

Cyclical Budget Management in New York City

by

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Abstract:

This paper describes and analyzes the unusual approach to cyclical budget management used by the City of New York. State law enacted after the 1975 fiscal crisis requires the City to end each fiscal year in GAAP balance, and provides for significant penalties if the City incurs a GAAP deficit of more than \$100 million. Since withdrawals draws from a rainy day fund are not revenue for GAAP budget-balancing purposes, New York City instead relies on a complex mechanism termed the “surplus roll” for managing cyclical budget pressures. This quasi-reserve fund was fashioned with the approval of the City’s independent auditors. The paper reviews the mechanics of the surplus roll and shows how it was used, in conjunction with other funding sources, to respond to shortfalls in economically sensitive revenues coincident with and following the attacks of September 11, 2001.

Introduction

In the immediate aftermath of the New York City fiscal crisis, the legislature of the State of New York passed the Financial Emergency Act of 1975 (FEA). This statute established a system for managing the City’s finances that has endured for more than thirty years. The original statutory date for the sunset of the FEA is 2008, and City and State officials have begun to debate the strengths and weaknesses of that statute as they ponder its extension or modification. Moreover, several new provisions of the City Charter mirroring sections of the State FEA were adopted by a ballot initiative in November, 2005.¹

Participants in this debate about the future of New York City financial management system disagree about several elements of the FEA regime. They differ, for example, about the continued existence of the State-dominated Financial Control Board (FCB), especially if it retains the power to impose a “control period.” During a control period, a number of important elements of the City’s financial management are handed over to or shared with the Financial Control Board. The sunset of the last control period in 1986 marked the end of the FCB’s active exercise of significant power over the City’s finances, and a shift in the agency’s mission to fiscal monitoring.

To date, however, there has been little controversy about another cornerstone of the FEA regime – the requirement that New York City end each fiscal year with a budget balanced

¹ As a member and vice chair of New York City’s Charter Revision Commission, I enjoyed the chance in 2004 and 2005 to listen to and participate in this debate. Transcripts of the hearings and meetings can be found on the City’s website at <http://www.nyc.gov/html/charter/html/home/home.shtml>, together with copies of the Commission’s reports and recommendations.

according to generally accepted accounting principles (GAAP). This has been much more than a paper mandate. There are consequences for any significant failure to achieve GAAP balance. The Financial Emergency Act of 1975 requires the FCB to impose a new control period if the City ends the year with a GAAP deficit of more than \$100 million. This paper outlines the actions the City has taken in response to this mandate for GAAP balance, and reflects on some of the consequences, intended and otherwise, of this provision of the FEA.

At a broader level of generality, the paper also highlights the tension between two models for financial management. The system established by the FEA, including the requirement for mandated GAAP balance, was designed to force New York City to balance its budget annually, and to guide it towards *structural budget balance*. Other state and local governments, especially those with economically sensitive revenue streams, typically operate with additional tools designed to help maintain *cyclical budget balance*.

Annual and Structural Budget Balance

The requirement for annual budget balance is a cornerstone of New York City's financial management system. With the consequences of manipulation of cash-basis budgets still evident, the authors of the Financial Emergency Act of 1975 required the City to budget according to GAAP, and to balance its operating budget annually. Moreover, the requirement to balance its budget under GAAP extends to the City's budget in every phase of its development: first, to the Executive Budget proposed by the mayor; next, to the budget as adopted by the City Council; and finally and most unusual, to the City's books when closed after the end of the fiscal year. As described above, a GAAP deficit of \$100 million or more also triggers the reimposition of a control period by the FCB, a consequence that no mayor would welcome.

In its simplest formulation, GAAP balance means that revenues must equal or exceed expenditures in the City's general fund. It is important to note that this approach makes it impossible for the City to use a rainy day fund as a countercyclical tool. Although "draws" from rainy day funds or from general fund balances can provide resources to cushion downturns, they cannot eliminate GAAP deficits in the City's financial statements. Under generally accepted accounting principles, draws from rainy day funds are not revenues in the years when they are used, since they were previously booked as revenues in the year they were earned or collected. So the FEA requirement for the imposition of a control period by the Financial Control Board would apply if the City used more than \$100 million from a rainy fund. To repeat a central fact of life under the FEA, failure to balance the budget according to GAAP is consequential, and potentially politically embarrassing.

The original goal of these requirements was to keep the City from manipulating its books and hiding operating large deficits, as it did in the years leading up to the fiscal crisis. In other words, transparency was a goal, along with structural balance. Contrary to original expectations, the practical requirement for annual GAAP balance, coupled with the cyclicity inherent in the City's tax structure, has forced the City to develop budget

management mechanisms that make the actual operation of the City's finances much less transparent. As described in detail below, New York City has developed its own mechanism to manage the budget pressures arising from economic cycles in the form of its "surplus roll," or "prepayment," as it is labeled in the City's financial statements. The surplus roll operates as a quasi-reserve fund for the City, but one which is carefully tailored to help the City achieve the FEA requirement for annual GAAP balance. However, the use of the surplus roll for cyclical budget management also makes it much more difficult for the public to understand the City's true current budget condition.

Annual balance is an explicit requirement of the FEA. An implicit goal of the Financial Emergency Act regime was structural budget balance for the City of New York, although the term does not appear in the law. While scholars and bureaucrats have struggled to define structural balance,² managers trying to achieve it might aim to keep recurring spending and recurring revenues growing at roughly the same rates, and to make adjustments early and often to keep divergences in those growth rates from compounding into significant and potentially dangerous budget gaps. New York City's four year plan and its quarterly plan modifications are the tools developed to meet those goals. These tools build on the mandate for GAAP balance in the first year of the plan, which is designed to ensure that expenditures and revenues are in balance at the beginning of each year.

