs 2007-09 will result from the phase in of past assessment growth rather than from additional increases in market value.

SOURCES OF GROWTH IN CITY SPENDING

In the January modification, the city expects spending between FYs 2005 and 2009 to rise considerably, as shown in Table 7. Over this period, the city's \$51 billion expense budget is projected to grow to over \$55 billion or 7.8 percent. The annual

growth rate ranges from a high of 4.3 percent between FYs 2006 and 2007 to a low of 2.2 percent from FY 2008 to FY 2009. The city's budget continues to be structurally unbalanced with revenue growth lagging that of expenses.

**EXPENDITURE GROWTH WILL OUTPACE REVENUE GROWTH
BETWEEN FYs 2005 AND 2009**

TABLE 7 (yr/yr percent change, \$ in millions)

	FYs 05-06	FYs 06-07	FYs 07-08	FYs 08-09	FYs 05-09	Level in FY 2005	Level in FY 2009
Total Expenditures	(1.7%)	4.3%	2.9%	2.2%	7.8%	\$ 51,454	\$ 55,452
Total PS	2.3%	2.8%	2.3%	0.9%	8.6%	\$ 25,704	\$ 27,902
Salaries and Wages	(2.0)	0.2	(0.7)	0.1	(2.4)	17,363	16,951
Fringe Benefits	5.4	5.3	6.0	5.2	23.8	5,235	6,479
Pensions	21.0	10.6	9.3	(1.6)	44.0	3,107	4,473
Total OTPS	(5.7%)	6.0%	3.5%	3.4%	7.0%	\$ 25,750	\$ 27,550
Public Assistance	(4.9)	(0.5)	0.0	0.0	(5.3)	2,487	2,354
Medicaid	3.4	5.3	7.1	7.5	25.4	4,901	6,148
Debt Service	4.1	16.4	6.7	6.2	37.3	4,254	5,841
Other OTPS	(12.0)	3.7	1.4	1.1	(6.4)	14,109	13,207

Numbers may not add due to rounding.

The growth in spending that the city projects reflects divergent trends in the various expenditure categories. Some categories, such as fringe benefits, pension costs, Medicaid and debt service, are expected to grow rapidly while others, such as salaries and wages and public assistance, are expected to decrease. Below, we review the underlying assumptions behind these expectations and assess their reasonableness.

Fringe Benefit Costs

Despite the city's attempt to ameliorate fringe benefit costs by increasing insurance co-payments and charging city employees administrative fees under Group Health Insurance (GHI), fringe benefit expenditures continue to remain one of the fastest growing components of the city's Personal Service budget. They are increasing not because benefits have been expanded but because the underlying cost of the existing structure is growing.

In the January plan, spending on fringe benefits is forecasted to increase nearly 24 percent over the course of the plan, from over \$5.2 billion in FY 2005 to nearly \$6.5 billion in FY 2009, as shown in Table 8. As it was in the November modification, the percentage of fringe benefits to the city's total expense budget averages around 11 percent throughout the plan. In FY 2003 this ratio was 9.9 percent.

Also shown in Table 8 fringe benefits consist of six major components, the largest and most important of which is Health Insurance. It accounts for more than half of overall spending on fringe benefits and likewise explains much of its growth. Adding Supplemental Welfare Benefit (which represents supplemental payments to the unions' welfare fund), the city's fringe benefits expense base rises to between 66 percent and 71

percent between FYs 2005 and 2009. At this point last year, the increased rates were 65 percent and 70 percent for FYs 2004 and 2008.

FRINGE BENEFIT COSTS CONTINUE TO INCREASE

TABLE 8 (\$ in millions)

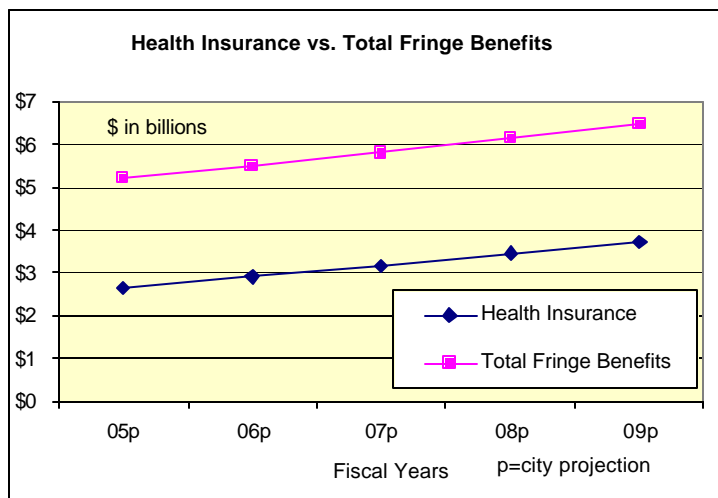
	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Health Insurance	\$2,634	\$2,901	\$3,152	\$3,451	\$3,735
Supplemental Welfare Benefit	836	846	858	870	884
FICA and Social Security	1,279	1,287	1,300	1,309	1,320
Worker's Compensation	193	211	230	252	275
Unemployment Insurance	48	49	49	50	50
Other	245	224	219	224	215
Total	\$5,235	\$5,518	\$5,808	\$6,156	\$6,479

Costs for Federal Insurance Contributions Act (FICA) and Social Security average around 22 percent per year of the total fringe benefits budget during the life of the plan. While the cost is significant (about \$1.3 billion per annum), both the growth rate (about three percent between FY 2005 and FY 2009) and the percent of overall fringe benefits are less problematic from an expense management viewpoint than health insurance. In fact the percentage share of FICA and Social Security to total fringe benefit expenses is actually declining over the plan (from around 24 percent to just over 20 percent in FY 2009).

Worker's Compensation costs represent about four percent of total fringe benefit expenses and are expected to rise steadily from FY 2005 (\$193 million) to FY 2009 (\$275 million). This reflects an anticipated increase of over 42 percent. Meanwhile, Unemployment Insurance is expected to range from \$48 million in FY 2005 to \$50 million in FY 2009. This represents an increase of around four percent.

