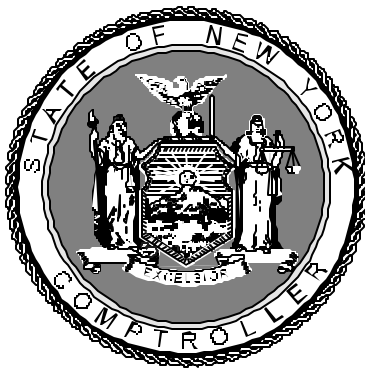


Review of the Four-Year Financial Plan for Fiscal Years 2002 Through 2005

December 2001



H. Carl McCall
State Comptroller

*Office of the State Deputy Comptroller for the City of New York
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I. Executive Summary

On December 4, 2001, New York City submitted a modification to its four-year financial plan to the New York State Financial Control Board (see Table 1). The Board, which oversees New York City's finances, was created during the 1970s fiscal crisis and is chaired by the Governor and includes the State Comptroller, Mayor, City Comptroller and three private-sector members. The Board meets at least annually to certify City compliance with the provisions of the Financial Emergency Act.

The modification shows a balanced budget in the current fiscal year (FY 2002) despite an anticipated revenue loss of \$1.1 billion due to the slowing economy and the attack on the World Trade Center, and other adverse developments. Budget balance would be achieved largely through a series of one-shots – actions that would not produce recurring benefits. Consequently, the modification still shows large out-year budget gaps, 50 percent greater than those projected by the City in June 2001.

Our analysis concludes that with respect to FY 2002, the City has not addressed a number of budget risks, such as higher costs for health insurance, judgments and claims, and Medicaid. Although the budgetary impact of these risks could be mitigated by the potential for higher revenues, the City could still face a potential budget gap of \$446 million in FY 2002 (see Table 2).

Fortunately, the City has not drawn down its reserves: \$200 million remains in the general reserve and \$375 million resides in the budget stabilization account. Also, the City could choose not to extend beyond December 31, 2001 the recent cut in the personal income surcharge, which would increase revenues by \$86 million in FY 2002 and by about \$400 million annually thereafter. As a result, the City should end the year with a modest surplus.

The outlook for fiscal years 2003 through 2005, however, is far more serious as evidenced by the “negative” outlook recently assigned to the City's credit rating.

While the WTC tragedy has adversely affected the City's finances, the City's financial problems did not begin on September 11th. Last June, the City projected a budget gap of \$2.8 billion for FY 2003 and the State Comptroller and other members of the Financial Control Board projected budget gaps of up to \$3.8 billion.

In the current modification, the City projects a budget gap of \$3.6 billion for FY 2003, because City fund revenues are projected to increase by less than 1 percent and City-funded spending is projected to grow by 13.4 percent. The FY 2003 budget gap represents an unprecedented 13.8 percent of City fund revenues, far larger than the gaps projected in the past by the City at this point in the financial planning process.

The City, however, may be underestimating the magnitude of the problem because its gap estimate does not take into account a number of budget risks. For example, the City is still counting on State approval for the sale of the Off-Track Betting Corporation (\$250 million); an increase in State education aid sufficient to maintain educational services and to help fund collective bargaining costs with Board of Education employees (\$238 million); and an increase in Port Authority airport lease payments (\$175 million). When combined with the risks we have identified for FY 2002 which have a recurring impact, the out-year gaps could be \$1.1 billion greater than forecast by the City. Consequently, the out-year gaps could total \$4.7 billion in FY 2003 and about \$5 billion in fiscal years 2004 and 2005 (see Table 2).

In addition, teachers, police officers and firefighters are seeking wage increases significantly greater than those negotiated by other unions. Also, the modification makes no provision for new labor agreements after June 2002. Moreover, the City could be required to increase future pension contributions if pension fund investment earnings fall short of target. Through the first five months of the fiscal year, the pension funds have lost 3 percent on their investments, compared with an expected gain of 8 percent for the year. Last year, the pension funds lost 8.25 percent, at a cost of \$1.2 billion by FY 2006, when the losses will be fully phased in.

Balancing the FY 2003 budget would have been easier if the City had made more prudent use of the large budget surpluses it recorded in recent years. Last year's surplus exceeded \$2.9 billion and the City recorded unprecedented surpluses during fiscal years 1997 through 2000, all fueled by extraordinary Wall Street activity. Rather than holding those surplus resources in reserve or using a portion to pay down debt to generate recurring savings, as recommended by the State Comptroller and others, the City used all but \$345 million to balance the FY 2002 budget. This approach of balancing the budget one year at a time with surplus resources permitted the City to avoid tough choices, but left the City poorly positioned for an economic downturn or other unforeseen contingencies, such as the World Trade Center tragedy.

Balancing next year's budget will also be more difficult because debt service costs are projected to grow faster than tax revenues, leaving fewer resources for other essential services. The percentage of tax revenues needed to pay debt service costs is projected to rise from 16 percent in FY 2001 to 19 percent in FY 2005. Similarly, Medicaid costs are projected to consume nearly 14 percent of City fund revenues by FY 2004, up from 12 percent in FY 2001. New York State is one of only three states that require localities to share in the cost of funding Medicaid and New York State receives only 50 percent federal reimbursement, the minimum level and significantly less than most other states. In addition, the public assistance caseload is rising for the first time since March 1995.

The recent growth in the municipal work force also complicates the task of balancing next year's budget. After reducing staffing levels in the mid-1990s, the portion of the work force funded by the City grew by 11,650 employees between June 1997 and September 2001. The Police Department and the Board of Education comprise 63 percent of the work force, and another 17 percent is devoted to Sanitation, Fire and Correction. In addition, the City spent about \$1.7 billion last year on part-time employees, an increase of 67 percent since FY 1997, the equivalent of 11,600 more full-time employees, mostly in the Board of Education.

No one can accurately predict the depth of the recession or the speed of the recovery, but the City should not depend on Wall Street to balance the budget as it has done since the late 1990s. If the City relies on one-shots and gimmicks to balance the FY 2003 budget, it could still face a daunting budget gap of \$5 billion in FY 2004. Instead, the City should implement actions that produce recurring benefits, such as productivity and management improvements, to shrink the size of the out-year budget gaps to manageable levels. Since the current modification does little to address the out-year gaps, it will be up to the next administration to present a detailed gap-closing program in February 2002 to balance the FY 2003 budget and to narrow the out-year gaps.

Table 1
Four-year Financial Plan Revenues and Expenditures

(millions)

	FY2002	FY2003	FY2004	FY2005
REVENUES				
Taxes				
General Property Tax	\$ 8,488	\$ 8,939	\$ 9,366	\$ 9,787
Other Taxes	12,644	12,697	13,524	14,220
Tax Audit Revenue	462	427	427	427
Tax Reduction Program	---	---	---	---
Miscellaneous Revenue	4,440	4,313	4,118	4,058
Unrestricted Governmental Aid	1,134	630	618	592
Other Categorical Grants	447	350	339	338
<u>Less: Intra-City Revenues</u>	<u>(1,352)</u>	<u>(1,315)</u>	<u>(1,271)</u>	<u>(1,271)</u>
Grant Disallowances	(15)	(15)	(15)	(15)
Subtotal City Funds	\$ 26,248	\$ 26,026	\$ 27,106	\$ 28,136
Inter-Fund Revenues	322	312	312	312
City & Interfund Revenues	\$ 26,570	\$ 26,338	\$ 27,418	\$ 28,448
Federal Categorical Grants	6,260	4,157	4,115	4,113
State Categorical Grants	7,907	7,982	8,074	8,150
Total Revenues	\$ 40,737	\$ 38,477	\$ 39,607	\$ 40,711
EXPENDITURES				
Personal Service	22,024	22,502	22,987	23,531
Other Than Personal Service	18,579	17,530	17,812	18,075
Pay-as-you-go Capital	135	135	135	135
Debt Service	776	2,764	3,219	3,450
Budge Stabilization Reserve	375	---	---	---
MAC Debt Service	---	240	489	490
General Reserve	200	200	200	200
Total	\$ 42,089	\$ 43,371	\$ 44,842	\$ 45,881
<u>Less: Intra-City Expenses</u>	<u>(1,352)</u>	<u>(1,315)</u>	<u>(1,271)</u>	<u>(1,271)</u>
Total Expenditures	\$ 40,737	\$ 42,056	\$ 43,571	\$ 44,610
Gap to be Closed	\$ ---	\$ (3,579)	\$ (3,964)	\$ (3,899)

Source: NYC Office of Management and Budget

Table 2
OSDC Assessment of NYC Four-Year Financial Plan

(millions)

Better/(Worse)

	FY 2002	FY 2003	FY 2004	FY 2005
Gaps per December Modification	\$ - - -	\$ (3,579)	\$ (3,964)	\$ (3,899)
OSDC Budget Risks				
Tax Revenues	100	150	150	150
Health Insurance Costs	(145)	(160)	(170)	(180)
Judgments and Claims	(100)	(125)	(150)	(175)
Medical Assistance	(50)	(75)	(100)	(200)
NYS Revenue Sharing Spin-up	(73)	---	---	---
Pensions Costs	(70)	(70)	(70)	(70)
Board of Education	(60)	(310)	(343)	(261)
Federal Medicaid Reimbursement	(48)	(66)	(66)	(66)
Sale of Off-Track Betting Corporation	---	(250)	---	---
Port Authority Airport Lease Payments	---	(175)	(320)	(285)
Police Overtime	---	(100)	(100)	(100)
Subtotal	(446)	(1,181)	(1,169)	(1,187)
Gaps to be Closed¹	\$ (446)	\$ (4,760)	\$ (5,133)	\$ (5,086)
Additional Risks and Offsets				
Wage Increases at Inflation	---	(170)	(660)	(1,125)
FY 2002 Pension Fund Investment Losses	---	(65)	(165)	(300)
Personal Income Tax Surcharge	86	435	377	407

Note: Each additional one percent wage increase for teachers, police officers, and firefighters above the amounts negotiated with the unions representing other civilian and uniformed employees would increase costs by about \$80 million annually.

