

Staff Report
REVIEW OF FY 2005
June 9, 2005

New York State Financial Control Board

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

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Saundra L. Truell

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I. Overview

This report looks back to examine the changes in the city's budget during FY 2005, from adoption last June to the current May modification. Most noteworthy was that over the course of the fiscal year, tax revenues, reflecting a strengthening economy and an ongoing real estate boom, soared beyond expectation. As a result, the city increased its FY 2005 city-fund revenue estimate by \$2.9 billion since the FY 2005 budget was adopted last year.

Over the course of the fiscal year, strong collections results for the major nonproperty taxes yielded \$3 billion in extra revenue in FY 2005. The personal income tax improved by nearly \$900 million, and the continuing low mortgage rates and strong real estate market increased the mortgage recording tax by over \$600 million and the real property transfer tax by over \$500 million. The business taxes increased by \$560 million, reflecting the improvements in the economy leading to stronger profits nationally and in the securities industry by the end of 2004. The sales tax is \$300 million higher than projected mainly due to a delay in the return of the exemption on clothing and footwear purchases priced under \$110, a higher tax rate, and an upsurge in tourism. Based on current collections data received after the submission of the May modification, FY 2005 tax revenues may exceed the city's latest estimate by \$350 million.

Overall, the city was able to contain FY 2005 expenses during the course of the fiscal year. While expenditures increased in a number of areas, the city implemented an agency reduction program that produced savings or revenue increases of about \$417 million, and generated debt service savings of \$92 million.

With the surge in tax revenues and with a large amount of nonrecurring resources, most notably the payment of back airport rent from the Port Authority, and the Municipal Assistance Corporation debt refinancing, the city is projecting that it will end FY 2005 with a record surplus of \$3.3 billion. At this level, the budget balance would be \$1.3 billion larger than the FY 2004 surplus used to support the current year's expenses. The city plans to apply the entire FY 2005 surplus to support FY 2006 spending, leaving unaddressed the projected FY 2007 budget gap of \$4.5 billion. Given recent tax collection information, tax revenues may be even higher than expected, and the \$3.3 billion surplus is likely to grow. Since the strong, unexpected revenue growth in FY 2005 is unlikely to continue, we urge the city not to spend any of the additional surplus, and instead create a budget stabilization account in FY 2006 to address the large budget gaps expected in FY 2007 and beyond.

**MODIFICATION HISTORY OF THE CITY'S
OPERATING BUDGET FOR FISCAL YEAR 2005**

TABLE 1 (\$ in millions)

| | Adopted Budget | October Modification | January Modification | May Modification |
|---|------------------------|-------------------------|-------------------------|------------------------|
| <u>Revenues</u> | | | | |
| Taxes | | | | |
| General Property | \$11,682 | \$11,518 | \$11,492 | \$11,416 |
| Other Taxes ^a | 15,613 | 16,253 | 17,240 | 18,689 |
| Tax Audit Revenue | 508 | 523 | 525 | 525 |
| Sale of Property Tax Liens | 118 | 98 | 44 | 85 |
| Tax Reduction Program | (300) | -- | -- | (23) |
| Miscellaneous Revenues | 6,591 | 6,783 | 7,096 | 7,023 |
| Unrestricted Intergovernmental Aid | 562 | 562 | 562 | 562 |
| Anticipated State & Federal Actions | 450 | 50 | -- | -- |
| Interfund Revenues | 348 | 349 | 357 | 358 |
| Less: Intracity Revenues | (1,146) | (1,189) | (1,268) | (1,289) |
| Disallowances | (15) | (15) | (15) | (15) |
| Total City Funds | \$34,411 | \$34,932 | \$36,033 | \$37,331 |
| Federal Categorical Grants | 4,733 | 4,957 | 5,563 | 5,873 |
| Federal-FEMA Insurance Program | -- | 1,000 | 1,000 | 1,000 |
| State Categorical Grants | 8,626 | 8,709 | 8,999 | 9,021 |
| Total Revenues | <u>\$47,770</u> | <u>\$49,598</u> | <u>\$51,595</u> | <u>\$53,225</u> |
| <u>Expenditures</u> | | | | |
| Personal Service | \$25,590 | \$25,741 | \$26,328 | \$26,305 |
| Other Than Personal Service | 20,427 | 21,315 | 22,097 | 22,612 |
| Debt Service | 3,339 | 2,207 | 3,202 | 3,172 |
| MAC Debt Service | -- | 120 | 130 | 128 |
| NYCTFA Debt Service | 560 | 530 | 525 | 509 |
| Budget Stabilization & Discretionary Transfers | (1,300) | 574 | 481 | 1,748 |
| General Reserve | 300 | 300 | 100 | 40 |
| Subtotal | \$48,916 | \$50,787 | \$52,863 | \$54,514 |
| Less: Intracity Expenditures | (1,146) | (1,189) | (1,268) | (1,289) |
| Total Expenditures | <u>\$47,770</u> | <u>\$49,598</u> | <u>\$51,595</u> | <u>\$53,225</u> |
| Gap To Be Closed | <u>\$0</u> | <u>\$0</u> | <u>\$0</u> | <u>\$0</u> |
| ^a Allocates NYCTFA debt service to expenditures. | | | | |

