

Staff Report
**REVIEW OF FYs 2009-2012
FINANCIAL PLAN**
July 22, 2008

New York State Financial Control Board

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I. Overview

The city has presented a balanced budget for FY 2009. Totalling \$59.4 billion, the FY 2009 budget is \$3.5 billion smaller than the FY 2008 budget, which was made possible through prepayments. The contraction is due to an expected decline in total revenue resulting from the economic downturn that is impacting the city to a greater extent than the rest of the nation. While revenue collection is forecasted to weaken, spending is projected to increase. To balance its budget, the city used a substantial amount of an accumulated \$6.6 billion budget surplus from FY 2008 to prepay FY 2009 expenses.

With the city-centered financial services industry in the midst of a significant downsizing, the economic downturn being faced by the city is likely to be more severe here than for the nation. The nonproperty taxes, which stagnated in FY 2008, fall by \$2.6 billion in FY 2009, as the leading component of a decline of \$3.1 billion in city-funded revenues and \$3.5 billion in total-funded revenues. Meanwhile, the expense budget for FY 2009 includes substantial spending growth, compared to FY 2008, in areas such as the Department of Education and pensions.

Fortunately, the city accumulated a surplus of \$6.6 billion in FY 2008 that it used to prepay \$3 billion of FY 2009 debt service expenses as well as \$960 million of subsidies and retiree health benefits. Additionally, the city provided a grant of \$546 million to the New York City Transitional Finance Authority in FY 2008 that it applied to its FY 2009 debt service payment, which freed up an equivalent amount of personal income tax for the city to use to balance its budget. The remainder of the surplus is being used to shrink the FYs 2010 and 2011 budget deficits.

While the city has presented a balanced budget, our analysis indicates that there is a \$334 million risk to the budget. Such a risk is manageable for the city particularly at this early stage of the fiscal year when the city still has a general reserve of \$300 million, among other options. However, the risks to the outyears of the plan are much larger and, when combined with already identified budget gaps, require immediate attention if the city is to achieve budget balance in the outyears. The city should consider, as they successfully did in FY 2008, taking actions during FY 2009 to either raise revenues or reduce expenditures, to build up a surplus to help balance FY 2010.

To narrow the budget gap projected for FY 2010, which increased due to the recent arbitration award concerning police salaries and the expectation that other uniformed services will reopen their negotiations, the city has applied \$2.4 billion of surplus resources from FY 2008 to reduce FY 2010 expenses. Additionally, the Mayor has proposed eliminating the seven percent property tax cut and has in fact augmented tax revenue by \$1.2 billion to \$1.4 billion in each of FYs 2010-12 to reflect this proposal. Despite these actions, the city estimates budget gaps of \$2.3 billion for FY 2010, \$5.2 billion for FY 2011 and \$5.1 billion for FY 2012.

We project, however, that the gaps could be larger by as much as \$2 billion in FY 2010 and \$2.4 billion in each of FYs 2011 and 2012, producing budget deficits totaling \$4.3 billion in FY 2010 and \$7.5 billion in each of FYs 2011-12. We believe that risks of

\$1.2 billion to \$1.4 billion exist to the financial plan until the city council approves the Mayor's plan to increase property taxes by seven percent. Furthermore, recent negative economic news and the severe downturn of the stock market have caused us to become increasingly pessimistic regarding the city's tax revenue plan. We expect that the nonproperty taxes will fall below the city's collection targets by \$400 million in FY 2009, \$425 million in FY 2010, and \$200 million in each of FYs 2011-12. These reductions are in addition to our expectation that there will be a \$200 million property tax shortfall in each of FYs 2010-2012, due to weak assessment growth.

To address the sizable outyear budget gaps it has projected for FYs 2011 and beyond, the city is now targeting the debt service cost, as it is one of the fastest growing components of the expense budget. The city announced that it will stretch out the four-year capital plan for FYs 2009-12 over five years. This will result in reduced capital financing and correspondingly lower debt service costs.

Of particular concern to us for the long-term fiscal health of the city is the rapid growth of the liability for Other Postemployment Benefits (OPEB). Our analysis of the unfunded OPEB liability beyond FY 2007, the final year for which an official city report has been released, indicates that the unfunded liability could climb by over \$20 billion from FY 2008 to FY 2012. The city created a fund to begin to address this growing liability, but has not applied any resources to the fund for the years covered by the financial plan. From a long-term perspective, the city needs to address this rapidly growing liability. Given few options, it has two possible ways, within its control, that it can approach the issue. One is to reduce healthcare costs to retirees through collective bargaining and, in conjunction with or alternatively to, increase contributions to the Retiree Health Benefit Trust Fund dramatically on a sustained year-to-year basis.

**JUNE FINANCIAL PLAN:
THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2009-2012**

TABLE 1

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
<u>Revenues</u>				
Taxes:				
General Property	\$13,744	\$14,703	\$15,645	\$16,392
Other Taxes ^a	21,650	21,685	23,067	24,551
Discretionary Transfers	546	--	--	--
Tax Audit Revenue	577	579	579	579
Tax Reduction Program	(3)	1,219	1,293	1,353
Sale of Property Tax Liens	38	34	31	31
Miscellaneous Revenues	6,700	6,308	6,371	6,393
Unrestricted Intergovernmental Aid	340	340	340	340
Anticipated Federal & State Aid	0	0	0	0
Interfund Revenues	463	425	419	419
Less: Intracity Revenues	(1,538)	(1,453)	(1,452)	(1,452)
Disallowances	(15)	(15)	(15)	(15)
Total City Funds	\$42,502	\$43,825	\$46,278	\$48,591
Federal Categorical Grants	5,366	5,283	5,273	5,282
State Categorical Grants	11,526	11,939	12,803	13,103
Total Revenues	<u>\$59,394</u>	<u>\$61,047</u>	<u>\$64,354</u>	<u>\$66,976</u>
<u>Expenditures</u>				
Personal Service	\$34,957	\$36,804	\$38,921	\$39,897
Other Than Personal Service	25,119	25,393	26,182	26,854
Debt Service	3,598	2,047	4,797	5,327
NYCTFA Debt Service	225	762	1,114	1,158
Budget Stabilization & Prepayments	(3,267)	(462)	(350)	--
General Reserve	300	300	300	300
Subtotal	\$60,932	\$64,844	\$70,964	\$73,536
Less: Intracity Expenditures	(1,538)	(1,453)	(1,452)	(1,452)
Total Expenditures	<u>\$59,394</u>	<u>\$63,391</u>	<u>\$69,512</u>	<u>\$72,084</u>
<u>Gap To Be Closed</u>	<u>\$0</u>	<u>(\$2,344)</u>	<u>(\$5,158)</u>	<u>(\$5,108)</u>
^a Allocates NYCTFA debt service to expenditures.				

**CHANGES TO THE CITY'S OPERATING PROJECTIONS FOR
FISCAL YEARS 2009-2012
JANUARY MODIFICATION COMPARED TO JUNE FINANCIAL PLAN**

TABLE 2

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
<u>Revenues</u>				
Taxes:				
General Property	(\$137)	(\$212)	(\$182)	(\$237)
Other Taxes ^a	699	(908)	(676)	(447)
Discretionary Transfers	0	--	--	--
Tax Audit Revenue	18	19	19	19
Tax Reduction Program	(3)	1,219	1,293	1,353
Sale of Property Tax Liens	0	0	0	0
Miscellaneous Revenues	367	107	142	162
Unrestricted Intergovernmental Aid	0	0	0	0
Anticipated Federal & State Aid	(100)	(100)	(100)	(100)
Interfund Revenues	29	3	2	2
Less: Intracity Revenues	(148)	(72)	(71)	(71)
Disallowances	0	0	0	0
Total City Funds	\$725	\$56	\$427	\$681
Federal Categorical Grants	(14)	(65)	(58)	(50)
State Categorical Grants	(42)	(491)	(70)	228
Total Revenues	\$669	(\$500)	\$299	\$859
<u>Expenditures</u>				
Personal Service	\$267	(\$523)	(\$176)	\$12
Other Than Personal Service	817	453	649	914
Debt Service	(222)	(2,125)	(158)	(212)
NYCTFA Debt Service	(1)	(1)	(35)	0
Budget Stabilization & Prepayments	(44)	(112)	(350)	--
General Reserve	0	0	0	0
Subtotal	\$817	(\$2,308)	(\$70)	\$714
Less: Intracity Expenditures	(148)	(72)	(71)	(71)
Total Expenditures	\$669	(\$2,380)	(\$141)	\$643
Gap To Be Closed	\$0	\$1,880	\$440	\$216

^aAllocates NYCTFA debt service to expenditures.

RISKS TO THE FINANCIAL PLAN

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

	FY 2009	FY 2010	FY 2011	FY 2012
Stated Financial Plan Gap	\$0	(\$2,344)	(\$5,158)	(\$5,108)
Estimation				
Nonproperty Taxes	(\$400)	(\$425)	(\$200)	(\$200)
Property Tax	0	(200)	(200)	(200)
Miscellaneous Revenue	150	125	100	100
Uniformed Services Overtime	(84)	(78)	(62)	(61)
Subtotal	(\$334)	(\$578)	(\$362)	(\$361)
Implementation				
Pollution Remediation	\$0	\$0	(\$500)	(\$500)
Subtotal	\$0	\$0	(\$500)	(\$500)
Not in Mayor's Control				
Property Tax Program	\$0	(\$1,223)	(\$1,298)	(\$1,359)
Health Insurance Savings	0	(200)	(200)	(200)
Subtotal	0	(\$1,423)	(\$1,498)	(\$1,559)
Risk Total	(\$334)	(\$2,001)	(\$2,360)	(\$2,420)
Total FCB Estimated Surplus/(Gap)	(\$334)	(\$4,345)	(\$7,518)	(\$7,528)
Note: The city has set aside \$300 million for a general reserve in each year of the financial plan.				

II. Balancing the FY 2009 Budget

The city has presented a balanced budget for FY 2009. Totalling \$59.4 billion, the FY 2009 budget is \$3.5 billion smaller than the FY 2008 budget. The contraction is due to an expected decline in total revenue resulting from the economic downturn that is impacting the city to a greater extent than the rest of the nation. While revenue collection is forecasted to weaken, spending is projected to increase. To balance its budget, the city used a substantial amount of an accumulated \$6.6 billion budget surplus from FY 2008 to prepay FY 2009 expenses.

With the city-centered financial services industry in the midst of a significant downsizing, the economic downturn being faced by the city is likely to be more severe here than for the nation. The nonproperty taxes, which stagnated in FY 2008, fall by \$2.6 billion in FY 2009, as the leading component of a decline of \$3.1 billion in city-funded revenues and \$3.5 billion in total-funded revenues.

Meanwhile, the expense budget for FY 2009 includes substantial spending growth in a few areas compared to FY 2008. The Department of Education increased its budget between FY 2008 and 2009 by over \$935 million to almost \$17.8 billion (excluding pension and debt service costs). Expanded state aid of over \$573 million accounts for part of this increase. The city's pension contribution is slated to rise by about \$550 million from FY 2008 to FY 2009. This is the result of salary increases and benefit enhancements reached through recent collective bargaining agreements and the phase-in of investment losses.

Fortunately, the city accumulated a surplus of \$6.6 billion by FY 2008 that it used to prepay \$3 billion of FY 2009 debt service expenses as well as \$960 million of subsidies and retiree health benefits. Additionally, the city provided a grant of \$546 million to the New York City Transitional Finance Authority (NYCTFA) in FY 2008 that it applied to its FY 2009 debt service payment, which freed up an equivalent amount of personal income tax for the city to use to balance its budget. The remainder of the surplus is being used to shrink the FYs 2010 and 2011 budget deficits.

While the city has presented a balanced budget, our analysis indicates that there is a \$334 million risk to the budget. Such a risk is manageable for the city particularly at this early stage of the fiscal year when the city still has a general reserve of \$300 million, among other options. However, the risks to the outyears of the plan are much larger and, when combined with already identified budget gaps, require immediate attention if the city is to achieve budget balance in the outyears.

THE WEAKER REVENUE OUTLOOK

Total revenue falls to \$59.4 billion in the city's plan for FY 2009, a decrease of \$3.5 billion from the previous year, as shown in the figure on page 7. City funds, which include taxes, intergovernmental aid and miscellaneous revenue, are down by \$3.1 billion due to a decline in nonproperty tax collections.

