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Inside the Budget

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What's Driving New York City's Growing Pension Burden?

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The city's pension contributions for its over 180,000 municipal retirees and 250,000 active employees have risen dramatically in recent years, from $1.1 billion in 2001, or 4.3 percent of city-funded spending, to an estimated $2.5 billion in the current fiscal year—8.3 percent of city-funded spending. Recent Mayor's Office of Management and Budget projections show pension costs growing to $4.3 billion by fiscal year 2007, or 12.4 percent of city-funded spending. Pension costs are the fastest-rising share of the budget: the average annual growth in pension costs between 2003 and 2007 is projected to be 29 percent, while all other city-funded spending will grow just 2 percent annually.

Several factors have contributed to this growing burden. Stock market losses in the pension funds' investment portfolios have received the most attention, but increases in pension benefits as a result of collective bargaining settlements and state legislation to provide a cost-of-living adjustment (COLA) to current and future pensioners have added substantially to the city's annual pension burden. Moreover, while the increase in city pension costs due to investment losses will grow over the next several years, the effect is temporary because the city will eventually pay off its liability for the losses. In contrast, recent benefit enhancements due to collective bargaining or state legislative action will permanently increase the city's annual pension costs.

Pension Contributions Are A Growing Share of City Spending
Dollars in millions

	2003	2004	2005	2006	2007
City-funded pension contributions	$1,532	$2,459	$3,083	$3,893	$4,300
Total city-funded spending	$29,493	$29,700	$32,028	$33,664	$34,665
Pension contributions as percent of spending	5.2%	8.3%	9.6%	11.6%	12.4%

SOURCES: IBO; Mayor's Office of Management and Budget.

Analyzing the Growth in 2004 Pension Costs. The pension burden for fiscal year 2004, which began July 1st, is nearly four times more than the Mayor's budget office expected just three years ago (the first time there was a projection for 2004). In April 2000, the Mayor's office projected city pension contributions of $650 million for 2004. Three years later, the budget adopted in June 2003 for the 2004 fiscal year forecasts $2.46 billion in pension spending, $1.8 billion more than expected. City pension contributions, originally forecast at 2.2 percent of city-funded spending, are now expected to consume 8.3 percent of city-funded spending in 2004.

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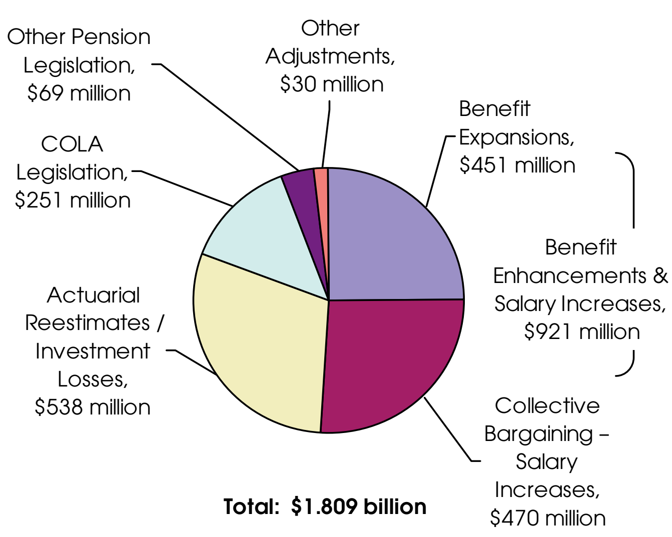
The large increase is in part due to an unusually low level of pension contributions at the time the original forecast was made in April 2000. Normally, gains and losses in the value of the pension funds' investments are phased in over time. In 2000, however, the city implemented a "market value restart," immediately recognizing the gains of the 1990s stock market boom in the pension fund portfolio, and reducing the city's required pension contributions accordingly. Because then-Mayor Giuliani's April 2000 forecast incorporated these historically low pension contribution projections, the April 2000 to June 2003 comparison represents a substantial increase.

Collective Bargaining/Benefit Enhancements. Despite the widespread attention received by the pension funds' investment losses, over half the required additional contribution for 2004, $921 million, is the result of salary increases and enhancements to retirement benefits, arising both from collective bargaining and from state legislation. For example, salary increases in 2001 added $371 million to 2004 pension contributions, and the United Federation of Teachers' 2002 salary increase added $99 million, for a total of $470 million. Benefit enhancements are attributable not only to collective bargaining, but also to unilateral state legislative action. Benefit improvements as part of a collective bargaining settlement in 2000 added $279 million, and the teacher union's successful ruling in the "per session" lawsuit cost the city an additional $100 million annually. Other benefit increases add $72 million, for a total of $451 million in benefit improvement costs.

Cost-of-Living Adjustment. By far the most costly benefit enhancement, however, was the enactment in 2000 by the state of an annual cost-of-living adjustment for all existing and future pensioners. Prior to this legislation, plan beneficiaries received a fixed, non-inflation-adjusted annuity. The city is allowed to phase in the additional annual cost of the COLA over 10 years, from 2001 to 2010, and it will contribute $251 million towards this obligation in 2004. The obligation will grow each year until 2010 when it is fully phased in, at which point it will permanently add $822 million to the city's annual pension contribution (an amount that should be sufficient to cover additional cost-of-living increases).