¹ The modification includes an annual general reserve of \$200 million. In addition, the budget stabilization account includes \$375 million, which can be used to help budget the balance in FY 2002.

II. Overview

The City projects a budget gap of \$1.3 billion in FY 2002, due largely to an anticipated revenue loss of \$1.1 billion resulting from the slowing economy and the attack on the World Trade Center (see Table 3). The modification also acknowledges that State funding to the Stock Transfer Incentive Fund will not be restored and that State approval for the sale of the Off-Track Betting Corporation is unlikely to occur in the current fiscal year. In addition, the City has revised downward its estimates of anticipated federal and State assistance. To partly offset the loss in revenues, the City has withdrawn a tax reduction program that was awaiting State approval.

Table 3
Financial Plan Reconciliation
(millions)

	<i>Better/(Worse)</i>			
	FY 2002	FY 2003	FY 2004	FY 2005
Surplus/(Gaps) per Adopted Budget	\$ 345	\$ (3,123)	\$ (2,611)	\$ (2,236)
Revenues	(1,104)	(1,565)	(1,415)	(1,532)
OTB Sale	(250)	250	---	---
Uniformed Coalition Agreement	(152)	(170)	(176)	(181)
Federal and State Aid	(119)	(116)	(116)	(116)
Stock Transfer Incentive Fund	(114)	(114)	(114)	(114)
Other Agency Spending	(103)	(110)	(108)	(114)
Tax Reduction Program	100	200	200	200
Pension Contributions	81	(57)	(208)	(311)
Prior Years' Expenses	210	---	---	---
Debt Service	156	158	160	108
Subtotal	(1,295)	(1,524)	(1,777)	(2,060)
Roll Budget Stabilization Reserve	(375)	375	---	---
Gaps per December Plan	\$ (1,325)	\$ (4,272)	\$ (4,388)	\$ (4,296)

Source: NYC Office of Management and Budget

Note: The Financial Plan includes a \$375 million stabilization reserve, which can be used to maintain budget balance in the current fiscal year or to narrow the FY 2003 budget gap.

The modification also reflects costs associated with the recently negotiated uniform coalition labor agreement and other new spending needs. These costs would be partly offset in the current fiscal year by savings in prior year's expenses, lower debt service costs as a result of debt refundings and lower interest rates, and lower pension costs. In subsequent years, however, pension costs rise primarily because

FY 2001 pension fund investment losses were far greater than anticipated, more than offsetting savings from earlier years when investments exceeded expectations.

The out-year budget gaps have grown by \$1.5 billion in FY 2003 and up to \$2 billion by FY 2005, reflecting the City's conservative economic outlook and the recurring impact of higher costs identified in FY 2002.

FY 2002 Gap-Closing Program

To balance this year's budget the City has proposed a \$1.3 billion gap-closing program (see Table 4). In total, two-thirds of the resources would not recur in subsequent years.

Table 4
FY 2002 Gap-Closing Program
(millions)

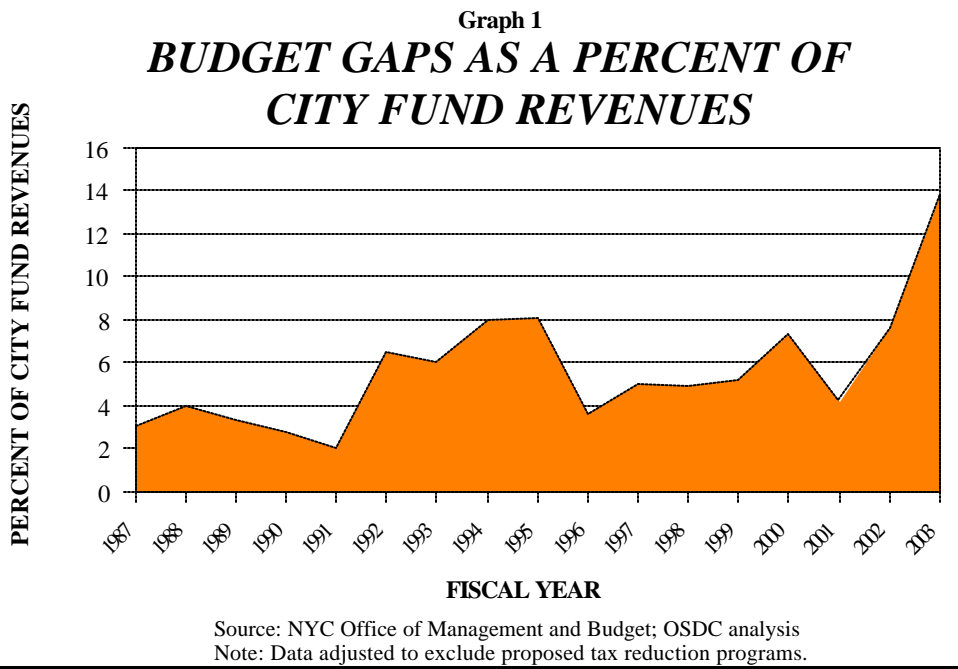
	FY 2002	FY 2003	FY 2004	FY 2005
Gaps per December Plan	\$ (1,325)	\$ (4,272)	\$ (4,388)	\$ (4,296)
Gap-Closing Program				
Agency Program	853	404	397	397
Federal Disaster Aid	399	39	27	---
NYS Revenue Sharing	73	---	---	---
MAC Reserve	---	250	---	---
Subtotal	1,325	693	424	397
Remaining Surplus/(Gap)	\$ ---	\$ (3,579)	\$ (3,964)	\$ (3,899)

Source: NYC Office of Management and Budget

As a result of the City's reliance on non-recurring actions to balance this year's budget, the FY 2003 budget gap has been reduced by only \$693 million to \$3.6 billion, and the gaps for fiscal years 2004 and 2005, which have been reduced by only \$400 million, now average almost \$4 billion. The gaps represent 13.8 percent of City fund revenues (see Graph 1), the largest gaps as a percent of City fund revenues at this point in the financial planning process since the budget was first balanced in accordance with generally accepted accounting principles in FY 1981.

The largest component of the FY 2002 gap-closing program is the agency program, which is valued at \$853 million in FY 2002. About \$290 million of the savings would come from delays in expanding programs, service reductions, and reductions in subsidies to entities that depend on the City for financial assistance. For example, the Mayor has proposed cutting funding to cultural institutions, libraries, and private bus carriers (\$58 million); delaying an expansion in childcare slots

(\$71 million); and eliminating the Board of Education’s minor maintenance program (\$20 million). The City Council is negotiating with the Mayor to restore cuts in some programs and to identify alternative savings. In addition, the City intends to offer early retirement or severance packages to about 3,500 employees to encourage them to leave the payroll for savings of \$50 million in FY 2002 and \$100 million annually thereafter. The balance of the savings would come mostly from reestimates and accruals (\$205 million), and funding shifts (\$180 million). In total, less than half of the savings from the agency program would recur in subsequent years.



The gap-closing program also counts on a one-time payment of \$399 million from the federal government to cover the salaries of employees assigned to WTC-related activities through October 2001 and to replace destroyed capital assets, such as fire trucks and roads. If these resources do not materialize, the City would reimburse the operating budget by issuing bonds under new authority granted to the Transitional Finance Authority (see Chapter V, “Federal Disaster Aid”). The modification also assumes that the federal government will reimburse the City for the entire cost of debris removal and overtime related to the WTC incident, currently estimated at \$1.6 billion. It does not anticipate federal reimbursement for any lost revenues. In addition, the gap-closing program assumes the State will accelerate revenue-sharing payments to the City for a one-time gain of \$73 million in FY 2002.

The City is also counting on \$250 million in non-recurring resources from the Municipal Assistance Corporation to narrow the FY 2003 budget gap. Under the City’s proposal, MAC would release reserve funds to the City after purchasing a

surety bond from an insurance company which would then be liable to replenish the reserves in the event it becomes necessary. The City, however, must still develop a strategy that overcomes provisions contained in MAC bond covenants.

Out-Year Gap-Closing Program

To close the gaps projected by the City for fiscal years 2003 through 2005, the Mayor has outlined a gap-closing program for those years (see Table 5). The program relies heavily on State and federal assistance, and unspecified actions. In particular, the Mayor has suggested that the next administration cut agency spending by up to \$1.2 billion, but he has not identified the agencies or the programs that would be affected. Instead, it will be up to the new administration to present a detailed program in February 2002 to balance the FY 2003 budget and to narrow the out-year gaps.

Table 5
Out-Year Gap-Closing Program
(millions)

	FY 2003	FY 2004	FY 2005
Agency	\$ 1,000	\$ 1,200	\$ 1,200
Federal Aid	1,250	1,250	1,250
State Aid	400	450	450
General Reserve	100	100	100
Asset Sales	200	200	200
Other Actions	629	764	699
Total	\$ 3,579	\$ 3,964	\$ 3,899

Source: NYC Office of Management and Budget

OSDC Assessment

Our review has identified a number of budget risks that total \$446 million in FY 2002. For subsequent years, we have identified risks of \$1.1 billion, raising the out-year budget gaps to \$4.7 billion in FY 2003 and about \$5 billion in fiscal years 2004 and 2005 (see Table 2).

