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Overview of New York City's Fiscal Crisis

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New York City faced a significant fiscal crisis and almost defaulted in 1975. It was a true crisis because the nation's largest city had literally run out of money and could not pay for normal operating expenses. Timely state and federal action saved the city from defaulting on its obligations and possible bankruptcy. At the time, New York City and its subdivisions had $14 billion of debt outstanding of which almost $6 billion was short-term. The city admitted to an operating deficit of at least $600 million, although honest accounting techniques put it at more like $2.2 billion and the city found itself shut out from credit markets.

New York's Fiscal Crisis Developed Over Many Years. The accumulation of short-term debt was a result of the city running chronic budget deficits since perhaps as early as 1961. Because of the city's poor budgetary and accounting practices, it is difficult to fix the date precisely. New York ran up these deficits even though a state law required political subdivisions to run balanced budgets. Despite the requirement, the city used obsolete and confusing budgeting and accounting systems that included such financial gimmicks as:

- Overly optimistic forecasts of revenues
- Heavy use of revenue anticipation notes, including notes for revenues that did not materialize
- Underfunding of pensions
- Use of funds raised for capital expenditures for operating costs
- Appropriation of illusory fund balances, meaning that special fund revenues were overestimated and used to balance the budget
- Writing checks late

The city began running budget deficits during the 1961-65 mayoral term of Robert Wagner. The mayor increased municipal expenditures to maintain his political support. The power of public employee unions were growing and they resorted to strikes on a number of occasions. The first of the nationwide ghetto riots occurred in Harlem in 1964. At the same time, rent control slowed the growth in property tax collections. Overall revenues increased because of higher taxes, but not as fast as expenditures.

John Lindsay, first elected in 1965, had the same solution to the city's problems. Borrowing paid for expanded city services. Welfare rolls were growing. In 1969, the mayor granted very generous contracts to the public employee unions to avoid labor unrest. The city was kept going by optimistic revenue forecasts for taxes and federal aid. State aid was also generous. One author attributed the generous state aid to Governor Nelson Rockefeller's ambitions for national office and a resulting desire to avoid visible troubles in New York City.

The city had little trouble selling its debt. Bond underwriters willingly took on the job of marketing the city's obligations and were able to assure the market that the city's problems would be worked out. The city's debt rating was downgraded in the mid 1960s and the city had to pay an interest premium even over other similarly rated jurisdictions, but the market was still absorbing the city's securities.

The Market Eventually Began to Take a Dimmer View of New York Municipal Debt in 1974. By July 1974, the Comptroller of New York City was railing against the markets because of the high interest rate the city was being forced to pay. An October securities issue sold poorly with the underwriters taking a loss. A February 1975 sale of tax anticipation notes was canceled when the underwriter backed out. In the meantime, banks began selling their own holdings of city securities.

New York's Actions Did Little To Reassure Markets. Mayor Beame took a series of steps during this period that he hoped would allow the city to access credit markets. The market was not impressed. The mayor discounted investors' concerns about city management and budgeting by telling bondholders that it was not their business as they had a first lien on any revenues. The "announced" layoffs of almost 8000 workers ended up with only 436 going out the door. Inflated announcements about employment reductions included retirees who had left months before. A later "hiring freeze" allowed city payrolls to grow by 13,000 in one quarter. The Mayor was reluctant to increase the size of the layoffs because he did not want a repetition of the labor unrest that had dogged his predecessor and the unions did indeed threaten unrest.

At a time when sophisticated investors began to resist purchasing more city debt, the city began issuing securities in small denominations. As a result, small investors and retirees began buying relatively large amounts of city notes and bonds.

In March of 1975, the underwriters were growing more and more resistant to working with the city on any more debt issuance. Several factors contributed to their decision:

- Bond counsel would not issue a clean opinion on the sale, which was necessary for reselling the notes and bonds
- The inadequate response of the city to the worsening situation
- The specter of liability for losses on securities sold to investors
- Doubts that bondholders could exercise their first lien on city revenues

The latter concern was heightened when the state Urban Development Corporation defaulted on some bond anticipation notes. Although the corporation was separate from the city, the projects of the corporation were in the city. Investor concerns grew when the legislature made sure that the suppliers and contractors were paid but not the bondholders. Underwriters and other bondholders had significant doubts that a bankruptcy judge would cut welfare payments and lay off police to make interest payments.

The city attempted to move debts off their own balance sheet and stretch out their maturity. The city planned to establish a separate corporation, the Stabilization Reserve Corporation, to hold the city's debt. This move was challenged as an unconstitutional attempt to get around the debt limit. The city was forced to drop the plan.

Underwriters and City at a Stalemate. By April 1975, the city was out of money. Just to meet its normal obligations, including payroll, the city scrambled and got a three day loan from the banks and pension funds. The main underwriters, Merrill Lynch and the six largest New York Banks, resisted underwriting any more securities issues. Planned bond sales had been canceled and their was no prospect of the city being able to enter the markets.