**CHANGES TO THE CITY'S OPERATING BUDGET
FOR FISCAL YEAR 2005 SINCE BUDGET ADOPTION**

TABLE 2 (\$ in millions)

| | October Modification | January Modification | May Modification |
|---|-------------------------|-------------------------|-----------------------|
| Revenues | | | |
| Taxes | | | |
| General Property | (\$164) | (\$26) | (\$76) |
| Other Taxes ^a | 640 | 987 | 1,449 |
| Tax Audit Revenue | 15 | 2 | 0 |
| Sale of Property Tax Liens | (20) | (54) | 41 |
| Tax Reduction Program | 300 | 0 | (23) |
| Miscellaneous Revenues | 192 | 313 | (73) |
| Unrestricted Intergovernmental Aid | 0 | 0 | 0 |
| Anticipated Federal and State Actions | (400) | (50) | 0 |
| Interfund Revenues | 1 | 8 | 1 |
| Less: Intracity Revenues | (43) | (79) | (21) |
| Disallowances | <u>0</u> | <u>0</u> | <u>0</u> |
| Total City Funds | \$521 | \$1,101 | \$1,298 |
| Federal Categorical Grants | 224 | 606 | \$310 |
| Federal-FEMA Insurance Program | 1,000 | 0 | 0 |
| State Categorical Grants | <u>83</u> | <u>290</u> | <u>22</u> |
| Total Revenues | <u>\$1,828</u> | <u>\$1,997</u> | <u>\$1,630</u> |
| Expenditures | | | |
| Personal Service | \$151 | \$587 | (\$23) |
| Other Than Personal Service | 888 | 782 | 515 |
| Debt Service | (1,132) | 995 | (30) |
| MAC Debt Service | 120 | 10 | (2) |
| NYCTFA Debt Service | (30) | (5) | (16) |
| Budget Stabilization & Discretionary Transfers | 1,874 | (93) | 1,267 |
| General Reserve | <u>0</u> | <u>(200)</u> | <u>(60)</u> |
| Subtotal | \$1,871 | \$2,076 | \$1,651 |
| Less: Intracity Revenues | <u>(43)</u> | <u>(79)</u> | <u>(21)</u> |
| Total Expenditures | <u>\$1,828</u> | <u>\$1,997</u> | <u>\$1,630</u> |
| Gap To Be Closed | <u>\$0</u> | <u>\$0</u> | <u>\$0</u> |
| ^a Allocates NYCTFA debt service to expenditures. | | | |

II. Balancing the FY 2005 Budget

The city adopted a FY 2005 budget that assumed \$220 million would be available to fund the budget stabilization account. Over the course of the fiscal year, tax revenues, reflecting a strengthening economy and an ongoing real estate boom, soared beyond expectation. The total revenue projection has now been raised by nearly \$5.5 billion over the forecast at adoption. Two main factors comprise the increase: \$3.1 billion from stronger tax receipts, particularly the personal income and the real property transactions taxes; and \$2.6 billion from higher federal and state categorical grants that are earmarked for specific programs. Concomitantly, the city contained total expenditures, excluding the use of the categorical grants, so that the combination of revenue and expenditure changes will provide \$3.3 billion of surplus resources for the city to fund its budget stabilization account.

In the following review of FY 2005, we will highlight the factors that contribute to the \$3.3 billion surplus identified in the May modification. We note that this budget balance includes \$1.9 billion of nonrecurring resources. Importantly, the city plans to use the entire surplus to balance its FY 2006 budget, effectively depleting its budget stabilization account and delaying taking measures to deal with an expected FY 2007 budget gap of \$4.5 billion.

CHANGES IN THE REVENUE PROJECTIONS

A strengthening local economic recovery, along with an ongoing boom in real estate, have pushed revenues in FY 2005, particularly tax collections, ever higher. This marks the second year of exceptionally strong tax collections; however the reasons for the current-year gains are not entirely the same as in the previous year. Tax collections in both FY 2004 and FY 2005 were enlarged by tax increases and by a real estate boom that was brought on by persistently low mortgage interest rates. The difference is that FY 2005 revenues are also responding to a local economic recovery that was only in the earliest stages one year ago. Despite uncertainty about the strength and staying-power of the recovery, the city incrementally increased its FY 2005 revenue projections. The estimate for total revenues, at \$53.2 billion, has improved by more than 10 percent since budget adoption, while the local economy and the real estate market continued to gain strength throughout the year.

The city increased its FY 2005 revenue estimate by \$5.5 billion since the FY 2005 budget was adopted one year ago, as shown in the figure to the right. City-funded revenue increased by \$2.9 billion to \$37 billion primarily as a result of strong tax collections, which surged by \$3.1 billion to \$30.7 billion. Miscellaneous revenues along with major nonrecurring actions each increased by over \$100 million, while anticipated intergovernmental aid (IGA) of \$450 million was removed from the budget plan. The recently adopted state budget provides

| Change in the FY 2005 Revenue Projections (\$ in millions) | |
|--|----------------|
| Total Taxes | \$3,071 |
| Anticipated IGA | (450) |
| Miscellaneous Revenue | 122 |
| Major Nonrecurring Actions | 118 |
| City Funds | \$2,861 |
| Categorical Grants | \$2,584 |
| Other Revenue | 10 |
| Total Revenue | \$5,455 |

for the continued sales taxation of clothing and shoe purchases that is projected at \$23 million in FY 2005 and \$230 million in FY 2006 and additional savings in FY 2006 from adjustments to the Medicaid cap and cost containment. Categorical aid, which is composed of federal, state, and other categorical grants, increased by a combined total of \$2.6 billion. About \$1 billion of the positive variance is due to an insurance program funded by Federal Emergency Management Agency (FEMA) and the rest of the variance represents gains in funding for education, welfare, and other programs.¹ By the end of FY 2005, federal categorical aid is projected at \$6.9 billion, while state categorical aid is estimated to exceed \$9 billion.