In FY 2002, the City has not addressed higher costs for municipal health insurance (\$145 million); tort claims against the City (\$100 million); pensions (\$70 million); and Medicaid (\$50 million). The modification also assumes that New York State will accelerate revenue-sharing payments (\$73 million) and that the federal government will increase its Medicaid reimbursement rate (\$48 million). While the State and federal government may be more sympathetic to the City's requests than in prior years, the outcome remains uncertain. The budgetary impact of these risks could be mitigated by the potential for higher revenues, which we estimate

could exceed the City's estimates by \$100 million in FY 2002 and by \$150 million annually thereafter.

The City still has \$200 million in the general reserve and \$375 million in the budget stabilization account, more than enough to offset these risks. If the City were to draw down resources from the stabilization account to maintain budget balance in the current fiscal year, however, the FY 2003 budget gap would grow by an equal amount since the City has already dedicated these resources to narrow the FY 2003 budget gap.

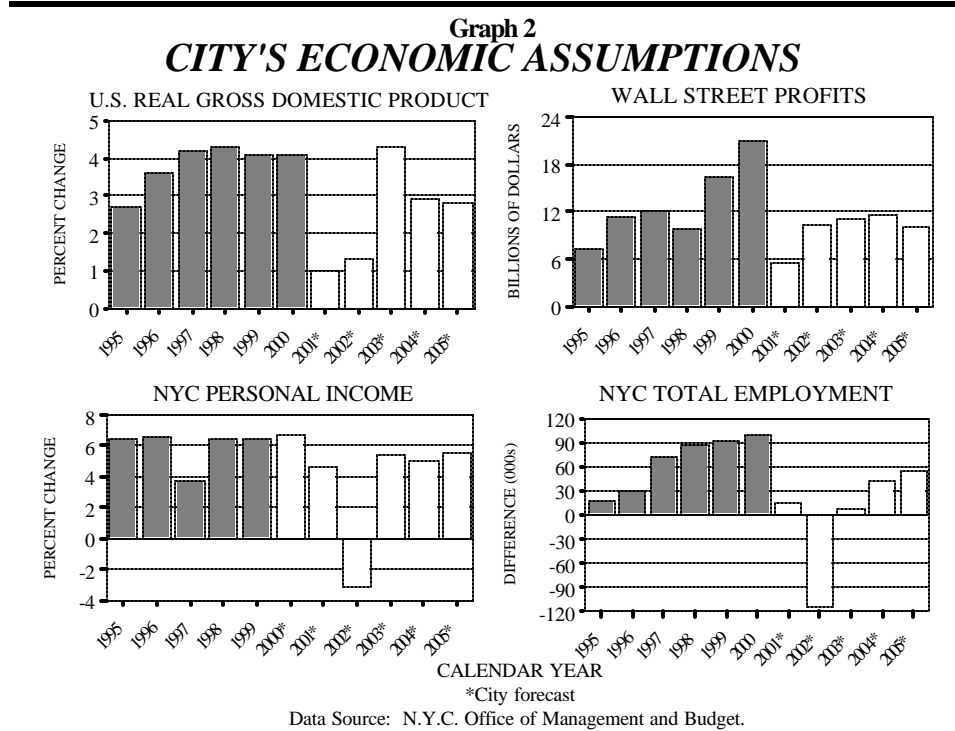
For fiscal years 2003 through 2005, we have identified additional budget risks, which when combined with those identified from FY 2002, could increase the out-year gaps by \$1.1 billion annually (see Table 2). The largest include the sale of the Off-Track Betting Corporation (\$250 million); an anticipated increase in State education aid to help fund collective bargaining costs at the Board of Education (\$238 million); and an anticipated increase in Port Authority airport lease payments (\$175 million). These actions are not within the City's sole control and the condition of the State and Port Authority budgets have also deteriorated as a result of the attack on the World Trade Center and the slowing economy. In addition, overtime costs in the Police Department are likely to be \$100 million more than forecast by the City.

The City's out-year gap estimates also do not take into account the potential for larger wage increases for teachers, firefighters and police officers than those granted to other unions, or for the potential for a shortfall in pension fund investment earnings. The modification also makes no provision for any wage increases after June 2002. A wage increase at the inflation rate would widen the out-year gaps by \$170 million in FY 2003, \$660 million in FY 2004, and by \$1.1 billion in FY 2005.

III. Revenues

The City's economic and revenue outlook has changed markedly since the July Financial Plan. At that time, the City forecast that growth in the national and local economies would be weak, but that a recession would be avoided. It is now believed that a national recession started in March and that the attack on the World Trade Center has increased its severity.

The City is forecasting that the nation will experience a short recession, with Gross Domestic Product (GDP) contracting for a few quarters. On an annual basis, GDP growth remains positive, increasing by 1 percent in calendar year 2001, 1.3 percent in 2002, and then rebounding to 4.3 percent in 2003 (see Graph 2).² National employment and wages are projected to follow a similar pattern, with positive gains in all years, while corporate profits decline by 18.1 percent in 2001 before increasing by 1.1 percent in 2002 and 9.9 percent in 2003.



² Unless otherwise specified, annual economic data are reported on a calendar year basis, while revenue data are reported on a City fiscal year basis.

The City is forecasting a more severe local recession. Average annual employment in the City is projected to increase by 15,700 jobs in 2001, decline by 114,000 jobs in 2002, and post a modest gain of 7,700 jobs in 2003. Wall Street profits are projected to decline from a record \$21 billion in 2000 to \$5.5 billion in 2001, then increase to \$10.2 billion in 2002 and \$11 billion in 2003. The City expects this decline in profits in 2001 to reduce year-end bonuses in the finance, insurance and real estate (FIRE) sector by almost 57 percent. Lower bonuses and declining employment ripple through the local economy, with the City forecasting that wages and personal income will decline in 2002 before growth resumes in 2003. While the local recession forecast by the City is significant, it is not as severe as that of the early 1990s, when the City lost 370,000 jobs.

The lower economic outlook has flowed through to the revenue forecast. City fund revenues are projected to decline by 5.7 percent or \$1.6 billion in FY2002, including the portion of the personal income tax dedicated to debt service payments of the Transitional Finance Agency and tobacco settlement revenues to pay debt service on tobacco bonds, after gains of 6.2 percent and 6.1 percent in the last two fiscal years (see Graph 3). This represents a reduction of \$849 million from the June forecast.

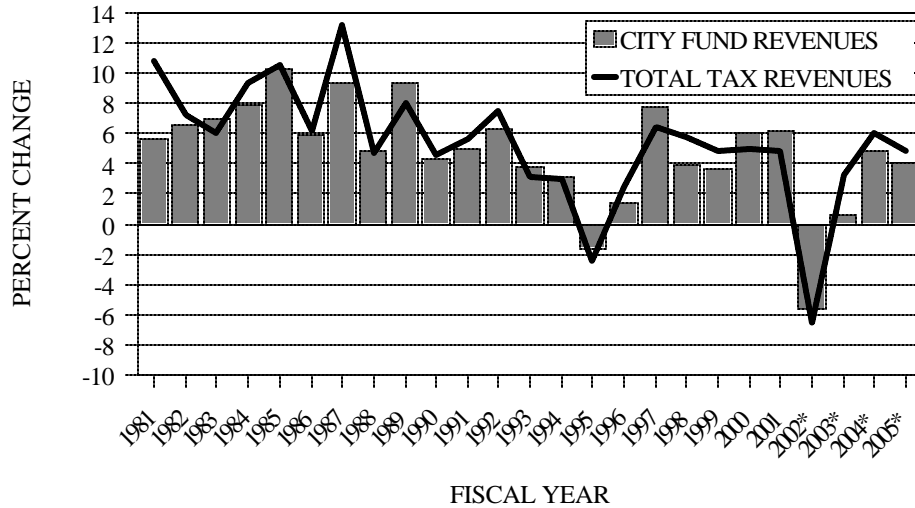
Taxes, which represent about 85 percent of City fund revenues, account for most of this change. Tax collections are projected in the current modification to be \$1 billion less than the July forecast. While the decrease is primarily due to the changed economic outlook, it also includes \$114 million from the State's elimination of the stock transfer tax incentive fund payment to the City and \$45 million in additional payments in lieu of taxes (PILOTs) the City had expected from the lease of the World Trade Center. In FY 2003, City fund revenues are forecast to increase by 0.6 percent, to \$26.5 billion, and then grow at an annual rate of 4.4 percent in fiscal years 2004 and 2005. However, the City's forecast for tax revenues in each fiscal year between 2003 through 2005 will be about \$1.5 billion below the June forecast.

The City forecasts that Wall Street profits will decline by 75 percent in FY 2002, but based on current data it appears that the fall off will not be as severe as projected by the City. An examination of recent tax data shows improvements, with most collections returning to pre-September patterns. Consequently, we believe revenues could exceed the City's estimates by \$100 million in FY 2002 and \$150 million annually thereafter.

Tax reductions of \$381 million in FY 2002 had already been enacted, but another \$100 million (growing to \$200 million annually in FY 2003 and thereafter) were not enacted. Thus, the modification does not include new tax reduction proposals. In addition, the modification has delayed the sale of the Off-Track Betting Corporation (OTB) (\$250 million) and of mortgages by the Department of Housing Preservation and Development (\$38 million) from FY 2002 until FY 2003.