The real property tax increases by about \$800 million to \$13.8 billion as a result of billable assessment growth of 6.8 percent on the FY 2009 tax roll. The continued tax base growth enabled the city to put off any increase to the average tax rate. The seven percent tax reduction, which was enacted in FY 2008 and which saves taxpayers \$1.4 billion in FY 2009, will remain in effect. Additionally, the \$400 rebate program, which saves owners of homes and apartments \$256 million annually, remains in the city's plan through FY 2012.

FY 2009 Revenues Fall by \$3.5 Billion (\$ in millions)	
Property Tax	\$761
Nonproperty Taxes	(2,584)
Audit Revenue	(462)
Tax Program	(3)
STAR Aid	(1)
Intergovernmental Aid	86
Miscellaneous Revenue	(883)
City Funds	(\$3,086)
Categorical Aid & Other Revenue	(462)
Total Change in Revenues	(\$3,548)

The nonproperty taxes are projected to fall by \$2.6 billion, to \$22.6 billion, largely because of expected decreases in personal income and business income tax collections. The drop in the nonproperty taxes is linked to the city's projection that the retrenchment of the local economy, particularly the financial services sector, will be far more severe than the relatively mild slowdown that is expected for the nation. The personal income tax is down \$1.2 billion in FY 2009 and the business income taxes are down by about \$550 million.

Additionally, property transactions tax collections are down by nearly \$640 million, indicating that the city's real estate market is weakening and is no longer able to shrug off the national downtrend. The softening of the local real estate market needs to be closely monitored, not only to estimate the shrinkage of transactions tax revenues, but because it could indicate the future direction of the real property tax, which is the most important of the city's tax revenue sources.

The city's tax audit program declines by about \$460 million in FY 2009, following a three-year run of unusually strong audit collections. Normally, audits produce about \$500 to \$600 million annually. However, for the past three years audits yielded as much as twice the normal amount. Amid the backdrop of weakening finance sector earnings, audit collections are scheduled to drop back within the normal range to \$577 million in FY 2009. However, even if audit collections slow down, the success of the audit program may be measured in improved taxpayer compliance and higher baseline tax revenues.

Intergovernmental aid increases by \$86 million in the city's plan because the state is restoring cuts to the city's share of the state's Aid and Incentives for Municipalities (AIM) program. The city's plan assumes that unrestricted state aid will increase to \$328 million in FY 2009 from \$254 million in FY 2008. Miscellaneous revenue declines by about \$880 million in FY 2009. Grants channeled through the state's School Tax Relief (STAR) program are virtually unchanged. Categorical aid declines by nearly \$480 million, but these program specific grants tend to increase as the fiscal year progresses.

Property Tax

The city expects the real property tax to yield \$13.8 billion in FY 2009, an amount that is about \$800 million, or nearly six percent, higher than FY 2008 revenue. A sharp slowdown in market values has slowed the growth of the billable tax base and the tax levy to 6.8 percent in FY 2009, down from eight percent in FY 2008. The one percentage point difference between the growth rates of the property tax levy (the total of all property tax bills) and expected tax revenue is due to an increase of about \$160 million in the reserves that are set aside for contingencies. For example, the reserve for delinquency or nonpayment of tax bills increased by nearly \$40 million in FY 2009, to \$370 million. Similarly, the reserve for refunds increased by over \$110 million to \$365 million.

Market values increased by a subpar 1.9 percent, down from 18 percent in the previous year. Tax roll growth resulting from new construction was unusually strong in FY 2009 and appears to have contributed almost 1.4 percentage points to the 6.8 percent increase in the property tax base, with the balance of 5.4 percentage points, attributable to assessment increases. The slowdown in current market values was offset by the flow-through of a “pipeline” of previously stored up market value increases. This pipeline, which can support tax base growth in the early years of a stagnant market, as it did in the FY 2009 tax roll, can quickly dry up should market value growth turn negative.¹

No increase in average tax rates was needed to produce the six percent growth for this revenue source in FY 2009. The seven percent tax reduction, which was enacted in FY 2008 and saves taxpayers \$1.4 billion in FY 2009, will remain in effect. Additionally, the \$400 rebate program, which saved owners of homes and apartments \$259 million in FY 2008, will remain in the city’s plan at a forecast level of \$256 million through FY 2012.

The city kept property tax rates steady in FY 2009 at an average rate of \$11.423 per \$100 assessed value, thereby maintaining the seven percent rate reduction that went into effect in FY 2008. Although overall tax rates did not go up, some taxpayers will see a slight increase in tax rates, and others will see a slight reduction, depending on the type of property. Owners of private homes will see a tax rate increase of 1.1 percent to \$15.605. The tax rate for residential apartment buildings increases somewhat faster, by 1.8 percent, to \$12.139, while utility properties are up one percent, to \$11.698. Offsetting these increases is a tax rate reduction of 1.9 percent for commercial properties, which brings this rate down to \$9.870. The tax rate shifts are relatively small in FY 2009 because the state approved legislation authorizing a zero percent limit on increases to the adjusted base proportion of any property class. Without this limit, residential properties would have experienced a much larger tax rate increase, while commercial properties would have received a larger tax reduction.

¹ For a more complete discussion of the flow-through of stored market value increases, please see “Property Tax Growth” on page 15.

Tax rate changes are not uniform in order to prevent sudden shifts of the class shares of the property tax levy borne by the four groups of property tax payers. Despite the modest tax increase received by private homeowners, their share of the tax burden declined by 1.1 percent in FY 2009 to 15 percent of the total. The share borne by residential apartment properties increased by 1.4 percent to 37.2 percent, while the share of commercial properties decreased by 1.5 percent to 40.5 percent. The share of the levy borne by utility properties increased by four percent to a 7.3 percent share.

Nonproperty Taxes

The city expects that the nonproperty taxes will decline by \$2.6 billion in FY 2009, to about \$22.6 billion. A local economic downturn involving the financial sector is expected to result in reduced collections of the city's personal and business income and sales taxes. The city also expects that a slowdown in the real estate market will result in a decline of the property transactions taxes.

The personal income tax declines by \$1.2 billion in FY 2009. The business income taxes decline by a total of about \$551 million, with each of the three taxes in this group falling by at least \$100 million. The real property transfer and the mortgage recording taxes are scheduled to fall by approximately \$360 million and \$280 million, respectively. The city sales tax, following along with this broad based revenue downtrend, falls about \$170 million. Bucking the downturn, with slight growth of about \$20 million each, are the hotel tax and the commercial rent tax.

Lest one think that the city may be exaggerating the shrinkage of FY 2009 tax revenues, we should be aware that the revenue downturn is already apparent from the rapid weakening of the property transactions and business income taxes at the end of FY 2008. Tax collections for the property transfer and mortgage recording taxes are each down about 35 percent in the five month period from January through May 2008. Similarly, the banking corporation and general corporation taxes are down by about 45 percent and 20 percent, respectively, for this same five-month period. Only one of the business taxes showed growth during this period and that is the unincorporated business tax, which increased by 15 percent. However, preliminary June collections data indicates that all three business taxes are continuing to weaken as FY 2008 ends. We expect that the collections downturn that has already begun could produce a tax revenue shortfall of \$400 million in FY 2009, as discussed in "Risks and Offsets" on page 33.

Miscellaneous Revenue

The city expects miscellaneous revenue to fall by 17.6 percent or \$883 million to \$4.1 billion in FY 2009 from the prior year, as shown in the figure on page 7. Almost half of the negative year-to-year variance can be attributed to a smaller payment anticipated from the tobacco master settlement agreement in FY 2009 (\$143 million) than in FY 2008 (\$551.6 million). If variable (e.g. tobacco proceeds) and dedicated (e.g. water and sewer charges) revenue streams are removed from the city's miscellaneous revenue forecast,

leaving the “core categories,” then FY 2009 collections are projected to decrease by 19.5 percent or \$567.6 million to \$2.3 billion on a year-over-year basis.² In the FY 2009 Adopted Budget, all six of the core categories contribute to the \$567.6 million negative year-to-year variance, which may not materialize by the end of the fiscal year. The rationales for the projected decline in core category revenue include conservative forecasting at the start of the fiscal year, less interest earned from short-term investments due to lower cash balances and interest rates, and smaller legal settlements. We expect that as FY 2009 progresses, the revenue projections for the core categories will be increased by \$150 million in FY 2009, \$125 million in FY 2010, and by \$100 million in each of FYs 2011 and 2012.

EXPENDITURE HIGHLIGHTS

The main sources of spending growth between FYs 2008 and 2009 are uniformed overtime, pensions and education. Uniformed overtime for FY 2008 is increasing from \$616 million in the FY 2008 Adopted Budget to \$699 million in the FY 2009 Adopted Budget and our analysis projects it to grow further to \$756 million. Pension costs are projected to increase by \$550 million to \$6.1 billion. The Department of Education operating budget increases by just over \$935 million to approximately \$17.8 billion. Of this increase, just under \$574 million is due to an increase in state aid. Fringe benefit costs decrease by \$587 million due largely to a prepayment of healthcare benefits of \$460 million being charged to FY 2008.

Overtime

The city’s total uniformed overtime expenditures, for the Police, Fire, Correction and Sanitation Departments, are expected to exceed \$700 million for the sixth straight fiscal year. Beginning in FY 2003, when the \$700 million level was first breached, higher overtime expenditures were mostly the result of increased spending by the Police Department in order to enhance its anti-terror capabilities. In recent years, grants from the federal government’s Department of Homeland Security have helped to mitigate much of those overtime expenditures. The city keeps the overtime budget close to a desired level of spending and then increases funding for the departments as needed during the fiscal year at the time of its budget modifications.

Increases in the budget usually result from adjustments for new spending needs, such as unexpected events, understaffing that calls for added overtime, a management decision to implement a new program, or an operation to enhance services. But recently, staffing problems in not only the Police Department but also in the Fire and Correction Departments have caused overtime spending to rise. Headcount for these three departments has fallen as the attrition rate for uniformed personnel has risen

² The “core categories” consist of licenses, fees, fines, rent, interest, and a miscellaneous category, and are responsible for recurring growth in miscellaneous revenue. Highly variable funds such as tobacco settlement proceeds, payments for HHC’s debt service, and nonrecurring actions, and funds tied to programmatic expenditures such as water and sewer charges are excluded from the analysis.

higher than that of new hires. The cause of this situation was a relatively low starting salary for the new recruits reached in earlier bargaining sessions. In the latest contracts, the starting salaries have risen to a higher level.

**TOTAL FY 2008 UNIFORMED AGENCY OVERTIME FROM ADOPTED FY 2008
THROUGH ADOPTED FY 2009 VERSUS YTD FY 2008 ACTUAL EXPENDITURES**

TABLE 4 (\$ in millions)

	Adopted 08	Nov Mod	Jan Mod	May Mod	Adopted 09	Actual 08
<u>Uniformed Personnel</u>						
Police	\$271.8	\$278.4	\$288.9	\$294.5	\$304.9	\$370.5
Fire	151.5	159.8	154.5	147.9	147.9	130.0
Correction	54.6	96.5	93.0	96.2	101.2	95.3
Sanitation	59.4	62.7	55.5	45.3	45.3	41.2
Total	\$537.3	\$597.4	\$591.9	\$583.9	\$599.3	\$637.0
<u>Civilian Personnel</u>						
Police	\$40.0	\$40.0	\$40.0	\$43.2	\$43.3	\$66.1
Fire	28.6	42.4	42.4	42.7	42.7	39.7
Correction	6.3	6.2	6.3	6.5	9.5	8.5
Sanitation	4.0	4.0	4.0	4.5	4.5	4.5
Total	\$78.9	\$92.6	\$92.7	\$96.9	\$100.0	\$118.8
<u>Total Personnel</u>						
Police	\$311.8	\$318.4	\$329.0	\$337.7	\$348.1	\$436.6
Fire	180.1	202.2	196.9	190.6	190.6	169.7
Correction	60.9	102.7	99.4	102.7	110.8	103.8
Sanitation	63.4	66.7	59.5	49.8	49.8	45.8
Total	\$616.2	\$690.0	\$684.8	\$680.8	\$699.3	\$755.9
Note: Numbers may not add due to rounding.						

As mentioned earlier, the city adjusts its uniformed overtime agency's budget as needed during the fiscal year. The budget process starts with an adopted budget on July 1 and ends on June 30. During the course of the fiscal year, the city makes adjustments to this budget. As shown in Table 4, the overtime budgets for the uniformed departments were expected to total \$616.2 million for FY 2008. The majority of the budget, about half, is dedicated to the Police Department. Much of the Police Department overtime is used to conduct special operations.