The Surprising Strength of Tax Receipts

Since budget adoption last June, strong collections results for seven major nonproperty taxes yielded \$3 billion in extra revenue in FY 2005, as shown in the figure to the right. The personal income tax (PIT) improved by nearly \$900 million to \$6.4 billion with much of this extra revenue being reported in the April final settlement and in higher withholding revenue from larger bonus payouts, while a three-year tax increase was in effect.² Continuing low mortgage rates and a strong real estate market increased the projection for the mortgage recording tax by over \$600 million to \$1.2 billion, while the real property transfer tax forecast increased by over \$500 million to \$1 billion. The \$300 million improvement in the sales tax forecast, which is expected to yield over \$4.3 billion, is due to a delay in the return of the exemption on clothing and footwear purchases priced under \$110, a higher tax rate, a stronger economy, and an upsurge in tourism. The business taxes increased by \$560 million and are now expected to generate \$3.5 billion, reflecting the improvements in the economy leading to stronger profits nationally and in the securities industry by the end of 2004. Based on the pace of current collections, FY 2005 tax revenues may exceed the city's latest estimate by \$350 million.

| Change in the FY 2005 Nonproperty Tax Revenue Projections (\$ in millions) | |
|--|----------------|
| Personal Income | \$885 |
| Mortgage Recording | 638 |
| Real Property Transaction | 532 |
| Sales | 342 |
| Banking Corporation | 208 |
| Unincorporated Business | 181 |
| General Corporation | 171 |
| Total Tax Revenue | \$2,957 |

Personal Income Tax. On a nominal basis, the city expects PIT to grow 14.9 percent over the prior year (before the NYCTFA retention) and collections are 17.5 percent ahead through April. The reason for the strong growth in PIT in FY 2005 is that wage and nonwage income sources, based on conditions in 2004 and 2005, are doing well. A more positive outlook for securities industry profits in 2004 translated into year-over-year increases in finance sector compensation including bonus payouts. Finance

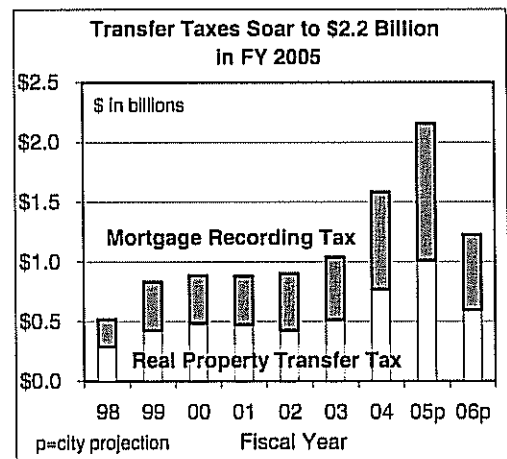
¹ In FY 2005, federal categorical aid included about \$1 billion from the FEMA to fund a captive insurance company started by the city to deal with general professional and environmental liability for contractors involved in debris removal from the World Trade Center area.

² There is a three-year PIT increase in effect that created two new income brackets and a tax table benefit recapture provision, which is scheduled to expire December 31, 2005. In the sales tax, there was a hike in the city and state sales tax rates to a combined total of 8.625 percent through May 31, 2005 and a repeal of the exemption on clothing and footwear purchases under \$110 through March 31, 2007.

sector compensation and modest job growth boosted overall wage growth in the city while nonwage sources of income were also posting gains. For example, the city projects capital gains realizations leaped 30 percent in 2004 and will rise by another five percent in 2005.

Sales Tax. On a nominal basis, the sales tax is projected to end FY 2005 up 7.7 percent and collections are ahead by 9.1 percent through April. During FY 2005, consumption increased from higher discretionary spending from both residents and tourists. Residents benefited from more jobs, higher wages, larger bonus payouts, and a wealth effect from the strong real estate market. The number of visitors and local employment in tourism-related industries have approached and exceeded pre-September 11th levels. Higher hotel room prices and occupancy rates, a resurgence in international visitors, and continued strength in domestic travel, all bode well for the sales tax in FY 2005 and FY 2006.

Real Property Transaction Taxes. The booming real estate market has transformed two formerly small taxes on property sales and mortgages into multi-billion dollar revenue producers. These two taxes soared to an estimated \$2.2 billion in FY 2005, up from \$1.6 billion in FY 2004, and more than four times the amount generated as recently as FY 1998, as shown in the figure to the right. Seeing the surge in these taxes as a temporary phenomenon driven by unusually low mortgage interest rates, the city has been reluctant to rely too heavily on these taxes until the revenue is already in hand. Consequently, the city originally planned for a combined total of only \$1 billion in revenues at the start of FY 2005, but adjusted that number upward to \$2.2 billion as the year progressed and mortgage rates remained stubbornly low. Given the Federal Reserve Board's steady pressure on interest rates, the city expects that these two taxes will drop by about \$1 billion in FY 2006.