Health Insurance

As stated previously, the most important component of fringe benefits, and the main cause of rapid growth in the category, is the rising cost of health insurance. As shown in the figure to the right, we see that between FYs 2005-09, health insurance costs range from \$2.6 billion to \$3.7 billion. This represents between 50 percent and 58 percent of the total fringe benefit costs, which range from just over \$5.2 billion to nearly \$6.5 billion during that same time frame.



Any efforts to manage these expenses more in line with the projected rate of inflation is dependent upon a number of key factors, with the most critical involving the various collective bargaining agreements. Previous negotiations that led to an increase in employee co-payment under GHI did not appear to slow down the growth in the expenses of health insurance.

Pension Costs

The city anticipates in its January budget modification that it will need to contribute more than \$3 billion to New York City’s Retirement System (NYCRS) in FY 2005. The contribution is smaller than had been previously projected in the October modification due to a strong FY 2004 investment performance. The city’s normal contribution comprises a very large percentage of annual pension costs, which is net of member contributions. Contributions are based on actual headcount, anticipated turnover, future salary increases, projected overtime, retirement and mortality probabilities, and the assumed rate of return on investments. Due in part to the impact of investment losses from prior years and the Cost of Living Adjustment (COLA), both of which are being phased-in at higher percentages in later years, pensions costs are expected to increase significantly.⁶ By FY 2009, the city expects pension costs to surpass \$4.4 billion.

In its latest budget modification, the city has proposed some combination of savings in health insurance and pension costs in FYs 2006 and 2007 of \$325 million and \$200 million, respectively. It is unclear at this juncture how the savings will materialize, thus we are holding these savings at risk.

Additionally, the City Actuary is considering proposing a package of actuarial assumptions and methods to the retirement systems later this fiscal year that, if it receives all required approvals, in the short-term would defer pension costs of \$900 million in FYs 2005 through 2007 to the later years of the financial plan, as shown in the figure to the right. The package has four primary components and will be presented as follows:

Impact to Pension Costs from Actuary Recommendations			
All Funds (\$ in billions)			
Fiscal Year	Current Costs	Proposed Costs	Increase / (Decline)
2005	\$3.5	\$3.3	(\$0.2)
2006	4.6	4.2	(0.4)
2007	5.1	4.8	(0.3)
2008	5.1	5.4	0.3
2009	5.0	5.5	0.5

- ✍ Gabriel, Roeder, Smith and Company (GRS) Recommendations
- ✍ Timely Recognition of All Liabilities
- ✍ Actuarial Asset Valuation Method (AAVM)
- ✍ One Year Lag Methodology

⁶ An explanation of COLA is presented under the heading “Timely Recognition of All Liabilities” in this pension section.

GRS Recommendations

The city's charter mandates a biennial independent audit of the actuarial assumptions used by the City Actuary to calculate the contributions made to NYCERS. The latest released report by GRS was published in calendar year 2003 and covered FYs 1998-01. The audit included an experience study of demographic assumptions such as, Accidental Disability, Probabilities of Retiring When Eligible, and Overtime Costs. GRS compared expected experience to what had actually occurred. Any changes to these demographic assumptions need approval by each individual actuarial system. Each system is governed by a Board of Trustees that determines its own investment and operations policies, such as asset allocation, asset management, and acceptance of an Actuarial Interest Rate (AIR) recommendation made by the City Actuary. NYCERS is comprised of five actuarial systems:

- ✍ NYC Employees' Retirement System (NYCERS)
- ✍ NYC Board of Education Retirement System (BERS)
- ✍ NYC Teachers' Retirement System (TRS)
- ✍ NYC Police Pension Fund (POLICE)
- ✍ NYC Fire Department Pension Fund (FIRE)

GRS also studied the economic assumptions and methods, which encompass the AIR or NYCERS's anticipated rate of return on its investment of assets. The AIR needs to be updated every five years and any change to it must be approved by the state legislature. Currently, the AIR is set at eight percent and assets invested in a variety of equity and fixed income securities are assumed to yield an investment return equal to the AIR.

This package of assumptions and methods will reflect updated demographic assumptions based upon the Actuary's best estimate of future experience after taking into account recommendations made by GRS in their study report. It will also recommend that the AIR stay unchanged.

Timely Recognition of All Liabilities

In June 2000, the state legislature passed a COLA for current and future retirees, which closely follows the recommendations made by the Governor's Task Force on Public Employees Pension Systems. The legislation provides for an annual COLA equal to 50 percent of the consumer price index (CPI) with a minimum annual adjustment of one percent and a maximum annual adjustment of three percent applicable to the first \$18,000 of a retiree's annual retirement allowance. The legislation also provides for a "catch-up" adjustment for current retirees by increasing their pensions to cover at least 50 percent of reported inflation from the year of retirement through 1997.

The additional liabilities associated with the COLA changes were originally phased-in over a five-year period (FYs 2001-05). As part of a cost containment initiative, the phase-in period was extended to 10 years from FYs 2003-10 with credit given for the first two years. The city Actuary may recommend COLA phase-in be removed and the

full liability be recognized. This recommendation must be approved by the state legislature.

Actuarial Asset Valuation Method

The Actuarial Asset Valuation Method (AAVM) recognizes investment returns greater or less than expected. A return greater than the AIR of eight percent is an investment gain and a return under eight percent is an investment loss. Investment gains and losses are phased-in over a five-year period at a cumulative rate of 10 percent, 25 percent, 45 percent, 70 percent, and 100 percent in order to smooth-out the fluctuations of gains and losses. However, when pension losses are concurrent as they were in FYs 2001-03, the effect in the later years of the phase-in causes pension costs to swell.

