# Review of the Financial Plan of the City of New York

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- **The City has closed a $3.8 billion budget gap for FY 2008 and has narrowed the FY 2009 budget gap by $2 billion from $4.6 billion to $2.6 billion.**
- **The City expects to realize net unanticipated resources of $7 billion over the course of fiscal years 2007 and 2008 when compared with the estimates in the July 2006 Financial Plan.**
- **Tax collections are now expected to exceed the estimates in the July 2006 Plan by $13.5 billion during fiscal years 2007 through 2010.**
- **Real property tax collections are forecast to grow from $12.5 billon in FY 2006 to $17.5 billion by FY 2011. Since FY 2000, citywide market values have more than doubled.**
- **In 2006, the City added 54,200 jobs, and wages grew by 8.4 percent—the largest gains since 2000. The unemployment rate declined to 5 percent—the lowest level on record.**
- **Wall Street profits reached $16.8 billion in 2006—the second-best year on record—and bonuses totaled $23.9 billion—the highest ever.**
- **Spending on nondiscretionary items (e.g., debt service and pension contributions) is projected to consume 49 percent of City fund revenues by FY 2009, compared with 37 percent in FY 2003.**
- **Debt service will grow by 60 percent between fiscal years 2006 and 2011, and will consume 13.7 percent of City fund revenues by FY 2010.**
- **The rapid growth in pension contributions over the past seven years will level off in FY 2010, but the annual contribution will remain at a high level—$6 billion, or four times larger than the average contribution during the 1990s.**
- **The City contributed $1 billion to a Retiree Health Benefits Trust Fund in FY 2006, and intends to contribute an additional $1 billion in FY 2007 and $500 million in FY 2008.**
- **Some City-related public authorities, such as the Housing Authority and the Health and Hospitals Corp., continue to face financial difficulties.**

A resilient real estate market and record Wall Street profits and bonuses continue to push tax collections far beyond the City's expectations. The revised four-year financial plan released by the Mayor on January 26, 2007 (the "January Plan"), projects a surplus of $3.9 billion for FY 2007—twice the projection in the November 2006 Plan, and higher than last year's record of $3.8 billion.

Last year the City prudently used the surplus and other unanticipated resources to improve its fiscal position and to provide financial assistance to City-related public authorities. So far this year, the City has recognized $7 billion in unanticipated resources for this year and next year, and the Mayor has proposed using these resources in similarly prudent ways.

Specifically, the Mayor would use $3.8 billion to balance the FY 2008 budget; $1.4 billion to narrow the FY 2009 budget gap; $1 billion to reduce the City's tax burden; $500 million to help pay down the unfunded cost of post-employment benefits; and nearly $300 million to leverage additional federal assistance to help balance the budget of the Health and Hospitals Corporation.

The January Plan also reflects the Mayor's proposal to increase education funding by $2.2 billion over the next four years. The Governor's proposed financial plan, which was released on January 31, 2007, would increase education aid to New York City by $3.2 billion during the same period. The combined increase of $5.4 billion would be more than twice the minimum amount recently ordered by the New York State Court of Appeals, which concluded the longstanding Campaign for Fiscal Equity lawsuit.

For next year, the Governor has proposed increasing education aid to New York City by $637 million. His proposed budget, however, includes recommendations that would adversely affect other parts of the City's budget by

$691 million over the course of this year and next year. Most of the negative impact would come from the elimination of revenue-sharing payments to New York City. To help the State balance its own budget and to mitigate the impact on the City's budget, the Governor has proposed closing certain corporate tax loopholes.

If all of the Governor's proposals are approved by the State Legislature, the City will realize a large increase in education aid next year but other parts of the City's budget will experience a net loss of $317 million over the course of this year and next year.

**Figure 1**
**OSDC Risk Assessment of NYC Financial Plan**
(in millions)

| | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 |
|---|---|---|---|---|---|
| | | | *Better/(Worse)* | | |
| **Gaps Per November Plan** | **$ - - -** | **$ - - -** | **$ (2,617)** | **$ (3,681)** | **$ (3,621)** |
| Tax Revenues | 400 | 250 | - - - | - - - | - - - |
| Hiring Delays | 15 | - - - | - - - | - - - | - - - |
| Uniformed Agency Overtime | - - - | (75) | (75) | (75) | (75) |
| **OSDC Risk Assessment** | **$ 415** | **$ 175** | **$ (75)** | **$ (75)** | **$ (75)** |
| **Gaps to be Closed** | **$ 415** | **$ 175** | **$ (2,692)** | **$ (3,756)** | **$ (3,696)** |
| **Additional Risks or Offsets[1]** | | | | | |
| State Budget Proposals[2] | (349) | 32 | 29 | 30 | 30 |
| Anticipated Federal Education Aid | (20) | (55) | (102) | (104) | (104) |
| Wage Increases at Inflation | - - - | (35) | (160) | (380) | (620) |
| Tax Reduction Proposals That Require State Approval | - - - | 548 | 593 | 621 | 667 |

[1] The Plan includes a general reserve of $100 million in FY 2007 and $300 million thereafter.
[2] The Governor's financial plan also would increase education aid to New York City by increasing amounts over the next four years.

Recent developments in the international financial markets are a reminder of the City's heavy reliance on Wall Street. Fortunately, the January Plan is premised on conservative economic and revenue assumptions, which would mitigate any adverse impact on the City's budget. In the short term, tax collections are still likely to be higher than forecast by the City because the City's economy remains strong. These additional revenues could ease the short-term budgetary impact of the Governor's proposals as well as other budget risks identified during the course of our review of the January Plan (see Figure 1).

The strength of the local economy over the past few years has enabled the City to balance the budget and narrow the out-year budget gaps while also supporting relatively rapid growth in spending. In the past six months alone, the City has closed a $3.8 billion budget gap for FY 2008, and has narrowed the FY 2009 budget gap from $4.6 billion to $2.6 billion—all while proposing significant tax cuts.

Closing future budget gaps—especially in the event of a downturn in the business cycle—may prove more difficult than in recent years because by FY 2009 nearly half of City fund revenues will be needed to fund nondiscretionary spending, such as debt service and pension contributions. During the current economic expansion the City has prudently increased its reserves to record levels, which would help mitigate the impact of any short-term adverse development.