Graph 3

ANNUAL CHANGE IN CITY FUND REVENUES



FISCAL YEAR

* City forecast

Source: NYC Comptroller's Office, NYC Office of Management and Budget;
OSDC analysis

Taxes

Total tax collections are now forecast by the City to fall by 6.6 percent in FY 2002, to \$22.1 billion. This would be the first decline since the 2.4 percent decline in FY 1995. This reduction reflects the economic slowdown, the impact of the World Trade Center attack, and the continued increase in the value of the tax reduction program. Continued growth in property tax revenues offsets a considerably larger decline that is expected in the economically sensitive non-property taxes. Tax revenue growth is then forecast to increase in subsequent years, to 3.2 percent in FY 2003 and to an average annual rate of 5.4 percent in fiscal years 2004 and 2005, as the local economy recovers.

Real Property Tax

Real property tax revenues are forecast to be \$8.5 billion in FY 2002, an increase of 4.1 percent, unchanged from the Adopted Budget. Because the tax roll for FY 2002 was set last May, and property owners have already paid half of their tax liability, there is expected to be little impact on revenues as a result of either the attack on the World Trade Center or the slumping economy. While some impact may be realized in FY 2003, there are several factors that minimize any potential revenue loss. Real property taxes were not paid on the World Trade Center, and many of the damaged properties located in Lower Manhattan are reopening and are again

generating income, which is the basis for assessing commercial properties. We estimate that these properties accounted for about \$60 million in real property taxes in FY 2002. State law also mandates that assessment reductions be phased in over five years, limiting the affect of assessment reductions for FY 2003 for all commercial properties, not just those located in Lower Manhattan. However, because of reduced tourism and the effects of the economic recession, the properties that may be most vulnerable to assessment reductions are hotels (whose billable assessments increased by 43 percent between fiscal years 1999 and 2002), and retail stores. However, these properties are also subject to the phase-in for assessment reductions. The impact on FY 2003 collections will be clarified in January, when the City releases the tentative tax roll. The City's current forecasts for real property tax collections for fiscal years 2003 through 2005 remain unchanged from June. For FY 2003, collections are forecast to rise 5.3 percent to \$8.9 billion, due to the higher expected billable assessed values that had been forecast at the start of FY 2002.

Non-property Taxes

The City has forecast that FY 2002 non-property tax collections will fall to \$13.6 billion, a decline of 12.3 percent. This is due to the recession, additional tax cuts, and the loss of both the stock transfer incentive fund payment and the increased World Trade Center PILOTs. This decline is considerably larger than the 5.2 percent decline forecast in June. These forecasts reflect a projected 75 percent decline in Wall Street profits and almost 57 percent decline in FIRE sector year-end bonuses. These lower profits and income, coupled with reduced tourism and new tax cuts, result in forecast declines of 17.7 percent for the personal income tax, 16.6 percent in the business income taxes, and 4.5 percent for the sales tax (see Table 6). Growth is expected to return in subsequent years as the economy recovers and growth in Wall Street profits, jobs and income resumes.

Table 6
Annual Percent Change in Non-Property Tax Revenues

	FY 2002	FY 2003	FY 2004	FY 2005
Non-property Taxes	-12.3	1.8	6.9	4.9
Personal Income Tax	-17.7	2.4	7.7	5.8
Sales Tax	-4.5	0.7	5.3	3.6
Business Income Taxes	-16.6	0.4	9.1	5.0
Other Taxes	-6.1	3.9	5.4	4.9

Source: NYC Office of Management and Budget

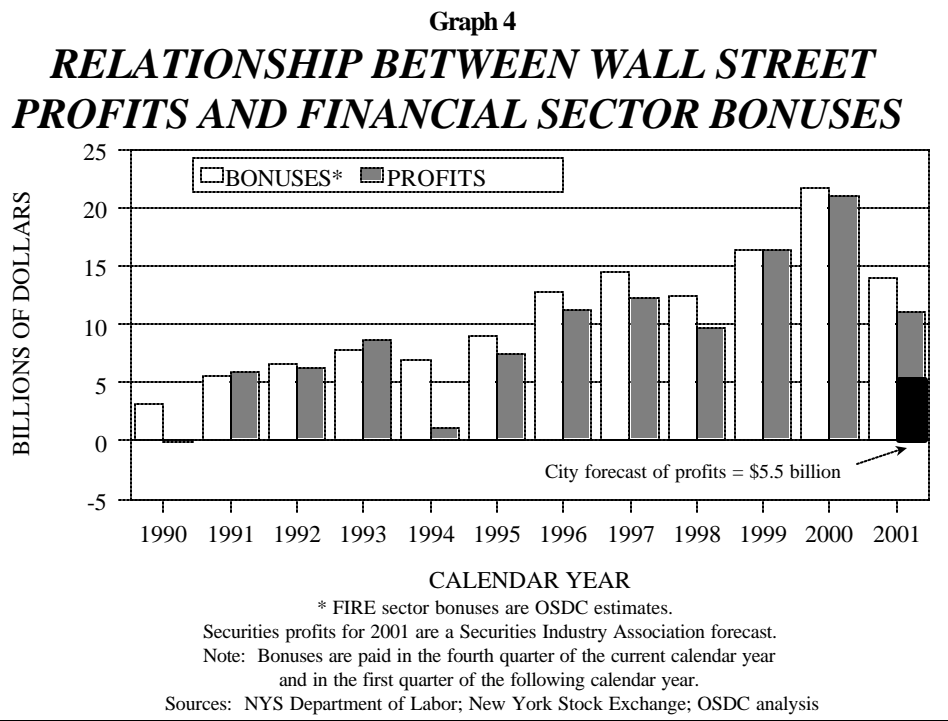
Although the economic slowdown forecast by the City does not exceed that of the recession of the early 1990s, the magnitude of the revenue loss does. After adjusting collections of the major economically sensitive non-property taxes for inflation and for rate and base changes, the City is forecasting that collections from these taxes will decline by 12.7 percent in FY 2002, before growth resumes with a 1.9 percent gain in FY 2003. By comparison, real adjusted collections declined at an average annual rate of 6.6 percent between fiscal years 1989 and 1992 (with a peak decline of 7.8 percent in FY 1991). Although the City is now more dependent on Wall Street profits and income flows than it was in the early 1990s, which would increase the potential revenue decline, the decline forecast by the City is much greater than current Wall Street trends or economic conditions would imply.

It is now clear that employment in the City peaked in April 2001; with the events of September 11th causing most of the 86,500 jobs lost through October. The highly paid securities industry has been hard hit, losing 21,000 jobs, but so have other major industries, including business services (29,200 jobs), airlines (4,400 jobs), hotels (3,500 jobs), and retail trade (16,000 jobs), primarily in restaurants. Small businesses south of Canal Street have been particularly hard hit, with many closing for an extended period or not reopening.

Non-property tax collections for the first four months of the fiscal year are 13.1 percent below collections in the same period of last year. However, part of the decline is attributable to the deferral of September quarterly payments until December 10 for those affected by the World Trade Center attack and another part to tax cuts enacted since last year. In addition, while several taxes continue to be adversely affected, some have shown improvement. Personal income tax collections, which declined 28 percent in September from the prior year, have returned to their summer pattern in October and November. Mortgage recording and utility taxes remain strong, recording year-to-date gains through October of 34 percent and 29.9 percent, respectively. A clearer tax revenue picture will emerge near the end of January, when results from the next quarterly installment on personal and business income taxes, and the payment deferred from September, will be known.

Although the financial markets suffered a severe price correction when they reopened after the attack, they have since rallied and offset those losses. The financial system has remained solid, helped by continued interest rate reductions and liquidity introduced into the system by the Federal Reserve. Because of this, it is expected that Wall Street profits will be higher than forecast by the City. Profits of \$8 billion were reported for the first three quarters of the year, and the Securities Industry Association is currently forecasting that profits for the year could be \$11 billion. Year-end bonuses should also be stronger than the City projects. Although Wall Street bonuses do respond to declines in profitability, they are slower to go down than to increase. In

1994, for example, profits declined almost 87 percent while bonuses only declined about 16 percent. Using historical relationships, we estimate FIRE sector bonuses could decline 35 percent to about \$14 billion (see Graph 4).



Miscellaneous Revenues

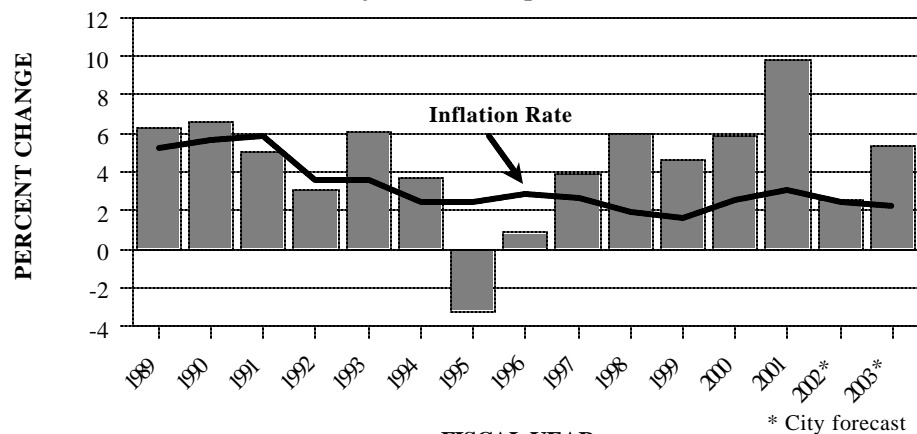
Miscellaneous revenues are forecast to be \$3.1 billion in FY 2002, a reduction of \$230 million from the amount forecast in the Adopted Budget. This reduction results from the City postponing the expected sale of OTB until FY 2003, the loss of revenues from interest income (\$74 million), largely as a result of declining interest rates, and the loss of \$24 million in parking fines. Partially offsetting these declines are additional revenues from the sale of assets, which now amount to \$220 million for FY 2002. Although the City has a large inventory of assets that could be sold in order to realize the amount projected for FY 2002, the City has had problems in previous years completing some transactions, resulting in the receipt of funds being delayed until later fiscal years. For FY 2003, the City has increased the forecast of miscellaneous revenues by \$300 million from the June forecast. This largely reflects the transfer of projected revenues from the OTB sale from FY 2002 and additional revenues from the tobacco settlement (\$52 million), offset in part by lower expected interest income (\$50 million). The total value for the sale of City assets, other than OTB, declines from \$222 million in FY 2002 to \$38 million in FY 2003.