The Actuary may recommend in its package that the AAVM be extended to a six year phase-in at the cumulative rate of 15 percent, 30 percent, 45 percent, 60 percent, 80 percent, and 100 percent. The change would have the effect of reducing the impact of gains and losses over the phase-in period and enhance the smoothing method. The AAVM is under the full discretion of the Actuary and needs no approval from the state or individual retirement system boards.

One Year Lag Methodology

Currently, the fiscal year contribution is based on demographic data and financial information collected as of June 30th of the prior fiscal year. The valuation process is complex and takes several months to prepare and the final contribution is not available until late that fiscal year. Thus, at the time of the adopted budget, the contribution is based on estimation. The Actuary is considering a method that will provide for greater budget certainty by determining employer contributions in advance of the fiscal years those contributions are to be made. Under this one year lag methodology, the fiscal year contribution is based on demographic data and financial information collected as of June 30th of the second prior fiscal year. This recommendation must be approved by the state legislature.

The Actuary's intention in proposing a package is to reflect an estimate of future experience, strengthen NYCERS's long-term fiscal health, reduce volatility of contributions, and provide greater budget certainty for the city. The impact of the package to pension costs is premature at this point since it relies in part on the approval of the state and each board of trustees. However, if it receives these approvals it may in the short-term reduce the city's pension contribution if everything else remains stable.

Medicaid

Medicaid expenditures are forecasted to increase from \$5.07 billion in FY 2006 to \$6.15 billion in FY 2009, as shown in Table 9. This represents an increase of 21 percent over the next four years. The city anticipates average annual growth above six percent for FYs 2006 through 2009, outpacing the city's total expenditure growth in city funds by

four percentage points. Meanwhile, the percentage of Medicaid costs to the city's total expense budget remains high at an average of over 10 percent per annum.

MEDICAID COSTS ARE INCREASING AT RECORD LEVELS

TABLE 9

(\$ in millions)

	<u>FY 2006</u>	<u>FY 2007</u>	<u>FY 2008</u>	<u>FY 2009</u>
Medicaid Total	\$ 5,067	\$ 5,337	\$ 5,719	\$ 6,148
City's Total Expense Budget	49,466	53,309	54,827	56,002
Percentage of Medicaid Costs	10.24%	10.01%	10.43%	10.98%

The cost to provide Medicaid benefits for over 2.6 million people enrolled in the program is escalating. In fact, from FY 2000 until FY 2005, the city's Medicaid spending has increased by an average of nine percent. These escalating costs can be attributed mainly to managed care, long-term care and rising pharmaceutical costs. As part of its request for an additional \$500 million in state aid, the city has compiled a list of numerous actions including several that would contain the growth in Medicaid costs. The Governor's executive budget acknowledges the need to contain the growth in these Medicaid costs.

State Actions

As shown in the figure to the right, the Governor's proposed budget indicates that the city would save \$421 million in FY 2006 through its Medicaid initiatives. The most significant portion of this proposal is the realization of cost containments of close to \$231 million through FY 2006. Over 45 percent of such containments would be realized through more stringent expense management by hospitals and nursing homes. The state recognizes other savings in pharmaceuticals (\$22 million), Family Health Plus/Benefit Reductions (\$49 million) and another \$40 million is savings in miscellaneous areas, such as adult dental services. The cost containment measures in the proposal must be approved by the state legislature, and thus their implementation is uncertain at this time.

Governor's Proposed Medicaid Initiatives Impact to the City's Financial Plan	
(\$ in millions)	<u>FY 2006</u>
Medicaid Cap Savings	\$ 190
Hospital Cost Containment	105
Family Health Plus/Benefit Reductions	49
Miscellaneous Cost Containment	40
Pharmaceutical Cost Containment	22
Nursing Home Cost Containment	15
Total	\$ 421

Along with these cost containment measures the state proposes to cap the local share of Medicaid costs at the 2005 level plus a growth rate of 3.5 percent or actual cost, whichever is less beginning January 1, 2006. The growth is lowered to 3.25 percent in 2007 and then to three percent in 2008 and thereafter. The state projects that such a cap would bring the city another \$190 million in cost savings in FY 2006 based on projected growth of nine percent in the city's Medicaid spending.

Given the uncertainty surrounding many of these actions at this time, we cannot anticipate their effect on the city's expenses until the state adopts its new budget.

Public Assistance

In the January modification, the city forecasts that the cost of Public Assistance (PA) is expected to decrease slightly at just under a half percent over the life of the plan, from approximately \$2.37 billion in FY 2006 to around \$2.35 billion in FY 2009, as shown in Table 10. The Department of Social Services is the principal source of PA costs, averaging over 86 percent of PA's budget. Although the forecasted growth in PA is insignificant, it is important to note that PA costs average over four percent of the city's total expense budget in a given year.

PUBLIC ASSISTANCE COSTS REMAIN STEADY

TABLE 10

(\$ in millions)

Agency	FY 2006	FY 2007	FY 2008	FY 2009
Department of Social Services	\$2,035	\$2,036	\$2,036	\$2,036
Department of Homeless Services	319	308	308	308
Department of Health and Mental Hygiene	11	11	11	11
Total	\$2,365	\$2,355	\$2,355	\$2,355

Total PA caseloads are calculated from the aggregate of three PA recipient populations: Family Assistance Program (FAP), Safety Assistance (SNA), and Safety Net Assistance Five-Year Limit (SNA 5-Year). FAP consists of those families with children who are in need of assistance and SNA is comprised of single adults without children who are not entitled to federal welfare. SNA 5-Year encompasses those families that have reached their five-year life-time limit of federal benefits and have moved into the Safety Net Assistance program.

The 1996 Federal Welfare Reform legislation was instrumental in reducing overall case loads and expenses from the mid-1990s. However, the number of recipients on PA has risen slightly over the past two years to a FY 2006 projected number of 438,295, as shown in the figure to the right. This represents a 0.5 percent growth from FY 2005, which in turn reflects growth of two percent from FY 2004.