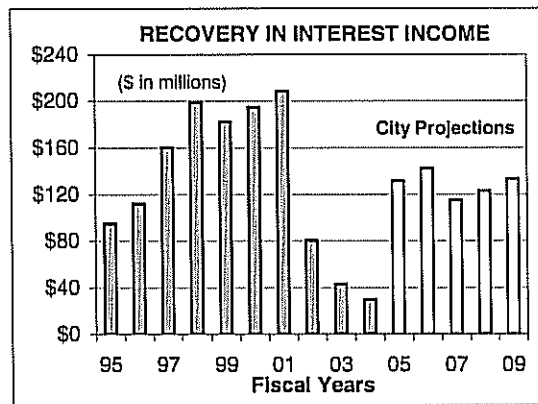
Miscellaneous Revenue and Nonrecurring Resources

During the course of FY 2005, the city increased the projections for miscellaneous revenue and nonrecurring resources by a net \$122 million and \$118 million, respectively, as shown in the figure on page 4. Gains in the forecast for miscellaneous revenue were reflected in most of the core categories, with the exception of a \$14 million slip in the rental income projection.³ The \$122 million total increase in the FY 2005 miscellaneous revenue projection represents a positive variance of \$245 million from charges, interest,

³ The core categories are responsible for recurring revenue growth and consist of licenses, fees, fines, rent, interest earnings and a residual miscellaneous category. They exclude tobacco proceeds from the Master Settlement Agreement and dedicated revenue streams. Dedicated revenues, such as water and sewer charges, are restricted in use and cannot provide gap-closing assistance.

finances, licenses and the residual category and a negative variance of \$123 million, which was primarily due to a shift of tobacco proceeds from FY 2005 to FY 2006.

Leading the core categories, interest earnings grew by \$96 million during FY 2005 because of rising interest rates and substantially more cash available for short-term investment than in prior years. The city projects interest income will reach \$131 million by the end of FY 2005, which would represent an increase of 337 percent or \$101 million from the \$30 million earned in FY 2004. The figure to the right shows that interest earnings were on an upward trend since FY 1995 and reached a peak of \$209 million in FY 2001 before falling for the next three years. The unexpectedly steep decline in interest income was caused by the historically low interest rate environment engendered by the Federal Reserve rather than a lack of funds available for investment. In FYs 2004 and 2005 unusually strong tax revenue growth presented an opportunity to invest more funds than usual for the city. In the latest forecast, interest income is poised for a sharp recovery in FY 2005 to \$131 million and is expected to exceed \$120 million annually thereafter, except for a slight retrenchment in FY 2007.



Nonrecurring Resources. While the projection of nonrecurring resources grew by only \$118 million from last June’s budget adoption to the May modification, the important point is that the level reached \$1.6 billion by the end of FY 2005. Despite the fact that the sale of land to the Battery Park City Authority for \$150 million did not materialize in FY 2005, the forecasted yield of other one-time actions increased over the year and new items were added to replace shortfalls in other initiatives. For example, the city’s initial forecast of rental arrears due the city from a new lease with the Port Authority to operate Kennedy and LaGuardia airports grew from \$690 million to \$782 million. Likewise, the benefit from the refinancing of debt issued by the Municipal Assistance Corporation (MAC) grew from \$502 million to \$631 million during the course of the year. The city was also fortunate that prices for taxi medallions sold during the year were higher than initially forecast and yielded an additional \$33 million to total \$98 million in FY 2005.

CHANGES TO THE EXPENDITURES ESTIMATES

Overall, the city contained FY 2005 expenses during the course of the fiscal year. While expenditures increased in a number of areas, the city implemented an agency reduction program that produced savings or revenue increases totaling approximately \$417 million, and generated debt service savings of \$92 million.

One area in which costs increased was uniformed services overtime, which was under budgeted at the beginning of the year at \$508 million and had to be increased by \$128 million to \$636 million by year end. However, this was still less than FY 2004 by

\$100 million. At the same time, some of these expenses are expected to be offset by the receipt of homeland security funds from the federal government. Some of the expense increases were in areas that are considered nondiscretionary, such as pension contributions and Medicaid. Though there were a number of adjustments within the pension budget, the bottom line change in the pension contribution is an increase of only \$7 million during the fiscal year. Over the course of FY 2005, Medicaid costs increased by \$151 million due largely to increasing insurance premiums, long-term prepaid care and rising pharmaceutical costs. Public Assistance costs over the same time frame increased by \$270 million despite a decreasing caseload. A major portion of the increase, \$139 million, was due to the appropriation of the Ryan White grant, which will be discussed in more detail in the Public Assistance section of this report.

These increases were partially offset by the \$417 million Agency Reduction Program, half of which was realized through initiatives undertaken by the uniform services. The debt service savings of \$92 million were achieved primarily from lower variable interest rates than originally assumed.