The multi-year planning process created in the FEA is quite elaborate. Spending and revenues for four full years are projected in broad categories, and the resulting budget gaps (and gaps they always have been) are analyzed, discussed and debated. The Office of Management and Budget is required to update the financial plan every quarter, and submit budget modifications to the City Council for legislative action when major changes in the budget are required. Under its original conception, this system treats projected budget gaps as permanent divergences between revenues and expenditures, and expects recurring cuts in spending or permanent revenue increases to close those gaps. These actions, called PEGs (for programs to eliminate the gap), are detailed and tracked in elaborate plans created by OMB each year to monitor implementation of the adopted budget. This PEG reporting and monitoring program, while not required by the FEA, is now well established practice.

GAAP balance might seem to be a simple standard, based as it is on a single, observable number in the City's financial statements, and verified by the City's outside auditors. Multi-year structural balance, on the other hand, is a much more slippery benchmark, and the City and its monitors have always found it difficult to arrive at operational definitions for structural balance. In the absence of such standards, mayors have not been required to prepare detailed gap-closing programs for the second, third and fourth year of the plans (typically called the out-years),³ but the plans and projected gaps still draw attention to future problems. Virtually every monitoring report by the City or the State comptrollers points to projected budget gaps in the out-years, and warns the Mayor and City Council

² See, for example, Financial Control Board (1992) and Forsythe (1993).

³ FCB 1992 (2) proposed a more extensive planning process which would produce detailed gap-closing plans for the out-years. The City did not adopt its recommendations.

against over-reliance on short-term resources to balance the City's budget. However, as memories of the fiscal crisis fade and out-year gaps appear and are closed without fanfare year after year, the planning process has grown more routine, and warnings about future deficits have lost their urgency. However, the annual requirement for GAAP balance maintains its salience, linked as it is to a resurgence of control by the FCB. No mayor wants to be responsible when power of the City's finances is taken from local officials and handed over to a state board.

Cyclical Budget Management

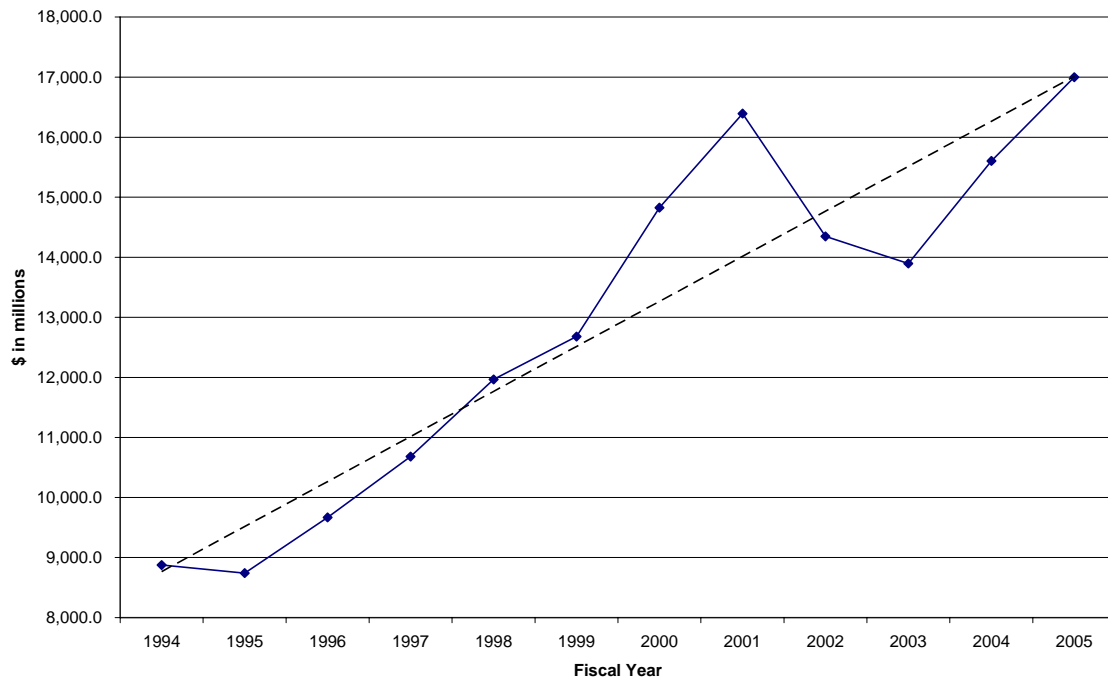
Cyclicality is an important feature of the budgets of many large governments, including New York City. When local economic growth slows, collections from several important tax sources grow more slowly or decline from year to year. Cyclical deficits may arise. Conversely, as the City economy speeds up, collections in those cyclically sensitive taxes grow more quickly and budget pressures diminish. Cyclical surpluses are the likely result. This pattern is characteristic of all governments that rely to any significant extent on economically sensitive sources of revenues.

Many local governments rely primarily on the property tax, which is relatively immune to cyclical fluctuations. In contrast, New York City relies on a variety of taxes which are affected by the local economy, most notably a personal income tax, a local sales tax, and several corporate income taxes. In 2005, those taxes accounted for 53% of the City's tax collections. As the chart below demonstrates, those taxes are sensitive to economic stimuli, and collections deviate significantly from the trend line, which is shown below with a dotted line.⁴

⁴ These data are New York City OMB's published common rate and base series for what I consider to be the City's economically sensitive taxes – the sales, income, hotel occupancy and corporate taxes.

Figure 1

Cyclically Sensitive Taxes



The City also collects real estate transaction taxes, which are sensitive to the vicissitudes of the City’s real estate market, not the general City economy. The rest of the City’s tax revenues – primarily the real property tax – are more stable than these economically sensitive revenue sources.

City expenditures are much less cyclical in their behavior, and the illustration above assumes for simplicity that the City’s expenditures grew at a steady rate equal to the trend line for its economically sensitive taxes. The expected result of these strong cyclical pressures on revenues would be budget surpluses when the City economy is strong and deficits when the economy weakens.