Public Assistance Caseloads Show Slight Increase		
<u>Fiscal Year</u>	<u>Recipients</u>	<u>Change</u>
1994	1,157,684	---
1995	1,046,432	(10%)
2001	462,595	(56%)
2002	421,242	(9%)
2003	431,052	2%
2004	428,208	(1%)
2005*	436,295	2%
2006*	438,295	0.5%

*OMB Projection

FY 2006 Agency Program

A new FY 2006 agency program of approximately \$506 million was included in the January modification. As shown in the figure below, over \$455 million of this program entails reduced expenditures by various agencies and almost \$51 million reflects enhanced revenues. Almost \$310 million, or 68 percent, of the reduced expenditures and close to \$27 million, or 53 percent, of the enhanced revenues are expected to be recurring.

As seen in the figure, over half of the expenditure reductions (slightly over 58 percent) are being made by the four uniformed services departments. The largest reduction is the \$125 million cut by the Police Department. Of this amount, \$92 million consists of salary savings generated by veteran officers leaving the department and being replaced by younger officers. Another \$30 million is savings that will be realized by applying increased federal homeland security aid to overtime costs.

The City's FY 2006 Agency Reduction Program (\$ in millions)		
Department	Expenditures	Revenues
Police	(\$125.3)	(\$5.4)
Fire	(45.1)	(6.1)
Sanitation	(46.1)	(4.7)
Correction	(49.1)	4.2
Children's Services	(34.7)	
Social Services	(16.2)	
Health & Mental Hygiene	(12.7)	(3.2)
Transportation	(7.4)	(5.9)
Parks & Recreation	(3.0)	(8.8)
Health & Hospitals	(11.4)	
Housing Preserv. & Dev.	(2.9)	(4.6)
Homeless Services	(7.5)	
Other	(93.9)	(16.1)
Total	(\$455.3)	(\$50.6)

Note: Negative numbers represent a reduction in the city's budget gap.

The Fire Department expects to save \$45 million, of which a significant portion, or \$17 million, will be gained by eliminating the fifth post at 49 companies. This can be accomplished due to the fact that according to the Roster Staffing Agreement of 1996 these posts may be eliminated if the medical leave rates show that the 365 day average of medical leave exceeds 7.5 percent. However, in February of this year the Kings County Supreme Court issued an order prohibiting the Fire Department from removing the fifth post at the 49 companies pending the arbitration of a grievance filed by the Uniformed Firefighters Association challenging the department's action. The department also plans to save over \$10 million in overtime through enhanced management initiatives. In the past, however, the department has sometimes struggled to make overtime savings. The Department of Sanitation is planning to reduce FY 2006 expenditures by \$46 million. Most of this reduction, \$38 million, comes from funding re-estimates for the Fresh Kills solid waste management plant closure. The city is still awaiting approval of the closure plan by the state. The Correction Department program is made up of 20 small initiatives, the largest of which is a reestimate of the FY 2006 personal service budget which is expected to yield almost \$12 million in savings.

Department of Education

During the year-end close of FY 2004, the Department of Education (DOE) announced that it had unexpectedly exceeded its budget by \$236 million. The factors contributing to this overage in spending and transfers ranged from procedural, such as the timing difference between DOE's Financial Accounting Management Information System (FAMIS) and the city's more updated Financial Management System (FMS), to unanticipated expenses in special education and pre-kindergarten. In order to address most of the recurring nature of this overage the city is using \$140 million of the \$311 million increase in state educational aid that it received for FY 2005. In addition, between the October and January modifications, the city increased its DOE funding by \$84 million in FY 2005. The process to integrate FAMIS with FMS has already begun. Also, many of the DOE budget's units of appropriation are being refined in order to more precisely describe charges.

On February 14th the State Supreme Court accepted the November recommendations of a panel of special masters in the Campaign for Fiscal Equity case. The ruling mandates that the DOE, beginning next year, receive an additional \$5.63 billion in baseline operational funding phased-in over a four-year period (\$1.41 billion per year incrementally). It also mandates that the city receive an additional \$9.2 billion for capital projects phased in over five years (\$1.84 billion per year). The court additionally ruled that the funding split between the state and city is to be determined by the state legislature. The Governor has announced that the state will appeal the ruling with the State Court of Appeals. The appeal means that there will most likely be no short-term impact on the city's budget. However, over the long term should the Court of Appeals uphold the lower court ruling and if the state legislature determines that the city should provide some percentage of the funding, the impact on the city's budget could be significant.

Labor Relations

The State Public Employment Relations Board (PERB) has declared an impasse in the negotiations between the city and three of its major unions, the Patrolmen's Benevolent Association (PBA), the Uniformed Firefighter's Association (UFA) and the United Federation of Teachers (UFT). Mediation is being conducted between the city and UFA. Mediation has also begun between the city and the UFT. The city and the PBA have concluded binding arbitration hearings and an impasse award is expected by the end of March 2005.

The city has funded wage increases patterned after the District Council 37 (DC 37) agreement that was ratified by the union in June 2004. This wage section of the contract calls for a \$1,000 one-time payment, no raise in the first year, a three percent raise in the second year, and a two percent raise in the third year, which could grow to three percent if the union agrees to further productivity savings.

The PERB recently made an impasse award to the Metropolitan Transportation Authority (MTA) police officers. The wage section of the award gives a 21 percent increase over a four-year period commencing retroactively on August 15, 2002. The MTA plans to appeal the PERB's ruling. This award is significantly higher than what the city has planned. Each additional one percent increase for the teachers and the four uniformed services would cost the city approximately \$154 million annually.

THE NEED TO CONTAIN THE RELATIVELY HIGH DEBT SERVICE BURDEN

The city characterizes debt service costs in the financial plan as non-discretionary. This is because debt service in the plan is largely an obligation generated from long-term borrowing undertaken to support capital commitments made in past years. While being characterized as non-discretionary, debt service has been on the rise and now represents one of the largest and fastest growing components in the operating budget.