## Economic Trends

The City's economy has remained strong, with employment and income growth propelled by high Wall Street and corporate profitability, a booming commercial real estate market, and a vibrant tourism sector. Weakness in the national economy, especially in the housing sector, has not yet had a significant impact on the City.

The January Plan, however, assumes that the City's economy will weaken in calendar years 2007 and 2008, as higher interest costs and a national slowdown take their toll on the City's financial and housing markets. Global Insight, a major economic forecasting service, also projects a slowdown in the City's economy, but expects slightly stronger growth than the City does.

The City's major economic assumptions follow.

- Wall Street profits will decline from $16.8 billion in 2006—the second-best year on record (see Figure 2)—to $14.3 billion in 2007 and then to $10.7 billion in 2008. (According to our estimates, Wall Street bonuses reached $23.9 billion in 2006, a new record.)
- The City added 54,200 jobs in 2006, but will add only about half that amount during 2007 and 2008.
- Wage growth will slow from 8.4 percent in 2006 to 5.1 percent in 2007 and then to 0.9 percent in 2008, due to the slowdown in job growth and decline in Wall Street profits.

- Local home sales will drop by 7 percent in 2007 and by another 3 percent in 2008, and prices will drop by 4 percent in each of those years. Sales volume and prices will begin to rebound in 2009.
- The commercial real estate market will remain strong, with lower vacancy rates and higher rental rates throughout the plan period.
- Inflation will moderate and remain subdued throughout the plan period.

Recent data show that the national Gross Domestic Product rose by 3.3 percent in 2006, although growth was considerably weaker during the second half of the year. Energy prices have dropped and the latest forecasts show that the national housing slowdown may be ending. Inflation, although easing, still stands a little higher than the Federal Reserve has targeted.

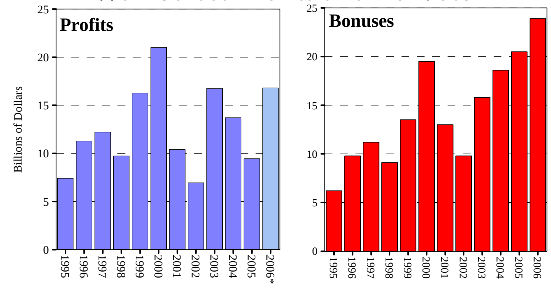
Preliminary data show the City added 54,200 jobs in 2006—the largest gain since 2000 and the seventh-best increase since the 1970s fiscal crisis (see Figure 3). Wall Street, business services, trade, health care, restaurants, and hotels (virtually all the major sectors except manufacturing) all gained jobs. Strong job growth helped push the City's unemployment rate to a record low of 5 percent.

The City's commercial real estate market is thriving. The vacancy rates for prime commercial properties continue to fall and rental rates continue to rise (see Figure 4). Building sale prices are also reaching new records. While the local residential real estate market has softened, it has performed better than the national housing market.

In 2006, the number of visitors traveling to the City set a new record high of 44 million, including 7 million from overseas (see Figure 5). Tourists spent an estimated $24 billion boosting hotel occupancy rates and room rates, generating strong retail sales, and filling Broadway theaters and other attractions. The weak dollar will continue to attract overseas visitors in 2007.

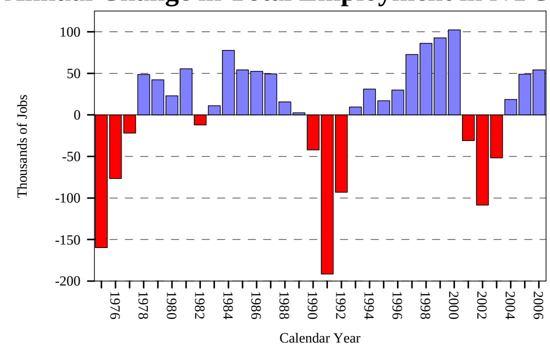
Despite the current strength of the local economy, risks do exist. Although it is too early to predict the implications that recent developments in the financial markets might have on our national and local economies, such events are a reminder of the City's dependence on Wall Street. In addition, consumer credit delinquencies have begun to rise and the real estate market may weaken.

**Figure 2**
**Wall Street Profits and Bonuses**



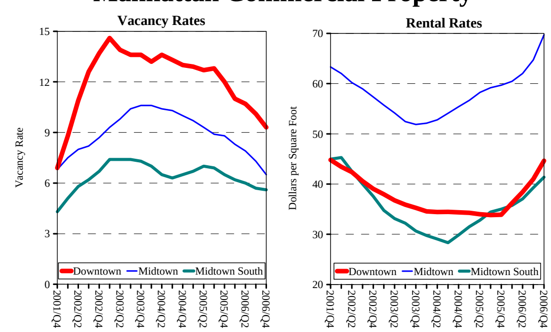

*2006 profits are a City forecast.
Notes: Bonuses are OSDC estimates. Profits are for broker/dealer operations of NYSE member firms.
Sources: NYS Department of Labor; New York Stock Exchange; Securities Industry and Financial Markets Association; OSDC analysis

**Figure 3**
**Annual Change in Total Employment in NYC**



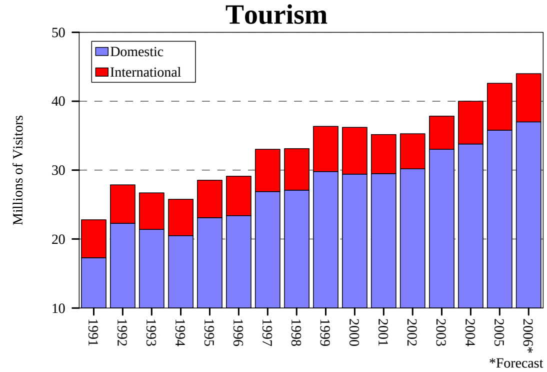

Sources: NYS Department of Labor; OSDC analysis

**Figure 4**
**Manhattan Commercial Property**




Note: Data is a four-quarter moving average for premium (Class A) commercial space.
Sources: Colliers ABR; OSDC analysis