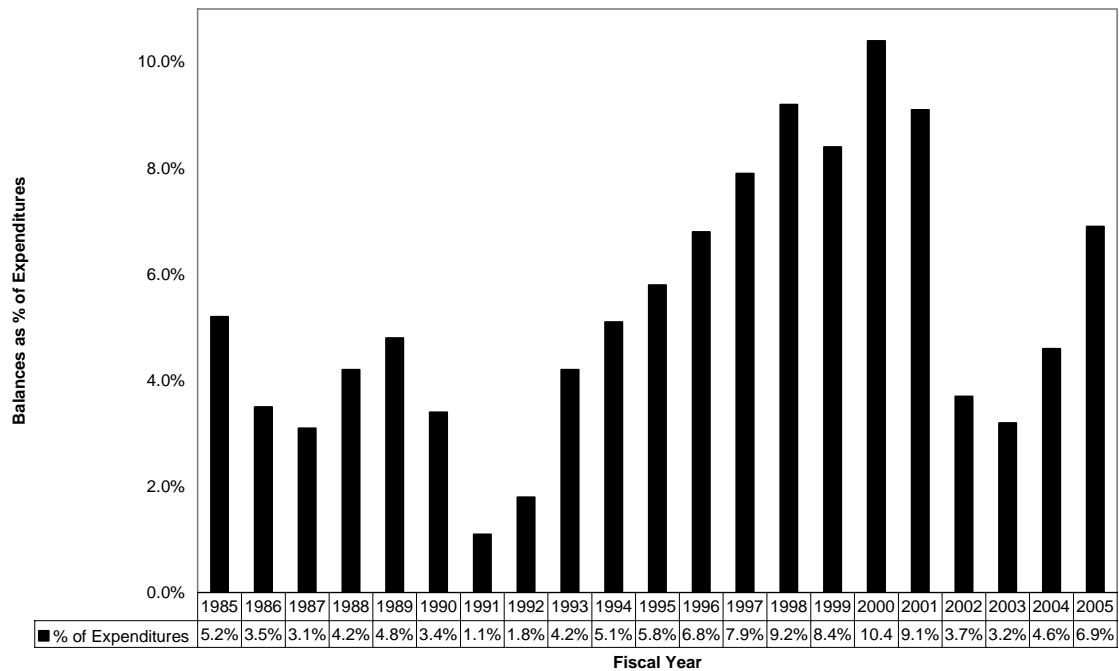
This is an oversimplified picture of the City’s budget. For example, it is likely that the City’s expenditures naturally show a slightly countercyclical trend, growing faster when the economy slows, reflecting higher costs for the City’s share of services to populations likely to be unemployed during recessions. But the expected result would still be cyclical surpluses and cyclical deficits as the economy grows faster or slower. In sharp contrast, the FEA requires GAAP balance each and every year.

The cyclical pressures faced by New York City are similar to those that affect most state budgets. To deal with these ups and downs, most states put aside money when cyclical surpluses arise in good years, and draw down those reserves to fund the cyclical deficits that result when the economy slows. The most visible state budget reserves are so-called “rainy day funds,” but countercyclical reserves are also salted away in other accounts on

the balance sheet. The National Association of State Budget Officers (NASBO) tracks these year-end balances for all the states and these data exhibit a strong cyclical pattern, as demonstrated in Figure 2.⁵ The states build up reserves in periods of economic strength, and draw them down in economic slowdowns.

Figure 2

Preparing for Recession: State Balances as a Percentage of Expenditures



Rainy day funds are not the only tools available to state and local governments for countercyclical budget management. Many governments also rely on pay-as-you-go capital to provide a cushion during economic downturns. Implicitly or explicitly, state governments often establish targets for the percentage of capital outlays to be financed out of current operating revenues. In good years, the government pays that target share of its capital needs – or more – from current operating revenues, funding the rest from federal revenues or receipts from the issuance of bonds. In economic slowdowns, financial managers bond out a larger share of capital outlays, reducing pressures on operating revenues. A recent report by New York State’s Comptroller shows swings in pay-as-you-go capital spending for the State.⁶ Once established in the budget, pay-as-you-go capital can serve as a cushion during periods of slower economic growth. Other cyclical management tools include temporary tax increases or tax cuts, which are used by some governments to help offset cyclical budget deficits or surpluses.

⁵ NASBO, *Fiscal Survey of the States 2005*, pp. 14-15.

⁶ Office of the State Comptroller, New York State, *2005-06 Budget Analysis: Review of the Enacted Budget*, May 2005, available on the web at <http://nysosc3.osc.state.ny.us/reports/budget/2005/enactedbudget051105.pdf>.

The tools described above are helpful in responding to cyclical budget shortfalls or other unexpected and temporary dips in revenues or increases in spending. Recessions are still a feature of the American economy, and those slowdowns can damage state and local budgets. Given their widespread use of those countercyclical tools, however, it is less true today than it was in 1993 that “our budgeting concepts, paradigms and strategies [have failed] to come to grips with the business cycle.”⁷ Scholars are also beginning to measure and track the fiscal shocks that states suffer, and are examining in detail how financial managers and elected officials use rainy day funds to respond to those shocks. Over time, this work will have a significant effect on theory and practice in the field of financial management.⁸

As suggested earlier, however, the rainy day fund cannot be an effective tool in New York City, since the City operates under a financial management paradigm designed to stave off structural budget collapse, not prepare for cyclical downturns. With conventional sources like rainy day funds or general fund balances unavailable, the City’s financial managers have created a quasi-reserve fund in the form of the surplus roll.