The underwriters were in a sensitive situation. They had large holdings of New York City securities. Any action they took to hinder the refinancing of New York City debt threatened their own profitability because about 20 percent of their equity was tied up in city paper. However, they were beginning to take losses on underwriting as the market was proving to be even more resistant than assumed. The underwriters also did not know what their own liability to bondholders might be as there was considerable discussion about whether they had adequately fulfilled their responsibilities to investors. And in the event of default they were unsure of the bondholders' call on city revenues. Some bankruptcy judges had honored the first lien of bondholders, others had ignored it. Bondholders might be paid first or last.

After considerable and lengthy negotiations, the underwriters agreed to underwrite more securities provided that the city adopted sound accounting principles, admitted that it had large operating deficits, and ended its budget ploys, including the practice of phony forecasts of revenues. The mayor rejected these conditions and started a campaign to reassure the public and investors that New York City was sound. As a result, the stalemate continued and New York was unable to borrow.

State of New York Steps in to Assist the City. The motives of the state were fairly simple. The effects of a bankruptcy were unknown and potentially serious. The state's own debt rating would probably have been adversely affected. If bondholders did have a first lien on city revenues, the state would probably have to step in to maintain order in the city. Otherwise chaos could result, especially if public employees were not willing to work if paychecks were missed. Another possible outcome of bankruptcy would have been the abrogation of union contracts which in turn could have led to widespread strikes and, perhaps, widespread social disorder.

First, when the city ran out of money in mid-April the state advanced revenue sharing funds to the city. Then New York Governor Hugh Carey appointed an advisory committee to monitor New York city affairs. One of the main recommendations of the advisory committee was the creation of a Municipal Assistance Corporation.

The Municipal Assistance Corporation (MAC) was an independent corporation authorized to sell bonds to meet the borrowing needs of the city. MAC was a creation and entity of the state. The majority of appointees on the Corporation's Board were made by the Governor. As part of the creation of MAC, the state passed legislation that converted the city's sales and stock transfer taxes into state taxes. These taxes were then used as security for the MAC bonds without ever passing through to the city. Besides creating the MAC, the state also advanced additional funds. The state prepaid state aid that the city was scheduled to get during the fiscal year, in an attempt to keep the city afloat.

New York City Continued to Deny Seriousness of Problem. Although there were some efforts to cut costs, including layoffs, these actions were very minor but were still accompanied by significant labor unrest. The city continued to change plans and borrowing needs on a frequent basis, further eroding the market's already limited confidence in the city's ability to handle their own financial affairs. The admitted deficit continued to grow, hitting $750 million.

The Municipal Assistance Corporation was not Greeted Warmly by Investors. The underwriters were only able to sell its securities at a significant loss. The MAC was authorized to sell $3 billion of securities but could only peddle $2 billion and only at a high interest rate. The notes yielded 11 percent interest at a time when an index of high-grade municipals was at an interest rate of 6.89 percent.

The MAC demanded that the city institute a wage freeze, lay off employees, increase subway fares, and begin charging tuition at city universities. Despite a summer of labor unrest, these measures stuck and MAC was able to refinance some city debt, but the market was still resistant.

State Increased Control Over the City. In an effort to bring some order to the budgeting and management of New York City, the Emergency Financial Control Board (EFCB) was created in September during a special legislative session. The creation of the EFCB was analogous to putting the city into receivership. The EFCB had authority over the finances of the city. They could control the city's bank accounts, issue orders to city officials, remove them from office, and press charges against city officials. The Governor made the majority of appointments to the Board. The state law creating the EFCB required the city to balance its budget within three years, change its accounting, and submit a three-year financial plan. The Board had the power to review and reject the city's financial plan, operating and capital budgets, contracts negotiated with the public employees unions, and all municipal borrowing.

Besides creation of the control board, other measures were taken. A deputy state comptroller was appointed to audit city books. The Mayor's Management Advisory Board

was created and staffed by business representatives to advise the mayor on management practices. The temporary Commission on City Finances was established to analyze, criticize, and recommend changes in the city's long-range taxation and expenditures policies.

City Still Shut Out From Markets. Despite these measures, the municipal credit markets remained closed to the city. MAC bonds were plummeting in price. Pensions funds were being pressured to buy the bonds and did indeed buy about $500 million worth. Their ability to take more was compromised by their own concerns about violating their own fiduciary responsibilities.

After Multi-Month Campaign, Feds Agree to Step In. The continuing difficulties of the city to borrow led the federal government to agree to assist the city in November of 1975. Federal legislation extending up to $2.3 billion of short-term loans to the city was passed. The House of Representatives passed the aid package by a 10 vote margin.