As FY 2008 progressed, the city allocated additional funds to the departments with the November budget modification calling for an additional \$73.8 million. The Department of Correction required an additional \$41.8 million for an unforeseen rise in the prison population and to fund staff overtime to maintain proper operations. Additionally, civilian overtime in the Fire Department was underfunded and was adjusted to compensate for the deficiency.

In the FY 2009 Adopted Budget, the city expects to spend \$699.3 million in uniformed agency overtime. This is \$83.1 million more than what was projected to be spent in the FY 2008 Adopted Budget. However, based on actual expenditures for FY

2008 we estimate that the city has underbudgeted by \$56.6 million. As the table shows, FY 2008 expenditures have reached \$755.9 million.

Pensions

For FY 2009, the city projects allocating more than \$6.1 billion in city-funded contributions to its pension systems. The contributions in FY 2009 will increase by about \$550 million or approximately 9.9 percent over what was contributed in FY 2008. In estimating the pension cost, the city has accounted for the likelihood of investment losses by assuming that investment returns will be zero. However, according to our analysis, losses will likely be considerably higher than the city has anticipated. Also included in the city's estimation is the cost of a new retirement program for city teachers that will enable those eligible (incumbents) to retire at age 55 after 25 years of service.

With the close of FY 2008, we project the pension systems will suffer substantial investment losses that will fall far below the systems' required rate of return or Actuarial Interest Rate (AIR) of eight percent. There are a number of major events taking place simultaneously in the U.S. economy and globally that are negatively impacting the markets and have led to our projections of substantial losses. We will discuss those factors and our analysis of pension costs over the life of the city's financial plan in "Pension Costs," beginning on page 23.

Fringe Benefits

In the FY 2009 Adopted Budget, spending on fringe benefits decreases by \$587 million, or close to nine percent, between FYs 2008 and 2009, to approximately \$6.3 billion. This is due to a prepayment of healthcare benefits of \$460 million being charged to FY 2008. Fringe benefits consist of six components, the largest and most important of which is health insurance, accounting for over half of all spending. For a more detailed analysis of fringe benefit costs over the life of the city's financial plan, see "Fringe Benefit Costs," beginning on page 29.

Department of Education

The FY 2009 Adopted Budget for the Department of Education (DOE) for FY 2009 is approximately \$17.8 billion (excluding pension and debt service costs, which are budgeted separately). This represents a \$159 million increase from the FY 2009 Executive Budget. Of this amount \$129 million will be used to ensure that individual schools receive the full funding proposed before the FY 2009 reductions in spending announced by the city in January of this year. These funds will also be used to focus on middle school reform and an initiative which will support English language learners. This budget is also approximately \$935.6 million, or 5.6 percent, more than the projected spending for FY 2008.

This almost \$18 billion in funding for FY 2009 is made up of city funds (including other categorical and intra-city) of \$7.48 billion or 42 percent, state funds of \$8.51 billion or 48 percent and federal funds of \$1.77 billion or 10 percent. Of the \$935.6 million

increase over FY 2008, \$379.8 million is provided by the city and \$573.5 million by the state. Federal funds decreased by \$17.7 million.

III. The FYs 2009-2012 Financial Plan

With the finance sector weakened by severe losses, the city expects revenues to fall sharply at the start of the four-year plan and gradually recover. The abrupt revenue drop-off follows the near-zero growth experienced by nonproperty tax collections in FY 2008 and represents a sudden downward shift from the strong growth of the previous four years, when tax collections were soaring. Total revenue falls \$3.5 billion in the city's budget for FY 2009 and tax collections remain weak through FY 2012.

On the expenditure side, the city has reflected in the current financial plan the recent arbitration award concerning salary increases for the Patrolmen's Benevolent Association. The city has included in the labor reserve sufficient funds to cover this award as well as funds for the other uniformed services that are expected to exercise their reopener clauses.

To narrow the budget gap projected for FY 2010, the city has applied \$2.4 billion of surplus resources from FY 2008 to reduce FY 2010 expenses. Additionally, the Mayor has proposed eliminating the seven percent property tax cut and has in fact augmented tax revenue by \$1.2 billion to \$1.4 billion in each of FYs 2010-12 to reflect this proposal. Despite these actions, the city estimates budget gaps of \$2.3 billion for FY 2010, \$5.2 billion for FY 2011 and \$5.1 billion for FY 2012.

We project, however, that the gaps could be larger by as much as \$2 billion in FY 2010 and \$2.4 billion in each of FYs 2011 and 2012, producing budget deficits totaling \$4.3 billion in FY 2010 and \$7.5 billion in each of FYs 2011 and 2012. We contend that risks of \$1.2 billion to \$1.4 billion exist to the financial plan until the council approves what will be a property tax increase to eliminate the property tax cut, like the Mayor proposed. Furthermore, recent negative economic news and the severe downturn of the stock market have caused us to become increasingly pessimistic regarding the city's tax revenue plan. We expect that the nonproperty taxes will fall below the city's collection targets by \$400 million in FY 2009, \$425 million in FY 2010, and \$200 million in each of FYs 2011 and 2012. These reductions are in addition to our expectation that there will be a \$200 million property tax shortfall in each of FYs 2010-2012, due to weak assessment growth.

To address the sizable outyear budget gaps it has projected for FYs 2011 and beyond, the city is now targeting the debt service cost, as it is one of the fastest growing components of the expense budget. The city announced that it will stretch out the four-year capital plan for FYs 2009-12 over five years. This will result in reduced capital financing and correspondingly lower debt service costs. We lay out the process by which the announced deferral materializes into reduced debt service costs. We also analyze the impact on the outyear budget gaps.

Of particular concern to us is the precipitous pace of which the liability for Other Postemployment Benefits (OPEB) is likely to grow in the future. Our analysis of the OPEB liability beyond FY 2007, the final year for which an official city report has been released, indicates that the unfunded liability could climb by over \$20 billion from FY

2008 to FY 2012. The city created a fund to begin to address this growing liability, but has not applied any resources to the fund for the years covered by the financial plan. However, from a long-term perspective, the city needs to continue its prudence in addressing this rapidly growing liability. Given few options, it has two possible ways that it can approach the issue. One is to reduce healthcare costs to retirees through collective bargaining and, in conjunction with or alternatively to, increase contributions to the Retiree Health Benefit Trust (RHBT) Fund dramatically on a sustained year-to-year basis.

THE OUTLOOK FOR REVENUE GROWTH

In the city's plan, total revenue falls by \$3.5 billion in FY 2009, after which revenue growth resumes, helped by a property tax increase in FY 2010 and by a gradual recovery of nonproperty taxes in FY 2011. The net effect of the revenue downturn followed by recovery is for total revenue to increase by \$4 billion, or 6.4 percent, over the four years of the plan from \$63 billion in FY 2008 to \$67 billion in FY 2012, as shown in Table 5. The growth of total revenue is enhanced by \$1 billion in additional categorical aid over the four-year period, which primarily reflects additional state education aid, as discussed in "Department of Education" on page 32.

CITY FUNDS INCREASE BY \$3.1 BILLION OVER THE NEXT FOUR YEARS, RECOVERING FROM THE DOWNTURN IN FY 2009

TABLE 5

(\$ in millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2008-12 % Change	FY 2008-12 \$ Change
Property Tax	\$13,163	\$13,918	\$14,873	\$15,812	\$16,559	25.8%	\$3,395
Nonproperty Taxes	25,677	22,637	22,128	23,510	24,994	(2.7)	(683)
Tax Program	0	(3)	1,219	1,293	1,353	NA	1,353
Miscellaneous	4,850	3,949	3,841	3,908	3,926	(19.1)	(924)
Nonrecurring	166	184	9	5	5	(96.8)	(161)
Unrestricted Aid	239	325	325	325	325	36.0	86
Total City Funds	\$44,096	\$41,010	\$42,395	\$44,853	\$47,161	7.0%	\$3,066
Categorical Aid*	\$18,400	\$17,921	\$18,227	\$19,082	\$19,395	5.4%	\$995
Interfund Revenue	446	463	425	419	419	(6.1)	(27)
Total Funds	\$62,942	\$59,394	\$61,047	\$64,354	\$66,975	6.4%	\$4,034

Notes: STAR Aid has been allocated to the property and nonproperty taxes. Categorical Aid is the sum of state, federal and other categorical grants. Numbers may not add due to rounding.

City-fund revenues, which fall by a precipitous \$3.1 billion in FY 2009, begin to recover in FY 2010 with the help of a \$1.2 billion boost that would be provided if a planned seven percent property tax increase were implemented.³ Revenues fall at the start of the plan largely because of weak nonproperty taxes, which fall \$3 billion in FY 2009 and decline by an additional \$500 million in FY 2010. Revenue growth strengthens

³ City-fund revenues represent funds produced by the local economy and include taxes, miscellaneous revenue (with nonrecurring resources), and unrestricted aid. However, city-fund revenues exclude categorical grants, which are payments from the state and federal governments and third parties that are restricted in use to specific programs and cannot assist in achieving budget balance.

in the outyears with the recovery of the nonproperty taxes in FY 2011. Revenue growth is further sustained by an implicit assumption that property assessments will increase by an average of six percent annually through the plan period. The net effect of these negative and positive growth trends is that over the next four years, city funds increase by \$3.1 billion, or seven percent, from \$44 billion in FY 2008 to \$47 billion in FY 2012.

The city expects that most of the growth in the plan will come from the real property tax, which increases by a planned \$3.4 billion, or 26 percent, from \$13.2 billion in FY 2008 to \$16.6 billion in FY 2012. In contrast to the strong growth of the property tax, the nonproperty taxes decline by nearly \$700 million, or nearly three percent over the four years, from \$25.7 billion in FY 2008 to \$25 billion in FY 2012. Miscellaneous revenue is projected to fall by about \$900 million, or 19 percent.

Property Tax Growth

The property tax, which grows by \$3.4 billion or 26 percent over the plan period, produces most of the revenue growth shown in the plan. Revenue growth accelerates from six percent in FY 2009 to seven percent in FY 2010, after which property tax growth slows to six percent in FY 2011 and to five percent in FY 2012. Since the real estate market is slowing down, this planned growth rests on the assumption that overbuilding has not been a major factor during the boom years of the city's real estate cycle and that property values will remain relatively stable.

A second assumption is that the pipeline of unused property value increases remaining from the strong growth of previous years will be phased in to support billable assessment growth over the next four years. Increases from past years, which had not been fully recognized in the tax base because of regulations limiting assessment increases with a system of assessment caps and phase-ins, can effectively boost assessment growth during periods of sluggish market values. This flow through effectively enabled FY 2009 billable assessments to grow by a very robust seven percent, even though the market value increase recorded on the tax roll was a very sluggish 1.9 percent.

Credit availability remains a significant downside risk to the real estate market, even if overbuilding is not a major factor. The big question is whether prices will merely soften or turn negative. The answer to this question will not be known until city assessors release the tentative tax roll for FY 2010, next January. For the city's real estate tax, the difference between these two trends is that the pipeline of stored market value increases can effectively boost assessment growth in a stagnant market but not in a down market. This pipeline, which can be extremely helpful in the early years of a stagnant market, can quickly dry up should property value growth turn broadly negative.⁴ It is for this reason that we estimate that the growth of the real property tax

⁴ The pipeline of stored market value increases tends to be quickly depleted in a down market because market value decreases immediately reduce billable assessments; whereas market value increases, for commercial properties and in most large residential properties, are generally phased in over five years. Thus market value decreases tend to have a more immediate effect than market value increases.

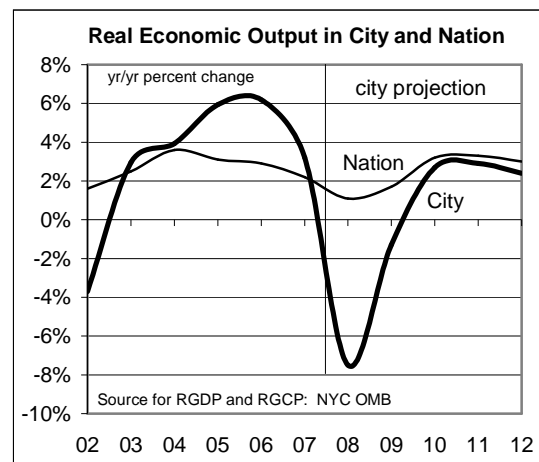
could be \$200 million below plan in FYs 2010-12. A more accurate estimation of this risk will be possible next January, with the release of the FY 2010 tentative tax roll, which will reveal overall market value growth as well as how many properties increased and decreased in value.