**Figure 5**
**Tourism**




Source: NYC & Company

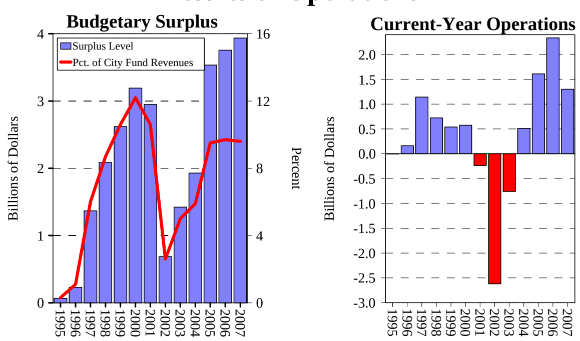
## Annual Operating Results

The City ended FY 2006 with a reported surplus of $3.8 billion, which was the largest on record (see Figure 6). Moreover, this excludes $2.6 billion in resources that were used by the City to fund the Retiree Health Benefits Trust Fund (RHBTF) and other discretionary initiatives that improved the City's fiscal position or assisted City-related public authorities. By our estimation, the City generated $6.4 billion in unanticipated resources during FY 2006 after covering obligatory liabilities—a remarkable achievement.

Continued strength in the real estate market and extraordinary Wall Street profits, as well as conservative revenue forecasts, have combined to produce a projected surplus for FY 2007 of $3.9 billion—which exceeds last year's record.

**Figure 6**

**Results of Operations**




Sources: NYC Office of Management and Budget; NYC Comptroller; OSDC analysis

The Mayor intends to transfer these resources to FY 2008 by prepaying debt service and other obligations, continuing a practice the City has followed since FY 1982. The transfer of resources between years, however, masks the relationship between recurring revenues and expenditures. We believe a more accurate picture of the City's fiscal condition is obtained by examining the results of current-year operations—the difference between revenues and expenditures in the current year.

As shown in Figure 6, the City posted current-year deficits during each of fiscal years 2001 through 2003, with the deficit reaching a peak of $2.6 billion in FY 2002. The deficits were caused by the rapid onslaught of the recession that began in March 2001, and the economic impact of the terrorist attacks on the World Trade Center.[1]

[1] To balance the budget in those years, the City relied on surplus resources from prior years and $2 billion in bond proceeds from the Transitional Finance Authority.

Last year, the City posted a record current-year surplus of almost $2.4 billion, including $1 billion that was deposited in the RHBTF and another $1.1 billion that was used to improve the City's fiscal position in other ways. This was a reversal of nearly $5 billion in only four years, and reflected the rapid improvement in the local economy and the impact of budgetary actions taken by the City and the State. The City is on track to end FY 2007 with a current-year surplus of $1.3 billion, including $1 billion that will be deposited in the RHBTF.

## Revenue and Expenditure Trends

As shown in Figure 7, the City has realized unanticipated resources of $7 billion for fiscal years 2007 and 2008 (compared with the forecasts in the July 2006 Plan), even after funding a new round of collective bargaining and other needs.

The Mayor has proposed using these resources to close a $3.8 billion budget gap that had been projected for FY 2008; narrow the FY 2009 budget gap by $1.4 billion; fund $1 billion in new tax reduction initiatives; contribute $500 million to the City's Retiree Health Benefits Trust Fund; and allocate $300 million to facilitate a $1.4 billion federal supplemental Medicaid payment to the Health and Hospitals Corporation.

### *Revenue Trends*

Since the beginning of the fiscal year, the City has raised its forecast of City fund revenues by $3.7 billion for FY 2007. More than $3 billion of this amount is expected to come from business taxes ($1.2 billion), taxes on real estate transactions ($1.1 billion), and personal income taxes ($752 million). Revenues are now forecast to grow by 6.4 percent in FY 2007 rather than fall by 2.9 percent as assumed in the July Plan.

The City also significantly raised its revenue forecast for FY 2008—by $3.9 billion. Many of the factors that guided the revisions for FY 2007 will have a recurring impact; also, the January Plan assumes that real property tax collections will be much higher than anticipated in the July Plan based on stronger growth in assessed values.

Despite these much higher revenue forecasts, the City's forecasts are based on conservative economic assumptions. The January Plan assumes that City fund revenues will increase by only 1.0 percent in FY 2008 and 1.8 percent in FY 2009, and then increase by about 5 percent in each of fiscal years 2010 and 2011.

**Figure 7**
**Financial Plan Reconciliation**
**July 2006 Plan vs. January 2007 Plan**
(in millions)

| | *Better/(Worse)* | | | |
|---|---|---|---|---|
| | **FY 2007** | **FY 2008** | **FY 2009** | **FY 2010** |
| **Surplus/(Gaps) Per July 2006 Plan** | **- - -** | **$ (3,810)** | **$ (4,584)** | **$ (4,069)** |
| **Revenues** | | | | |
| Real Estate Transaction Taxes | $ 1,127 | $ 902 | $ 734 | $ 714 |
| Business Taxes | 1,237 | 1,122 | 752 | 824 |
| Personal Income Taxes | 752 | 789 | 409 | 350 |
| Real Property Taxes | (31) | 389 | 882 | 1,333 |
| All Other Taxes | 382 | 411 | 236 | 238 |
| **Subtotal** | **3,467** | **3,613** | **3,013** | **3,459** |
| Non-Tax Revenues | 205 | 241 | 27 | 25 |
| **Total** | **3,672** | **3,854** | **3,040** | **3,484** |
| **Expenditures** | | | | |
| Collective Bargaining | (296) | (568) | (880) | (1,055) |
| Education | (47) | (60) | (58) | (420) |
| Pension Contributions | 25 | 44 | (164) | (185) |
| Debt Service | 166 | 175 | 165 | 202 |
| General Reserve & Savings from Prior Payables | 600 | - - - | - - - | - - - |
| Other Agency Expenses | (183) | (357) | (365) | (405) |
| **Total** | **265** | **(766)** | **(1,302)** | **(1,863)** |
| **Net Change During FY 2007** | **$ 3,937** | **$ 3,088** | **$ 1,738** | **$ 1,621** |
| Tax Reduction Program | - - - | (1,042) | (1,147) | (1,233) |
| Retiree Health Benefits Trust Fund | - - - | (500) | - - - | - - - |
| Health and Hospitals Corporation | - - - | (297) | - - - | - - - |
| Surplus Transfer from FY 2007 to FY 2008 | (3,937) | 3,937 | - - - | - - - |
| Surplus Transfer from FY 2008 to FY 2009 | - - - | (1,376) | 1,376 | - - - |
| **Surplus/(Gaps) Per January 2007 Plan** | **$ - - -** | **$ - - -** | **$ (2,617)** | **$ (3,681)** |