IV. Expenditures

City-funded expenditures are projected by the City to total \$25.8 billion in FY 2002, \$1.7 billion less than FY 2001 because the City transferred the FY 2001 surplus by prepaying FY 2002 debt service and other expenses. In FY 2003, City spending is projected to grow by \$3.5 billion or 13.4 percent.

After adjusting for surplus transfers that can distort spending patterns, the FY 2003 rate of growth is reduced to 5 percent (including debt service on bonds issued by the Transitional Finance Authority and TSASC, Inc.), still twice the projected inflation rate (see Graph 5). In FY 2001, City-funded spending grew by 9.8 percent, three times the inflation rate, and is projected to rise by 2.5 percent in FY 2002.

Graph 5
**PERCENT CHANGE IN
CITY-FUNDED SPENDING**
(Adjusted for Surplus Transfers)



Source: NYC Comptroller's Office, NYC Office of Management and Budget;
OSDC analysis

Collective Bargaining

In April 2001, New York City reached a labor agreement with the City's largest civilian employee union, District Council 37, which represents 125,000 members in more than 1,000 job titles from 56 local unions. The agreement provides a 9.87 percent wage and fringe benefit increase over a 27-month period. The agreement does not include improvements in productivity or changes in work rules, but the City did obtain the right to give employees merit increases based on performance. The District Council 37 agreement also includes a no-layoff clause, effective through

June 2002, and the City and District Council 37 intend to negotiate a revised employee redeployment procedure in the event that downsizing the work force becomes necessary.

In July 2001, the City reached a tentative labor agreement with a coalition of unions representing 45,000 uniformed employees, which provides for wage and fringe benefit increases of 12.49 percent over a 30-month period. The unions representing correction officers and sanitation workers, as well as the unions representing fire superior officers and police lieutenants ratified the agreement. Firefighters and police detectives and sergeants did not approve the agreement.

The unions representing teachers and police officers (which was not part of the uniform coalition) are seeking substantially larger wage increases to achieve parity with their counterparts in surrounding counties, and to deal with difficulties in recruiting and retaining qualified workers. An agreement with police officers could be subject to binding arbitration under the aegis of Public Employment Relations Board (PERB), which has declared an impasse in the negotiations.

A 1998 State law transferred responsibility for handling police officer contract disputes from the City's Office of Collective Bargaining to PERB. City efforts to overturn the law have been unsuccessful. The Governor has proposed legislation that would require PERB arbitration panels to consider, above all other factors, the financial ability to pay without resorting to tax increases. Similar legislation has been proposed in the past, but was not enacted by the State Legislature.

PERB has also declared an impasse in the negotiations for a new teachers' contract, but its recommendations are not binding on either party although they could influence negotiations. In its petition to PERB, the teachers' union has requested a wage increase of 22.7 percent over two years.

Last spring, the City reached an agreement with the City's librarians that addresses difficulties in recruiting and retaining qualified workers and provides a wage increase of 17 percent, 8 percent more than the District Council 37 pattern. A similar agreement for teachers, police officers and firefighters would increase costs by about \$600 million in FY 2002³ and similar amounts in subsequent years, but the cost could be reduced to the extent that the City obtains productivity improvements or changes in work rules.

New York City's four-year Financial Plan does not include any resources to fund new wage increases during fiscal years 2003 through 2005. A wage increase at

³ Each additional one percent wage increase for teachers, police officers and firefighters above the amounts negotiated with the unions representing other civilian and uniformed employees would increase costs by about \$80 million annually.

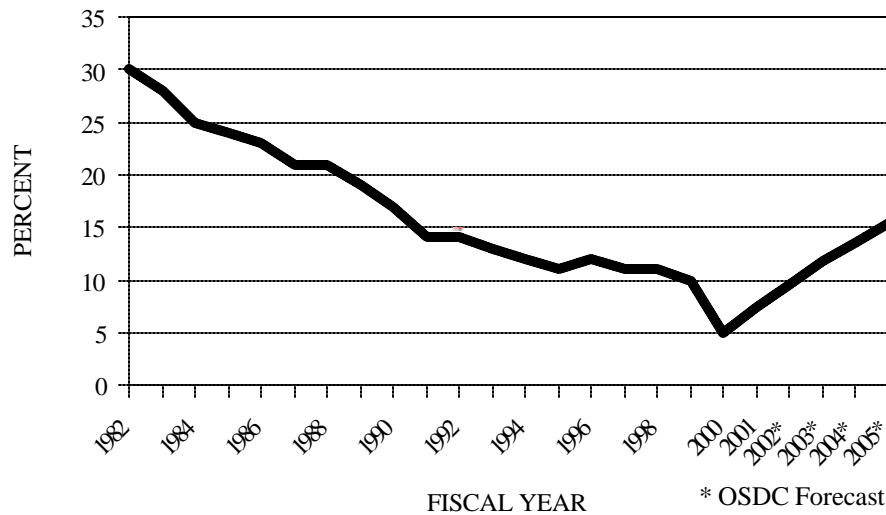
just the projected inflation rate would increase costs by \$170 million in FY 2003, \$660 million in FY 2004, and by \$1.1 billion in FY 2005.

Pension Contributions

City-funded pension contributions are projected to more than double from \$1.1 billion in FY 2001 to \$2.4 billion by FY 2005. Most of the increase is due to poor investment performance in FY 2001, which increases FY 2005 costs by about \$850 million. Pension contributions also increase to fund enhanced pension benefits, such as eliminating contributions for Tier III and Tier IV members with 10 years or more of service and providing retirees with permanent cost-of-living adjustments. In addition, pension costs could increase due to wage increases associated with recent collective bargaining agreements. As a result, City contributions as a percent of salary and wage costs will rise from 5 percent in FY 2000 to 15 percent by FY 2005 (see Graph 6).⁴

Graph 6

PENSION CONTRIBUTIONS AS A PERCENT OF SALARY



Source: NYC Office of Management and Budget; OSDC analysis

Between fiscal years 1995 and 2000, as the stock market boomed, the pension funds earned an average of about 16.7 percent per year on their investments, nearly twice the assumed rates of return (see Graph 7). In FY 2001, however, the pension

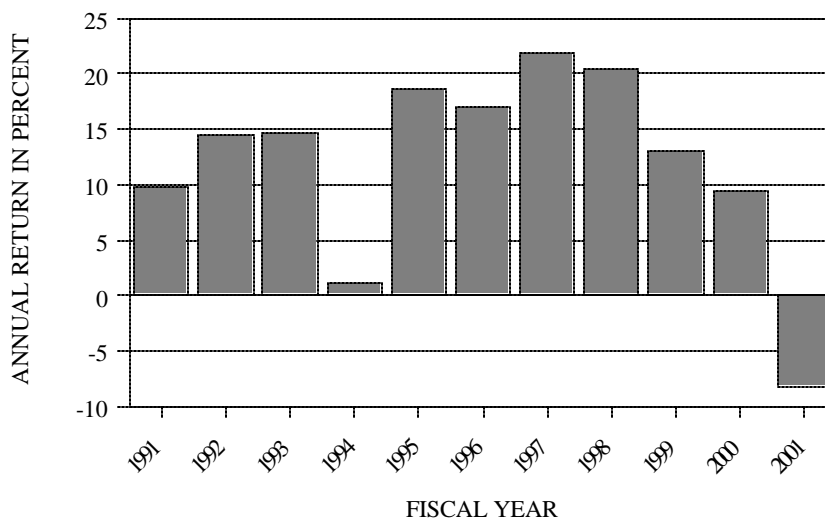
⁴ The dip in FY 2000 primarily reflects market value restart, which permitted the City to reduce its planned contribution to help balance the budget.

funds lost 8.25 percent of their value, compared with an expected gain of 8 percent for the year.

Since investment gains or losses are phased in over a five-year period, the full cost will not be felt until FY 2006 at which time the City's pension contribution will be \$1.2 billion greater than previously planned. In addition, the City reduced its planned contributions for fiscal years 2000 and 2001 by \$800 million to help balance the FY 2001 budget. This was achieved by accelerating the recognition of extraordinary investment gains of the last four years (*i.e.*, market value restart), but those savings will have to be repaid, given the poor return on investments in FY 2001.

Graph 7

**PENSION FUND
INVESTMENT EARNINGS**



Source: NYC Comptroller's Office; OSDC analysis

During the first five months of FY 2002, the pension funds have lost about 3 percent of their value. While it is still early in the fiscal year and investment performance is volatile, losses of this magnitude for the full fiscal year would increase pension costs by about \$65 million in FY 2003, \$165 million in FY 2004, \$300 million in FY 2005, \$455 million in FY 2006 and by \$665 million in FY 2007.

Furthermore, pension costs could be higher by \$70 million annually beginning in FY 2002, because a New York State Supreme Court ruled that teachers' summer school salaries and all other "per session" earnings should count toward their pensions. This decision was unanimously sustained in a recent State appeals court ruling.

Health Insurance

Health insurance premiums grew at a double-digit pace during the early 1990s, but the City then negotiated a three-year freeze in rates for fiscal years 1996 through 1998 as part of a package to help the City balance its budget during a period of fiscal stress. In the three years that followed the rate freeze, health insurance premiums grew at an average annual rate of 7.1 percent.

