CITIZENS BUDGET COMMISSION

One Penn Plaza ▪ Suite 640 ▪ New York, NY 10119

March 22, 2006

Honorable Michael R. Bloomberg
Office of the Mayor
City Hall
New York, NY 10007

Dear Mayor Bloomberg:

Your January Financial Plan contained good news for New Yorkers: local economic growth that continues to exceed expectations, a current year surplus in excess of $3 billion, and an important and praiseworthy proposal to use surplus funds to create a Health Insurance Trust Fund. The CBC has already conveyed its enthusiasm for the Trust Fund and for other elements of your Plan in testimony before the City Council earlier this month. The purposes of this letter are (1) to express again our strong support for your health insurance initiative, and (2) to make suggestions for how the January Plan can be improved as it is shaped into the Executive Budget scheduled for release next month.

1. Strong Support for the Health Insurance Trust Fund

The City's current policy of paying the full cost of comprehensive health insurance for retired workers and their dependents creates an enormous future fiscal obligation. Until recently there has been no requirement to estimate or report the magnitude of that liability, and the City and other public employers have not done so. However, recent changes in generally accepted accounting principles will require that the City estimate the size of this liability, and preliminary estimates suggest it may be as high as $50 billion. Although there is no requirement to fund this liability, neglecting to do so may adversely affect the City's credit rating and standing in public credit markets.

Your proposal to establish a Health Insurance Trust Fund and to deposit approximately $3 billion in that fund this year and next will significantly improve the situation. The proposed deposits exceed the cash liability by about $1 billion, leaving the City in two years with $2 billion in added resources to help finance future obligations at the end of fiscal year 2007. That would be a meaningful contribution to dealing with a difficult long-run problem.

This fund is potentially a strong tool for fiscal responsibility; however, its strength will be determined by three factors. First, as you propose, deposits into this fund should be irrevocable; there should be no potential to divert them to other purposes in the future. Second, the Fund's transactions and condition should be transparent. Since the Fund will be an off-budget entity maintained with deposits from the general fund, there should be consistent, comprehensive and clear reporting of its activities to ensure transparency and accountability. Third, deposits should continue beyond the first two years. The City should commit to a long-term funding policy for retiree health insurance benefits, and should

appropriate funds in each future year in accord with a predetermined schedule in order to reduce its unfunded liabilities for this purpose.

The proposed Health Insurance Trust Fund also is important and promising because it helps highlight the large and rising costs associated with the current policy of paying the full costs of health insurance for retirees and their dependents. As the CBC documented in its recent report, *The Case for Redesigning Retirement Benefits for New York's Public Employees,* this policy is unusual and unnecessarily generous relative to other large employers. In the ongoing negotiations with municipal employee unions, you and Commissioner Hanley should give priority to changes that will reduce the future cost of retiree health insurance, such as requiring some employee and retiree contribution towards premium costs.

2. Recommendations for Improving the Financial Plan

As you move from the preliminary January Financial Plan to the Executive Budget for fiscal year 2007, there are three noteworthy ways in which the Plan can be improved:

- *Better Use of the Surplus* – Surplus revenues should be used to prepare the City for future economic downturns and reduce future fiscal obligations, not as one-shots to help cover operating deficits.
- *Restraint on Spending* – Aggressive efforts should be made to limit "uncontrollable" items, such as pensions, fringe benefits, Medicaid and debt service, thereby slowing the growth of municipal expenditures.
- *Reducing the Cost of Government* – New approaches should be developed to increase productivity and thereby reduce the cost of providing public services.

Surplus revenues should be used to prepare the City for future economic downturns and to reduce future fiscal obligations. Although $2 billion of unanticipated resources generated this year will be allocated to the Health Insurance Trust Fund, the City's surplus is even larger and you propose devoting the remainder of these funds to less prudent purposes. The January Plan proposed that $3.2 billion generated in fiscal year 2006 be "rolled over" to provide fully 55 percent of the total gap-closing actions needed to bring the fiscal year 2007 budget into balance. Rolling a surplus into the next year through prepayments of expenses has become a common budgetary practice; however, the repeated use of unanticipated resources to reduce projected deficits and support ongoing operations masks the structural imbalance between the growth of the tax base and that of expenditures and only postpones taking needed actions to achieve true budget balance.