Sources: NYC Office of Management and Budget; OSDC analysis

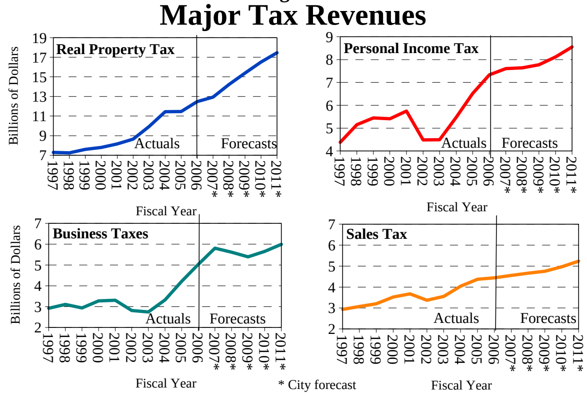
The January Plan also assumes that growth in tax revenues will slow from 6.1 percent in FY 2007 to about 2.5 percent in each of fiscal years 2008 and 2009. Our analysis indicates that tax collections could still exceed estimates, by $400 million in FY 2007 and another $250 million in FY 2008.

The January Plan is premised on the following major revenue assumptions.

- Real property tax collections will rise at a rapid rate during the financial plan period based on increases in assessed values over the past few years. (Since FY 2000, citywide market values have more than doubled.) Property tax collections will grow from $12.5 billon in FY 2006 to $17.5 billion by FY 2011 (see Figure 8), excluding the impact of the proposed tax reduction program.

  In recent years, market values have increased at a faster rate than assessments because State law limits the growth in assessed values for one-, two-, and three-family homes; it also phases in (over a five-year period) increases for other residential properties and most commercial properties.[2] As a result, a record $22 billion pipeline of assessment increases is now waiting to be phased in, which will help sustain revenue growth despite lower projected growth in real property values.

**Figure 8**
**Major Tax Revenues**



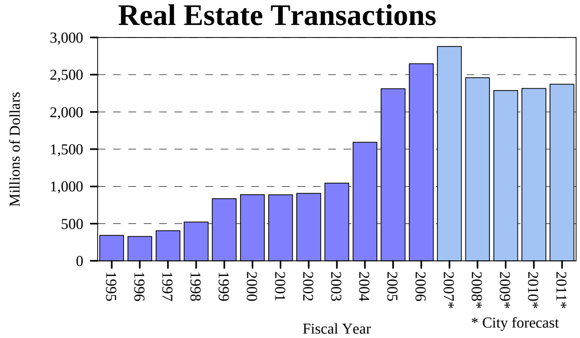

Note: Excludes impact of proposed tax reduction program.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

[2] According to the tentative tax roll for FY 2008, market values increased by 19 percent, but State law limited the increase in assessments to 8.9 percent.

- Personal income tax collections will total $7.6 billion in FY 2008 (essentially unchanged from the FY 2007 level), and then increase by only 1.7 percent in FY 2009 (see Figure 8). These rates of growth are much slower than in recent years, when collections were boosted by record Wall Street bonuses and large increases in capital gains realizations. The City also expects a slowdown in wage growth and a slight decline in capital gains realizations.
- Business tax collections will decline by 3.3 percent in FY 2008 to $5.6 billion (see Figure 8)—a stark reversal from the 15.4 percent increase projected for FY 2007. The January Plan assumes that the slowdown will continue into FY 2009, with collections declining by another 4 percent.
- Collections from taxes on real estate transactions will reach $2.9 billion in FY 2007—$1.1 billion more than anticipated—but will decline next year by $421 million, or 14.6 percent (see Figure 9). The January Plan assumes that collections will decline by another 7 percent in FY 2009 before growth resumes in FY 2010.

**Figure 9**

**Tax Collections From Real Estate Transactions**




Note: Collections include the mortgage recording and real property transfer taxes.
Sources: NYC Office of Managment & Budget; OSDC analysis

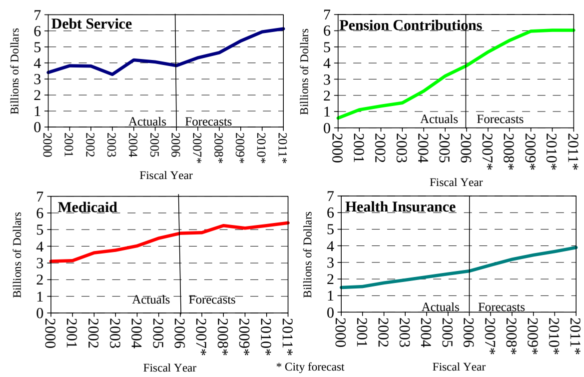
## *Expenditure Trends*

City-funded expenditures are projected to increase by 5.9 percent in FY 2008, which is nearly three times the projected rate of inflation. The relatively rapid rate of growth comes on top of a 6.9 percent increase in FY 2007.

Spending in these years will be driven by rising debt service, pension contributions, and health insurance costs, and the cost of actual and anticipated collective bargaining agreements. Medicaid is no longer expected to be a major factor in the growth in City-funded expenditures because the State capped the growth in the local share of Medicaid to 3 percent per year (see Figure 10). The growth in spending is projected to slow down to about 4 percent per year during fiscal years 2009 through 2011, with some easing in the growth of pension contributions and debt service. Nevertheless, spending on these and other nondiscretionary items is projected to consume 48.5 percent of City fund revenues by FY 2009, compared with 36.8 percent in FY 2003.

**Figure 10**

**Trends in Selected Expenditure Categories**




Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC analysis

The January Plan is premised on the following major expenditure assumptions.