The modification includes \$1.7 billion for municipal health insurance in FY 2002, based on the assumption that health insurance premiums will rise by only 4 percent each year. The Health Insurance Plan of Greater New York (HIP), however, increased rates by 11.9 percent in FY 2002 and is contemplating similar increases in subsequent years.⁵ As a result, health insurance costs could exceed the City's estimates by \$110 million annually based on the FY 2002 rate hike and even larger amounts in subsequent years to the extent premiums grow faster than 4 percent. The City, however, is not paying the higher amount and the municipal unions have filed a grievance and a demand for arbitration with the Office of Collective Bargaining since the higher costs have been passed along to the employees. HIP has already indicated that it intends to raise premiums by 8.5 percent next year, twice the amount assumed by the City.

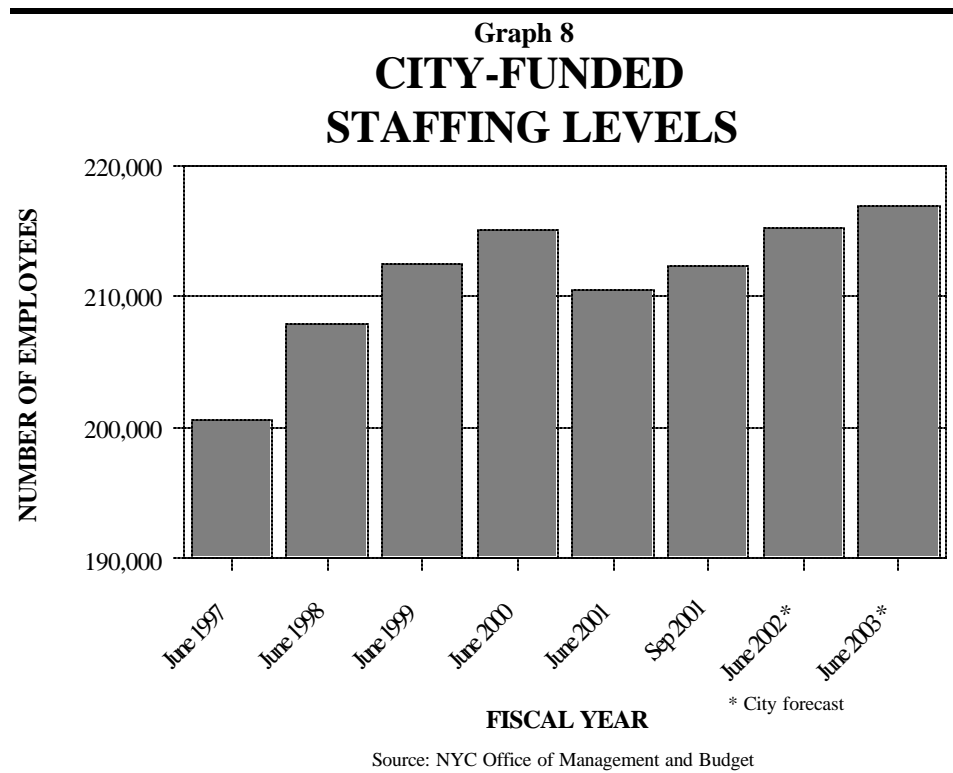
In addition, the City Council overrode the Mayor's veto in June 2001 of legislation that would fully reimburse Medicare-eligible retirees for premiums incurred for Medicare Part B insurance. The Mayor has filed a lawsuit challenging the legislation on the grounds that such a change is the exclusive subject of collective bargaining, and beyond the City Council's purview. As recently as 1997, however, Medicare Part B reimbursement rates were raised by the City Council with the Mayor's approval. Pursuant to the legislation and federal projections for Medicare Part B premiums, we estimate that health insurance costs for retirees could increase by \$35 million in FY 2002, \$50 million in FY 2003, \$60 million in FY 2004, and \$70 million in FY 2005.

Staffing Levels

In September 2001, the City-funded work force totaled 212,310 full-time employees, an increase of 11,650 employees since June 1997 (see Graph 8), with most of the increase concentrated in the Board of Education and the Police Department. In addition, spending on part-time employees totaled \$1.7 billion in

⁵ Under agreements between the City and its unions, premiums paid to HIP determine the City's cost for all municipal health insurance providers.

FY 2001, 67 percent higher than FY 1997 or the equivalent of adding 11,600 full-time employees.



The City intends to offer employees early retirement incentives or severance packages to reduce the size of the work force, avoiding the need for more painful actions, such as layoffs. The City estimates that about 3,500 employees would have to participate to meet its savings target of \$50 million in FY 2002 and \$100 million in each subsequent year.

Early retirement and severance programs are cost-effective in the long run only if the positions remain vacant. A program of this size, however, could be difficult because 63 percent of the work force is concentrated in the Board of Education and Police Department, and another 17 percent in the Fire, Sanitation, and Correction Departments. In addition, there are signs that the demand for social services is on the rise, as evidenced by the recent increase in the public assistance caseload and the number of homeless.

The City could realize significant personnel savings, however, because the numbers of police officers, firefighters and teachers retiring, even without incentives, are greater than anticipated. For example, 1,240 police officers left the force during the first five months of the fiscal year, 49 percent more than during the comparable

period last year. Unanticipated turnover savings could be used to fund labor agreements or to help balance the budget.

Police Overtime

The Police Department intends to spend \$373 million on overtime in FY 2002 on crime fighting and activities related to the attack on the World Trade Center. Of this amount, the City expects \$181 million in federal reimbursement. For fiscal years 2003 through 2005, the modification includes an annual appropriation of only \$125 million for overtime.

After the attack on the World Trade Center, the Police Department temporarily suspended Operation Condor, a crime-fighting initiative funded entirely with overtime at an annual cost of \$100 million. Last spring, Police Department officials testified that without Operation Condor, the City would not have been able to achieve further reductions in crime. Operation Condor has since resumed, but it is funded only through March 2002 and the modification makes no provision for Operation Condor, ongoing anti-terrorism measures, or other initiatives in subsequent years. Based on current trends, we estimate that overtime costs in the Police Department could exceed the amounts set aside by the City for fiscal years 2003 through 2005 by \$100 million annually.

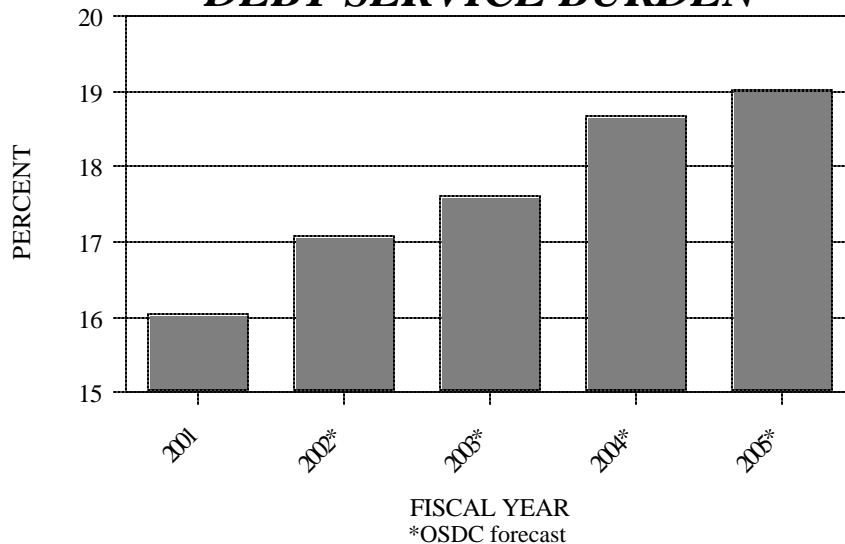
Debt Service

City-funded debt service costs are projected to total \$3.7 billion in FY 2003, more than twice the FY 2002 level. After adjusting for surplus transfers, the rate of growth is reduced to 6 percent, still twice the inflation rate. Debt service costs are projected to rise by 12.5 percent in FY 2004 and then by another 6.5 percent in FY 2005. Throughout the Financial Plan period, debt service costs are rising faster than tax revenues. The debt service burden – the portion of tax revenues needed to pay debt service – grows from 16 percent in FY 2001 to 19 percent by FY 2005, leaving fewer resources for other essential services (see Graph 9).

The rapid growth in debt service costs reflects the planned expansion in the City's capital program. City-funded capital commitments during fiscal years 2001 through 2005 are expected to total \$33.3 billion, compared with \$19 billion during the prior five years. As a result, the amount of outstanding debt is projected to total nearly \$66 billion in FY 2005, 36.8 percent more than in FY 2001.