An annual surplus should not be treated as a recurring revenue that can support ongoing operating expenses; rather these resources should be devoted to preparing the City for future economic downturns through the creation of a rainy day fund or to reducing future financial obligations. Creating the Health Insurance Trust Fund with a portion of the surplus revenues is an excellent example of his strategy; however, the City should pursue other forward-looking actions with the additional current year surplus. Desirable options include increasing

pay-as-you-go capital investments, retiring outstanding debt, and larger contributions to the Health Care Trust Fund.

Aggressive efforts should be made to limit so-called "uncontrollable" expenditures. The City should exercise greater restraint in its spending plans. City-funded expenditures grew at an average of 8 percent annually from fiscal year 2002 to 2005 – a rate much higher than general price inflation. The January Plan projects growth in expenditures at an annual average rate of 3.5 percent for fiscal years 2006 – 2010, but the Plan the does not reflect risks associated with new costs from future rounds of collective bargaining and from the implementation of the State Court decision in the CFE case, which may boost future expenditure requirements.

The major drivers of expenditures are the so-called "uncontrollables" – debt service, Medicaid, pensions and fringe benefits. These items have grown at an average annual rate of 11 percent for the past four fiscal years, compared to only 4.7 percent for the rest of the budget. According to the January financial plan, while the rest of the budget will grow at an average annual rate of 1 percent, the uncontrollables will grow 6 percent annually, on average. In fiscal year 2010, the uncontrollable portion of the budget is projected to be $24.2 billion – 40 percent of the total budget and roughly half of all City funds.

In our May 2005 report, *The Myth of the "Uncontrollables,"* the CBC recommended ways to save $2.5 billion by taking control over these items, and we are pleased that you have been responsive to some of this advice. In your latest "State of the City" address and your January budget presentation, you emphasized the importance of working with municipal unions to negotiate employee contributions to health insurance plans and to enact pension reform. As the CBC has documented, the benefits provided by the City are more generous than those provided by private employers, the federal government and other state and local governments. Furthermore, the generosity of these benefits can no longer be justified on the basis that workers earn less than their counterparts in the private sector; recent data indicate that workers in the public sector earn more than their counterparts in the private sector for most occupations. We strongly support your proposals to add another tier to the pension system and to obtain contributions from workers for their health insurance.

Proactive steps are needed to address Medicaid and debt service expenses, as well. Recent State action to cap the growth in the City's Medicaid payments is an important step in controlling local Medicaid expenses, but it does not reduce the enormity of these expenses, which will reach $5.4 billion in fiscal year 2010. Aggressive lobbying of Albany should continue, focusing on stricter cost-containment of Medicaid expenses. The CBC's 2004 report, *Confronting the Tradeoffs in Medicaid Cost Containment,* offers specific recommendations that could yield significant savings without adversely affecting medical care for the indigent. Taking these steps will be critical to maintaining the long-term fiscal health of New York State and New York City.

Debt service can be controlled by limiting borrowing for capital projects. While the January Plan provides $200 million for pay-as-you-go capital investments in each year, this is a small dent against a $38 billion capital commitment plan. Greater reliance on pay-as-you-go

funding and careful screening of planned capital projects could limit future debt service payments.

New approaches are needed to reduce the cost of government. Besides reining in the uncontrollables, another way to reduce spending is to lower the unit cost of providing services. A necessary first step in this strategy is to identify and report the unit cost of the major municipal services. As CBC has previously expressed to the Office of Operations, there should be a greater focus in the *Mayor's Management Report* on reporting the unit cost for the services provided by City government. Such reporting would allow for greater precision in agency cost-reduction programs and for comparison with other local governments. For example, the cost of library services as measured by City-funded operating expenses per item circulated is estimated at $5.54; figures from the International City/County Management Association show the cost to be somewhat higher in San Francisco ($6.31), but lower in most other large cities, including Phoenix ($1.99) and San Diego ($4.50). Reporting and benchmarking unit costs is a basic and vital step in pursuing an efficiently-run government.

Another key to efficient government is a productive workforce. One key way to promote a more productive workforce is to negotiate work rule changes in collective bargaining agreements. The last round of collective bargaining established a good beginning for this strategy by requiring that a portion of the salary increase be funded by some concessions from the unions. However, most of the concessions involved lower starting salaries or "time-for-money" increases that do not change the way the workforce operates. CBC urges continuing your insistence on productivity-funded increases in the next round of bargaining, but recommends that all raises be offset by such gains and that the new concessions involve work rule changes that lower the unit cost of producing services.

We hope you find the CBC's support and suggestions helpful as you formulate the Executive Budget and would be pleased to discuss our concerns with you and your staff.

Respectfully,

H. Dale Hemmerdinger
Chairman

Diana Fortuna
President