Economic Outlook

Local tax revenues are declining in step with the weakening economic outlook for both the nation and the city. National economic growth for the past half year is weaker than it has been for the past five years. The lackluster output growth has been insufficient to produce any positive job growth; and, indeed, the national job count has fallen since the start of 2008. Unlike the nation, the city job count appears to be growing slowly, and has not yet turned negative. Nevertheless, with city-centered banks and brokerages taking a severe hit from the turmoil in subprime mortgages and the credit markets, the economic downturn is likely to be more severe in the city than in the nation. Furthermore, the combined difficulties posed by a softer economy and accelerating inflation could restrict the policy options of the Federal Reserve Board.

Although the local employment statistics only reveal the barest hint of the massive finance industry layoffs that have been announced, the losses that have been sustained by this sector are staggering. New York Stock Exchange member firms lost \$11 billion in 2007 and these firms reported losses of \$22 billion in the first quarter of 2008. These brokerage industry losses and similar large losses announced for major city-based banks have resulted in a massive selloff of financial stocks, causing the stock market valuation of the finance sector to fall by \$1 trillion, through July 2008.

The local economy, which continued to accelerate even while national economic growth was ebbing, is likely to fall much harder, in the current downturn, than the national economy. The figure to the right, which shows the annual growth of real gross domestic product (GDP) along with real gross city product (GCP), compares the real output growth of the city to that of the nation. Following the recession of 2001, GDP growth recovered to a peak of 3.6 percent in 2004. In the four years since that high point, national output growth has gradually slid back to a near recessionary estimated growth rate of 1.1 percent in 2008. The city's forecast sees national growth rising above three percent by 2010, partly as a result of the timely infusion provided by the national economic stimulus tax rebate program.



In contrast to the downward trend in national growth, real gross city product (GCP) rapidly climbed from the negative growth of the previous recession, surpassed the nation in 2003 and kept climbing even as national growth was weakening. City output growth topped out at six percent in 2006. However, severe losses in the city's

financial services industry have led to job cutbacks in this very high-paying sector and result in a steep eight percent slide in GCP in 2008. The city outlook sees a recovery for GCP during the outyears of the plan but local economic growth is likely to lag behind that of the nation.

The city's economic forecast sees a mild recession, with a peak-to-trough job loss reaching about 600,000 to 700,000 for the nation. According to this outlook, the city would see an employment decline of 90,000, with about 25,000 of these being highly paid finance sector jobs. The nation has lost jobs in each month since the start of 2008, with the six month job loss at 438,000, through June. The unemployment rate, which increased to 5.5 percent in June from 4.6 percent one year earlier, confirms the weakness noted in the persistent job loss reports.

The city employment numbers indicate that job growth is continuing, however growth is quickly decelerating. Local job growth retreated to 0.6 percent in June, which is equivalent to an increase of about 24,000 jobs per year. These data portray a weakening labor market, with growth slowing considerably from the 79,000 jobs produced in 2007. The growth slowdown has had a slight effect on the local unemployment rate, which increased to 5.3 percent in June from 4.8 percent in May. Aside from the perpetually declining manufacturing sector, the weakest segment of the local labor market appears to be the securities industry, which contracted by about 12,000 jobs or six percent to 180,000 jobs since securities employment peaked at 192,000 jobs in August 2007. These employment statistics appear to be only a preview of the massive job cutbacks that have been announced by major city-centered banking and brokerage firms.

Inflation is one area where the city's economic forecast is likely to be on the low side. The city plan for 2008 sees the local inflation rate rising to 3.6 percent from the rather moderate 2.8 percent price increase in 2007 and then dropping back to slightly above two percent in the outyears. However, with the flooding of the nation's agricultural heartland and the dollar's continuing weakness, inflation is more likely to accelerate than to ebb. Local consumer price inflation increased to 4.5 percent in June from four percent in May, pushed upward primarily by food, which increased by 5.5 percent; by transportation costs, which increased by 12 percent; and by gasoline prices, which soared by more than 30 percent.

With inflation poised for acceleration, the policy options of the Federal Reserve Board will be severely constrained and it is possible that interest rates could also be headed higher. Over the past two years, the Federal Reserve Board has brought short term interest rates down from 5.25 percent to two percent, but these policy moves failed to budge long term interest rates, as represented by AAA-rated long term bond yields, out of a narrow five to six percent range. If accelerating inflation forces up interest rates, the resultant credit tightening could prolong the local and national downturn, deepen the real estate slump, and ultimately affect city tax revenues.

Nonproperty Taxes

The city expects the nonproperty taxes to decrease by \$683 million over the next four years, a decline of 2.7 percent. This decline, in which the nonproperty taxes fall from \$25.7 billion in FY 2008 to \$25 billion in FY 2012, actually consists of a sharp decline in the first two years of the plan followed by a weak recovery in the outyears. The steepest decline comes in FY 2009, when these taxes fall by \$3 billion, including a \$462 million decline in tax audit revenue. The nonproperty taxes slide by an additional \$500 million in FY 2010, after which these taxes recover with growth of about \$1.4 billion in FY 2011 and \$1.5 billion in FY 2012. The declining nonproperty taxes reflect the weakness of the business and personal income taxes and the real estate transactions taxes, as well as the reduced growth of the sales tax.

Recent negative economic news and the severe downturn of the stock market have caused us to become increasingly pessimistic regarding the city's tax revenue plan. We expect that the nonproperty taxes will fall below the city's collection targets by \$400 million in FY 2009, \$425 million in FY 2010, and \$200 million in FYs 2011-2012. These reductions are in addition to a \$200 million property tax shortfall in each of FYs 2010-2012, due to our expectation of weak assessment growth.

Property Transactions Taxes. With real estate prices slowing to 1.9 percent growth on the city's FY 2009 tax roll, from the stellar 18 percent increase that was reported for the previous year, the two property transactions taxes (the real property transfer tax and the mortgage recording tax) are also slowing down. These taxes declined by an average of 22 percent in FY 2008 to a combined total of \$2.6 billion, marking the end of a stellar five year run of strong collections growth. Revenue falls by another 25 percent in FY 2009, to \$1.9 billion, and growth does not resume until FY 2012. Previously, these two transactions taxes had soared by an average of 30 percent annually, increasing from \$900 million in FY 2002 to \$3.3 billion in FY 2007. Stricter mortgage lending requirements, implemented in response to subprime mortgage delinquencies, and a decline in large office building transactions are the principal causes of the revenue slowdown.

The real estate industry may be responding to slower sales by offering newly completed apartments to the rental market instead of the condominium market. This trend is evident from tax roll data indicating that rental apartment units increased by 2.2 percent, in comparison to the 1.1 percent increase that was reported for condominium units. If this trend continues, transactions volume from apartment sales could remain weak.

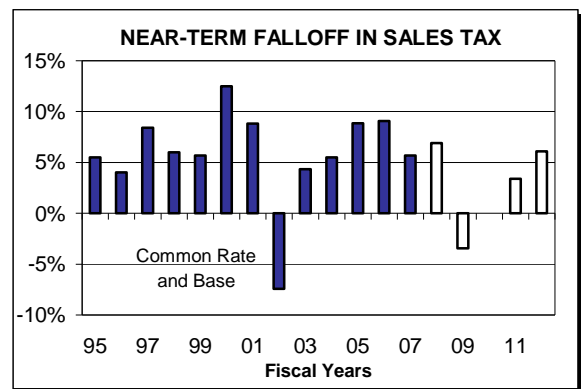
On the positive side, the recent sales of trophy office buildings to foreign investors, like that of the General Motors Building in May as well as the July sale of a majority interest in the Chrysler Building, could restore some transactions tax revenue to the city following a long period of inactivity in the high end of the office market.

Business Taxes. The huge losses sustained by the financial services industry, are already having a negative impact on the city's business taxes and are the major reason why the city expects the downward tax collections trend will continue through FY 2010.

The city's three business income taxes (the general corporation tax, the banking corporation tax and the unincorporated business tax) declined by an average of nine percent in FY 2008 to \$5.5 billion. Tax receipts fall by another 10 percent in FY 2009 and remain stagnant in FY 2010, before growth of about eight percent resumes in each of FYs 2011 and 2012. Previously, the business taxes were booming at an annual rate of 27 percent, having increased from \$2.3 billion in FY 2003 to a peak of \$6 billion in FY 2007. However, the moderate growth projected for the outyears could be insufficient to fully offset the steep decline occurring in FYs 2008 and 2009, leaving FY 2012 revenues below the peak achieved in FY 2007.

The city's business taxes remain weak because of a sharp slowdown in national pretax corporate profits and securities industry profits. Corporate profit growth has fallen from over 30 percent in both 2004 and 2005 to 14 percent in 2006 to four percent in 2007; and negative growth of four percent was reported for the first quarter of 2008. The city's economic forecast expects corporate profits to fall by 14 percent in 2008, before recovering with 20 percent growth in 2009. The securities industry, which achieved near-record earnings of \$21 billion in 2006, reported losses of \$11 billion in 2007 and an even more severe loss of \$22 billion in the first quarter of 2008. Because of these pessimistic profit reports, we expect that business tax revenue could come in \$200 million below the city's projections in all four years of the plan.

Sales Tax. Already under pressure from consumer pessimism caused by increasing food and energy prices, declining home values, and rising home foreclosures, personal consumption expenditures may take another hit if the city's expectation of layoffs and lower wages comes to pass in calendar years 2008 and 2009. If this scenario occurs, sales tax revenue on a continuing base is projected to exhibit negative growth of 3.4 percent in FY 2009 and no growth at all in FY 2010, as seen in the figure to the right.⁵ This would mark the third time since FY 1992 when sales tax collections on a common rate and base fell on an annual basis. In the outyears, with recoveries in the local and national economies underway, sales tax collections are forecast to spurt 3.4 percent in FY 2011 and 6.1 percent in FY 2012.



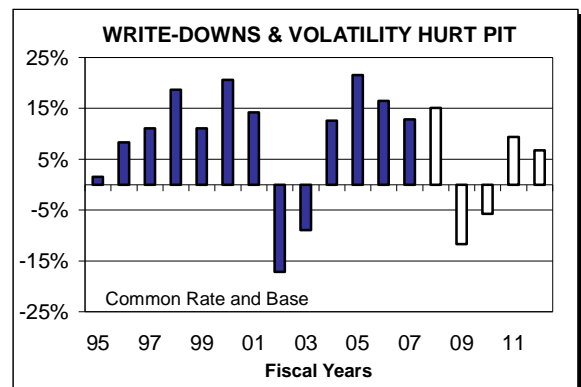
On a year-over-year basis, after job gains of 78,800 in calendar year 2007, the city's latest economic forecast for job losses (including Wall Street) is 10,700 in calendar year 2008 and 46,300 in calendar year 2009, and annual employment growth of only 0.7 percent or 26,700 jobs in calendar year 2010. In addition, in prior years, sales tax collections benefited from higher discretionary spending that was largely sponsored by

⁵ "On a common rate and base" or "on a continuing base" refer to tax collections that have been adjusted to remove the effects of tax programs (and law changes) to focus on the influence of the economy.

Wall Street compensation, particularly from bonus payouts, and home sales. Now, the city is expecting those still employed on Wall Street to face reduced compensation in calendar years 2008 and 2009 (down 9.2 percent and 15.5 percent, respectively), which will hamper total wage growth.⁶

Based on announcements of further layoffs nationally and in the local securities industry, continued weakness in residential housing prices and sales, and the possibility of a resurgence in inflation, sales tax collections may fall by an additional \$50 million in FY 2009 and \$75 million in FY 2010. Even though city sales tax collections benefit from higher energy prices, it is outweighed by the contraction in personal consumption expenditures. In the outyears, a rebound in the national economy will help to increase the demand for the city's goods and intellectual products. Continued business and personal trips by tourists could provide an offset to this evaluation if international tourists do not face visa backlogs due to new security procedures set to begin this summer.

Personal Income Tax. As opposed to the double-digit growth of the “boom” years of FY 2004 through FY 2008, personal income tax revenues (on a continuing base) are expected to undergo two “bust” years of negative growth in FYs 2009 and 2010, before recoveries in the national and local economies propel growth in FYs 2011 and 2012. In its near-term forecast, the city believes that several events that occurred in calendar year 2007 that caused personal income tax (PIT) revenue in FY 2008 to leap by 15.1 percent from the prior year--job gains, large bonus payouts, investment and fee income from hedge funds, and non-wage income growth (e.g. capital gains realizations)--will be missing in calendar years 2008 and 2009. As a result of the absence of these factors, a national recession, and Wall Street layoffs, PIT revenue is projected to contract by 11.7 percent in FY 2009 and decline further by 5.8 percent in FY 2010, before positive growth of 9.4 percent and 6.7 percent, respectively, is realized in FYs 2011 and 2012. The figure to the right shows the city's latest forecast and that the last time there was such a large change in the direction of tax collections was in FYs 2002 and 2003.



