THE NEVER-ENDING HANGOVER

How New York City’s Pension Costs Threaten Its Future

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Executive Summary

Over the past 15 years, New York City’s budget has been hit with extraordinary and unprecedented increases in pension costs. Yet the city’s five pension plans remain significantly underfunded by accepted government accounting standards, posing a significant risk to New York’s fiscal future.

During Mayor Michael Bloomberg’s 12-year tenure, New York City’s annually required pension contributions more than quintupled, from $1.4 billion to $8.1 billion. Pension costs have continued rising under Mayor Bill de Blasio, whose $84.9 billion budget proposal for fiscal 2018 includes pension contributions of $9.6 billion—an increase of $177 million over the current fiscal year and $1.4 billion (18%) above the level in Bloomberg’s last budget.

Today, pension contributions stand at a near-record 11% of the city’s total budget—and 36% of payroll alone. They consume 17% of city tax revenues, double the average proportion of the 1990s and early 2000s. Increasingly, city pension costs crowd out spending on other public services while limiting options for tax relief. Indeed, New York’s annual pension contributions will soon displace social services as the second-largest spending category in the city budget, behind only education, consuming more than 80 cents of every dollar raised by the city’s personal income tax.

This report reviews some sobering truths about New York City’s pension systems, including:

- Despite the sevenfold run-up in annual taxpayer-funded pension contributions since 2002, New York City’s unfunded pension liabilities officially ballooned to nearly $65 billion in fiscal 2016, up from $60 billion just three years earlier. More than half of its current pension contributions are required simply to pay down unfunded pension liabilities.

- New York will need at least 15 more years to eliminate its pension debt, even assuming annual average investment returns of 7%. In other words, a shortfall that can be traced to the early 2000s won’t be paid off until 2032—if the systems’ generous investment assumptions pan out.

- When New York’s future stream of pension obligations is discounted using a lower “market value” rate of interest—as modeled in this report and recommended by most independent actuaries and economists—its real pension debt soars to $142 billion, more than double the official number.

- By our estimate, the city’s five pension systems ended fiscal 2016 with an average funded ratio of 47% on a market-value basis (i.e., they had less than half the money needed to pay promised benefits). When the city’s preferred actuarial standard is used, the average funded ratio is still only 66%.

New York City cannot afford to stand pat, accept current pension cost levels as a new normal, and hope for the best: when the next downturn strikes, it will inflate the pension deficit, creating even bigger burdens and more difficult choices. In the short term, New York should take two steps. First, reduce overoptimistic investment-return assumptions, as recommended by independent actuarial consultants in 2015. Second, tap into the large pots of money that the mayor has reserved for pay raises in the next round of contract settlements to fund the $655 million a year in required additional pension contributions.
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Introduction

For more than a decade, New York City has been diverting ever larger amounts from its operating budget to bail out its employee pension systems, or “funds.” Forty years ago, it was the other way around.

During the city’s fiscal crisis that erupted in the mid-1970s, the pension funds’ purchase of $3.5 billion in city Municipal Assistance Corp. (MAC) bonds, as well as general-obligation bonds, was all that stood between the Big Apple and bankruptcy. With the approval of union trustees on the city’s five pension system boards (see sidebar), MAC and city bonds ultimately represented 35% of the pension funds’ total assets—which, at the time, were already well short of the amounts needed to cover future obligations to retirees and beneficiaries.
As of 1978, the city’s pension-funding ratio was barely 50%, with total unfunded pension liabilities estimated at roughly $10 billion (equivalent to $37 billion today). James Brigham, the city’s budget director at the time, sought to assuage the worries of fiscal conservatives in Congress, which was then considering an extension of federal loan guarantees to New York. “Over the next 40 years, the city will fund that unfunded accrued liability,” Brigham told the Senate Finance Committee at a March 1978 hearing. “This is not an uncommon feature of pension systems, and we are advised that the funding of an unfunded liability over 40 years is sound practice.”

In the end, it didn’t take 40 years. Even when measured by today’s more exacting actuarial measures, most of New York City’s unfunded pension liability had been erased by 2000. But the pension debt would reemerge, bigger than ever, in the decade that followed.