Debt service beyond the five years covered in the financial plan will be heavily impacted by the size of the capital program in the plan years. A review of the city's capital program indicates that the city expects to commit itself to a massive amount of projects in the near future. The city released a preliminary ten-year capital strategy that outlines its priorities for the next decade.⁷ Prominent in the strategy is the allocation for expansion of and physical improvements to schools. It is the largest ten-year strategy ever proposed, but it assumes a considerable amount of non-city funding for education, which, at this point, has not been secured. Additionally, the capital contracts are disproportionately larger in the early years of the ten-year strategy, so that in the near future the city will lock itself into more long-term fixed costs that it will then characterize as non-discretionary.

The city is planning to undertake several capital projects that are designed to stimulate economic activity, some of which have not been included in the capital strategy. The city believes these projects will expand the revenue base and ultimately ease the debt service burden. While this investment strategy has merit, the amount and flow of the new revenue streams are not guaranteed. If the revenues do not materialize as projected, payment of debt service may require displacement of other competing operating needs.

Rising Debt Service

The amount of resources, net of budget surpluses, used to pay total debt service costs generated by the city, the New York City Transitional Finance Authority (NYCTFA), and the Municipal Assistance Corporation (MAC) is projected to increase by 37 percent, from \$4.25 billion in FY 2005 to \$5.84 billion in FY 2009.⁸ Tax revenues, the main payment source, are currently forecasted to grow by less than half this rate at 15 percent, rising from \$29.3 billion in FY 2005 to \$33.55 billion in FY 2009. The stark increase in debt service will result in it consuming 17.4 percent of tax revenues by FY 2009, which is a level experienced only once during the past ten years, as depicted in Chart 4.

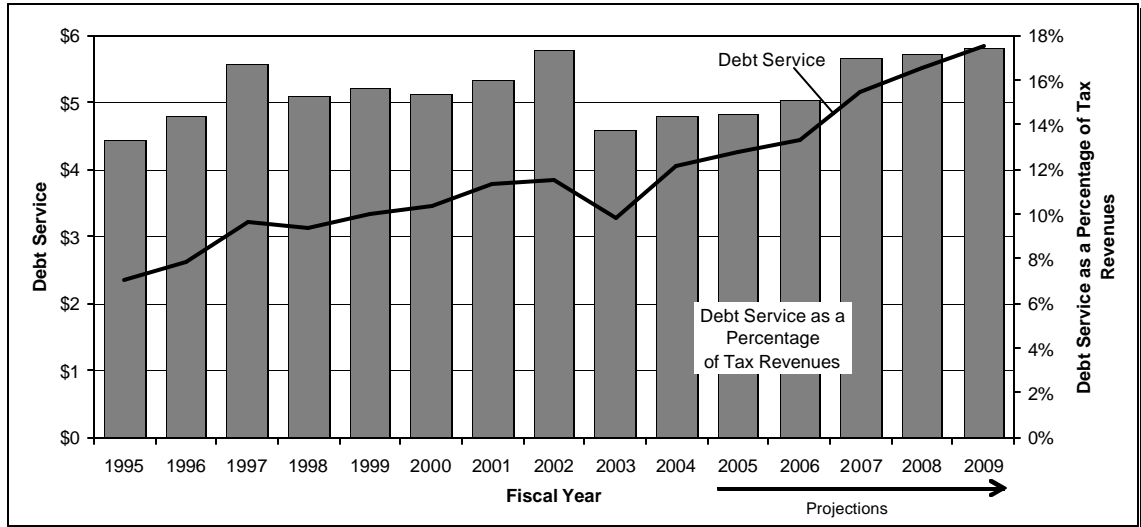
During the ten-year period from FYs 1995-2004, debt service costs increased by 73 percent, from \$2.35 billion to \$4.06 billion. Tax revenues grew at a comparatively slower pace of 60 percent, increasing from \$17.69 billion in FY 1995 to \$28.25 billion in FY 2004. The percentage of tax revenues absorbed by the surging debt service fluctuated during this ten-year period from a low of 13.3 percent in FY 1995 to a high of 17.3 percent in FY 2002, and then receded to 14.4 percent in FY 2004. The peak in FY 2002 reflected a recessionary year when tax revenues abruptly declined and the payment of debt service was facilitated by the availability of a \$3 billion prior-year budget surplus.

⁷ The city is required by its charter to produce a Ten-Year Capital Strategy biennially. A preliminary version is submitted with the January modification and a final version is issued along with the executive budget.

⁸ The vast majority of total debt service is city funded; additionally, there is an annual \$11 million to \$19 million that is state funded and an annual \$73 million to \$153 million that is funded by swap receipts.

THE SHARPLY INCREASING DEBT SERVICE COSTS REPRESENT A RELATIVELY HIGH BURDEN

CHART 4 (\$ in billions)



The similarly high debt service burden projected for FY 2009 is problematic because it coincides with an estimated budget deficit of over \$3 billion. For this level of debt service to be sustainable, revenues would have to rise precipitously or spending on other expense budget areas would have to be pared back.