The city's latest forecast includes the assumptions that the current turmoil in the credit and equity markets will end in the second half of calendar year 2008 so that New York Stock Exchange (NYSE) member firms could earn a profit of \$7.1 billion for the year, and that from the peak in the third quarter of 2007 to the trough in the second quarter of 2009, securities sector employment will contract by about 25,000 jobs. Unfortunately, since the city developed this forecast in April, conditions in the housing,

⁶ The federal rebate checks recently received by consumers may temporarily raise discretionary spending and personal income in FY 2008 and to a much less extent in FY 2009.

labor, and financial markets have not significantly improved and there are indications that it may take more time for a recovery in each of these three markets to take hold. For example, a report in a business magazine in early June stated that layoffs announced to-date on Wall Street totaled 22,000 with more to come, which will show up in the employment data in the second half of calendar year 2008 when severance packages are exhausted.⁷ There is also additional evidence for a downward risk to the city's already conservative forecast for PIT in the near term.

One recent unpleasant surprise was that NYSE member firms posted a pre-tax loss of \$22.4 billion for the first quarter of 2008, after recording losses of \$3.8 billion and \$16.4 billion in the third and fourth quarters of 2007, respectively. Numerous banks (commercial and investment) are still writing-down the value of mortgage-backed securities and loans related to leveraged buyouts, and trying to recapitalize and increase loan reserves. These activities have been borne out by largely disappointing second quarter earnings results for firms in the securities sector. After the release of selected second quarter earnings reports there were announcements of more layoffs from Citigroup and Goldman Sachs that go beyond the firms' earlier statements and policies (e.g. mortgage and fixed income areas, and annual performance evaluations) to possibly include investment bankers and commodities traders.

We believe that it is possible that total layoffs on Wall Street and in related areas, such as the professional and business services and information sectors, may exceed the city's forecast for calendar years 2008 and 2009 and further depress personal income. The continued slump in the residential housing market and the difficulties in obtaining credit for commercial development may further constrain capital gains realizations in the near-term. Besides more write-downs on assets, another problem facing firms in the financial sector is that the ongoing volatility in the credit and equity markets has made it difficult to earn revenue from traditional lines of business such as trading, advising for mergers and acquisitions, and initial public offerings. For these reasons, PIT collections may be lower than the city's forecast by \$150 million in both FY 2009 and FY 2010.

SOURCES OF EXPENDITURE GROWTH

The city's projected spending growth between FYs 2008 and 2012 is 17.4 percent, with total spending almost reaching \$71.7 billion in the final year of the plan, as shown in Table 6 on page 22. Personal service increases 21.3 percent between FYs 2008 and 2012. The growth in salaries and wages is projected at 18.8 percent or \$3.8 billion. This growth largely represents the costs of the new Patrolmen's Benevolent Association contract and the fact that all the other uniformed services unions are expected to exercise their reopener clauses.

Fringe benefit costs increase by 5.2 percent between FYs 2008 and 2009. Between FYs 2008 and 2012, fringe benefit expense increases 28.5 percent from approximately

⁷ *Crain's New York Business* Vol. XXIV, No. 22 (June 2-8, 2008): 1, 3.

\$6.4 billion to just over \$8.2 billion mostly due to increasing health insurance costs. The city's pension contribution increases 22 percent between FYs 2008 and 2012. Most of the growth is between FYs 2008-09 and FYs 2009-10 at 9.8 percent and 8.5 percent, respectively. This additional spending is due to salary increases and benefit enhancements reached through recent collective bargaining agreements and the phase-in of prior-year investment losses. The growth rate slows significantly to one percent between FYs 2010 and 2011 and 1.5 percent between FYs 2011 and 2012. In FY 2012 pension costs will be \$6.9 billion. These pension projections assume a zero return on the system's assets. A negative return on assets would cause these pension costs to increase.

Under the other than personal service (OTPS) category, both debt service and Medicaid increase between FYs 2008 and 2012. Debt service increases 47.7 percent from almost \$4.4 billion in FY 2008 to almost \$6.5 billion in FY 2012, driven largely by over 23 percent growth from FYs 2010 to 2011. Medicaid expense decreases 3.4 percent between FYs 2008 and 2009 while the annual growth rate between FYs 2009 and 2012 ranges from 2.7 percent to 2.9 percent. This moderate growth is due largely to the cap imposed on the city's Medicaid costs by the state. Public Assistance is projected to decrease slightly from \$1.22 billion in FY 2008 to \$1.18 billion in FY 2012.

THE CITY'S EXPECTED GROWTH BETWEEN FYs 2008 AND 2012

TABLE 6 (yr/yr percent change, \$ in millions)

	FYs 2008-09	FYs 2009-10	FYs 2010-11	FYs 2011-12	FYs 2008-12	Level in FY 2008	Level in FY 2012
Total Expenditures	2.8%	4.3%	6.2%	3.2%	17.4%	\$ 61,029	\$ 71,665
Total PS	5.9%	5.5%	5.9%	2.6%	21.3%	\$ 32,314	\$ 39,200
Salaries and Wages	5.1	5.0	6.5	1.1	18.8	20,307	24,120
Fringe Benefits	5.2	4.3	8.5	7.9	28.5	6,386	8,210
Pensions	9.8	8.5	1.0	1.5	22.2	5,620	6,870
Total OTPS	(0.7%)	2.8%	6.5%	4.0%	13.1%	\$ 28,716	\$ 32,465
Public Assistance	(3.5)	(0.1)	0.0	0.0	(3.5)	1,219	1,176
Medicaid	(3.4)	2.7	2.8	2.9	5.1	5,797	6,089
Debt Service	(0.5)	9.8	23.3	9.7	47.7	4,390	6,485
Other OTPS	0.4	1.2	3.6	2.7	8.1	17,310	18,716

Note: Includes city, state, and federal funds. Numbers may not add due to rounding.

Uniformed Overtime

The four uniformed departments -- Police, Fire, Correction and Sanitation -- are projected to spend \$756 million in uniformed and civilian overtime in FY 2008. As shown in Table 7, the city expects to spend close to \$672 million in FY 2009, \$678 million in FY 2010, \$694 million in FY 2011, and \$695 million in FY 2012.

PROJECTED OVERTIME RISK FOR FYs 2009-2012

TABLE 7

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
City Projected Overtime	\$672	\$678	\$694	\$695
FCB Projected Overtime	756	756	756	756
Over Budget/FCB Risk	\$84	\$78	\$62	\$61

However, our analysis of historical trends projects that overtime spending could be higher. The city, in recent years, has been spending more than \$700 million on overtime in its uniformed agencies. Based on those figures, we hold at risk \$84 million in FY 2009, \$78 million in FY 2010, \$62 million in FY 2011 and \$61 million in FY 2012.

Pension Costs

In the FY 2009 Adopted Budget, the city reports FY 2009 pension costs (total funds) of almost \$6.3 billion, which is expected to be about \$550 million higher than in FY 2008. As shown in Table 8, over the life of the financial plan, pension costs are projected to rise considerably in FY 2010 to more than \$6.8 billion, an increase of over \$500 million, but are expected to climb moderately in FYs 2011 and 2012. The city anticipates FY 2011 pension costs of nearly \$6.9 billion, an increase of more than \$68 million over FY 2010, and projects an increase in FY 2012 of slightly more than \$100 million.

TABLE 8

PROJECTED PENSION CONTRIBUTIONS FOR FYs 2009-2012

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
City	\$6,124.2	\$6,645.4	\$6,713.4	\$6,817.0
State	44.7	50.1	50.1	50.1
Federal	2.5	2.5	2.5	2.5
Intra-City	124.3	124.3	124.3	124.3
Total Contributions	\$6,295.7	\$6,822.3	\$6,890.3	\$6,993.9

The city's pension contribution covers contributions made to five primary systems and an additional number of non-city and non-actuarial systems, as shown in Table 9. The New York City Retirement Systems (NYCRS) is comprised of the New York City Employees' Retirement System (NYCERS), the Teachers' Retirement System of the City of New York (TRS), the New York City Police Pension Fund, the New York City Fire Department Pension Fund, and the New York City Board of Education Retirement System (BERS).

TABLE 9

PROJECTED CONTRIBUTIONS PER PENSION SYSTEM FOR FYs 2009-2012

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
NYCERS	\$1,143.5	\$1,156.0	\$1,156.0	\$1,156.0
TRS	2,112.1	2,186.8	2,186.8	2,186.8
Police	1,863.8	1,909.0	1,909.0	1,909.0
Fire	823.9	837.1	837.1	837.1
BERS	124.7	134.2	134.2	134.2
Non-City Systems	62.9	65.9	65.9	65.9
Non-Actuarial Systems	45.8	45.8	45.8	45.8
Financial Plan Adjustments	118.9	487.5	555.4	659.1
Total Pension Contributions	\$6,295.6	\$6,822.3	\$6,890.2	\$6,993.9

Numbers may not equal those in Table 8 due to rounding.

Every fiscal year, the city makes a normal contribution to the pension systems. As shown in Table 9, the city's overall annual contribution is comprised of separate contributions to each pension system, non-city systems and non-actuarial systems. In addition, the city must often make financial adjustments. Often the pension systems need additional funding to meet obligations, such as in the case of a new employee

contract or an investment loss. Each system invests its portfolio of assets in a variety of investments such as common stocks, bonds or real estate with the goal of attaining a positive return above a required rate of return. A gain on investments above this required rate of return or Actuarial Interest Rate (AIR) increases the value of assets; a loss depreciates their value. The city manages the ebbs and flows of investment gains and losses by using a six year phase-in policy. This phase-in method allows the city to manage severe losses at the time that they occur. Investment gains are also phased in over time and offset the phase-in of investment losses. This process smoothes investment returns and reduces fluctuations.

As mentioned earlier, the city routinely makes financial adjustments to pension costs to compensate for additional funding needs. As shown in Table 9 on page 23, the city expects to make adjustments of \$118.9 million in FY 2009, \$487.5 million in FY 2010, \$555.4 million in FY 2011 and \$659.1 million in FY 2012. Part of these adjustments is due to recently reached collective bargaining agreements. The city has anticipated that it will need \$117 million in FY 2009, \$122 million in FY 2010, \$98 million in FY 2011 and \$103 million in FY 2012 to cover the pension costs associated with these contracts. Also, beginning in FY 2010 and baselined over FYs 2011 and 2012, the city has expensed \$200 million per fiscal year to cover costs associated with a scheduled independent audit of the systems. Also, as mentioned earlier in "Pensions" starting on page 12, the city has reserved funds to address a change in the retirement age of teachers.

The city expects investment performance to miss the required benchmark AIR of eight percent. The city has allocated funds in FYs 2010 through 2012 (a two-year lag occurs before the phase-in is implemented) to cover a zero percent return on assets, which means that it expects the systems to realize no gain or loss. By our calculations, the dollar value of this loss equates to about \$7.4 billion.

The city's assumption of a zero return on the system's assets is not consistent with the current conditions occurring in the markets. In recent weeks, the equity markets have been adversely affected by a barrage of serious economic events. The price of oil and other commodities have risen to unforeseen new highs. The consequences of this affect many facets of economic activity and have pushed prices higher on many other goods and services sold in the United States and around the world. Meanwhile, difficulties in the housing and credit markets still linger and for now have prevented the Federal Reserve Board from increasing the rate on short-term borrowing to head off inflationary pressures. Further, the threat of recession is still very real and has panicked consumers and businesses alike, resulting in cautious spending behavior even though the government's stimulus package is well under way. In the face of these pressures, business earnings are likely to suffer.

The stock market is in most cases forward looking. The anticipation of a low earnings season, coupled with the perception that the financial sector will experience more write-downs to their already deteriorated balance sheets, have caused many investors to sell their holdings, driving down financial stocks. Additionally, those investors who do not directly hold stocks but instead invest in asset pools, such as mutual funds, hedge funds and the like, are beginning to cash out their investments.

The funds that manage these large investment pools have found themselves in a quandary over this predicament and must sell off well performing holdings to cover those redemptions since they have found it difficult to raise new capital in a tight credit market. This act pushes down stock prices of relatively good companies, thus adding further downward pressure to the overall stock market. The confluence of these events has pushed stock prices down to such low levels that the stock market moved into or close to “bear market territory” or about a 20 percent decline from its last high.