- Salaries and wages will total $12 billion in FY 2008, and then grow at about 5 percent annually through FY 2011, reflecting the cost of actual and anticipated labor agreements.
- Overtime in the uniformed agencies will reach $702 million in FY 2007, which is $132 million more than assumed in the July Plan. Most of the increase is attributable to the Police Department, which in January authorized higher overtime spending. The January Plan assumes that overtime will decline in subsequent years, but we estimate that these costs are likely to be higher by $75 million annually.
- Medicaid will total $5.2 billion in FY 2008, an increase of 8.9 percent. Although a State cap limits the growth in the local share of Medicaid to 3 percent, the City is allocating additional resources so the Health and Hospitals Corporation (HHC) can obtain a $1.4 billion supplemental federal Medicaid payment, similar to an action taken by the City last year.
- Debt service will increase by 7.5 percent in FY 2008, to $4.6 billion, and will rise by another 28 percent over the two following

fiscal years. Debt service is projected to reach $6.1 billion by FY 2011.

- Pension contributions will grow from $1.5 billion in FY 2003 to $6 billion by FY 2009, and then level off in FY 2010. The rapid rate of growth is primarily due to pension fund investment shortfalls during fiscal years 2001 through 2003; benefit enhancements; and recent labor settlements. The January Plan also sets aside $200 million in each of fiscal years 2009 through 2011 to implement the recommendations contained in a City Charter–mandated biennial audit.
- Health insurance costs will increase from $3.2 billion in FY 2008 to $3.9 billion in FY 2011—an average annual growth rate of 7 percent—reflecting anticipated increases in insurance premiums.
- Low natural gas prices and unseasonably warm weather held down the growth of energy costs to 6.5 percent in FY 2007. The January Plan assumes that energy costs will rise by another 6 percent in 2008 and then remain level in subsequent years.
- The cost of judgments and claims will grow from $635 million in FY 2008 to $795 million in FY 2011, including costs associated with HHC. The January Plan assumes that no liability will arise from the cleanup of the World Trade Center site or from the Staten Island Ferry crash. A federal judge, however, has rejected the City's attempt to cap its liability from the ferry crash at $14.4 million.
- Public assistance costs will decline slightly, to about $450 million, in FY 2008, and will remain at that level in subsequent years. Caseload is projected to remain stable at about 373,000 persons during the plan period.
- The City-funded workforce will grow by 2,890 employees during FY 2007, with most of the planned additions in social services agencies, and essentially remain at that level during FY 2008. The mayoral agencies were below planned levels in December 2006 by 2,032 employees, mostly in the Department of Social Services (DSS). As the DSS is unlikely to fill all of its vacancies, the City could realize savings of $15 million in FY 2007.

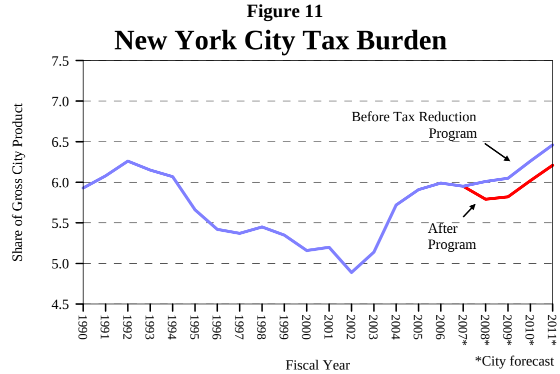
## The Mayor's Tax Reduction Program

The Mayor has proposed a tax reduction program valued at $1.3 billion in FY 2008 that would grow in value to nearly $1.6 billion by FY 2011. The program is designed to ease the growing tax burden on home owners and businesses in New York City and to improve the City's competitiveness with surrounding areas. The City has the authority to reduce real property tax rates, but other elements of the proposed program, valued at a total of about $600 million annually, require State approval.

The local tax burden (i.e., City tax revenues as a percentage of the gross city product) declined from 6.3 percent in FY 1992 to 4.9 percent in FY 2002, as a result of enacted tax cuts and the economic impacts of the recession that began in March 2001 and the attacks on the World Trade Center. Since then, the burden has been rising, primarily because of a hike in property tax rates in January 2003, temporary increases in sales and personal income taxes that became effective in July 2003, and a surge in real estate transactions.

The Mayor's tax reduction proposals would cut the tax burden in fiscal years 2008 and 2009, and while the burden would still grow in subsequent years, it would be lower than previously forecast (see Figure 11). The Governor, however, has proposed closing tax loopholes that would increase the tax burden on certain corporations, with most of the revenue expected to come from businesses operating in New York City.

**Figure 11**




Note: Tax burden is calculated as the ratio of all taxes to gross city product.
Sources: NYC CAFR, NYC Office of Management and Budget; OSDC analysis

The annual values of the Mayor's tax reduction proposals are shown in Figure 12. A discussion of the initiatives follows.

***Property Tax Rate:*** Reduce the average property tax rate by 5 percent. The average owner of a one-, two-, or three-family home (i.e., Class 1) would benefit by $170. The average owner of commercial property (i.e., Class 4) would benefit by $3,700. The benefit for Manhattan commercial and residential property owners would be much higher because the values of these properties are higher than the citywide average.

**Figure 12**
**Proposed Tax Reduction Program**
(in millions)

| | FY 2008 | FY 2009 | FY 2010 | FY 2011 |
|---|---|---|---|---|
| Property Tax Rate | $ 750 | $ 810 | $ 868 | $ 917 |
| Home Owner Rebate | 256 | 256 | 256 | 256 |
| Small Business Relief | 140 | 177 | 202 | 244 |
| Sales Tax on Clothing | 110 | 117 | 119 | 122 |
| Child Care Credit | 42 | 43 | 44 | 45 |
| **Total** | **$ 1,298** | **$1 ,403** | **$ 1,489** | **$ 1,584** |

Note: The home owner rebate was included in the July Plan.
Source: NYC Office of Management and Budget

***Home Owner Rebate:*** Continue the $400 home owner property tax rebate scheduled to end in FY 2007. In recent years, property taxes have grown because of the rapid increase in property values (not higher citywide tax rates), and residential property values are growing at a faster rate than commercial property values. Even with the combined benefit of a rate reduction and rebate, the average residential home owner in all boroughs will pay more property taxes next year than in the current year.