During the year, the City accumulates resources. These resources come from revenues above projections in the adopted budget estimates, or spending below appropriated levels. Preliminary analysis of the sources of the surplus roll is displayed in Table 1. This data set is drawn from tables in the 1990-2005 New York City financial statements that detail variances from the adopted budget. Positive variances result from revenues above budget estimates or spending below appropriated levels. Positive variances are used, first, to offset any negative variances resulting from shortfalls in revenues or overspending. Whatever resources remain are available to fund the surplus roll and the small GAAP surplus that the City runs each year. As Table 1 indicates, the City has recently run very sizable positive variances in taxes and other revenues, including intergovernmental aid. Even after offsetting increasing large variances on the spending side, the remaining net variances have produced significant resources to roll into the next fiscal year.⁹

⁷ Forsythe, 1993, p. 1.

⁸ See, for example, Shanna Rose, “State Rainy Day Funds and Responses to Fiscal Shocks Under Rules Versus Discretion,” Stony Brook, 2006.

⁹ Of the total \$3.529 billion rolled from FY 2005 to FY 2006, only \$3.308 billion was generated from variances from the adopted budget. The other \$221 million was in the Budget Stabilization Account when the FY 2005 budget was adopted in June of 2004. To make this point more precisely, in previous years the column in Table 1 marked Net Variance was equal to the roll out plus the very small GAAP surplus. In FY 2005, it was equal to the surplus roll plus the GAAP surplus less the \$221 million already included in the adopted budget for the surplus roll.

Table 1
Variances from the Adopted Budget
(\$ in million)

Fiscal Year	Revenues	Spending	Miscellaneous	Net Variance
1990	(532)	18	767	253
1991	(500)	252	275	27
1992	700	(283)	153	570
1993	803	(456)	65	412
1994	401	(46)	(283)	72
1995	(68)	484	(241)	175
1996	689	(106)	(225)	358
1997	1,473	(67)	(37)	1,369
1998	2,022	302	(98)	2,226
1999	1,886	687	33	2,606
2000	2,985	(92)	(127)	2,766
2001	2,790	(595)	(149)	2,046
2002	1,472	(997)	(134)	341
2003	2,361	(911)	(28)	1,422
2004	3,972	(2,030)	(14)	1,928
2005	4,876	(1,560)	(3)	3,313

The surplus roll uses a variety of mechanisms to move these funds into the next fiscal year. These mechanisms can be summarized as: prepayment of debt service through one device or another; and prepayment of subsidies to organizations which rely on City funding for some portion of their funding. These organizations include the mass transit authority, the public hospital system, and the public libraries. Conceptually, these mechanisms for moving funds from year to year are similar to the games budgeteers used to play with the timing of payments under cash-basis financial systems. However, the City has refined the mechanisms for rolling the surplus so that they are acceptable to its auditors under the GAAP framework. As Table 2 details, between fiscal 2005 and fiscal 2006, the City rolled over a total of \$3.529 billion, including prepayments of subsidies of \$645 million and actions to reduce debt totaling \$2.884 billion.

Table 2
Rolling Funds from Year to Year
(\$ in millions)

	FY 2005	FY 2004	FY 2003
Actions to Prepay Debt			
Transfer to the General Debt Service Fund of real estate taxes collected in excess of the amounts required to finance debt service	341	307	166
Discretionary transfers to the General Debt Service Fund	1,507	662	237
Net equity contributions to bond refundings	1	3	4
Prepayment of lease purchase debt service	88	71	73
Grant to Transitional Financing Authority (TFA)	947	400	624
Prepayment of subsidies			
Advance cash subsidies to libraries	225	112	107
Advance cash subsidies to the TA and MTA	248	209	206
Advance cash subsidies to HHC	172	159	-
Total surplus roll	3,529	1,923	1,417

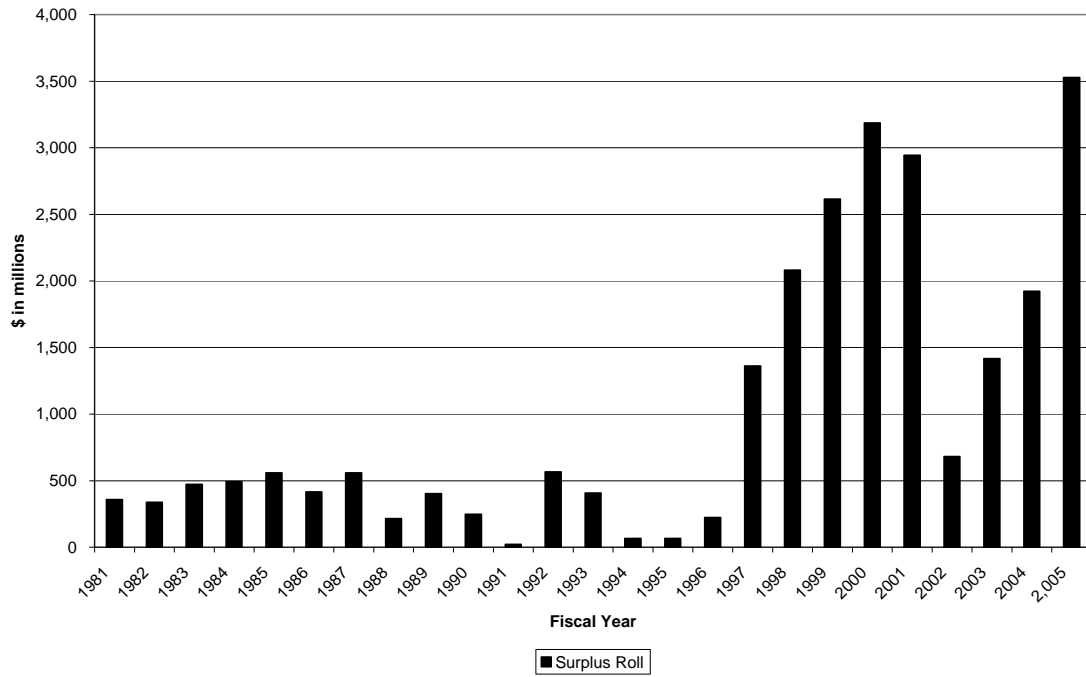
Source: FY 2005 CAFR, p. 18

The grant to the Transitional Financing Authority (TFA) is a relatively new mechanism for moving money from year to year. The TFA grant allows that bonding authority to fund its debt service with a reduced draw on its primary funding source, which is the City's personal income tax (PIT). The result is higher general fund collections of PIT in the next fiscal year.