The Path to Today’s Pension Crisis

In 1980, when New York was still struggling to get its finances on a solid footing, the city’s pension contributions reached 21% of city tax revenues. However, as luck would have it, the early 1980s also represented the start of one of the most spectacular bull markets in Wall Street history.

Public pension funds across the U.S., saddled with large unfunded liabilities while investing mainly in safe fixed-income securities, responded by shifting more and more of their assets into corporate stocks. For New York City, the stock-market boom of 1982–2000 was especially fortuitous. Pension investment returns averaged 12.9% a year; during the same period, Wall Street profits and bonuses fueled a sharp rise in tax revenues, interrupted only by an economic downturn in the early 1990s.

As a percentage of tax revenues, the city’s pension burden dropped steadily: from 21% in 1980, to 12% in 1990, to 7% in 1999. But pension costs would not remain that low indefinitely (Figure 1).

The New York State legislature, which writes the laws shaping public pensions across the state, saw pension funds’ soaring returns in the early 1980s as an invitation to begin sweetening pension benefits. In 1984, the legislature effectively rolled back the Tier 3 pension reform of the 1970s, which was designed to save money by imposing new limits on benefits. Over the next 15 years, more pension increases, benefiting different categories of public employees in New York City and across the state, were enacted in Albany.

The fuse on New York City’s latest explosion of pension costs was lit by the market downturn of 2000–2002, from which the funds have never fully recovered. However, investment losses were only partly to blame, as a subsequent report by the city comptroller’s office showed. Bad policy choices, invariably egged on by public-employee unions, were also responsible.

Making matters worse, in the spring of 2000, Governor George Pataki and the state legislature approved sweeping public pension benefit enhancements that ultimately resulted in nearly $13 billion in cumulative pension cost increases for the city during 2000–

### FIGURE 1.

**New York City Pension Contributions, 1980–2021**

<table>
<thead>
<tr>
<th>BILLIONS OF DOLLARS IN PENSION CONTRIBUTIONS</th>
<th>PERCENT OF CITY TAXES</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>12%</td>
</tr>
<tr>
<td>1983</td>
<td>10%</td>
</tr>
<tr>
<td>1986</td>
<td>8%</td>
</tr>
<tr>
<td>1989</td>
<td>6%</td>
</tr>
<tr>
<td>1992</td>
<td>4%</td>
</tr>
<tr>
<td>1995</td>
<td>2%</td>
</tr>
<tr>
<td>1998</td>
<td>0%</td>
</tr>
<tr>
<td>2001</td>
<td>5%</td>
</tr>
<tr>
<td>2004</td>
<td>10%</td>
</tr>
<tr>
<td>2007</td>
<td>15%</td>
</tr>
<tr>
<td>2010</td>
<td>20%</td>
</tr>
<tr>
<td>2013</td>
<td>25%</td>
</tr>
<tr>
<td>2016</td>
<td>15%</td>
</tr>
<tr>
<td>2019</td>
<td>10%</td>
</tr>
</tbody>
</table>

*Actual and projected totals (left): pension share of city taxes, total budget (right)
Source: Empire Center for Public Policy, based on data from the New York City Comprehensive Annual Financial Reports and the New York State Financial Control Board
2010. The sweeteners, enacted over Mayor Rudolph Giuliani’s objections, included the elimination of the employee share of pension contributions for many workers as well as a partial, automatic, cost-of-living adjustment in pension benefits.

The Importance of the Discount Rate

In calculating the long-term liabilities of any pension fund, the discount rate is a crucial variable: the lower the rate of assumed earnings on money set aside to pay promised future benefits, the larger the employer contributions required to maintain “fully funded” status, defined as assets sufficient to pay all promised benefits to current members. Private corporate pension plans in the U.S. are required by federal law to discount liabilities based on a “market” rate—typically, the interest paid on highly rated corporate bonds, which, in recent years, have yielded 4%–5%.

This rate is often much lower than the plans’ earnings targets; but it reflects what the money would be earning if invested in lower-risk assets, matching the low-risk tolerance of future retirees who are counting on their promised pensions. The expense of fully funding defined-benefit pension plans on this basis is a major reason for their gradual disappearance from the private sector.