Overtime

At the start of the fiscal year, the city had anticipated that it would spend about \$500 million on uniformed overtime. That figure has now grown to \$636 million. However, the amount of city funds required for the overtime budget may even be less with the additional homeland security funds that the city expects to collect.

As shown in the figure to the right, we expect that the city will spend \$33 million less than it has projected based on spending as of April 2005. This fiscal year, the city estimated that overtime costs would total \$508 million in the adopted budget and has increased its estimates by \$128 million thus far. The city historically underestimates its overtime spending and increases its assumptions with each budget modification based on the current spending level. We also project that uniformed overtime expense will be higher than budgeted by \$139 million in FY 2006 and by \$158 million in each of the outyears of the financial plan.

| FY 2005 Adopted vs. May Modification (\$ in millions) | | |
|--|--------------|------------------|
| | Adopted | May Modification |
| Police | \$285 | \$342 |
| Fire | 111 | 153 |
| Correction | 45 | 62 |
| Sanitation | 67 | 79 |
| Total City OT | \$508 | \$636 |
| FCB Projected | 656 | 656 |
| Homeland Security | (53) | (53) |
| Over / (Under) Budget | \$95 | (\$33) |

Almost half of the FY 2005 increase is attributed to the Police Department's anti-terrorist security efforts (the increase is partially offset because the city will receive \$53 million in federal funds for homeland security this fiscal year and \$30 million next year) and the highly successful Operation Impact. Operation Impact is an initiative that floods high-crime areas with police to discourage criminal activity.

Additional spending has also occurred in the Fire Department to cover additional shifts in EMS, and facility and vehicle maintenance. Also, the Department of Correction has had higher than anticipated attrition of officers and officers on leave that

has added about \$10 million in overtime. The winter snow removal cost the Department of Sanitation an additional \$11 million in overtime cleanup.

Medicaid

The City of New York's Medicaid program currently provides essential health benefits for over 2.5 million enrollees and accounts for over nine percent of the city's expense budget, as shown in Table 3. In the May modification to the financial plan, the city's share of the Medicaid budget is projected to be over \$4.9 billion in FY 2005 and increases to approximately \$5.5 billion in FY 2009. The FY 2004 numbers are shown for comparison purposes.

TABLE 3

| MEDICAID COSTS AND ENROLLEES RISE IN FY 2005 | | | |
|---|----------------|----------------|-----------------|
| (\$ in millions) | | | |
| | FY 2004 | FY 2005 | FY 2009 |
| Medicaid Total | \$ 4,383 | \$ 4,917 | \$ 5,458 |
| City's Total Expense Budget | 48,833 | 54,005 | 57,153 |
| Percentage of Medicaid Costs | 8.98% | 9.10% | 9.55% |
| | July 04 | Nov 04 | March 05 |
| Total FY 05 Medicaid Enrollees | 2,493,036 | 2,527,000 | 2,542,066 |
| Medicaid Users | 1,666,493 | 1,700,826 | 1,726,326 |
| Note: FY 2004 represents actual data. | | | |

Since last June, the city has increased its Medicaid cost projections in FYs 2005-06. In FY 2005, the increase amounted to \$151 million. In fact, according to the city, in FY 2005, Medicaid is projected to increase approximately 12 percent, or over \$534 million from the previous fiscal year's actual expenditures, as shown above. These escalating costs can be attributed mainly to insurance premiums, long-term care and rising pharmaceutical costs. While Medicaid expenditures are expected to remain on an upward trend, steps have been taken by the state to ameliorate growth.

During the course of FY 2005, the city has benefited from a number of state initiatives. As shown in the figure to the right, the most notable initiative was the state's takeover of the Family Health Plus program. Beginning in January 1, 2005, the state began its takeover of 50 percent of the city's cost for this program. As a result, the city projects a savings of \$77.5 million in FY 2005 and significantly more in the future. Other savings derive from pharmaceutical and managed care cost containments. This was partially offset by \$52.3 million of additional costs and adjustments in the areas of long-term care and overall reestimates. The city expects to realize a net savings of \$30.5 million in FY 2005.

| Impact of State Initiatives to the City's Financial Plan in FY 2005 | |
|--|-----------------|
| (\$ in millions, in city funds) | |
| Savings | |
| Family Health Plus Takeover | (\$77.5) |
| Pharmaceutical Cost Containment | (4.7) |
| Managed Care | (0.6) |
| Subtotal | (\$82.8) |
| Additional Costs/Adjustments | |
| Nursing Homes | \$19.8 |
| Miscellaneous | 32.5 |
| Subtotal | \$52.3 |
| Net Savings | (\$30.5) |

Public Assistance

In the May modification to the financial plan, the city forecasts that the cost of Public Assistance (PA) is expected to be almost \$2.6 billion in FY 2005 and decreases by eight percent to approximately \$2.4 billion in FY 2009, as shown in Table 4. Meanwhile, costs in FY 2005 are estimated to increase by only \$30 million versus FY 2004 actual spending. The Department of Social Services remains the principal source of PA costs, averaging around 85 percent of PA's budget, while total PA costs represent over four percent of the city's total expense budget in a given year.