NYCRS follows a long-term growth strategy for its assets, investing a majority of its assets in domestic and foreign equities with the remainder in fixed income. Over the long term, equities have historically outperformed other asset classes, however, equities increase the exposure to risk. While prudence in investing requires the diversification of assets, the city’s assets are weighted heavily towards equity investments comprising about two-thirds, with the remainder invested in fixed income. This allocation of assets, particularly for a pension fund that must strictly meet its obligations, is a concern in a highly volatile equities market. It is reasonable to assume that a continued economic downturn would cause the pension systems to suffer larger investment losses than currently projected. Additional investment losses would increase the already growing pension contributions that the city must make each year, at the same time that it is experiencing budget gaps in the outyears.

Through May 31, 2008, the pension systems’ investment return on its assets is a negative 0.22 percent. This is an improvement from the March return of negative 4.46 percent. However, our data is lagging the final results for fiscal year-end, as they were not available for our analysis at the time of this report. We believe that the losses to the systems will be much greater than what the city projects and our analysis currently indicates. Nonetheless, the impact of the latest return of negative 0.22 percent will result in higher pension costs in the outyears than the city has assumed a zero percent return. We project the loss the city would be responsible for, phased-in over the six years starting in FY 2010, would be \$114 million in FY 2010, \$229 million in FY 2011, \$343 million in FY 2012, \$457 million in FY 2013, \$610 million in FY 2014 and \$762 million in FY 2015. We should note that it is possible that the burden of these costs in later years will be ameliorated by the phase-in of investment gains that could materialize from a market recovery which historically has followed market downturns.⁸

Unfunded Other Postemployment Benefit Liabilities to Grow Substantially

As reported by the city in its four-year financial plan, total expenditures are expected to exceed \$62.7 billion in FY 2008 and top \$70 billion by FY 2012. One reason expenditures are rising is the growth in the cost of providing healthcare benefits to the more than 500,000 active and retired city employees. In recent years, healthcare and health insurance costs have increased substantially and are expected to continue this trend. Health insurance premiums alone are expected to increase annually by an

⁸ These cost estimates do not include the impact of the phase-in of prior year gains and losses.

average rate of about 10 percent. In total, health insurance expenses are anticipated to cost the city nearly \$4.4 billion in FY 2008 and reach \$5.9 billion by FY 2012.

Health insurance provided to active and retired city employees is an earned benefit for the services provided to the city in addition to their salary and pension payments. The benefits provided to eligible retirees and beneficiaries or what are known as Other Postemployment Benefits (OPEB), are funded through the New York City Health Benefits Program. OPEB is comprised of not only health insurance costs, but also dental, vision, prescriptions, Pre-Medicare and Medicare payments, welfare

fund contributions and Medicare Part B reimbursements. The city negotiates these benefits with employees in collective bargaining sessions. The OPEB costs, contained in the city's financial plan, are shown in the figure to the right. The OPEB cost represents the health insurance benefits claimed or distributed to retirees for a given fiscal year. For example, in FY 2008, the OPEB portion for total city health insurance benefits is almost \$1.4 billion which is part of the city's overall healthcare cost of \$4.4 billion. The city follows a pay-as-you-go policy in paying OPEB costs, meaning that the cost is paid each year as benefits are claimed or distributed. However, in 2004, the Governmental Accounting Standards Board (GASB) established a set of standards for governments to follow for reporting OPEB costs much like the standards set forth for pension reporting.

Other Postemployment Benefits (OPEB) (\$ in millions)	
FY 2008	\$1,378
FY 2009	\$1,639
FY 2010	\$1,727
FY 2011	\$1,921
FY 2012	\$2,104

GASB is an independent, private sector, not-for-profit organization. Governments and the accounting industry recognize GASB as the official source of Generally Accepted Accounting Principles (GAAP) for state and local governments. GASB standards help to ensure that those who finance government or who participate in the financing process have access to relevant, reliable, and understandable information that assists them to make better, more informed decisions.⁹

In moving to establish accounting and financial reporting standards, GASB reasoned that postemployment benefits are a component of compensation that employees earn annually. Though these benefits are earned but not received until retirement starts, GASB recognizes the cost of these future benefits as a cost to governments today. Most state and local governments do not report the full cost of OPEB earned by their employees each year. Thus, before GASB established standards to be followed, the city paid OPEB costs claimed by retirees for a given fiscal year as pay-as-you-go transactions, but did not recognize future OPEB costs earned by active employees who had not yet retired.

GASB Statement No. 43 addresses financial statement and disclosure requirements for reporting by administrators or trustees of OPEB plan assets or by employers or sponsors that include OPEB plan assets as trust or agency funds in their

⁹ GASB at www.gasb.org

financial reporting. Statement No. 45 follows the approach previously adopted in GASB Statement No. 27, Accounting for Pensions by State and Local Governmental Employers, with modifications to reflect differences between pension benefits and OPEB. However, GASB Statements No. 43 and No. 45 set the requirements that governments should follow in addressing the accounting and financial reporting of OPEB liabilities but does not mandate the funding of them.¹⁰

As noted, it is not required for the city to fund the OPEB liability it incurs as a provider of retiree benefits. Notwithstanding, the New York City Retiree Health Benefits Trust (RHBT) was legally formed and initially funded in June 2006 with an allocation of \$1 billion. In FY 2007, the city made an additional \$1.5 billion payment to the trust. In doing so, the city took prudent steps in addressing the new set of standards set forth by GASB. Consequently, with the city choosing to establish the trust fund, two important developments occur. The first is the recognition of a large and growing liability on the books of the city and the second is the expectation that substantial funds will be needed to address this liability at some point in the future. This being the case, the RHBT was established and funded to address this issue sooner rather than later.

GASB makes clear the recommended parameters and actuarial valuation methods that governments are to use in reporting OPEB liabilities and trust fund plans. These methods and accepted standards and practices are set forth by the Actuarial Standards Board. Using one of GASB's accepted valuation methods, the City Actuary makes actuarial assumptions based on an experience which encompasses a variety of factors that are both economically and demographically related to benefit recipients. The most important factors are the number of eligible beneficiaries, their expected work longevity, life expectancy, projected future healthcare and health insurance costs and the required rate of return on invested trust plan assets.

The funding of the plan is determined by calculating the time value or accrued cost of future OPEB obligations in terms of their value in the present. Similar to an insurance annuity set to begin paying annual payments at some future point in time, an initial lump sum equal to the present value of a future stream of payments, is required to fund the annuity today and annual fixed payments are made to the annuity until it is fully funded. The payments plus accumulating returns on invested assets build to the fully funded annuity by the maturity date. In annuities, assets are invested in securities which yield a required rate of return. At maturity, the annuity would ideally have reached its designated level and funds could be distributed as required. This is the fundamental structure that pension and OPEB plans follow, though they differ in the fact that the annual payments made to the plans are not constant and fluctuate annually due to many factors. These factors are: annual cost increases in benefits, enhancements to benefits, additional benefits negotiated in collective bargaining and investment losses and gains on assets held in the plan.

¹⁰ GASB at www.gasb.org

As mentioned earlier, the city established and allocated an initial deposit to the RHBT. In doing so, the city also chose to recognize on its books the OPEB liability promised to employees. Those promised benefits, to be paid in their retirement years, are the Unfunded Actuarial Accrued Liability (UAAL) accounted for and reported by the city in FY 2006 based on a June 30, 2005 valuation. As shown in the figure to the right, the total unfunded employee benefits the city would have been responsible for is \$50.5 billion, if this liability was required to be fully funded. This amount represents the required allocation of funds needed to fully fund the RHBT or the present value of all future benefits. As detailed earlier in the annuity illustration, the initial setup of the RHBT would require the present value of the liabilities to be unfunded today. This unfunded amount, or \$50.5 billion, is known as the Unfunded Actuarial Accrued Liability.

Unfunded Actuarial Accrued Liability (\$ in millions)	
Benefits earned by Active Members	\$22,494
Retirees in Receipt of Benefits	25,745
Deferred and Undesignated Benefits	<u>2,285</u>
UAAL	\$50,523
Note: Numbers may not add due to rounding.	

The cost of future OPEB benefits accrued to active employees would equate to the city's annual required OPEB contribution to the RHBT or what is known as the Normal Cost. As noted earlier, OPEB is earned annually by employees. Additionally, health insurance costs increase, as do premiums to Medicare. Further, new contracts bring about enhanced benefits paid in retirement. These factors cause the OPEB liability to increase year to year. However, salary increases have no impact on OPEB costs.

As presented in Table 10, we summarize the city's accounting and reporting of OPEB, which the city has prepared in accordance with GASB Statements No. 43 and No. 45. As previously mentioned, the city valued the UAAL for FY 2005 as \$50.5 billion based on the actuarial valuation performed at the end of FY 2006. This figure becomes the UAAL for the beginning of FY 2006, as shown in the table below.

TABLE 10 **SUMMARY OF UNFUNDED ACTUARIAL ACCRUED LIABILITY**
(\$ in millions)

	FY 2006	FY 2007
UAAL at Beginning of Year	\$50,523	\$53,483
Refinements and Modifications		853
Changes to Medicare Part B Premiums		723
Normal Cost (Required Annual Contribution)	3,002	3,262
Subtotal	\$53,525	\$58,321
Interest @ 4%	2,141	2,333
Pay-As-You-Go OPEB	(1,183)	(1,410)
RHBT Contribution	(1,000)	(1,500)
UAAL at End of Year		

As shown in the table, the cost of future benefits accrued to active city employees or the normal cost (the city's required annual contribution) is about \$3 billion. Because of the economics of health insurance costs, the normal cost the city would face each year is expected to increase. This will be a major cause of growth in the OPEB liability in future years.

In FY 2006, the city paid out nearly \$1.2 billion in OPEB costs in accordance with their pay-as-you-go policy and contributed an initial deposit of \$1 billion to begin the

trust fund. As shown, the liability in the first year grew from \$50.5 billion to almost \$53.5 billion after all calculations were computed. In FY 2007, after adjustments (refinements in participation, modifications in calculations and census data reclassifications) of about \$1.6 billion were made, and the normal cost and interest were calculated, the liability grew to more than \$57.7 billion once payments to OPEB were made and an additional \$1.5 billion was contributed to the trust fund.

The city has not released an official report on the OPEB liability beyond FY 2007. However, we have projected over the financial plan years, FY 2008 through FY 2012, the potential increase in the OPEB liability under the following assumptions: (1) annual growth of the normal cost (accrued benefits) of 10 percent and (2) headcount of city workers remains relatively flat over the period.

As shown in Table 11 on page 29, beginning with FY 2008, the UAAL of \$57.7 billion at the beginning of the fiscal year is the ending value at the end of the previous fiscal year. With anticipated growth of 10 percent, we expect that the normal cost will increase to almost \$3.6 billion. The current trend assumption for the near-term has been for healthcare costs, in particular premiums and hospital care, to grow at an average rate of approximately 10 percent. Finally, as explained earlier, the cost of interest must be accounted for and this adds nearly \$2.5 billion to the liability.

TABLE 11 **SUMMARY OF PROJECTED UNFUNDED ACTUARIAL ACCRUED LIABILITY**
(\$ in millions)

	FY 2008p	FY 2009p	FY 2010p	FY 2011p	FY 2012p
UAAL at Beginning of Year	\$57,744	\$62,408	\$67,371	\$72,854	\$78,815
Normal Cost	3,589	3,948	4,342	4,776	5,254
Subtotal	\$61,333	\$66,355	\$71,713	\$77,631	\$84,069
Interest @ 4%	2,453	2,654	2,869	3,105	3,363
Pay-As-You-Go OPEB	(1,378)	(1,639)	(1,727)	(1,921)	(2,104)
RHBT Contribution	0	0	0	0	0
UAAL at End of Year	\$62,408	\$67,371	\$72,854	\$78,815	\$85,328
Note: Numbers may not add due to rounding.					p=projected

As shown in the table, the city's payment of almost \$1.4 billion reduces the OPEB liability to a net \$62.4 billion. The FY 2009 Adopted Budget reported a prepayment of \$460 million to OPEB in FY 2009. Because the city utilizes the RHBT as a conduit for OPEB payments, this prepayment increased the OPEB cost in FY 2008 by \$460 million to more than \$1.8 billion and reduced the OPEB cost in FY 2009 to about \$1.2 billion and subsequently increased the RHBT by \$460 million. Because the \$460 million was transferred from the BSA to RHBT as a technical adjustment for the purpose of the FY 2009 prepayment, we have chosen to ignore this budgetary measure for this analysis.