Capital Program Agenda

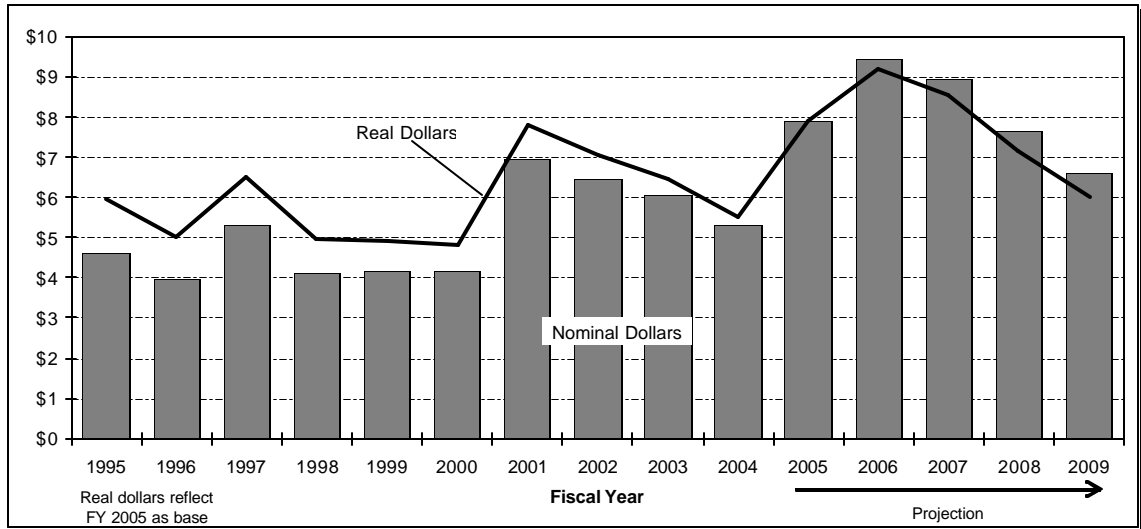
The city is engaged in a massive undertaking to reconstruct, expand and modernize its physical assets. For the past ten years, from FYs 1995-2004, the city has undertaken \$51 billion of capital projects. That is the equivalent of \$59 billion in FY 2005 dollars.⁹ Chart 5 illustrates that a dramatic increase in the capital program began in FY 2001 when the city committed \$7 billion for capital projects. Since then, annual capital commitments have not fallen below \$5 billion. The vast majority of these capital contracts are city funded.¹⁰ The \$5.84 billion FY 2009 debt service projection mostly reflects bonding by the city and the NYCTFA for a large portion of these past commitments and is therefore non-discretionary.

⁹ In adjusting for inflation, we use the consumer price index for the New York region rebased to FY 2005.

¹⁰ The primary sources of city funds include general obligation bonds sold by the city and repaid from tax revenues; revenue bonds sold by the Water Finance Authority for environmental protection projects and repaid from user fees; and revenue bonds sold by the NYCTFA and repaid from personal income tax revenues.

ANNUAL CAPITAL COMMITMENTS WILL REMAIN LARGE

CHART 5 (\$ in billions)



The city’s current capital program calls for a continued high level of investment in the physical assets. The city expects to commit a targeted amount of \$40.5 billion during the five-year period of FYs 2005-09, which is equivalent to \$39 billion in FY 2005 dollars. During this period, annual commitments are projected to surge to almost \$9.5 billion in FY 2006 before sliding to a nonetheless high level at \$6.6 billion in FY 2009.

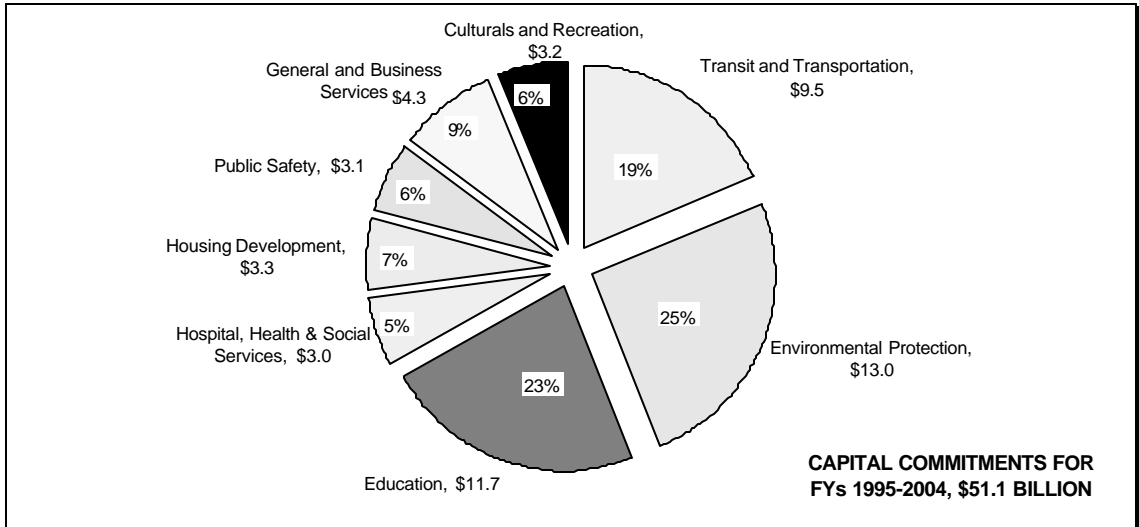
The city is currently developing a comprehensive plan to meet its capital needs for the coming decade, and has released a preliminary version of its ten-year capital strategy for FYs 2006-2015. The strategy will be finalized and released with the executive budget in April. The preliminary strategy sheds some light on the city’s capital priorities. To evaluate the city’s priority over time, we compare groupings of capital commitments for the ten-year periods of FYs 1995-2004 and FYs 2006-2015.

Chart 6 reveals that during FYs 1995-2004, the city allocated 44 percent of the total \$51 billion of commitments to improving infrastructure areas relating to environmental protection, transit and transportation.¹¹ In addition to addressing its infrastructure needs, the city allocated 23 percent of commitments, or \$11.7 billion, to tackle accumulated programmatic needs related to schools. The remaining 33 percent of commitments were distributed among five broad categories.

¹¹ We use a traditional public works definition of infrastructure and limit the category to physical assets that are indispensable to economic activity such as bridges, highways, and water and sewer projects.