Since public pensions are offered as a risk-free proposition to their beneficiaries, most economists, actuaries, and financial analysts agree that public pension fund liabilities should use fair-value accounting (i.e., discounting liabilities on the basis of a risk-free or low-risk market rate, such as the yield on AAA-rated corporate bonds or long-term U.S. Treasury securities). However, under rules set by the Government Accounting Standards Board (GASB), public employers are allowed to discount their long-term liabilities based on the rate of return that they hope to earn from investments.

As noted, public pension funds have chased higher yields in the form of riskier stock-market investments (both domestic and global). This fuels a negative cycle: pension funds need replenishment when states are struggling to emerge from recessions, which often coincide with stock-market downturns. The stock-market volatility of the past 15 years has exposed serious fiscal fault lines in America’s public pension sector.

By relying on inflated discount rates—reflecting the long-term average of past asset returns but failing to account for short-term volatility or market risk—state and local pension funds across America have obscured the true size of their liabilities. New York City has been no exception. Even so, in several crucial respects the city has been less reckless and, until recently, more transparent than any other large U.S. public pension plan sponsor. In other words, while lax government accounting standards contributed to the building of huge public pension debts throughout the U.S., the pension crisis that New York City now faces is ultimately due more to the sheer scale of its pension promises than to any egregious abuse of accounting standards.

New York’s assumed rate of return had been 8% for more than a decade before it was reduced in 2012 to 7%, one of the biggest rate reductions adopted by any major public pension plan up to that time. The change was strongly supported by Mayor Michael Bloomberg—although Bloomberg noted that banking on 7% returns would still be considered “indefensible” by private-sector standards. “If somebody offers you a guaranteed 7% on your money for the rest of your life, you take it and just make sure the guy’s name is not Madoff,” the mayor said.

However, an immediate switch to the 7% assumption also would have required an immediate $2.8 billion boost in the pension contribution. To lessen the impact on current budgets, the transition was “amortized,” spreading the costs into the future.

Most pension plans amortize their unfunded liabilities over a period of about 30 years and also reset their payment schedule each year, a technique known as open amortization. New York City, however, chose an increasing dollar amortization method, increasing payments by 3% a year over a closed 22-year period, based on the 2010 actuarial estimate of liabilities and reflected in contributions starting in fiscal 2012. It also adopted “level dollar amortization,” a strategy in which pension debts realized in any subsequent year are amortized using level payments over a closed 15-year period.

Amortizing each year’s pension gain or loss over fixed periods is called “layered amortization”: for each subsequent year, the sponsor could potentially pay off another layer of pension debt. An advantage of this approach is that it is more responsive to each year’s gain or loss, and it keeps plan sponsors from accumulating too much debt.

Starting in 2003, as part of the information attached to the comprehensive annual financial reports of the city’s five pension systems, Chief Actuary Robert C. North,
Jr. included an expanded table of alternative measures of funded status—including, crucially, a ratio comparing the market value of assets with the market value accumulated benefit obligation (MVABO). As North later explained: “[T]he MVABO is calculated by projecting the accrued portion of benefits (i.e., the benefits earned to date without use of future salary increases or benefit service credits, allowing eligibility service to grow) and discounting at each payment date those accrued benefits using discount rates equal to U.S. Treasury spot yields.”

Estimating the current value of all future pension promises based on U.S. Treasury bond yields, which for many years have been well below 7%, essentially recognized that pension liabilities have characteristics similar to traded securities that promise a fixed payoff to investors. What would the promise of a guaranteed stream of pension income be worth, in current terms, if traded in securities markets? The MVABO essentially provided a collective answer to that question for the entire New York City workforce.

The actuarial measures used to determine the city’s pension contribution showed growing and sizable pension liabilities. But North’s mark-to-market alternative valuations revealed that the true pension debt was growing much larger, especially after the financial crisis of 2008.