As shown in Table 11, our analysis projects that the OPEB liability could likely climb to more than \$85 billion. Clearly, further contributions to the RHBT are missing in the financial plan years. The city has contributed a total of \$2.5 billion to date but, as reported in their latest budget modification, have not made any additional allocations of funds.

The city is facing considerable fiscal strain in the years ahead with multi-billion dollar gaps to be closed. Also, it is clear from our analysis that the OPEB liability is likely to grow rapidly in the future. The city needs to address this serious growing liability. Given few options, it has two possible ways, within its control, that it can approach the issue. One is to reduce healthcare costs to retirees through collective bargaining and, in conjunction with or alternatively to, increase contributions to RHBT dramatically on a sustained year-to-year basis.

Fringe Benefit Costs

Fringe benefits continue to be a considerable expense in the city's Personal Service budget. In recent years the city has taken several key steps, in an attempt to lower or control fringe benefit costs, such as increasing insurance co-payments, charging city employees administrative fees under Group Health Insurance, and negotiating with insurance companies to get more cost effective rates. However, fringe benefit costs continue to rise mostly due to increased health insurance costs.

In the four-year financial plan, spending on fringe benefits is forecasted to increase from close to \$6.3 billion in FY 2009 to over \$8.2 billion in FY 2012, as shown in Table 12. This represents an increase of over 31 percent. The city is projecting average annual growth of around 10 percent during the plan period.¹¹ Meanwhile, the share of the city's total expense budget (excluding NYCTFA debt service) related to fringe benefits is estimated to be over 10 percent per annum throughout the four years of the plan.

As shown in Table 12, fringe benefits consist of several major components, the largest and most important of which continues to be health insurance. As in recent years, health insurance accounts for well over half of overall spending on fringe benefits. Supplemental welfare benefit payments represent an average of 14 percent of the fringe benefits budget over the next four years. This category reflects supplemental payments to the unions' welfare funds. Health and welfare costs combined will represent between 67 percent and 72 percent of total fringe benefit costs between FYs 2009 and 2012. This percentage share is consistent with that of the recent past.

FRINGE BENEFIT EXPENDITURES GROWTH BETWEEN FYs 2009 and 2012

TABLE 12

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012
Health Insurance	\$3,209	\$3,828	\$4,305	\$4,848
Supplemental Welfare Benefit	992	1,012	1,031	1,048
FICA and Social Security	1,613	1,701	1,777	1,787
Worker's Compensation	215	236	260	285
Unemployment Insurance	48	48	50	53

¹¹ Without the prepayment of \$460 million for healthcare benefits, fringe benefit costs would have been \$6.719 billion in FY 2009, resulting in a 22 percent increase in FYs 2009-2012. The average annual growth rate would have been seven percent for the same four-year period.

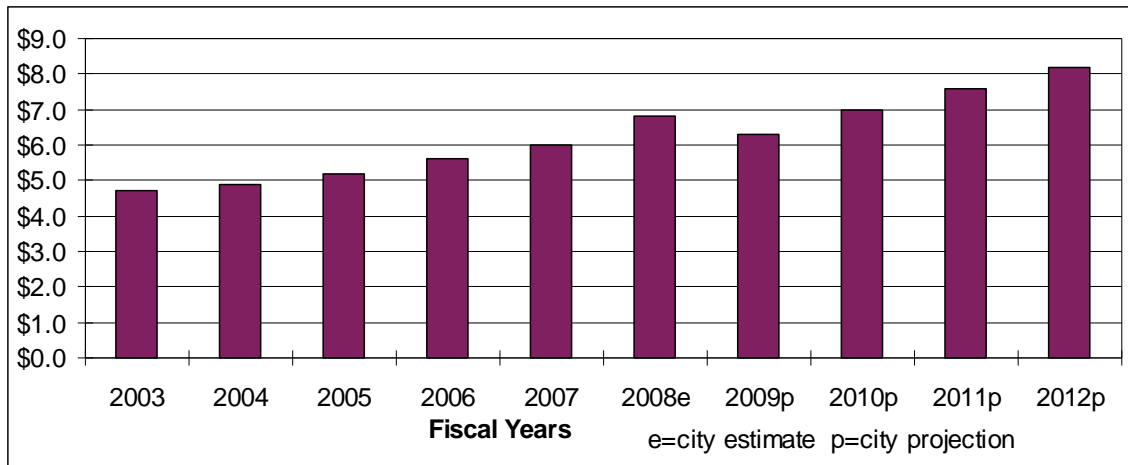
Other	182	183	184	189
Total	\$6,259	\$7,008	\$7,607	\$8,210

Costs for Federal Insurance Contributions Act (FICA) and Social Security average around 23 percent per year of the total fringe benefits budget during the life of the plan. While the cost is significant (averaging over \$1.7 billion per annum), the growth rate is significantly more moderate than that of health insurance. Worker's compensation costs represent about three percent of total fringe benefit expenses and are expected to rise steadily from \$215 million in FY 2009 to \$285 million in FY 2012. Meanwhile, unemployment insurance is expected to hover around the \$50 million range during the plan period.

Historically, fringe benefit expenditures have grown steadily, as shown in Chart 1. In FY 2003, the city paid around \$4.7 billion to cover the cost of fringe benefits, while in FY 2007 this expense stood at \$6 billion, a nearly 28 percent increase. On a year-to-year basis, spending on fringe benefits grew by an average of over six percent per year over this five-year period, ranging from a low of four percent between FYs 2003 and 2004 to a high of approximately eight percent between FYs 2005 and 2006. When we look at the projections from FYs 2008-2012, the growth rate continues to be around the seven percent range. As a result, the growth rate outpaces both actual and forecasted increases in the local inflation rate over that time frame. From FY 2006 to FY 2007, the fringe benefits growth rate was just over seven percent, whereas the local inflation rate was over three percent. From FY 2009 to FY 2012, the cost of fringe benefits increases at an average rate of around nine percent per fiscal year while the local inflation rate is projected by the city to increase at an average of around 2.4 percent per fiscal year during the same time frame.

FRINGE BENEFIT COSTS TREND FOR FYS 2003-2012

CHART 1 (\$ in millions)



Health Insurance

As mentioned earlier, the most important component of fringe benefits, and the main cause of growth in this expense, is the significant cost of health insurance. Between FYs 2009-12, these costs are projected to increase by 51 percent, from over \$3.2 billion to over \$4.8 billion. Last year at this time, the increase over the plan period was 22 percent. In the current plan, health insurance costs represent between 51 percent and 59 percent of the total fringe benefit costs.

The costs in health insurance are mainly attributable to the premiums set by the Health Insurance Plan (HIP), which statutorily drives the city's liability. The premium rate for FY 2009 is 9.43 percent up from 9.36 percent in FY 2008 and 8.65 in FY 2007. The HIP monthly cost for FY 2009 is \$372.99 for individual and \$913.83 for family. The city carries an eight percent increase in each of the outyears in the financial plan until the actual rate is determined in January. Health insurance estimates reflect current levels of coverage based on the latest population and premium data available from the city's health insurance providers.

Federal and State Funds

The city is projecting the receipt of \$71 million in federal funds and \$45 million in state funds in FY 2009 and \$52 million and \$37 million, respectively, in each of FYs 2010-2012. The federal funds are related to the increase of the Federal Fringe Benefit Rate. The Federal Fringe Benefit Rate is used for federal grant reimbursements, and is negotiated with the U.S. Department of Health and Human Services. The Fringe Benefit Rate is based on calculations of six components of benefit costs - Pensions, Social Security, Health Insurance, Supplemental Employee Welfare Benefits, Workers Compensation, and Unemployment Insurance Benefits. For each component, the Fringe Benefit Rate is calculated by dividing the city's actual (audited) expenditures by the total

of actual (audited) salaries and wages paid. The state funds are primarily related to two areas: additional state reimbursements related to the state takeover of Medicaid and additional staffing for the protective services at the Administration of Children's Services.

New York City Housing Authority

In its calendar year (CY) 2007 financial plan, the New York City Housing Authority (NYCHA) projected a budget gap of \$123 million in 2009 and slightly over \$117 million in each of 2010 and 2011. The financial plan also projected that Personal Service costs during these years would remain relatively flat, which has not been the case. In the 2008 financial plan, NYCHA projects the employee benefit portion of Personal Service to increase by \$43 million in 2009, almost \$76 million in 2010 and \$110 million in both 2011 and 2012. These increases are a significant reason for the growth in NYCHA's budget gaps to \$198 million in each of 2009 and 2010 and almost \$208 million in both 2011 and 2012. NYCHA must continue to try to close these increasingly large gaps or they could put pressure on the city to increase its subsidy to NYCHA in the future in order to prevent service reductions.

Department of Education

The New York City Department of Education (DOE) offers primary and secondary education for just over one million children. The city's public schools give basic instructional services and provide students with special and bilingual education and vocational training. Support services include free and subsidized transportation, breakfast and lunch services, and the operation and maintenance of just over 1,400 schools.

The DOE's FY 2009 Adopted Budget is approximately \$17.8 billion (excluding pension and debt service costs). By FY 2012, its budget is expected to grow to \$20.5 billion, an increase of almost \$2.8 billion or 15.6 percent. The largest share of this budget increase is in state aid which grows by \$1.6 billion or 18.9 percent between FYs 2009 and 2012. The largest increase is in FY 2011 at almost \$862.7 million or 9.7 percent. The city's share (including other categorical and intra-city revenues) will grow by over \$1.1 billion or 15.2 percent by FY 2012. These funding increases are being used to meet the court-ordered Campaign for Fiscal Equity mandate. The federal share remains flat at approximately \$1.8 billion in FYs 2009 through 2012.

The FY 2012 budget of \$20.5 billion is comprised of \$10.1 billion, or 49.3 percent, in state aid. City funds (including other categorical and intra-city revenues) make up \$8.6 billion, or 42 percent, while the federal share is \$1.8 billion, or 8.7 percent.

Collective Bargaining

As a result of the May 19, 2008 Public Employees Relations Board (PERB) Impasse Panel award to the Patrolmen's Benevolent Association (PBA), the Lieutenants Benevolent Association (LBA) has successfully exercised the reopener clause of its contract and has negotiated a restructuring of its agreement. To get the additional 3.48

percent increase in pay that they received, the city will be allowed to give lieutenants last-minute schedule changes for an additional five days. They also agreed on a deal to reduce the retroactive pay by making it effective after 14 months of the contract. Both the Uniformed Fire Officers and the Sergeants Benevolent Association reached tentative agreements in the first week of July with similar terms.

The PBA arbitration award, which covers the period from August 1, 2004 through July 31, 2006, entails a 4.5 percent increase backdated to August 1, 2004 (the first day of the contract) and another five percent increase compounded backdated to August 1, 2005. The total increase over the two-year period will be 9.73 percent compounded. Also, the award increases the top pay for veteran police officers from \$59,588 to \$65,382 and starting pay for police officers from \$25,100 to \$35,881 retroactive for those hired since January 1, 2006. The city received a number of productivity improvements that total 2.81 percent in savings bringing the total cost of the contract to 7.41 percent, which the city estimates creates a 1.16 percent differential with the other uniformed services.

It is estimated that the PBA award will increase costs by approximately \$110 million annually starting in FY 2009. If all uniformed services unions exercise the reopener clause of their contracts and restructure their agreements to that of the PBA, the city forecasts increased labor costs over what was projected in FY 2009 Executive Budget of \$276 million in FY 2009, \$290 million in FY 2010, \$271 million in FY 2011 and \$278 million in FY 2012.

In the four-year financial plan, the city is projecting the labor reserve to be at \$985 million in FY 2009, \$1.8 billion in FY 2010, \$2.2 billion in FY 2011, and \$2.6 billion in FY 2012.

RISKS AND OFFSETS

Our evaluation of the city's financial plan is shown in Table 3 on page 5. We project a decrease in nonproperty tax revenue of \$400 million in FY 2009, \$425 million in FY 2010 and \$200 million in each of FYs 2011 and 2012. We also project a \$200 million reduction in property tax collections in each of FYs 2010-2012. We estimate that uniformed overtime costs, based on our analysis and historical growth rates, will exceed what the city has budgeted by \$84 million in FY 2009, \$78 million in FY 2010, \$62 million in FY 2011 and \$61 million in FY 2012. As a potential partial offset to this risk, we project miscellaneous revenue, based on historical patterns of growth, to be higher by \$150 million in FY 2009, \$125 million in FY 2010, and \$100 million in each of FYs 2011 and 2012.