***Small Business Relief:*** Make several modifications to the general corporation and unincorporated business taxes, including raising credits and deductions, in order to reduce taxes on small businesses.

***Sales Tax on Clothing:*** Eliminate the City's sales tax on clothing purchases valued at more than $110. The State and City have already eliminated taxes on purchases valued at less than $110.

***Child Care Credit:*** Create a refundable credit targeted at families with children younger than 3 years old and incomes below $30,000. The credit would be a percentage of the State credit, with a maximum value of about $1,000, and would be phased out as incomes increased.

## Impact of the Governor's Budget

The Governor's proposed budget includes a number of ambitious proposals that would continue to restructure the financial relationship between the State and its localities, a process that began under his predecessor.

The Governor has proposed increasing State education aid to New York City by $637 million in FY 2008, but he has also proposed actions that would adversely affect other parts of the City's budget by $691 million over the course of this year and next year. Most of the negative impact would come from the elimination of revenue-sharing payments to New York City. To help the State balance its own budget and to mitigate the impact on the City's budget, the Governor has proposed closing certain corporate tax loopholes.

If all of the Governor's proposals are approved by the State Legislature, the City will realize a large increase in education aid next year but other parts of the City's budget will experience a net loss of $317 million over the course of this year and next year (see Figure 13).[3]

**Figure 13**
**Potential Impact of the**
**Governor's Budget Proposals**
(in millions)

| | | *Better/(Worse)* | | |
|---|---|---|---|---|
| | **FY 2007** | **FY 2008** | **FY 2009** | **FY 2010** |
| **Education Aid** | **$ - - -** | **$ 637** | **$ 1,400** | **$ 2,264** |
| **Impact on Other Parts of the City Budget** | | | | |
| Revenue Sharing | (328) | (328) | (328) | (328) |
| Other | (21) | (14) | (22) | (21) |
| Tax Loopholes | - - - | 374 | 379 | 379 |
| **Total** | **$ (349)** | **$ 32** | **$ 29** | **$ 30** |

Sources: NYS Division of the Budget; OSDC analysis

In subsequent years, the benefit of the Governor's proposals would grow from $1.4 billion in FY 2009 to $3.2 billion in FY 2011 because of planned increases in State education aid. The Governor's financial plan, however, projects out-year budget gaps that grow from $2.3 billion in SFY 2008 to $6.3 billion by SFY 2011. The Governor has not indicated how the State would balance the budget in those years, but future gap-closing programs could mitigate City gains in education aid in those years.

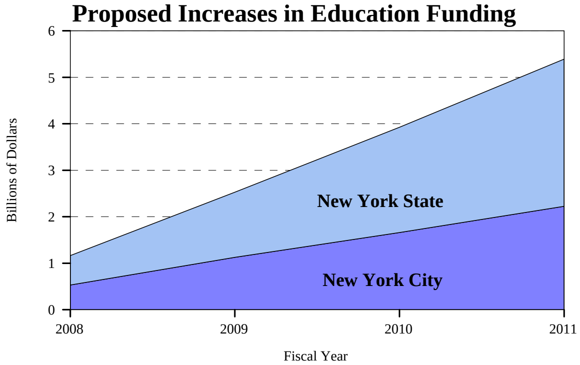
New York City will continue to benefit from State initiatives implemented in prior years; however, the recurring impact of these initiatives was previously reflected in the City's four-year financial plan. These initiatives include the State cap that limits the annual growth in the local share of Medicaid to 3 percent, and the State takeover of the local share of the Family Health Plus program, which together will benefit the City by $706 million in FY 2008.

[3] The State budget anticipates $428 million from the City for the State's role in certain transactions that benefited the City. The State and City are moving toward a resolution that would avoid an adverse impact on the City.

***Education Aid:*** The Governor would increase education aid statewide by $7 billion over the next four years, and would allocate $3.2 billion of that amount to New York City. When combined with the Mayor's commitment to increase education aid, funding to the City's public schools would rise by $5.4 billion over the next four years (see Figure 14), more than twice the minimum ordered by the State Court of Appeals when it decided the Campaign for Fiscal Equity lawsuit. Despite the proposed increase in State education aid, the City's share of statewide education aid would increase by only a small amount.

**Figure 14**

**Proposed Increases in Education Funding**




Sources: NYS Division of the Budget; NYC Office of Management and Budget

The Governor's budget shows an increase in education aid to the City of $637 million in FY 2008. This estimate, however, credits the State for funding the debt service on $1.8 billion in bonds issued by the Dormitory Authority of the State of New York for capital projects in the City (part of the resolution of the CFE litigation). Thus, the net benefit to the City Department of Education's operating budget equals $543 million. This still represents an increase of 8 percent over the current appropriation, and is substantially greater than last year's actual increment of $454 million, which was considered large.

***Revenue Sharing:*** The Governor would eliminate revenue-sharing payments to the City under the Aid and Incentives for Municipalities program and would redistribute the funds to localities in distress. In past years when the City had its own financial difficulties, the State advanced payments to the City, which allowed the City to recognize two payments in one fiscal year. If the Governor's proposal is enacted, the City will lose $328 million annually beginning in FY 2007.

***Tax Loopholes:*** The Governor would close certain corporate tax loopholes, which would generate $374 million for the City and another $450 million for the State, mostly from businesses operating in New York City. It remains to be seen whether revenues will materialize in the amounts forecasted by the State, and whether any economic impact is passed along to consumers.

***Other Budget Proposals:*** The Governor would increase the amount the State charges the City to administer the personal income tax by $30 million, to reach $70 million annually. In addition, the Governor has proposed tort reform and an exemption from the Wicks Law for City projects of up to $2 million. The City believes the benefit from the proposed change in the Wicks Law would be minimal because most construction projects in the City would exceed the threshold.

The Governor's budget also anticipates $950 million over three years from the conversion of the nonprofit health insurer HIP/GHI to a private, for-profit company. The Mayor opposes the conversion, which he believes could lead to less competition and even faster growth in health insurance premiums. Regardless, the Mayor believes that the proceeds could be higher and should be shared proportionally with the City.