For example, as of 2012, the official measure showed an average funded ratio of 61%, from a high of 66% for the New York City Employees’ Retirement System, to 52% for the Fire Department Pension Funds. However, the MVABO revealed an average ratio of 36%, with the Fire Department at an alarmingly low 28%.

Meanwhile, effective in 2013 for cities such as New York, GASB Statement 67 imposed new rules requiring pension funds to report “net pension liabilities” based on the fair-market value of their total assets available to fund benefits. Combined with the city actuary’s alternative measures, as well as other improved reporting requirements and changes to actuarial assumptions, the new GASB rules have shined a light on the extent of New York’s true shortfall.

Beyond the Happy Talk

After losing 23% in the market downturn of 2007–09, the city’s pension funds reported double-digit returns in four of the next five years, including 17.4% in 2014. City Comptroller Scott Stringer hailed this “good news” and said that it would allow the city to “save” nearly $18 billion in contributions over the next 20 years. But the fund earned only 3.15% in fiscal 2015, followed by just 1.46% in 2016.

The average of those wildly varying numbers was an annual return of 7.1% from 2013 to 2016—slightly more than the city’s assumed rate of return. Nonetheless, the city’s net pension liability ended up increasing, from about $60 billion in fiscal 2013 to about $65 billion last year (Figure 2).

What next? It is possible that New York City’s pension systems will meet or exceed their target; it is also possible that they won’t. As of February 17, the city’s pension systems had earned about 8.3% in fiscal 2017, according to the deputy state comptroller’s office. However, this gain was fueled by a postelection stock-market surge that stalled in late March. Even a year-end gain slightly above 7% will barely make a dent in the net liability.

The city’s five pension systems will ultimately recover to fully funded status within the next 10 to 20 years—without putting more pressure on the city budget—only if financial and policy outcomes throughout the period are consistent with this optimistic scenario:

1. Investment returns average 7% a year
2. Public pension benefits are not increased
Based on historical experience, this optimistic scenario almost certainly will not happen. If pension fund returns are stronger than expected, perennially meeting or even exceeding the 7% target in the short term, public-employee unions will almost certainly lobby for benefit increases. Indeed, they can be expected to do so regardless of pension fund returns or rising pension debt.

In recent years, the state legislature has also passed several sweeteners, including a bill that would restore early retirement options for uniformed state court officers that had been eliminated as part of the Tier 6 pension reform enacted in 2012. Even if initially limited to a small group of employees, such a change would surely incite a flood of similar proposals that would further inflate pension obligations. Governor Cuomo has vetoed all these bills, but the legislature will surely continue to reintroduce them.

Last year, Cuomo signed bills restoring disability pensions equal to 75% of final average salary for New York City firefighters, corrections officers, and sanitation workers hired since 2009, reflecting side deals reached in contract talks between Mayor de Blasio and the unions representing those employees. The added benefit required an immediate increase in firefighter pension contributions of $6 million, which will grow to $12.6 million by 2021. (The corrections-officer and sanitation-worker benefits are supposed to be fully self-financed through member contributions, while the firefighter benefit will be funded partly by the city.) A similar disability pension benefit restoration was included in the newly ratified contract between the city and the Police Benevolent Association (PBA).

While firefighters, corrections officers, and sanitation workers affected by the deal are expected to contribute an extra 2% of salaries to help pay for the added benefit—and affected PBA members are to pay an extra 1.5% of salary—the cost calculations associated with the disability-benefit increases are based on the underlying actuarial assumption of 7% pension fund returns.

City officials remain likely to seize on short-term improvements in pension-funding ratios as evidence that the pension systems pose less of a threat to the city’s long-term financial stability. But even when annual returns fell short of the 7% mark in the last few years, there was a notable lack of urgency surrounding the pension issue—perhaps because city leaders, the media, and the public have failed to focus on the true dimensions of New York’s pension debt.