PUBLIC ASSISTANCE SUMMARY IN FY 2005

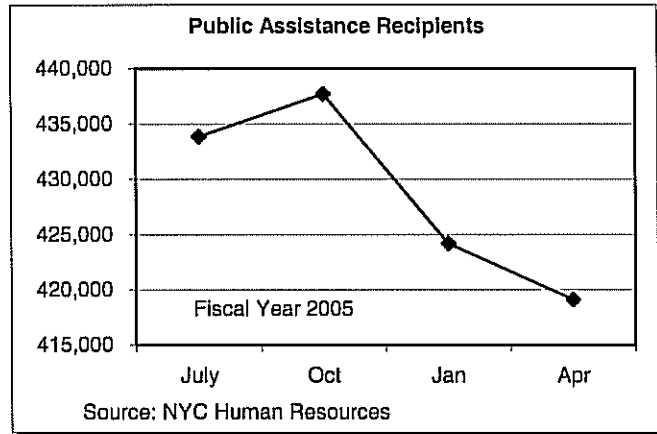
TABLE 4

(\$ in millions)

| Agency | Actual FY 2004 | Adopted Budget* | May Mod* | Change | Plan FY 2009 |
|--------------------------------------|----------------|-----------------|----------------|--------------|----------------|
| Department of Social Services | \$2,079 | \$1,972 | \$2,096 | \$124 | \$2,036 |
| Department of Homeless Services | 316 | 310 | 319 | 9 | 306 |
| Department Health and Mental Hygiene | 137 | 11 | 148 | 137 | 11 |
| Total | \$2,532 | \$2,293 | \$2,563 | \$270 | \$2,353 |

*Fiscal Year 2005

During the course of FY 2005, the city increased its estimate of PA spending by \$270 million, to nearly \$2.6 billion in the May modification, as shown in the table. A major portion (\$139 million) of the increase is due to the appropriation of the Ryan White grant. The Ryan White Comprehensive AIDS Resources Emergency Act is federal legislation that addresses the unmet health needs of persons living with HIV disease by funding primary health care and support services. The remainder of the increase can be attributed to re-estimates and overall operational adjustments by the Department of Social Services. Meanwhile, as shown in the figure to the right, total PA caseloads have steadily decreased since October 2004. In fact, from July to April, the decrease is over three percent. The 1996 Federal Welfare Reform legislation remains instrumental in supporting state and city management in reducing overall case loads and expenses since the mid-1990s.



Pension

Since the adopted budget, the city's anticipated pension contribution to its retirement system has risen modestly and calls for a FY 2005 contribution of \$3.2 billion. The city's contribution is expected to rise considerably in the outyears. The city expects that in FYs 2006-09 pension costs will increase by \$649 million, \$497 million, \$401 million, and \$272 million, respectively, thus costing the city almost \$4.6 billion by FY

2009. The rise in costs is attributed mainly to the cost of anticipated changes to actuarial assumptions and the reconciliation in the accounting for approximately 1,000 teachers.

Each fiscal year the city is required to appropriate funding to meet a normal contribution and, in addition, fund any investment losses that the system may have incurred. In recent years, the major contributor to rising pension costs has been investment losses.

Although losses are still being phased in, much of this fiscal year's reestimate is due mainly to the impact of an actuarial adjustment of \$144 million, as shown in the figure to the right.

| FY 2005 Adopted vs. May Modification (\$ in thousands) | |
|---|--------------------|
| Adopted Budget | \$3,203,871 |
| Actuarial Adjustment | \$144,000 |
| Investment Fee Increase | 27,000 |
| Collective Bargaining | 2,354 |
| Timing Adjustment | (94,197) |
| Investment Gains | (59,000) |
| Other Adjustments | (13,122) |
| Net Change | \$7,035 |
| May Modification | \$3,210,906 |

The City Actuary has presented a package of actuarial assumptions and methods to the retirement systems that would defer pension costs of \$900 million in FYs 2005-07, if approved.⁴ The city has chosen to only recognize projected increases in costs as presented in the package, starting in FY 2006, and not incorporate any potential deferment that requires the approvals of the review boards and/or the state legislature. If the boards choose to accept the entire package of recommendations and the city obtains all necessary state approvals, then pension costs may be reduced. Alternatively, costs may rise even further if the expected return on asset investment is not realized. In addition, increased investment fees and expected collective bargaining costs have also added to pension costs, however, those increases were offset by a timing adjustment in collective bargaining of \$94 million and the phase-in of investment gains of \$59 million.

FY 2005 Agency Program

In April of 2004, the city's Office of Management and Budget created a new agency reduction program of \$324 million for FY 2005. With the January modification the city increased this program to over \$422 million. This program incorporated many initiatives designed to either reduce spending or increase revenues at the agency level. As shown in the figure to the right, over \$417 million of these efforts are considered to be fully implemented, while \$5 million have been restored.

| The City's FY 2005 Agency Reduction Program (\$ in millions) | | |
|---|--------------------|-----------------|
| <u>Department</u> | <u>Implemented</u> | <u>Restored</u> |
| Police | (\$135.5) | |
| Sanitation | (34.5) | |
| Fire | (24.6) | |
| Transportation | (22.5) | |
| Housing Pres. & Dev. | (19.3) | |
| Correction | (14.2) | (\$5.0) |
| Finance | (18.1) | |
| Children's Services | (17.6) | |
| Citywide Services | (14.1) | |
| Other | (117.3) | |
| Total | (\$417.7) | (\$5.0) |

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

⁴ A complete explanation of the actuarial package can be viewed in the March 2005 FCB Staff Report "Pension Costs" starting on page 25.