Sources of Growth in 2004 Pension Contributions April 2000 Projection to 2004 Adopted Budget



SOURCES: IBO; Mayor's Office of Management and Budget; Office of the Actuary.

Investment Losses. Investment losses from fiscal years 2001 and 2002, along with revised estimates by the city's actuary of future liabilities, account for $538 million of the additional pension cost in 2004. Despite the widespread public attention on the bear market and its effect on the city's pension funds, the effect of investment losses is relatively less in 2004 than the recent benefit enhancements resulting from collective bargaining and state legislation. Paying for the investment losses will grow rapidly over the next few years, however, while most of the other changes—with the notable exception of the COLA—have already been fully recognized.

The city's actuary by law assumes that pension fund investments will return 8 percent each year, but in both 2001 and 2002, the city's pension investments in fact *lost* over 8 percent each year. The liability arising from these losses is phased into the city's pension balance sheet over five years. Each year as a share of the liability is recognized, the city begins a series of long-term payments to retire the investment-loss liability. The full cost of the losses is then amortized over a period of years (the exact period is calculated based on the estimated average number of years to retirement of city workers). Should the city experience no further sizable gains or losses in its investment portfolio, the cost to the city associated with the 2001 and 2002 losses will grow substantially over the next years—adding over $1.5 billion to pensions costs in 2007—remain steady thereafter, and eventually decline as the liability is paid off after a number of years.

Other Legislation/Adjustments. Other legislation and actuarial adjustments account for nearly $100 million in additional costs in 2004. These include changes in how the base salary is calculated to determine pension contributions, the cost of early retirement initiatives, certain supplemental benefits, and other actions.

A Growing Burden? The city's growing pension costs result from a combination of investment losses, negotiated salary increases, and benefit enhancements. Going forward, the city's pension costs attributable to investment losses will grow relative to benefit enhancements, which have already largely been phased in. While the cost of the unfunded liability associated with the investment losses is large, it will eventually decline as it is paid off. In contrast, salary increases and benefit enhancements permanently increase annual pension costs. Of the $1.8 billion in increased pension cost for 2004, nearly $1.3 billion represents a permanent annual increase in pension costs, including the current amount needed for the COLA. When the phase in of the COLA is complete in 2010, the total amount of the permanent pension contribution increases currently in effect for the city will be $1.9 billion. In the future, the city faces not only growing, but also permanently higher pension contributions.

Written by Eric Bickford

Temporary Tax Hikes, Declining Revenue

To help balance its fiscal year 2004 budget, the city is counting on what IBO estimates will be over $1.4 billion in new taxes that were authorized by the state legislature in May. Most of these increases are scheduled to expire within the next 36 months, which means that the total additional revenue is expected to decline to $813 million in 2005, $419 million in 2006, and then $126 million in 2007. The largest increases were in the personal income tax and the sales tax; the increases for these taxes are among those scheduled to expire.

Personal Income Tax. Personal income tax rates were increased for high-income households (individuals with income over $100,000 and couples over $150,000) beginning with calendar year 2003. The higher rate will be scaled back for 2004 and then again for 2005. The higher rates are scheduled to be fully eliminated as of January 1, 2006. (There was a similar increase for the state income tax, which will also be eliminated using the same schedule.) IBO estimates that under this schedule the rate increase will yield $784 million for the city in fiscal year 2004, $551 million in 2005, and $281 million in 2006.

Sales Tax. The city's basic sales tax rate was increased from 4.0 percent to 4.125 percent for 24 months beginning on June 1, 2003, which will produce $131 million annually in fiscal years 2004 and 2005. On June 1, 2005 the rate will return to 4.0 percent and as a result there will be no additional revenue in fiscal year 2006. (The state sales tax rate was also temporarily increased from 4.0 percent to 4.25 percent for the same period.)

Sales Tax Exemption on Clothing. In addition to the sales tax rate increase, the state ended the state and city sales tax exemption for clothing items costing under $110 as of June 1, 2003. The total tax on these items is now 8.625 percent (4.125 percent for the city, 4.25 percent for the state and 0.25 percent for the Metropolitan Transportation Authority.) There will be two one-week holidays from the new clothing tax during this fiscal year, one around Labor Day and the other around Martin Luther King, Jr. Day. While the state change is permanent, the city plans to reestablish its clothing exemption after one year. Therefore, on June 1, 2004 the city sales tax on clothing items under $110 will once again be zero, while the combined state and transportation authority tax will be 4.5 percent until May 31, 2005 and 4.25 percent thereafter. After accounting for the impact of the tax holidays, IBO expects the city to raise $200 million for fiscal year 2004. The restoration of the exemption means that there will be no new revenue in 2005 and 2006.

Written by George Sweeting