More Disclosure Needed

The true extent of New York’s pension debt became clearer once the city’s chief actuary began to disclose alternative measures of liabilities calculated on the basis of a low, risk-free, market rate of interest. But after North retired in 2014, the city pension systems stopped releasing those estimates. His successor, Sherry Chan, provided this explanation for the change: “The calculation of market value ratios are outside the statutory duties of the OA [Office of Actuary] and, due to the short-term volatility and inherent unreliability of such ratios, they do not provide a useful measure of mandated funding requirements. Therefore, public resources are not used to publish such measurements.”12

Chan’s statement is out of step with a growing consensus among economists, financial analysts, and actuaries who have studied public pension funding. For example, in a widely heralded 2014 report, the Blue Ribbon Panel of the Society of Actuaries recommended that to help stakeholders make informed, effective decisions about funding, financial benchmarks disclosed by public pension plans should include “the plan liability and normal cost calculated at the risk-free rate, which estimates the investment risk being taken in the investment earnings assumption.”13

New York City’s pension systems once led the way on pension disclosure. Now, with no objection from the mayor or the other elected officials who serve on their boards of trustees, the funds have become unhelpfully opaque. However, using the data published in the comprehensive annual financial reports for the city and its pension systems, it is possible to estimate a market value of pension liabilities—and to compare the result-

### FIGURE 3.

**Alternative Measures of New York City Pension Debt (USD, millions)**

<table>
<thead>
<tr>
<th>Plan</th>
<th>Current Actuarial Rate (7%)</th>
<th>1% Decrease in Current Liability Discount Rate (6%)</th>
<th>Market Rate (3.61%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRS</td>
<td>25,600</td>
<td>32,714</td>
<td>52,092</td>
</tr>
<tr>
<td>PPF</td>
<td>15,638</td>
<td>21,344</td>
<td>37,039</td>
</tr>
<tr>
<td>FDPF</td>
<td>8,906</td>
<td>11,203</td>
<td>17,563</td>
</tr>
<tr>
<td>NYCERS</td>
<td>13,307</td>
<td>18,246</td>
<td>31,968</td>
</tr>
<tr>
<td>BERS</td>
<td>1,384</td>
<td>1,948</td>
<td>3,533</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$64,836</td>
<td>$85,454</td>
<td>$142,195</td>
</tr>
</tbody>
</table>

Source: Authors’ estimates, based on City of New York, FY 2016 Comprehensive Annual Financial Report and the city’s annual pension fund reports
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As of 2016, the true size of New York City’s pension debt was $142 billion (Figure 3). The pension system shortfall is 17% of gross city product—71% more than the city’s total bonded indebtedness and 78% more than city taxes will raise next year (Figure 4).

Conclusion

From 2014 through fiscal 2017, for the first time on record, New York City’s pension contributions exceeded actual and projected (mostly bond-financed) capital expenditures. In other words, the city has been spending more to meet its pension obligations than to build and renovate bridges, parks, schools, and other public assets. In fiscal 2018, roughly 57% of contributions will be needed simply to continue paying down what the city still owes its pension systems, in order to continue paying benefits promised to retirees. The rest will cover the “normal” cost of added benefits earned by city employees. In other words, if the pension systems had been fully funded in the past, the city would have saved more than $5 billion.

Since 2000, the total asset value of the city’s five pension systems rose by about 50%, from $106 billion to $165 billion. During the same period, the outflow of benefit payments more than doubled, from $5.5 billion in fiscal 2000 to nearly $13 billion in fiscal 2016. The only guarantee associated with New York City pension funding—a guarantee backed by the state constitution—is that those benefit payments, driven by the rising salaries and life expectancies of city employees, will continue rising.

Ideally, the city should aim to shorten the amortization period for remaining liabilities, reduce the assumed rate of return, or do both. The real-world costs of such actions are daunting:

- Paying off the debt within 10 years instead of the scheduled 15, while keeping a 7% discount rate, would cost $2.2 billion more a year—over and above current projected levels.
- Maintaining a 15-year payoff period but reducing the discount rate to 6% would boost the contribution by $3.7 billion per year.
- Bringing the assumed return in line with a market rate of 3.61% across a 15-year payoff period would cost an extra $7 billion a year.

There is another, less expensive, option for at least slightly increasing the rate at which the city pays down its pension debt. In an October 2015 report, based on the charter-mandated biannual performance audit of the pension systems, the city’s independent actuarial consultants recommended a reduction in the assumed rate of return on investments, to 6.75% from 7%.