In FY 1981, the City achieved its first GAAP balanced budget after the fiscal crisis of the mid-1970s. Since then, the budget variances depicted in Table 1 have funded a surplus roll which plays an increasing important role in the management of the City's finances. The amounts of surplus rolled out of one year to prepay expenses in the next are charted below in Figure 3. At the end of FY 2005, the City of New York rolled a record \$3.529 billion into FY 2006. The sharp increases in rolled surplus in the years between FY 1997 and FY 2000 are particularly striking. As detailed below, that build-up left the City with a sizable cushion to help it weather the fiscal storms that followed September 11, 2001.

Figure 3

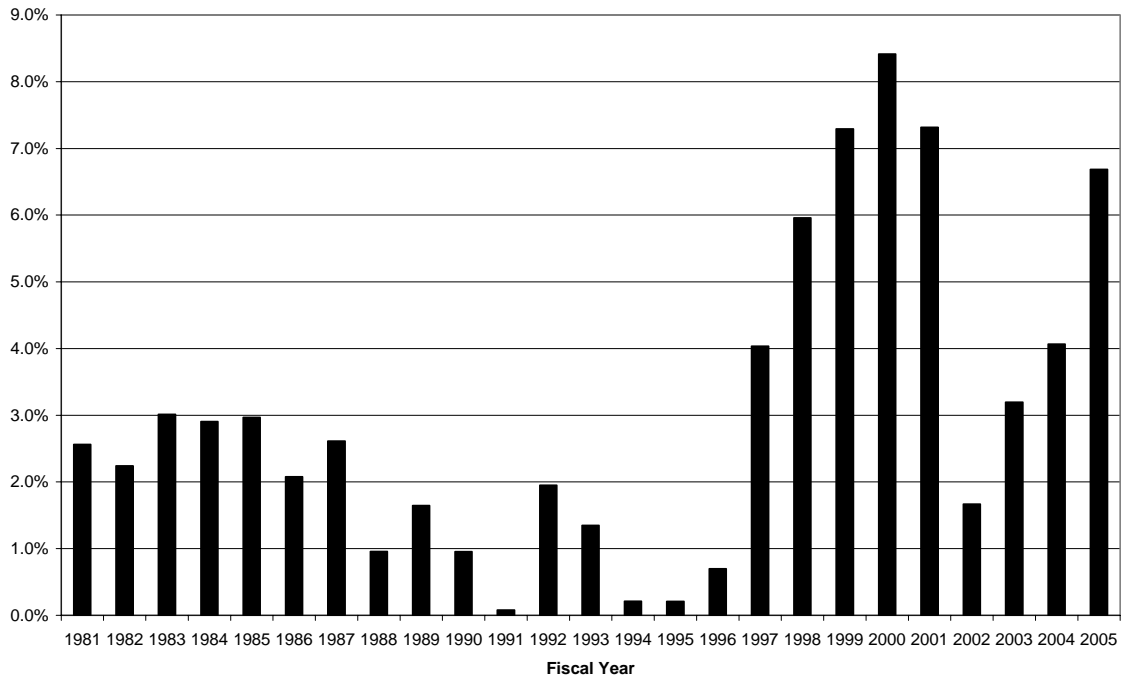
New York City's Surplus Roll



Even when presented as a percentage of general fund revenues in Figure 4, the growth of the surplus roll is still impressive. Currently 6.7% at the end of FY 2005, this quasi-reserve is sizable, although well below its peak of 8.4% in FY 2000.

Figure 4

Surplus Roll as a Percentage of General Fund Expenditures



The prepayment solves the problem of maintaining GAAP balance, allowing OMB to “manage” its GAAP results with remarkable precision. As outlined in Table 3, the City regularly runs a GAAP surplus of approximately \$5 million, a tiny amount in a budget which currently exceeds \$50 billion. Any available resources above that amount are rolled forward to prepay expenses in the fiscal year that follows. In contrast, state governments typically show large GAAP surpluses and deficits on their books, reflecting the ups and downs of the economy in their region.

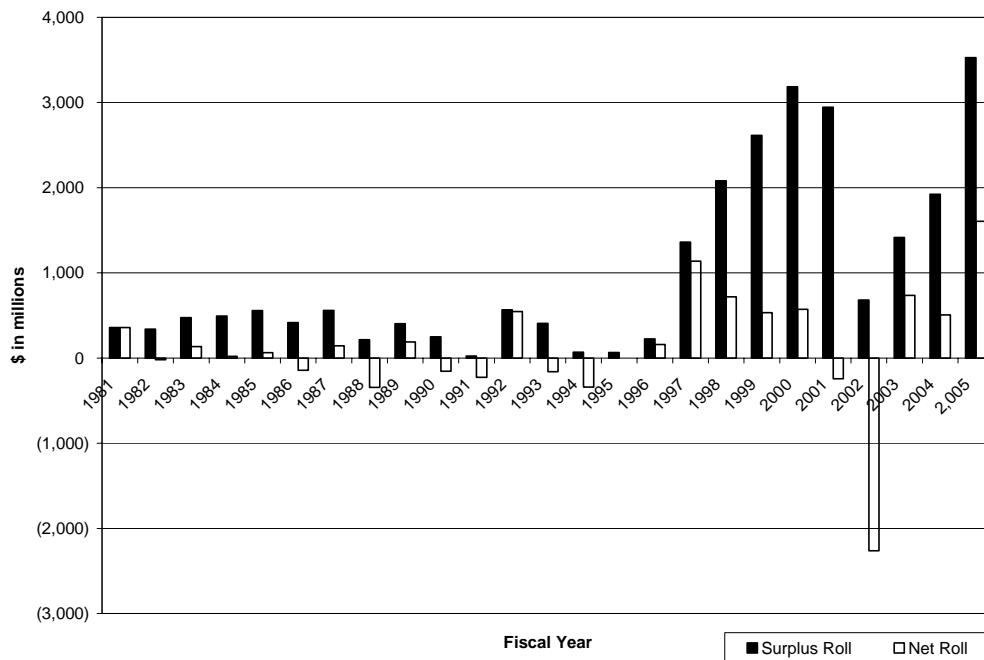
Table 3
Fiscal Years 1996 through 2005—GAAP Balance
(\$ in millions)