***The Governor's Tax Reduction Program:*** The Governor would expand the existing School Tax Relief Program by $2.5 billion over the next three years (to $6 billion).[4] The new relief would be based on income, with the largest increases going to home owners with incomes at or below $60,000 ($80,000 in the downstate metropolitan area). New York City residents would receive only 14 percent of the benefit from this program.

In FY 2008, for those New York City residents with incomes of less than $80,000, married couples would benefit by an additional $240 and individuals would benefit by another $205, which would bring the total benefit to $682 for married couples and $532 for individuals. For those living in rental housing, married couples would benefit by an additional $70 and individuals would benefit by an additional $35, bringing the total benefit to $300 for married couples and $150 for individuals.

***Medicaid Initiatives:*** Medicaid accounts for about one third of the State budget and has grown by more than 50 percent since SFY 2001 to nearly $47 billion. The Governor would hold down growth to 1.7 percent in SFY 2008 by implementing a number of cost-reduction

[4] A portion of the funding would come from eliminating last year's property tax rebate that was valued at $675 million.

measures valued at $1.3 billion in the first year. These measures include freezing reimbursement rates for hospitals and nursing homes, cutting subsidies for health care worker training and medical education, increasing the use of generic drugs, and improving antifraud capabilities. It is likely that many of these initiatives, as in the past, will be opposed by health care providers and institutions, as well as unions.

The Governor also would raise the income eligibility ceiling for participation in the federal Children's Health Insurance Program (CHIP) to add 50,000 children to the 385,000 currently served, and would simplify application processes to ensure continuity of coverage for 900,000 adults and children currently in Medicaid and Family Health Plus. These and other proposals would benefit health care providers (such as HHC) that serve the uninsured or a large proportion of Medicaid patients. The President, however, would reduce income eligibility requirements for CHIP, which would reduce, rather than expand, coverage in New York State.

## Preliminary Ten-Year Capital Plan

In January 2007, the City released its biennial preliminary ten-year capital plan covering fiscal years 2008 through 2017. Rather than cutting back the program, as had been contemplated in the fall, the plan calls for investing $77.3 billion over the next ten years—an increase of nearly 24 percent compared to the prior ten-year plan. Most of the increase would be allocated to education, which would receive $28 billion—nearly $11 billion more than the previous ten-year plan. The City would finance $200 million annually of its capital needs through FY 2010 on a pay-as-you-go basis; the rest would be financed through debt.

As shown in Figure 15, most of the City's capital resources would be invested in education, environmental protection, and transportation. These three categories alone account for 73 percent of the planned capital spending.

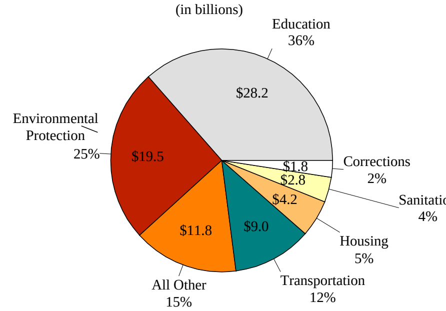
Debt service funded directly through the City's operating budget, or with funds that would have otherwise benefited the City's operating budget,[5] is projected to rise from $3.8 billion in FY 2006 to $6.1 billion in FY 2011, an increase of 60 percent (see Figure 16). As debt service is projected to

**Figure 15**

**Preliminary Ten-Year Capital Strategy**

**2008-2017 Capital Strategy = $77.3 billion**

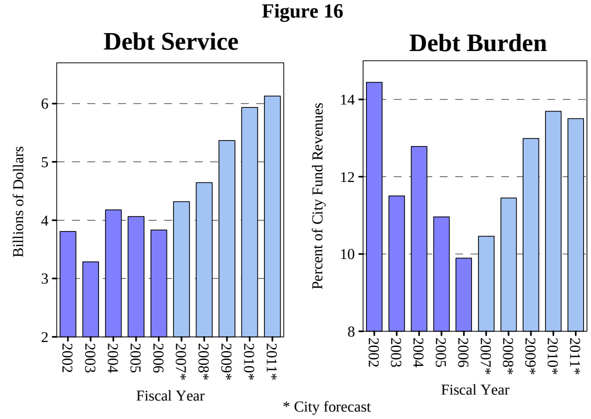
(in billions)




Sources: NYC Office of Management and Budget; OSDC analysis

grow much faster than revenues, debt service will consume an increasing share of City fund revenues in future years, growing from 9.9 percent in FY 2006 to 13.7 percent by FY 2010—which is the highest level since FY 2002, when the City experienced an economic recession.

**Figure 16**




Sources: NYC Office of Management and Budget; NYC Comptroller; OSDC analysis

The cost of financing prior capital programs and future investments will increasingly compete with other budgetary priorities for resources. Although the capital program is clearly affordable in the current economic environment, the rapid growth in debt service could limit the City's options during an economic slowdown or contraction.

## Other Developments

The following issues could have a significant impact on the City's financial plan.

### *Collective Bargaining*

For the current round of collective bargaining, the City has reached agreements with the unions that represent most of the municipal workforce. The Patrolmen's Benevolent Association (PBA), which represents the City's police officers, is seeking larger wage increases than those provided to other uniformed workers. The last agreement with the

[5] Estimates include debt service on bonds backed by personal income taxes and tobacco settlement revenue.

PBA was settled through binding arbitration, and the PBA and the City are currently in arbitration.

The January Plan assumes that federal education aid will grow by $20 million in FY 2007, $55 million in FY 2008, $102 million in FY 2009, and $104 million in each of fiscal years 2010 and 2011, in order to fund the cost of wage increases in programs funded by the federal government. In the event of a shortfall, the City could provide additional funding or cut back service levels.

The January Plan assumes that wages will increase annually by 1.25 percent after the expiration of the 2006-2008 round of bargaining. Wage increases at the projected inflation rate during these years would increase costs by $35 million in FY 2008, $160 million in FY 2009, $380 million in FY 2010, and $620 million in FY 2011.