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

Of the most recently implemented initiatives, the largest was \$18.8 million by the Department of Sanitation which received an additional reimbursement for the closure of the Fresh Kills landfill. The funds were received from the New York State Department of Environmental Conservation. The Department of Homeless Services saved \$13 million through the restructuring and streamlining of its Employment Services function.

The one restoration was by the Department of Correction which had planned to save \$5 million in overtime. This savings assumed a seven percent annual attrition rate which is now projected at ten percent.

Debt Service Savings

FY 2005 debt service costs for the city, the New York City Transitional Finance Authority (NYCTFA), and the Municipal Assistance Corporation (MAC), excluding the effects of prepayments, have decreased by \$92 million since the budget was adopted last June. The debt service projection for FY 2005 totals \$4.2 billion and reflects an increase of \$141 million over the amount in FY 2004. However, debt service will represent a smaller percentage of tax revenues in FY 2005, at 13.7 percent, than in FY 2004 when it was 14.4 percent. This is because the FY 2005 tax revenue projection of \$30.7 billion is \$2.4 billion higher than the amount collected in FY 2004. Thanks to a robust economy, the debt service burden in FY 2005 will be the lowest of the most recent ten years. Then again, this burden is expected to climb to over 17 percent by FY 2009, as debt service is forecasted to grow at a faster rate than tax revenues.

While debt service has been reduced over the fiscal year, it could have been higher had the city not incorporated conservative interest rate assumptions that provided savings used to offset an unbudgeted charge for MAC debt service costs. Specifically, the city and the NYCTFA realized \$220 million of debt service savings that more than offset an increase in MAC debt service of \$128 million.⁵

Most of the savings were generated from variable rate debt. The city has a total of \$5.7 billion of variable rate debt outstanding; and the NYCTFA has a total \$3 billion outstanding. The city and the NYCTFA project interest rate savings averaging three percentage points on variable rate debt compared to fixed rate debt. The rates the city realized in FY 2005 were considerably lower than assumed. The conservative forecast is

⁵ The city had assumed that a sale of bonds to defease MAC debt was to have taken place in FY 2004 and would have resulted in city sales tax revenue no longer being needed to pay FY 2005 MAC debt service. The sale was ultimately postponed to October 2004, requiring the use of city sales tax revenue to pay \$128 million of MAC debt service for FY 2005.

reasonable in light of the nature of variable rate debt, which is that the rates can rise and even exceed those of fixed rate bonds.

In general, FY 2005 has been a banner year for the cost of borrowing on city fixed rate bonds. Even before the city received rating upgrades from Moody's Investors Service on April 4th and the Standard and Poor's Corporation on May 17th, its cost of borrowing relative to certain indices had been declining. The city's credit ratings are now at their highest level ever. The g.o. bonds are rated A1 by Moody's Investors Service, A+ by the Standard and Poor's Corporation, and A+ by FitchRatings.

The city also eliminated \$40 million of interest expense by foregoing short-term borrowing in FY 2005. Traditionally, the city sells notes in the fall to even out its cash flow. Fortunately, the city had ample cash on hand during the course of the fiscal year to satisfy its expense obligations.

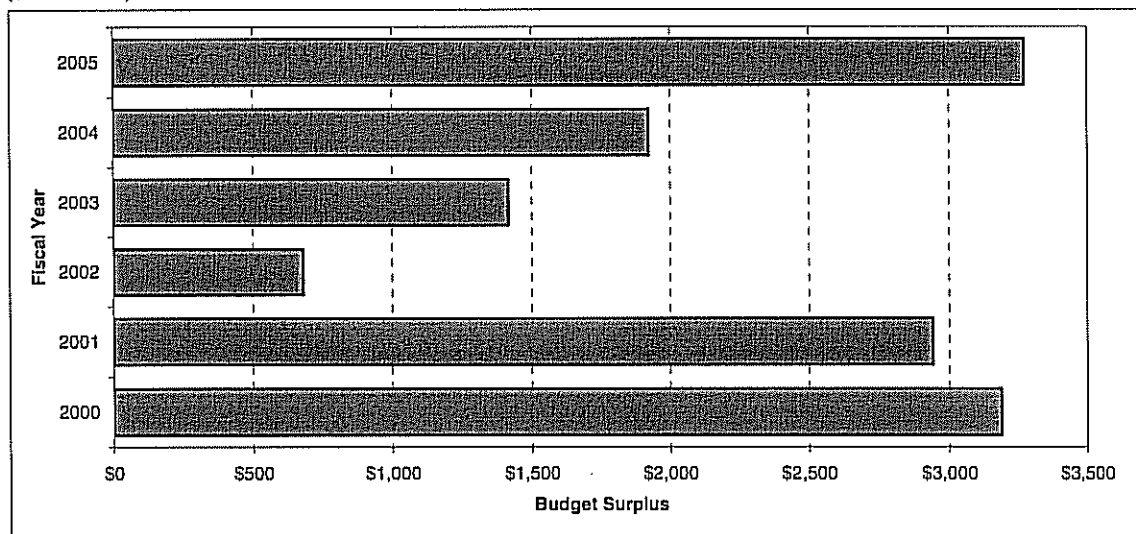
THE FY 2005 BUDGET SURPLUS

With the surge in tax revenues and nonrecurring resources, the city is projecting that it will end FY 2005 with a record surplus of \$3.3 billion. At this level, the budget balance would be \$1.3 billion larger than the FY 2004 surplus used to support the current year's expenses. The city plans to apply the entire FY 2005 surplus to support FY 2006 spending, effectively choosing to delay taking measures to deal with an expected FY 2007 budget gap of \$4.5 billion.