Fiscal Year	Revenues	Expenditures	Surplus
1996	32,315	32,311	4
1997	33,986	33,981	5
1998	35,196	35,191	5
1999	36,251	36,246	5
2000	38,399	38,394	5
2001	40,974	40,969	5
2002	41,670	41,665	5
2003	45,284	45,279	5
2004	47,276	47,271	5
2005	47,297	47,292	5

As suggested above, the prepayment functions like a quasi-reserve fund, providing a cushion against the normal fluctuations of the economic cycle. When the economy improves and revenues grow faster, the prepayment grows. When growth slows, the surplus roll shrinks from year to year. Thus, the growth or the shrinkage of the surplus roll is a key indicator of the City’s operating budget results. This “net roll,” calculated by subtracting the roll *into* a fiscal year from the roll *out* of that year, is one of the few numbers not published in the City’s financial statements, but the net roll is closely watched by the monitors, including the City Comptroller, the Independent Budget Office, the Financial Control Board and the credit rating agencies. , Everything else being equal, the City’s operating budget is in surplus when the net roll is positive. When the net roll is negative, the City is operating in deficit. Figure 5 shows the net roll and the surplus roll for each fiscal year since 1981.

Figure 5

The Net Roll



While the prepayment solves the puzzle of mandated GAAP budget balance for a government with cyclical revenues, it also creates a variety of distortions in the City’s financial management and reporting structure.

- o Difficulty identifying operating results: The use of the surplus roll for financial management is less intuitive than the typical practice of state and local governments, which report surpluses and deficits in their financial statements and use resources from rainy day funds to offset those cyclical deficits. For all but a technically sophisticated observer, it is difficult to understand the size of the prepayment, or how much the City has added to it or drawn it down. These data are critical to an understanding of the City’s true financial position. However, neither the net roll nor

any number resembling operating results are published in the City's voluminous financial statements, leading to considerable confusion about the City's financial position. In June of 2005, for example, an arbitration panel ruled on the City's contractual dispute with the police union. The panel's award was larger than earlier labor settlements with other unions, and the panel cited as one rationale the City's plan to roll a surplus of over \$3 billion from FY 2005 to FY 2006.¹⁰ Like most New Yorkers, the arbitration panel seemed not to understand that the surplus roll, which is accumulated over many years, is different from an annual operating surplus. The question of operating surpluses and deficits is discussed in greater detail below.

- Artificially large gaps in the four year plan: The regular use of the surplus roll also distorts the Four Year Financial Plan, one of the centerpieces of the City's financial management regime. The impact is especially serious in the second year of the plan, which assumes no roll in to help balance the budget, and thus shows an unrealistically large projected deficit based on the loss of those resources. Ironically, as operating results improve and the surplus roll grows, the out-year gaps grow apace.
- Distortions in year to year spending comparisons: Reported debt service numbers are skewed because such a large amount of principal and interest is prepaid. This makes year-to-year comparisons difficult, requiring corrections to provide for true comparability. Broader comparisons of year-to-year spending levels are similarly distorted. These distortions were especially problematic during the Giuliani years because the mayor made no attempt to correct year to year spending data, and indeed tried to argue that the artificial reductions in spending growth were evidence of the administration's tight control over expenditures.
- Incentives for off-balance sheet financing: The need to avoid significant GAAP deficits at all costs has also made off-balance sheet entities and resources, like the Transitional Financing Authority (TFA), more attractive to City managers. These devices, which were originally designed to help the City avoid legal limits on City debt, add to the opacity of the City's financial statements.
- Wider variances in the adopted budget: Finally, the City's proposed and adopted budgets do not track well to actual results. Like most budgets, the City's budget as adopted provides detailed estimates for what will be collected, as well as targets for spending. However, because OMB needs to build up a surplus to roll every year, most revenue estimates are typically understated and some spending levels are overstated. As a result, the task of managing the budget during the year is much more complex than the simpler but still demanding requirement that most other governments aim for, which is to hit their budget estimates. If the City simply hits its budget targets during the year, no surplus will be available to roll forward.

The city relies almost entirely on the surplus roll for cyclical budget management. Another common tool – pay-as-you-go capital – is not used by the City, which regularly

¹⁰ *In the Matter of the Arbitration Between the Patrolmen's Benevolent Society of the City of New York and the City of New York*, June 2005, New York State Public Employment Relations Board, p. 26.

bonds out all its capital needs. Thus, the City cannot switch from pay-go to bond funding of capital needs in times of fiscal stress.

In the last few years, the City has used property tax rebates to homeowners as a countercyclical tool. These rebates have reduced what would be even larger cyclical surpluses. The City has also agreed to statutory phase-outs of some of its recently enacted tax increases, under the implicit assumption that they would not be needed in a stronger economy.