### *Other Post-Employment Benefits (OPEBs)*

New accounting rules require governmental entities to calculate and disclose the accrued actuarial liability and the annual cost of post-employment benefits other than pensions, primarily health insurance. The City's accrued liability was estimated at $50.5 billion as of June 30, 2005, and the present value of future obligations was estimated at $41.4 billion—a total of $92 billion.

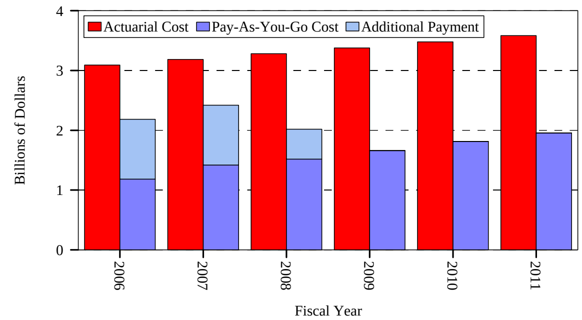
The "normal cost," or the portion of the present value of future obligations that are attributed, on an actuarial basis, to services received in the current year, was estimated at $3 billion. In FY 2006, the City appropriated $1.2 billion at the beginning of the fiscal year to fund benefits on a pay-as-you-go basis, and contributed $1 billion from unanticipated resources that materialized during the fiscal year to a Retiree Health Benefits Trust Fund. The total amount funded by taxpayers—$2.2 billion—was still $800 million less than the actuarial cost of benefits attributed to that year (see Figure 17).

The January Plan assumes that the City will make additional payments of $1 billion in FY 2007 and $500 million in FY 2008. The annual actuarial cost, however, is still higher despite these payments. Consequently, the accrued liability will continue to grow and the difference will be funded by future taxpayers.

The City's contribution to the trust fund will be determined during the annual budget process. Thus, the City could forgo all or part of its planned contribution to the trust fund and meet its obligations on a pay-as-you-go basis from available resources in the trust, freeing up resources for other purposes. In this manner the trust could also serve as a rainy-day fund, although that is not its intended purpose and doing so would place an even greater burden on future taxpayers.

**Figure 17**

**Annual Cost of Post-Employment Benefits Other Than Pensions**




Sources: Office of the Actuary, NYC Office of Management and Budget; OSDC analysis

## City-Related Public Authorities

The following public authorities have a financial relationship with the City that could affect the City's finances during the financial plan period.

### *New York City Housing Authority*

In February 2006, the New York City Housing Authority (NYCHA) projected a $168 million budget gap in calendar year 2006 and similar-sized gaps in subsequent years. To balance its budget, the NYCHA proposed a gap-closing plan that included raising the rents for higher-income tenants, applying for federal grants, and taking other management actions. Also, the City provided the NYCHA with $100 million in transitional assistance for one year. The gap-closing plan was unsuccessful, but the 2006 budget was balanced with savings from lower energy costs and by shifting capital funds to the operating budget.

The NYCHA faces a budget gap of up to $300 million in 2007, and it is seeking additional financial assistance from the City, State, and federal governments. In addition, the NYCHA is considering a range of other options to balance the 2007 budget, including staff and service reductions.

### *Health and Hospitals Corporation*

In July 2006, the Health and Hospitals Corporation (HHC) projected annual budget gaps, on an accrual basis, which approached $1 billion during fiscal years 2007 through 2010. The January Plan shows that the HHC's financial outlook has improved as a result of the City's efforts to obtain supplemental federal Medicaid reimbursements.

While HHC now projects a surplus, on an accrual basis, of $610 million for FY 2007, it still projects large out-year budget gaps. Supplemental federal Medicaid reimbursements, however, are expected to increase HHC's cash reserves to $1.1 billion by the end of the current fiscal year, which would permit HHC to balance its budget on a cash basis through FY 2009.

Balancing future budgets could be more difficult if a proposed federal regulation that would effectively eliminate supplemental Medicaid payments to public providers is implemented. The President has also proposed large cuts in the graduate medical education reimbursement rate, which could also reduce revenues to HHC.

### *Off-Track Betting Corporation*

The New York City Off-Track Betting Corporation (OTB) continues to experience significant fiscal stress stemming from increased statutorily mandated distributions to the State and racing industry; as well as rising expenses. To manage these financial pressures, the OTB has taken a number of steps, such as delaying payments and implementing cost reductions, and the City has proposed State legislation that would ease the burden of State-mandated distributions. As of December 2006, the OTB had $18 million in cash, which officials believe will be enough to sustain operations in FY 2007.

### *West Side Development*

As part of the City's efforts to redevelop the far West Side of Manhattan, the MTA will construct the extension of the No. 7 subway line, which will be funded through the issuance of $2 billion in bonds by the Hudson Yards Infrastructure Corporation (HYIC). The cost of large construction projects in New York City, however, has been growing faster than expected, and there is currently no agreement on whether the MTA, the HYIC, or the City would fund cost overruns, if any, on the extension.

The HYIC is authorized to issue up to $3.5 billion in bonds to finance the subway extension and other improvements, including new parkland. The HYIC has begun to issue bonds and will incur debt service beginning in FY 2008, but the project is not expected to generate sufficient revenues to cover the debt service until some later date.

The City Council has agreed to support, subject to annual appropriation, the interest on HYIC bonds to the extent that project revenues are insufficient to cover these costs. The City estimates the interest costs at $417 million through FY 2011. Repayment of the principal would begin after the project generates sufficient revenues to cover interest costs. Developers have shown considerable interest in building residential projects in the area.

### *Lower Manhattan Redevelopment*

In November 2006, the Port Authority of New York and New Jersey, the Governor, the Mayor, and Silverstein Properties, the leaseholder of the World Trade Center site, signed an agreement over each entity's responsibilities at the site. Under this agreement, the Port Authority is responsible for the construction of the Freedom Tower and Tower 5, and Silverstein is responsible for the three remaining buildings.

According to the Port Authority's most recent capital budget, the cost of the Freedom Tower has increased from $2.5 billion to $3 billion. This increase is attributed to site security, contract integrity monitors, and finance and marketing costs. Recent news reports have suggested that construction costs for the new PATH station have also increased, from $2.2 billion to over $3 billion. The Port Authority is exploring ways to bring down the cost of this project.