**ENVIRONMENTAL PROTECTION, EDUCATION AND
TRANSPORTATION PROJECTS REPRESENT TWO THIRDS
OF COMMITMENTS OVER THE PAST DECADE**

CHART 6 (\$ in billions)



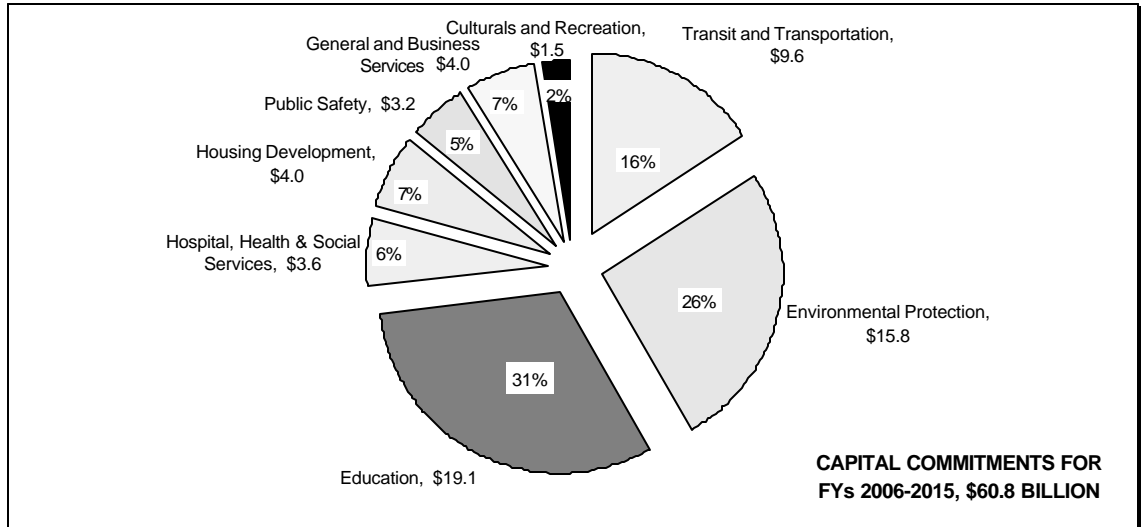
Building on the \$51 billion of commitments undertaken over the past decade, the city has identified an additional inflation-adjusted \$61 billion of capital projects it intends to undertake during FYs 2006-2015, as illustrated in Chart 7.¹² The city plans to undertake the commitments on an accelerated basis, with 62 percent scheduled for the first five years. The single largest category is education, at \$19 billion, or 31 percent of total commitments. The allocation for education is higher than in the past decade by \$7.4 billion. Additionally, the city augmented infrastructure commitments for environmental protection, transit and transportation by \$2.9 billion. However, proportional representation for these areas declined two percentage points to 42 percent. The area that reflects a significant reduction in commitments in both absolute and relative terms is culturals and recreation. Commitments for cultural and recreation projects are lower in the ten-year strategy by \$1.7 billion so that the value as a percentage of total commitments has decreased from six percent to two percent. The higher commitments in FYs 1995-2004 include a few large projects in the more recent years that have been completed.

The preliminary ten-year capital strategy reflects the city's emphasis on upgrading and expanding school facilities, to address years of deferred maintenance and a growing student population. The \$19 billion allocation for education assumes that \$13 billion of the projects will be undertaken in the first five years, with the state contributing \$6.6 billion of funding in the initial five years and the city covering the balance of \$6.4 billion. The state has not agreed to this level of funding.

¹² Commitments in the ten-year strategy do not include interfund agreement transactions, which averaged \$268 million annually over the past ten years. Moreover, the final ten-year strategy may be even larger given that it is likely for a portion of the \$11.6 billion of authorized commitments for FY 2005 to be deferred to FY 2006.

EDUCATION PROJECTS ARE GIVEN THE HIGHEST PRIORITY IN THE TEN-YEAR STRATEGY

CHART 7 (\$ in billions)



In a recent landmark decision in the Campaign for Fiscal Equity lawsuit, a State Supreme Court judge ruled that the state is required to provide the opportunity for a sound, basic education, and on the capital side assessed the city's total need for education at \$9.2 billion for the five-year period of FYs 2006-10. This is \$3.8 billion less than the city has in its capital strategy. Moreover, given that the city plans to spend \$6.4 billion of its resources on education capital projects, there is a \$2.8 billion unfunded balance of the court's five-year assessment of \$9.2 billion.¹³ The judge ruled that the funding distribution between the city and state should be determined by the state legislature and has set a period of 90 days for the state to act. It may be some time before the ultimate size of and funding distribution for the school construction program are determined because the Governor has indicated that he will appeal the judge's ruling on the city's education funding needs.

Economic Development

To a somewhat smaller degree, a key component of the city's capital strategy is economic development. The strategy includes, in the business services category, the city's contribution of \$350 million toward the expansion of the Javits Convention Center.¹⁴ The city's position is that the expansion will result in additional economic

¹³ The city had originally expected that in FY 2005 it would receive the first installment of \$1.3 billion of the requested state funds for education. When it became apparent that it would not receive this first installment, the city deferred the projected schedule of the state-funded commitments by a year, reducing education commitments by \$1.3 billion in FY 2005. Recently, the mayor announced that the city will accelerate city funding of education commitments by \$1.3 billion, from FYs 2006-09 into FY 2005, and concomitantly increase non-city funding by an equivalent amount over FYs 2006-09.

¹⁴ The Javits Convention Center expansion is projected to cost \$1.2 billion. The state is expected to provide \$350 million, and the remaining \$500 million is expected to be raised from the sale of non-state/non-city bonds supported by a \$1.50 per key, per night charge on city hotel rooms.

activity and generate incremental tax revenues that would be used to support the high debt service levels. Similarly, the strategy includes \$100 million of city funds for the site development of Brooklyn's Atlantic Yards in conjunction with private financing of an arena that would serve as home to the Nets basketball team.

Despite being a substantial part of its program to stimulate and support economic activity, \$2.5 billion of projects related to the development of Manhattan's far West Side have been excluded from the preliminary ten-year strategy. The project scope includes a \$1.8 billion phase-one extension of the No. 7 subway line to provide a link to the Javits Center and \$700 million to lay the groundwork for commercial and residential development in the area.¹⁵ Funding for the projects is slated to be provided by the Hudson Yards Infrastructure Corporation (HYIC), a newly created local development corporation, which expects to sell bonds for this purpose beginning later in 2005.