Graph 9

**NEW YORK CITY
DEBT SERVICE BURDEN**



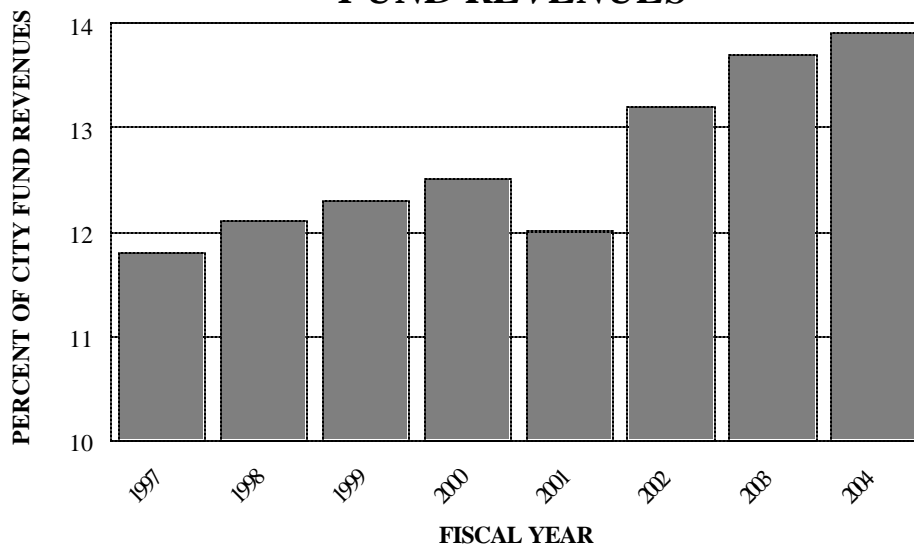
Data Source: NYC Office of Management and Budget; OSDC analysis

Medical Assistance

City-funded Medicaid expenditures averaged about 12 percent of City fund revenues during fiscal years 1997 through 2001 (see Graph 10). In FY 2002, Medicaid expenditures are projected to total \$3.4 billion, an increase of \$106 million over last year's level. Since City fund revenues are projected to decline in the current fiscal year and then grow more slowly than Medicaid in future years, an increasing portion of City fund revenues will be needed to fund Medicaid, leaving fewer resources for other essential services. In FY 2001, 12 percent of City fund revenues were needed to fund Medicaid, but that amount will increase to almost 14 percent by FY 2004.

In response to the economic fallout from the WTC attacks, the State implemented a temporary Disaster Relief Medicaid program (DRM) with a simplified application process. Over 90,000 families have enrolled in less than two months, considerably more than anticipated. The modification anticipates \$35 million in federal disaster funding in FY 2002 and \$7 million in FY 2003 to help cover the added costs for these individuals. Since most of these individuals are expected to transfer to the regular Medicaid Program or Family Health Plus, and others are likely to apply in the future, the City could face significantly higher Medicaid costs beginning in FY 2003.

Graph 10
***MEDICAID AS A PERCENT OF CITY
FUND REVENUES***



Source: NYC Office of Management and Budget, OSDC Analysis

Based on this development and a review of Medicaid spending patterns, Medicaid costs could be higher by \$50 million in FY 2002, \$75 million in FY 2003, and by \$100 million annually beginning in FY 2004. The modification also assumes an unrealistically low rate of growth in FY 2005. Taking into account recent rates of growth and those predicted by the City for FY 2004, we estimate that Medicaid costs could be higher by another \$100 million in FY 2005. The City is also reviewing Medicaid spending patterns and anticipates updating its estimates in the February 2002 Plan.

The modification also assumes that the federal government will increase the Medicaid reimbursement rate for New York State resulting in savings to New York City of \$48 million in FY 2003 and \$66 million annually thereafter. New York State is one of only three states that require localities to share in the cost of Medicaid, and New York State receives the lowest reimbursement rate from the federal government. The federal government may be more sympathetic to the City's request in light of September 11th, but since it is facing its own budget problems the outcome is uncertain.

Public Assistance

Between fiscal years 1995 and 2001, the average number of persons receiving public assistance in New York City fell to 534,805 from 1,146,829 recipients, a

reduction of 53 percent. Caseload declines provided the City with cumulative savings of \$1.9 billion and about \$450 million in recurring savings.

The modification assumes that the caseload will continue to decline, but the caseload grew in October 2001 by 3,500 persons, the largest monthly increase since March 1995, and by another 2,000 persons in November. Nearly two-thirds of the increase was in the Safety Net Assistance Program, which provides benefits to those ineligible for the federal Temporary Assistance to Needy Families program. While this is a worrisome development, it is too early to determine whether these increases represent a long-term trend.

As a result of the slowing economy, rising unemployment levels, and shortcomings in the City's employment programs, the job market for welfare recipients appears bleak. These factors signal the possibility that, for the first time in six years, the City and the State could be faced with higher caseloads. The modification, however, lacks funding to cover a sustained caseload increase.

Changes in City, State or federal policies could also affect future expenditures. The TANF program is currently under review by Congress and is up for reauthorization in October 2002. It remains to be seen whether the block grant will be reduced in light of the large caseload reductions since 1995.

Under federal welfare reform, federal benefits are limited to a lifetime cap of 60 months. About 38,000 families statewide will lose their federal benefits in December 2001, of which 32,000 live in New York City. An additional 10,000 New York City families could lose benefits in January and February 2002, and another 1,300 families could lose benefits each month from March 2002 through September 2002.

Those losing federal benefits can apply for similar benefits under the State Safety Net Assistance Program, which is funded exclusively by the State and its localities. In the wake of the September 11th terrorist attack, which damaged the City's welfare information systems, there is concern about processing delays disrupting benefits to the needy.

Judgments and Claims

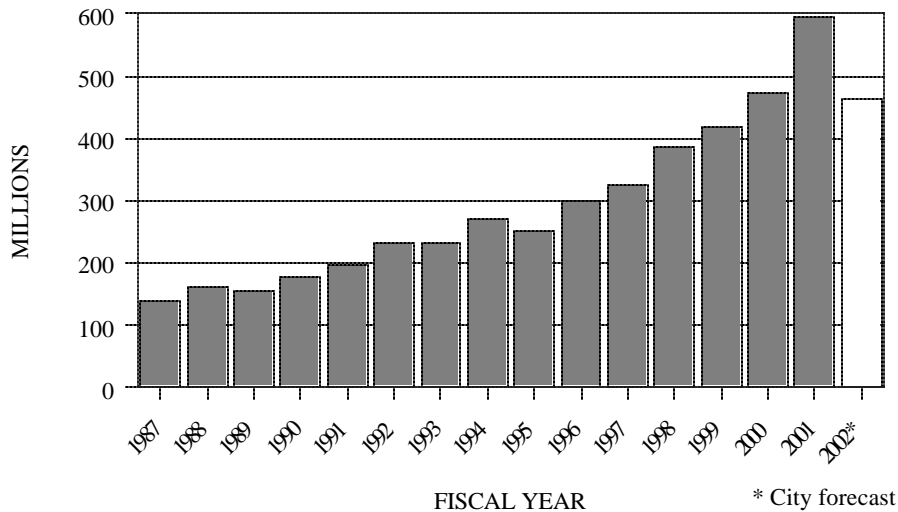
The City spent a record \$600 million on judgments and claims in FY 2001, an increase of more than 300 percent since FY 1987 and twice the FY 1996 amount (see Graph 11). Much of the growth is due to an increase in the number and size of "heavy hitters", cases that cost the City \$1 million or more.

In FY 2001, "heavy hitters" cost \$237 million, an increase of \$81 million, or 52 percent, compared with the prior year. Medical malpractice cases, which have the

highest average cost per case at about \$450,000, constitute about one-third of judgments and claims expenditures, and have increased by 64 percent since FY 1996.

Graph 11

**JUDGMENTS AND CLAIMS
EXPENDITURES**



Data Sources: NYC Comptroller's Office, Office of Management and Budget

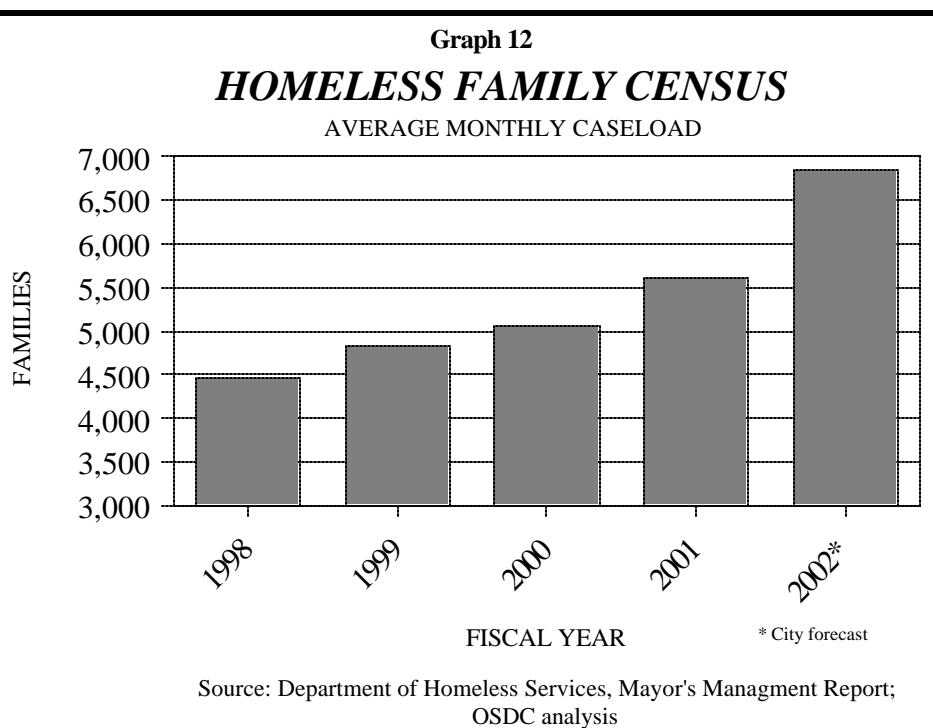
The modification, however, includes only \$464 million in FY 2002 to settle cases against the City and an average of \$509 million in subsequent years. Based on current trends, caseload, and policies, we estimate that judgments and claims expenditures could exceed the City's estimates by \$100 million in FY 2002, \$125 million in FY 2003, \$150 million in FY 2004 and \$175 million in FY 2005.

In addition, the City faces the possibility of liability costs as a result of the World Trade Center disaster and, in fact, the City has already been notified by potential litigants of their intention to file a lawsuit. The federal government capped the City's liability at \$350 million and also capped the liabilities of the Port Authority of New York and New Jersey, Silverstein Properties, Inc., and the airline industry.