Mandated GAAP Balance and the Funding of Emergency Needs

In addition to cyclical budget pressures, state and local governments sometimes face temporary and unexpected emergencies which may affect expenses and revenues. In New York City, the attacks on the World Trade Center on September 11, 2001 caused much higher costs for police and fire overtime, as well as other emergency expenditures. According to the City Comptroller, overtime costs related to the attacks totaled \$365 million, and other clean-up costs were estimated at \$659 million. Capital costs totaled an additional \$171 million. September 11th also caused further damage to an already sagging local economy, resulting in sharp reductions in collections from economically sensitive taxes. The Comptroller estimates that September 11 reduced those taxes by \$2.0 billion.¹¹

In response, the City reduced its prepayment, drawing down on its quasi-reserve. It also used notes and bonds issued by the Transitional Financing Authority, a financing mechanism outside the general fund funded with receipts from the City's personal income tax, to pay for some of those emergency-related outlays. With authorization from the state legislature, TFA proceeds provided more than two billion in direct support for the City's operating budget in FY 2002 and 2003.

Before the fiscal crisis, New York City regularly issued long-term debt to fund operating expenses, including vocational education costs, and this practice was ridiculed and discredited after the City's near bankruptcy in 1975. However, long-term borrowing to pay for operating expenses is not explicitly barred under the Financial Emergency Act. Perhaps its authors assumed that the proceeds of sales of City general obligation debt sold to cover operating expenses would not have been GAAP-good revenue, and that the practice was therefore prohibited by the mandate for GAAP balance. The FEA does include a narrower provision requiring that "The city shall eliminate expense items from its capital budget" no later than the end of FY 1981.¹²

Notwithstanding that history, the City's accountants ruled that receipts from \$2.1 billion in TFA debt issued after the attacks of September 11, 2001 were indeed revenue under generally accepted accounting principles, presumably using the TFA's location outside

¹¹ Two valuable sources detail the fiscal impact of September 11 on New York City: a report by the City Comptroller (2002) published a year after the attacks, and a volume of essays edited by Howard Chernick and published in 2005.

¹² Financial Emergency Act of 1975, §8a, Unconsolidated Laws of New York State.

the City's general fund in support of this decision. While the practice of governmental borrowing to fund emergency expenses is neither unknown nor unreasonable, the decision to book bond proceeds as revenues without public debate does seem remarkable in post-fiscal crisis New York. The silence surrounding this action perhaps reflected a sense that, notwithstanding GAAP, the City should not suffer the penalties required by the FEA for borrowing for operating expenses after what was unquestionably a genuine emergency. The legislature helped by exempting the proceeds of these borrowings from the FEA trigger for a control period. Other City outlays after the September 11th attacks were covered by extraordinary grants from the Federal government, received in the form of Federal Emergency Management Agency (FEMA) grants to the City. In the year after September 11, FEMA reimbursements totaled \$901 million, according to the City Comptroller (2002, p. 42).

Proposals for Change: A Rainy Day Fund

Several observers have suggested that the problems outlined above would be mitigated if a rainy day fund (RDF) were grafted onto this existing system. So long as the requirement for annual GAAP balance remains and leads to consequential changes like the imposition of a new control period, any statute establishing a rainy day fund would also have to modify the GAAP balance mandate to facilitate the use of the RDF. For example, the statute might still require the City to balance its budget according to GAAP, but the allowable margin for error would be automatically modified to allow for draws from the fund. With no other changes in the FEA framework, the \$100 million trigger for a control period would presumably become \$100 million plus the level of draw-downs from a rainy day fund. Proponents of a rainy day fund suggest that these changes would remove the most important obstacles to establishing and using a rainy day fund, which would provide the City with a more transparent tool for cyclical budget management.

Several practical problems may undermine this supposition, and these problems associated with a rainy day fund for the City may create significant disincentives for the mayor and the director of OMB to make full use of an RDF.

Any newly created rainy day fund, established in law or the City charter, would likely be hedged around with restrictions on its use. For example, many financial observers would argue in favor of criteria restricting the planned use of rainy day fund resources to periods of economic slowdown or to offset unplanned shortfalls after budget adoption. Restrictions might also require speedy repayment of any draws on the fund, paralleling an existing provision of the FEA which requires repayment of any GAAP deficit in the following year. Such restrictions are presumably aimed at keeping mayors and the city council from drawing the rainy day fund down for strictly political purposes. In contrast, the surplus roll as it now exists is entirely under the control of the executive, and there is no requirement that "draws" from the surplus roll be repaid.

An analogous situation existed in New York State. New York State established its Tax Stabilization Reserve Fund (TSRF) shortly after World War II. However, state officials proved reluctant to allow surpluses to get "trapped" in that rainy day fund. The executive

and legislature cooperated to keep resources out of the rainy day fund, and used those funds instead for budget support in the next fiscal year. Governor George Pataki made contributions to the rainy day fund a higher priority, and the level of funding in the budget and stabilization reserve slowly increased during his years in office, but New York's reserves are still lower than those in many other states.

Another potential problem for City officials is that the City's financial statements will still show GAAP deficits in any year when the City's budget is balanced by a draw on a rainy day fund, notwithstanding any statutory revision of the trigger for a control period to allow for such draws. In contrast, the surplus roll allows the City to manage GAAP balance with precision, and each mayor has been able to continue the proud boast that the City has balanced its budget on GAAP for more than twenty years. Will New York City mayors be willing to show significant GAAP deficits (see the estimates below) when they can dress up the books and continue to take credit for GAAP balance by continued use of the surplus roll?

If reformers establish a rainy day fund but mayors and budget officers are loath to discontinue the surplus roll, the likely result will be a mixed system, with the executive continuing to use the surplus roll while making minimal deposits to the rainy day fund. This mixed system could end up even more opaque than the current financial management regime.

Enhanced Reporting: Another Option for Change

Are there any other options that might help dissipate some of the fog that surrounds the City's financial management? One possibility is an additional set of regular reports, ideally with numbers supplied by the City Comptroller. These reports would create and maintain a data series on the City's *operating results*. As suggested earlier, one short-cut to calculating operating results is the net roll, or the difference between the surplus rolled into a fiscal year and the surplus rolled out of the year.