The city has budgeted funds in the financial plan assuming that the seven percent property tax cut will be restored in FY 2010. If approval from the City Council for this action is not received, revenue will be reduced by \$1.223 billion in FY 2010, \$1.298 billion in FY 2011 and \$1.359 billion in FY 2012. The city hopes to achieve health insurance savings of \$200 million beginning in FY 2010 and continuing throughout the life of the plan. Negotiations are in the early stages with the Municipal Labor Council, thus there are no details available as to how these savings will be realized. The city is

required to begin funding pollution remediation projects in FY 2011 in its expense budget instead of the capital budget. The city estimates this could cost up to \$500 million annually. This funding is not included in the current financial plan.

We now estimate that the city will have a budget gap of \$334 million in FY 2009, almost \$4.3 billion in FY 2010, and over \$7.5 billion in each of FYs 2011 and 2012.

DEBT SERVICE IMPACT OF CAPITAL PROGRAM DEFERRAL

To address the sizable outyear budget gaps projected for FY 2011 and beyond, the city is now targeting the debt service component of its budget, as it represents a substantial share of total expenditures. The city announced that it will stretch out the four-year capital plan for FYs 2009-12 over five years. This will result in reduced capital financing and correspondingly lower debt service costs. In this section, we lay out the process by which the announced deferral materializes into reduced debt service costs. We also analyze the impact on the outyear budget gaps.

Capital Program

The city, at the time the Executive Budget was released in May, announced that it will defer 20 percent of its capital projects funded with general obligation (g.o.) bonds from each of FYs 2009-2012 to FY 2013. The reduction is applied to authorized levels of capital commitments the city had increased since releasing its last capital plan in January 2008. An analysis of the capital program stretch-out, as outlined in Table 13 on page 35, reveals a multi-step approach that began with an 11 percent (\$2.5 billion) increase in commitments compared to the January plan, followed by the 20 percent (\$5.1 billion) reduction from the higher level. In a January to May plan-to-plan comparison, the amount of commitments the city is authorized to enter into was actually scaled back by 11 percent (\$2.6 billion). Similarly, the targeted level of commitments—the amount the city realistically expects to enter into, given programmatic as well as scheduling issues that often arise, and therefore the amount that g.o. financing is based on—was reduced by a similar 10 percent (\$2.6 billion) for the four-year period of FYs 2009-12.

As shown in Table 13 on page 35, the current plan assumes that the city will enter into a targeted \$22.3 billion of g.o. funded capital contracts during FYs 2009-12, amounting to average annual commitments of \$5.6 billion. Annually, commitments are projected to decline substantially from a high of \$8.2 billion in FY 2009 to a low of \$3.6 billion in FY 2012. Given that commitments to be entered into will be front-loaded, the city will become locked into the need for substantial g.o. borrowing and the corresponding debt service costs early in the plan.

THE SCALE OF THE CAPITAL PROGRAM DEFERRAL

TABLE 13 (\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012	FYs 09-12	FY 2013
Authorized G.O. Funded Commitments						
January 2008 Plan	\$9,537	\$5,036	\$4,729	\$3,624	\$22,926	\$3,574
Revised Forecast	11,031	5,737	4,943	3,721	25,432	NA
Revised Compared to January	1,494	701	214	97	2,506	--
Percentage Change	16%	14%	5%	3%	11%	--
May 2008 Plan*	8,825	4,590	3,954	2,977	20,346	5,103
May Compared to Revised	(2,206)	(1,147)	(989)	(744)	(5,086)	--
Percentage Change	(20%)	(20%)	(20%)	(20%)	(20%)	--
May Compared to January	(712)	(446)	(775)	(647)	(2,580)	1,529
Percentage Change	(7%)	(9%)	(16%)	(18%)	(11%)	43%
Targeted G.O. Funded Commitments						
January 2008 Plan	\$8,929	\$6,398	\$5,313	\$4,215	\$24,855	\$3,799
May 2008 Plan	8,248	5,870	4,624	3,554	22,296	4,561
May Compared to January	(681)	(528)	(689)	(661)	(2,559)	762
Percentage Change	(8%)	(8%)	(13%)	(16%)	(10%)	20%
*The authorized level for FY 2009 may be augmented by \$3.8 billion -- the difference between the authorized level of commitments for FY 2008 and the lower targeted amount that the city expected it could realistically undertake.						

At the time the plan was released, the city had not identified the capital projects that will be deferred. Moreover, the city, customarily, does not submit a revised capital plan with the adopted budget. We expect the next financial plan will reflect the reductions by project area to enable us to determine the programmatic impact of the cuts. We hope that, as the city goes about deciding which projects to defer, it will give priority to funding maintenance of its existing assets.

The city in its 2008 Maintenance Report identified 60 percent, or \$3 billion, of \$5 billion of recommended maintenance to bring its physical assets up to a state of good repair as being funded in the capital program for FYs 2009-12.¹² This is the highest projected funding ratio since FY 2001. However, the percentage of asset maintenance recommendations that is funded is based on a reconciliation performed on the higher commitments of the revised capital plan. The recommendations in the maintenance report could provide the city a framework to effectively allocate resources to fund work that is critical to the structural integrity of the capital stock. As the city attempts to rein in the growth in debt service costs, it should give consideration to the long-term value of

¹² The city is required by charter to produce an annual maintenance report each October that details the recommended amounts of funding over the ensuing four fiscal years to maintain assets and asset systems with a replacement cost of \$10 million or greater and a useful life in excess of 10 years. Additionally, the city produces a separate document, usually published around the time the executive budget is released, that reconciles the funding needs to the planned funding for each agency.

fully funding timely maintenance of its assets, as this will serve to minimize more extensive work that can ensue from delaying maintenance.

It should be noted that the city requested and the Financial Control Board (FCB) granted a deferral of budgetary implementation of Statement No. 49 of the Government Accounting Standards Board (GASB), which requires specific pollution remediation costs that currently are categorized as capital items to be accounted for in the expense budget starting in FY 2009. Implementation of GASB 49 would adversely impact the city's budget because, under the Financial Emergency Act for the City of New York (FEA), expense budget items are not eligible to be capitalized and would have to be paid from current resources.

The city preliminarily has assessed the current environmental remediation costs in question at roughly \$500 million annually. The city has engaged the accounting firm KPMG to assist in implementation of GASB 49 but asserted that it needs more time to interpret and implement key aspects of the new accounting standard. The city expects full reporting of the information required by GASB 49 in the FY 2009 Comprehensive Annual Financial Report to be issued by the City Comptroller by October 31, 2009.

Meanwhile, on April 30, 2008, the FCB, with authorization under the FEA, approved a resolution that allows the city to defer budgetary implementation of GASB 49 until July 1, 2010 (through the end of FY 2010). This will allow the city to move forward with capitalizing currently planned projects that include environmental remediation components. Until July 1, 2010, the city is required by the resolution to report on its progress in budgetary compliance with GASB 49 twice each year.

The current financial plan does not include an allocation to cover operating expenditures for pollution remediation in FYs 2011 and 2012, when the city is required to begin compliance with GASB 49. This places a risk to the financial plan of \$500 million in each of FYs 2011 and 2012 based on the current cost estimate of pollution remediation. The reclassification of pollution remediation from capital to expense items would result in a commensurate cut in the capital program, with corresponding reductions in borrowing amortized up to 30 years.

Debt Service Impact

Along with cutting the capital program for each of FYs 2009-12, the city projects that its g.o. borrowing will be reduced by seven percent (\$1.7 billion) over the four-year period, as seen in Table 14. Capital financing generally occurs at a slower pace than the commitments entered into because the related cash flow usually transpires over a number of years, which explains why the reduction in borrowing lags the amount of commitments deferred. The largest impact of the cumulative cuts is first realized in FY 2011 when financing is scaled back by \$674 million. Borrowing will continue to be reduced beyond FY 2012 to capture the full effect of the decrease in capital commitments.

**G.O. BORROWING WILL BE REDUCED BY SEVEN PERCENT AS A
RESULT OF THE DEFERRAL OF CAPITAL COMMITMENTS**

TABLE 14

(\$ in millions)

	FY 2009	FY 2010	FY 2011	FY 2012	FYs 09-12
City G.O. Financing Assumptions					
January 2008 Plan	\$5,060	\$7,008	\$6,874	\$5,930	\$24,872
May 2008 Plan	4,800	6,800	6,200	5,400	23,200
May Compared to January	(260)	(208)	(674)	(530)	(1,672)
Percentage Change	(5%)	(3%)	(10%)	(9%)	(7%)
Note: The city has since adopted a budget for FY 2009, which reflects a slippage of \$800 million of capital borrowing from FY 2008 to FY 2009.					

Using the city's g.o. borrowing assumptions, debt service savings attributable to the \$1.7 billion reduction in the financing amount total \$7 million in FY 2009, \$20 million in FY 2010, \$54 million in FY 2011 and \$99 million in FY 2012. Beyond FY 2012, the annual savings climb to as much as \$143 million in FY 2015 before declining. This illustrates that it takes several years to realize the maximum benefit of a reduction in the capital program.

City debt service costs, when combined with that for the New York City Transitional Finance Authority, are currently projected to grow from \$4.369 billion in FY 2009 to \$4.795 billion in FY 2010, and then jump by over \$1.1 billion in FY 2011 to \$5.911 billion then \$6.485 billion in FY 2012, as illustrated in the figure to the right.¹³ For FY 2011, when debt service is substantially higher than the preceding years, the announced 20 percent cut in capital commitments provided only a \$54 million savings.

Debt Service as a Percentage of Tax Revenues			
(\$ in millions)			
FYs	Debt Service	Tax Revenue	Percent
2009	\$4,369	\$36,552	12.0%
2010	4,795	38,220	12.5%
2011	5,911	40,615	14.6%
2012	6,485	42,906	15.1%
Average Annual Growth Rate			
	14.1%	5.5%	

Moreover, the rising debt service costs are projected to absorb a growing share of tax revenues, accelerating from 12 percent in FY 2009 to 12.5 percent in FY 2010, 14.6 percent in FY 2011 and 15.1 percent in FY 2012. For the period covering FYs 2009-12, debt service is projected to grow at an average annual rate of 14.1 percent, while tax revenue, its source of payment, is forecasted to grow by 5.5 percent, as shown in the figure above.

The vast majority of debt service costs projected for the plan years consist of principal and interest on bonds that had already been issued to support the city's mounting capital program. Over the last several years, the city had been expanding its capital program as its revenue collection soared. Unfortunately, revenue collection is

¹³ Debt service costs for FYs 2009 and 2010 have been lowered substantially as a result of the prior use of windfall tax revenues for the early redemption of debt originally scheduled to mature in those years.

volatile, particularly tax revenues. And now, the city is expecting a slowdown in tax revenue collection but the debt service costs are locked in.¹⁴ It would take a massive scaling back of capital commitments to yield a large enough reduction in debt service costs that will put a dent in the outyear budget gaps. Such a cut could have serious consequences for the city's infrastructure and could be disruptive to the economic vitality of the city. However, in the absence of higher revenues, the city will have to take far-reaching measures to close the \$5.2 billion budget gap projected for FY 2011, including further cuts to the capital program as well as reductions to other competing expenditures.

¹⁴ Tax revenues are forecasted to decrease in FY 2009 compared to FY 2008 by \$2.3 billion, or 5.9 percent.

Glossary of Acronyms

AIM	Aid and Incentives for Municipalities
AIR	Actuarial Interest Rate
BERS	Board of Education Retirement System
BSA	Budget Stabilization Account
CPI	Consumer Price Index
CY	Calendar Year
DOE	Department of Education
FCB	Financial Control Board
FEA	Financial Emergency Act for The City of New York
FICA	Federal Insurance Contributions Act
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GASB	Governmental Accounting Standards Board
GCP	Gross City Product
GDP	Gross Domestic Product
G.O. Bonds	General Obligation Bonds
HHC	Health and Hospitals Corporation
HIP	Health Insurance Plan
LBA	Lieutenants Benevolent Association
NYCHA	New York City Housing Authority
NYCRS	New York City Retirement Systems
NYCTFA	New York City Transitional Finance Authority
NYSE	New York Stock Exchange
OPEB	Other Postemployment Benefits
OT	Overtime
OTPS	Other than Personal Services
PBA	Patrolmen's Benevolent Association

PERB	Public Employees Relations Board
PEG	Program to Eliminate the GAP
PIT	Personal Income Tax
PS	Personal Service
RHBT	Retiree Health Benefits Trust
STAR	School Tax Relief Program
TRS	Teachers' Retirement System
UAAL	Unfunded Actuarial Accrued Liability