Victims of the September 11th attack are being encouraged to seek compensation from the newly created federal Victims Compensation Fund. The Fund offers survivors and victims' relatives compensation, which could total up to \$11 billion, but only if they agree to forego litigation.

Housing the Homeless

The number of homeless families in City shelters has increased dramatically since FY 1998 (see Graph 12). On November 30, 2001, there were 6,669 families (22,226 individuals) living in City shelters, 53 percent more than in June 1998 and the largest population in at least 13 years. In addition, the average length of stay has increased to 343 days, 20 percent longer than June 1998.



The main factor contributing to the increase in homeless families is the scarcity of permanent housing for low-income families.⁶ In recent years, the number of homeless families relocated by the City to permanent housing has been declining, primarily because fewer landlords are accepting Section 8 federal housing vouchers, the condition of many apartments offered by landlords are unacceptable, and fewer apartments are being renovated by the City's Department of Housing Preservation and Development.

The number of homeless individuals using shelters is also increasing. In November 2001, almost 7,600 persons slept in City shelters on an average night, an increase of 8 percent since November 2000.

⁶ See Report No. 8-2000, *No Room for Growth: Affordable Housing and Economic Development in New York City*.

V. Federal Disaster Aid

In the aftermath of the attack on the World Trade Center, President Bush promised New York City \$20 billion in assistance. Under pressure from the administration to keep spending for homeland security and recovery costs under \$40 billion in the current federal fiscal year, the House of Representatives passed a bill that would provide New York City with \$9.8 billion. A Senate bill would provide New York City with \$12.4 billion, including \$5.8 billion to remove debris and repair public works projects, such as the PATH train; \$2 billion for community development block grants; \$290 million for highways, ferries and mass transit; \$175 million for workers' compensation; \$140 million to reimburse New York hospitals; \$120 million for loans to small businesses; and \$100 million for Hudson River Rail Tunnel security. The President has indicated that the balance of the promised funds will be appropriated as needed in subsequent federal fiscal years.

Although the federal government does not intend to reimburse the City's budget for lost revenues related to September 11th, it's unclear to what extent the City may be able to use some of the resources appropriated by the federal government to supplant current City efforts, thereby helping to balance the operating budget.

The City currently estimates that rescue, recovery and clean-up costs related to the World Trade Center tragedy could total about \$2 billion, far less than the initial estimate of \$11.5 billion. Of this amount, the City estimates that \$1.6 billion will be needed from the federal government to remove debris; stabilize the area; and pay overtime costs in the Police and Fire Departments (see Table 7 on next page).

In addition, New York City is requesting another \$399 million in unrestricted federal aid in the current year and much smaller amounts in subsequent years to help balance the budget. These resources would offset capital losses (\$163 million) and to fund the salaries (\$236 million) of police officers and firefighters assigned to "Ground Hero" between September 11th and the end of October.

Since the City did not hire additional personnel to help in the rescue and recovery efforts, but instead assigned existing personnel, such as police officers and firefighters, the federal resources would free up City funds that had previously been appropriated in the Adopted Budget. The freed up City funds could then be used to help balance the City's operating budget. Similarly, the City intends to use federal resources that are intended to replace capital assets, such as fire trucks or roads, in its operating budget and then use proceeds from long-term bonds to replace the damaged assets. If the federal resources are not available, the City intends to issue bonds under new authority granted to the Transitional Finance Authority, and to use the proceeds in its operating budget.

Table 7
Extraordinary Costs Related to the Attack
On the World Trade Center
(millions)

Debris Removal	\$ 1,047
Police Department	210
Fire Department	76
Department of Sanitation	59
Department of Administrative Services	44
Department of Social Services	35
Awards to Widows of Police and Firefighters	25
Department of Health	20
Board of Education	18
Department of Transportation	15
Office of the Mayor	14
Department of Telecommunications and Technology	11
Department of Homeless Services	10
Board of Elections	10
Family Center	10
Health and Hospitals Corporation	7
Department of Environmental Protection	6
Office of Emergency Management	<u>5</u>
Subtotal	1,622
All Other	45
Total	\$ 1,667

Source: NYC Office of Management and Budget

Shortly after September 11th, the State authorized the Transitional Finance Authority (TFA) to issue notes and bonds to reimburse the operating and capital budgets for costs related to the World Trade Center disaster. The proceeds of the notes are intended to provide the City with up-front cash in the event that federal and State aid is not received on a timely basis. The City expects to repay the notes when the aid is received, but if the aid is not available when the notes mature, the principal and interest will be repaid with proceeds from TFA bonds or renewal notes. In October 2001, the TFA issued \$1 billion of recovery notes, which will mature in October 2002.

According to the City, the proceeds from the TFA notes and bonds can also reimburse the operating and capital budgets for disaster-related costs not recognized by the federal or State governments. As previously discussed, the FY 2002 gap-closing program assumes the receipt of \$399 million in federal disaster aid to cover the cost of lost capital assets and the salaries of firefighters, police officers and others involved in the rescue and recovery efforts. If these costs were not deemed eligible for federal reimbursement, then the City would use TFA proceeds to reimburse the operating budget.

VI. Covered Organizations

Covered organizations are semi-autonomous agencies subject to the Financial Emergency Act and include the Board of Education, the Health and Hospitals Corporation, and the Transit Authority. The City has a financial relationship with these agencies and may be called upon to provide additional funding to help balance their budgets.

Board of Education

Prior to September 11th, the Board of Education projected a budget gap of \$291 million in the current fiscal year. The gap resulted from a \$120 million shortfall in City funding and a \$171 million shortfall in State education aid.

The City had assumed that State education aid would grow fast enough to fund both planned educational initiatives and to cover 40 percent of a proposed labor agreement with Board of Education employees, patterned after the agreement reached with District Council 37. Since all of these resources failed to materialize in the current fiscal year, the Board was required to cut planned spending to maintain budget balance. The Board still faces a liability of \$238 million in FY 2003 and \$247 million in each of fiscal years 2004 and 2005 if State education aid does not grow fast enough to cover the cost of both planned educational initiatives and higher labor costs in those years. Moreover, as discussed earlier in this report, the unions representing certain City employees, such as teachers and police officers, have requested wage increases significantly greater than those granted to District Council 37.

City funding to the Board was reduced by another \$97 million as part of a citywide program to offset anticipated revenue losses from the World Trade Center disaster. Thus, in total, the Board faced a total budget gap of \$388 million in the current fiscal year.

To help close the gap, the Board of Education ordered school districts to cut planned spending by \$151 million. Some school districts were able to avoid a reduction in educational services by returning surplus funds to the central board, but other school districts cut after-school programs, district office personnel, professional development courses, and support staff. The Board also implemented a series of management improvements, such as cutting central administrative costs, which are expected to yield another \$100 million in savings, and a freeze in planned program expansions, such as Project English and Project Science, for savings of \$40 million. The Board is also working with the State to use \$32 million in aid targeted to expand pre-kindergarten programs (*i.e.*, categorical aid) to offset the reduction in City funding

to avoid an impact on other educational services. To meet the balance of its cost-reduction target, the Board intends to eliminate funding for minor maintenance and reduce funding to other programs.

In addition, the State budget includes only \$33 million to fund State education aid owed to the City from prior years. The City Comptroller has stated that he will write off unpaid claims that are ten or more years old and \$93 million in claims will be reaching the time limit in FY 2002. As a result, the Board faces a liability of \$60 million in FY 2002, \$72 million in FY 2003, \$96 million in FY 2004, and \$14 million in FY 2005.

The Board of Education is also seeking federal resources to provide counseling services to students affected by the World Trade Center disaster; extend the school day to make up for lost instructional time; repair damaged buildings; purchase replacement textbooks and supplies; and to relocate students from affected buildings.

The Board's five-year capital program is in its third year and was projected to exceed its budget by as much as \$2.3 billion. On December 14, 2001, the Board passed an amendment to the capital program that reduces the number of projects to be completed during the balance of the five-year capital program to ensure a balanced budget.

Health and Hospitals Corporation

The Health and Hospitals Corporation (HHC) has greatly improved its fiscal position and operations since the mid-1990s. Nonetheless, HHC will be hard pressed to maintain positive cash balances in the years ahead. HHC is currently projecting cash deficits of \$217 million in FY 2003, \$486 million in FY 2004, and \$560 million in FY 2005, due largely to nonreimbursed costs for providing care to the indigent. To close these gaps, HHC is counting on the federal and State government for additional aid, but given the magnitude of the projected gaps the City could also be called upon to increase its funding. In addition, the gap-closing program calls for staff reductions of 3,500 employees, which could adversely affect services and HHC's efforts to increase its market share of insured patients.

New York City Transit Authority

The Metropolitan Transportation Authority (MTA) operates the City's buses and subways (New York City Transit Authority), the commuter railroads that serve the central business district, and major bridges and tunnels. The World Trade Center tragedy severely affected the MTA's operating and capital budgets, both in the short-term and long-term. The MTA's finances, however, were already deteriorating before September 11th due to the slowing economy. The MTA is especially vulnerable

because economically sensitive revenues, such as fares, tolls and taxes, fund 85 percent of its operations.

Although the MTA expects to balance its 2002 operating budget with insurance proceeds, federal aid and other actions, no timetable has been set for revising its budget estimates for 2003 and 2004. A recent report found that the budget gaps for 2003 and 2004 are likely to be significantly higher than currently forecast by the MTA (see Report 9-2002, *The Impact of the World Trade Center Tragedy on the Metropolitan Transportation Authority*).