AFTER SHRINKING PRECIPITOUSLY IN FY 2002, THE BUDGET SURPLUS HAS GROWN TO A RECORD LEVEL IN FY 2005

CHART 1

(\$ in millions)



As can be seen in Chart 1, the budget surplus has been increasing since FY 2003, the year after the surplus shrank precipitously by \$2.3 billion. The current-year surplus is projected to exceed the previous record surplus of \$3.2 billion realized in FY 2000. The magnitude of the current-year surplus is largely reflective of a revived economy, with

revenue collections having surged well beyond anticipation. Unfortunately, economic swings can be sudden and dramatic, as was the case after September 11, 2001 when most of the prior-year's surplus had to be absorbed to stabilize the budget.

The thriving economy provides an opportunity for the city to use the windfall to build its budget stabilization account to support budget balance for a future time when the financial health of the city recedes unexpectedly. However, the city is choosing to draw down the full amount of these resources to close the known FY 2006 budget gap, thereby eliminating the fiscal cushion for the eventuality of a sudden economic downturn. If the city instead were to choose to adopt gap-closing actions that produce recurring resources and/or savings, it would get a head start on addressing the looming \$4.5 billion budget gap projected for FY 2007.

MAJOR ONE-SHOTS

During FY 2005 the city successfully completed two difficult initiatives to realize \$1.4 billion in nonrecurring resources from airport rental arrears and a debt refinancing, while at the same time, an increase in tax revenues allowed a \$3.3 billion surplus to be created within the year. In its current plan, the city intends to use all of the funds to prepay FY 2006 expenses. The difference between the flow of \$1.9 billion from FY 2004 into FY 2005 and the planned movement of \$3.3 billion from FY 2005 into FY 2006 is a negative \$1.3 billion. In this case, the negative sign means that more nonrecurring resources are expected to be moved out of FY 2005 than remain in the year.

The city typically generates about \$500 million to \$1 billion annually in one-time resources to bridge the gap between recurring revenues and expenditures. One-time resources include debt service refundings, asset sales (financial and physical), and payments from state and federal entities. As seen in the figure to the right, the city generated a total of \$1.9 billion in nonrecurring resources in FY 2005. Nearly three-quarters of the \$1.9 billion total originates from just two initiatives—airport rental arrears (\$782 million) and refinancing of Municipal Assistance Corporation (MAC) debt (\$631 million).

| Nonrecurring Resources in FY 2005 (\$ in millions) | |
|---|----------------|
| Airport Rental Arrears | \$782 |
| MAC Refinancing | 631 |
| Asset Sales | 177 |
| Debt Service Savings | 171 |
| Expenditure Savings | 87 |
| Other Revenues | 84 |
| Resources Generated | \$1,932 |

For over a decade, the city and the Port Authority negotiated the amount of annual rent and arrears payments that the city should receive from the Port Authority for the operation of Kennedy and LaGuardia airports. Under the old lease agreement, the city was guaranteed annual rent of \$3.5 million from 1998 to 2015. In November 2004, the Governor and the Mayor announced a new lease agreement that included \$782 million of arrears payments and a higher base rent of \$93.5 million annually starting in FY 2006. The refinancing of MAC debt was completed in October 2004 when the city's Sales Tax Asset Receivable Corporation sold \$2.55 billion of bonds in order to pay the principal and interest of outstanding bonds issued by MAC in the 1970s and reimburse the city for \$631 million retained by MAC since July 1, 2003 for its debt service. It took over a year for the city to receive the funds because of ongoing legal action that ended after the New York Court of Appeals upheld the constitutionality of state legislation permitting the refinancing.

It is important to note how long and involved the process became before the city successfully completed these two initiatives and that the \$1.4 billion will need to be replaced next year with recurring revenue streams. The remaining \$519 million of nonrecurring actions generated by the city in FY 2005 include \$177 million of asset sales (primarily sales of taxi medallions, parcels of land, and mortgages), debt service savings (\$171 million), various expenditure savings (\$87 million), and a refinancing by the Battery Park City Authority (\$54 million).

Glossary of Acronyms

| | |
|-------------------|--|
| FCB | Financial Control Board |
| FEMA | Federal Emergency Management Agency |
| FY | Fiscal Year |
| G.O. Bonds | General Obligation Bonds |
| IGA | Intergovernmental Aid |
| MA | Medical Assistance |
| MAC | Municipal Assistance Corporation |
| NYCTFA | New York City Transitional Finance Authority |
| OT | Overtime |
| OTPS | Other than Personal Service |
| PA | Public Assistance |
| PIT | Personal Income Tax |
| PS | Personal Service |