The debt service is expected to be paid from incremental revenues mainly in the form of payments in lieu of taxes (PILOTS) generated from related commercial development and property taxes on related residential development. However, the Mayor and the City Council came to an agreement that calls for the city to assume responsibility for the interest component of the debt service to the extent that the project revenues are insufficient to cover the payments.¹⁶ Accordingly, the financial plan reflects city lease payments to HYIC ranging from \$6 million in FY 2005 to \$162 million in FY 2009 to cover most of the projected interest expense. The city anticipates that after FY 2009 the primary source of payments will be the project revenues, and reliance on existing tax revenues will diminish. The city estimates that project revenues could total as much as \$16 billion through FY 2035. Others have claimed that estimate is too optimistic. Since there is no guarantee of the amount and flow of the incremental revenues, the city is liable to support all of HYIC's interest expenses if the revenues do not materialize. With the city assuming responsibility for the interest costs related to these capital projects, we believe the projects should be reflected in its capital strategy.

One major element of the development plan for Manhattan's far West Side is the construction of a multi-use sport facility that would serve as home to the New York Jets and is considered the linchpin of the city's bid to host the 2012 Olympics. This plan, which also has been excluded from the ten-year capital strategy, assumes the city and the state will each raise \$300 million to cover the cost of constructing a platform and a retractable roof, and the Jets will fund the \$800 million cost of building a stadium.

¹⁵ Additionally, the city plans to undertake a future phase of this project, which is forecasted to cost \$521 million and involves construction of a 41st Street station as well as creation of a mid-block boulevard and parks.

¹⁶ An earlier plan had called for HYIC to sell up to \$1 billion of commercial paper to cover the interest costs during the period before the new stream of revenues begins to flow, with the NYCTFA as a source of credit enhancement for the commercial paper. The current agreement assumes the issuance of up to \$750 million of variable rate debt for the project costs, which will be credit enhanced by the NYCTFA. In the event HYIC cannot meet its obligation, the NYCTFA would have to purchase HYIC's debt with personal income tax revenues that would otherwise be used by the city to support operating expenses.

Under the plan, a local development corporation will sell \$600 million of bonds on behalf of the city and state, and a possible \$400 million that would be secured by Jets lease payments. While the city believes that this project will generate additional revenues, it intends to assign incremental revenues from existing PILOT agreements to back its share of the bonds. Specifically, the city has identified certain PILOTs that currently generate approximately \$40 million annually, but are expected to yield a higher revenue stream for the city of about \$70 million annually. The city plans to assign the additional revenues to pay the debt service on its share of the bonds. While the PILOTs are not tax revenues, they would have supported other operating expenses, thus freeing up an equivalent amount of tax revenues to cover debt service costs in the plan.

This plan is currently at a crossroad because the Metropolitan Transportation Authority (MTA), which owns the land on which the stadium is proposed to be built, is now soliciting competing bids for the development rights. The Jets had offered to pay \$100 million for the development rights; another corporation, Cablevision, made a last-minute offer of \$600 million, which includes the cost of building a platform. The MTA has decided to open up the bidding process to any prospective bidders, and has set a March 21st deadline for proposals. It is unclear what the impact will be on the other far West Side development plans if the multi-use sports facility is not built. The economic viability of the No. 7 subway line extension may be questionable in the absence of the multi-use sports facility.

The city aims to undertake economic development projects as a means of expanding its revenue base, which will have the ancillary benefit of relieving the debt service burden. We believe that it is also important to control the rapid growth in debt service, which could be done by containing future capital spending through current investment in maintenance of the capital stock. We urge the city to ensure that its most critical maintenance needs are addressed on a priority basis. To that end, the city should utilize the information provided in its annual maintenance report to identify such needs and fully fund the recommendations outlined in the report.¹⁷ By providing adequate capital resources for full maintenance of existing assets on a timely basis, the city will minimize the need to replace assets prematurely or undertake more extensive repairs. This would reduce unnecessary borrowing and, over time, help contain the pressure debt service places on future operating budgets.

¹⁷ The city is required by its charter to produce, each October, an annual maintenance report that projects the amount of funding needed over the ensuing four years to maintain assets and asset systems with a replacement cost of \$10 million or greater and a useful life of more than ten years. In addition, the city is required to publish, each April when the executive budget is released, a supplemental document reconciling the funding need to the planned funding for each agency.

Glossary of Acronyms

AAVM	Actuarial Asset Valuation Method
AIR	Actuarial Interest Rate
BCT	Banking Corporation Tax
BPCA	Battery Park City Authority
CFE	Campaign for Fiscal Equity
COLA	Cost of Living Adjustment
CPI	Consumer Price Index
DC 37	District Council 37
DOE	Department of Education
FAMIS	Financial Accounting Management Information System
FAP	Family Assistance Program
FICA	Federal Insurance Contributions Act
FCB	Financial Control Board
FEMA	Federal Emergency Management Agency
FMS	Financial Management System
FY	Fiscal Year
GCT	General Corporation Tax
GHI	Group Health Insurance
G.O. Bonds	General Obligation Bonds
GRS	Gabriel, Roeder, Smith and Company
HHC	Health and Hospitals Corporation
HYIC	Hudson Yards Infrastructure Corporation
MA	Medical Assistance
MAC	Municipal Assistance Corporation
MTA	Metropolitan Transportation Authority
NYCRS	New York City Retirement System
NYCTFA	New York City Transitional Finance Authority

NYPD	New York Police Department
OT	Overtime
OTPS	Other than Personal Service
PA	Public Assistance
PERB	Public Employment Relations Board
PBA	Patrolmen's Benevolent Association
PILOTS	Payments in Lieu of Taxes
PIT	Personal Income Tax
PS	Personal Service
RNC	Republican National Convention
SNA	Safety Net Assistance
SNA 5-Year	Safety Net Assistance Five Year Limit
UBT	Unincorporated Business Tax
UFA	Uniformed Firefighter's Association
UFT	United Federation of Teachers