Even that slight change of 25 basis points would add $655 million a year to pension contributions, according to the consultants’ estimates. That’s still a lot of money. But chipping away faster at the enormous unfunded pension liability is the only way to reduce what otherwise looms as a serious threat to New York’s future.

As it happens, enough money to cover the added contribution has been squirreled away in Mayor de Blasio’s fiscal 2017 financial plan, in the form of a collective bargaining reserve to cover pay raises for city employees in the next round of union contracts. Excluding a lump-sum payment owed to unions under prior contracts, the available amounts grow from $946 million in fiscal 2018 to $1.3 billion in 2021.

New Yorkers have forgone billions of dollars a year in services, infrastructure improvements, and poten-
tial tax savings to back up the state’s constitutional guarantee of generous pensions for city employees. Since pensions are an integral element of employee compensation, a strong argument can be made that it’s time for city workers themselves to pitch in and help backfill the amounts still needed to make their pension systems whole again—before the pension hole inevitably grows deeper.

Appendix

To estimate New York City’s pension plans’ liabilities using different discount rates, we use each plan’s stated liability number as well as additional information required by the GASB 67 on the value of those liabilities using different rates. Each pension plan reports, in its comprehensive annual financial report, the present discounted value of its benefit commitments to workers (i.e., liabilities). For New York City’s plans, these liabilities are valued using a 7% discount rate. In addition, GASB 67 requires that plans report liabilities valued using discount rates that are +/- 1 percentage point from their chosen discount rate. Having calculated the average duration of each plan’s liabilities, we can then estimate the value of liabilities at different discount rates by compounding the plan’s stated liability number at the plan’s discount rate over the estimated average duration; and discounting the resulting future value back over the same estimated average duration, using our chosen discount rate.

Our market-rate calculation was based on a rate of 3.61%, as listed in the Citigroup Pension Discount Curve and Liability Index for plan fiscal years ending June 30, 2016. The Citi Index is a common benchmark used by analysts and credit-rating agencies, including Moody’s Investors Service, to discount pension liabilities for purposes of comparing the funded status of different plans.15

Endnotes

1 Officially, the “pension system” is the entity paying benefits and keeping records, while the “pension fund” is the investment vehicle. In practice, “system” and “fund” are used interchangeably.
4 Ibid.
5 The rate had previously been 8.75% from 1996 to 1999, after peaking at 9% from 1991 to 1995.
7 The New York State and Local Retirement System, which covers state and local employees outside New York City, lowered its rate from 8% to 7.5% in 2010, and to 7% in 2015. The New York State Teachers’ Retirement System lowered its discount rate from 8% to 7.5% in 2015. As of 2015, the median rate for public pension systems was 7.5%.
10 The benefits were reduced for future hires when then-governor David Paterson vetoed a previously routine extender of the pension benefit “tiers” that had covered all police and firefighters hired since the early 1970s.
11 New York State law prohibits collective bargaining of pension benefits; but mayors and public-employee unions nonetheless have periodically agreed to jointly ask the legislature to approve pension benefit increases laid out in memorandums attached to labor contracts.
15 “Citi Pension Discount Curve,” Society of Actuaries.
Abstract

New York City’s pension contributions stand at a near-record 11% of the city’s total budget—and 35% of payroll alone. They consume 17% of city tax revenues, double the average proportion of the 1990s and early 2000s. Increasingly, city pension costs crowd out spending on other public services while limiting options for tax relief. Indeed, New York’s annual pension contributions will soon displace social services as the second-largest spending category in the city budget, behind only education, consuming more than 80 cents of every dollar raised by the city’s personal income tax.

New York City cannot afford to stand pat, accept current pension cost levels as a new normal, and hope for the best: when the next downturn strikes, it will inflate the pension deficit, creating even bigger burdens and more difficult choices. In the short term, New York should take two steps. First, reduce overoptimistic investment-return assumptions, as recommended by independent actuarial consultants in 2015. Second, tap into the large pots of money that the mayor has reserved for pay raises in the next round of contract settlements to fund the $655 million a year in required additional pension contributions.