Since 2002, the Office of Special Deputy Comptroller, a monitoring unit within the State Comptroller's office, has published a simple estimate of operating results in its monitoring reports, based in large part on the net roll. The July 2005 review of the City's financial plan argues for regular scrutiny of a data series on operating results instead of a narrower focus on the surplus roll:

The City projects a surplus of \$3.5 billion for FY 2005, but this estimate includes resources transferred from prior years. While the surplus is certainly a favorable development, the transfer of resources from prior years masks the results of operations in the current year. We believe a more accurate picture of the City's fiscal conditions can be obtained by examining the results of current-year operations – the difference between revenues received and expenditures incurred in the current year.¹³

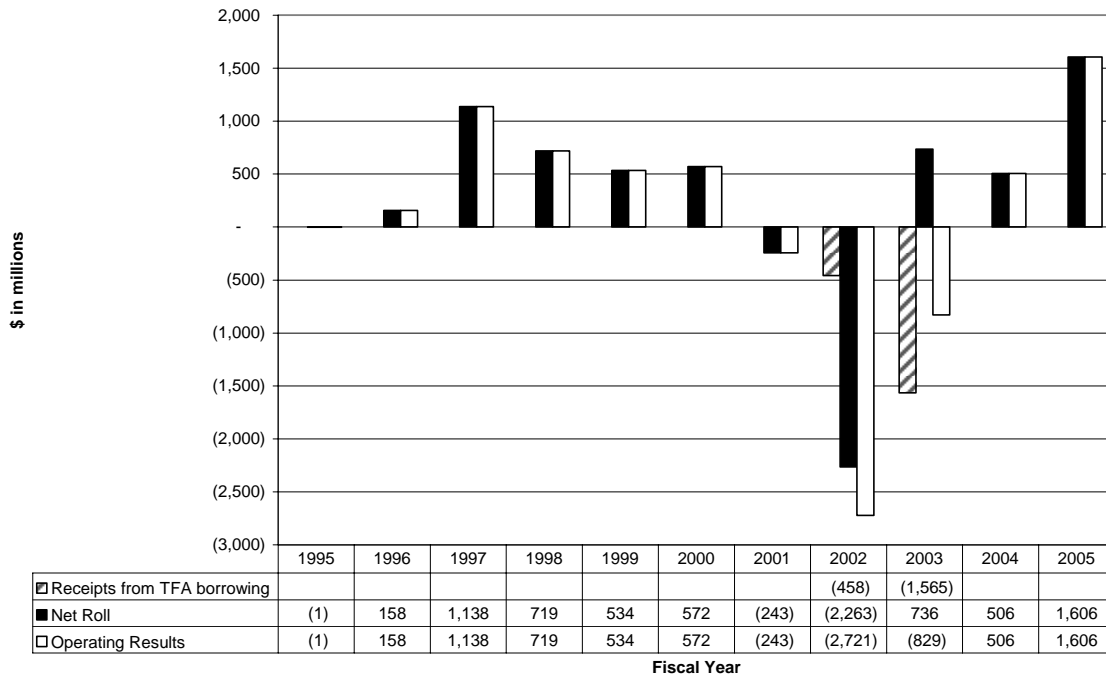
¹³ Office of the State Comptroller, New York State, *Review of New York City's Financial Plan for Fiscal Years 2006 Through 2009*, Report 3-2006, July 2005, p. 17.

OSDC’s methodology estimates operating results after the fact, using data from the City’s financial statements. To adjust reported GAAP results to get operating results, OSDC first calculates the net roll using data from the City’s financial statements. As discussed above, the focus on the net roll takes seriously the idea of the surplus roll as a substitute for a rainy day fund, and the difference between the roll-out and the roll-in is a surrogate measure of draws from or increases to this quasi-reserve fund. In other words, a negative net roll – or a reduction in the surplus to be rolled – is a use of non-operating revenue to support the budget. An addition to the surplus roll is the functional equivalent of an operating surplus, analogous to a deposit in a rainy day fund.

When necessary, OSDC has included a second factor in this simple equation by adding to the difference between the roll-out and the roll-in any other sizable non-recurring funding sources which provide non-operating support to the budget in that fiscal year. To date, the only such items in the OSDC calculations have been TFA borrowings in 2002 and 2003, but the logic of the methodology suggests that it is possible that other large non-operating one-shots would fall into this category.

Figure 6

Operating Results



This two-step calculation – adding TFA borrowing to the net roll – provides a simple but reasonable estimate of operating results in a fiscal year. As this is written, however, no common methodology for calculating operating results is currently accepted by the all of the City’s monitors, much less by OMB. It would make sense for the New York City Comptroller, as the official overseer of the City’s financial statements, to establish that methodology. There is much value in the simple but indirect approach adopted by

OSDC, if only because it is much easier to explain than more complex methods of comparing operating revenues and expenditures, and because it does not require endless wrangling about which one-time revenues or non-recurring expenditures should be included or omitted from operating revenues and expenditures.

As Figure 6 demonstrates, in the absence of tools like the surplus roll and TFA borrowing, New York City would have booked large deficits and surpluses, driven primarily by the vicissitudes of the local economy and by emergency spending after the September 11 emergency. Without those budget management devices, those surpluses and deficits would have shown up in the GAAP financial statements, and triggered a control period under the Financial Emergency Act after September 11, 2001.

If the City Comptroller reported the City's operating results on a standardized basis, and if those results were discussed regularly in the press and in public debate, knowledgeable observers and public officials might develop a clearer understanding of the City's true financial picture. More specifically, they might come to recognize that operating deficits and surpluses were normal occurrences in a City dependent on cyclically sensitive revenue sources. That understanding, in turn, might make it possible for the City to move someday beyond the limitations of its current GAAP balance regime, with all the opacity and distortions implied by that system, and develop a more sophisticated and transparent countercyclical financial management system. A rainy day fund could be one important component of such a system.

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