Federal involvement was motivated by concerns over the impact of a bankruptcy on the city, state, other public agencies, and on the banking community. In addition, many small investors had bought New York City debt. The impending bankruptcy of New York had become an international issue. Both President Giscard of France and Chancellor Schmidt of West Germany told President Ford they were worried about the impact of a possible bankruptcy on the international banking system. The recent hike in oil prices had pushed the oil consuming countries into a harsh recession and the banking system had yet to recover. In addition, the finances of the State of New York were so intertwined with the City of New York that a municipal bankruptcy could have meant a state bankruptcy as well. In that event, other public agencies would have to pay higher interest rates to market their own securities.

The Ford administration was concerned about setting a precedent and having other public agencies come for federal assistance. As a result, the conditions were set so that no other entity would ever want to come to the federal government for help. In addition, the major stakeholders, banks, employees, and state taxpayers had to provide additional assistance. Following are the major conditions:

- The city was forced to hike fees for services, especially for the city university and the subway. Other services were cut. The city's work force was trimmed and a wage increase was rescinded.

- Up to 40 percent of the assets of the city pension fund were invested in MAC securities. The state pension fund also invested in MAC securities. A total of $2.7 billion of city debt was bought by the pension funds.

- The banks who had served as the underwriters for New York's securities agreed to purchase additional securities and/or lengthen the maturity or lower the interest rate on the securities that they held. Other holders of securities had to exchange them for ten-year MAC securities or face a three-year moratorium on the repayment of

principal on the notes. The banks turned in $819 million in notes for MAC debt and restructured the interest and maturities of the other debt they held.

- The city raised taxes an additional $200 million.

- The city would have to balance its budget by 1978. The budget had to be balanced using generally accepted accounting principles. Most notable of these were the elimination of financing operations from capital funds and a requirement that the city fully fund its pension plans.

- The First Deputy Mayor, Deputy Mayor for Finance, and the budget director all had to resign so that trustworthy staff could be appointed.

- The federal loans were made at 1 percentage point over the cost of funds to the federal government.

- The city was obligated to regain access to the credit markets in 1978.

At this point, New York City was again able to borrow, but only from the institutions that had a stake in its survival, namely the banks, the state and federal government, and from the employees' pension funds. The city was still unable to borrow in the municipal bond market.

The City's Return to Solvency was not Smooth. Problems came to a head in November 1976, when the New York Court of Appeals threw out the debt moratorium. More problems occurred throughout 1977 and 1978 as one or more of the stakeholders threatened to bail out. In each instance, actual default was always averted as one or another of the recalcitrant interested parties were forced to make a concession.

One of the federal conditions was that the city regain access to credit markets by 1978, a condition that the city was unable to meet. As a result, additional assistance was requested from the federal government. This request was granted on the condition that the Emergency Financial Control Board be extended until after the year 2000. In addition, “Emergency” was dropped from the board's name.

The city kept its part of the bargain in dealing with public employees. City employment fell by 20 percent and work rules were loosened. Wages were reduced and eventual raises were held below the level of inflation. By 1977-78, the city had no short-term debt.

As part of its obligation imposed by the federal government, the state assumed the full cost of financing the city university system and a portion of welfare and court systems. The state also tightened controls over Medicaid reimbursements to health care providers.

The Financial Control Board was Relatively Constrained in its Dealing With the City. The Board did not take control of every facet of city administration. By and large it let the city do what it wanted to do, but of course its existence may have had a sobering influence.

The Board did step in to reign in pay raises. In 1976, the Board approved a cost of living allowance for city workers, but only an amount that was consistent with productivity gains. Also it conditioned the raise on gaining changes in restrictive work rules.

Securities Exchange Commission Criticized Wall Street for Their Role. The Securities Exchange Commission (SEC) conducted a special report in the aftermath of New York City's brush with bankruptcy. All of the players came in for their share of criticism. The report criticized the opinion of bond counsel for not being accurate and ignoring important information. For example, most of the notes sold by New York City did not have a true first lien on revenues. The bond counsel's opinion stated that such a lien existed. According to the SEC, the major underwriters failed to fulfill their responsibilities to the investing public. Between October 1974 and March 1975, Merrill Lynch and six big banks underwrote $4 billion in New York City debt despite the clear financial problems that the city was having including a 15-year string of budget deficits. As one author noted:

> "The more New York City notes Merrill Lynch moved the more commissions it earned."

The underwriters were concerned enough to reduce their own holdings of New York City securities.

Bond Rating Agencies Failed the Investing Public. The city's debt had started the 1960s with a rating of A. By the mid-60s, the rating was downgraded to BAA. The city reacted to the downgrading by starting a political campaign against the rating agencies, despite the fact that the city was paying higher rates than other similarly rated agencies. In 1972, Moody's relented and upgraded the city bonds to A. Standard and Poor's waited until December 1974 when the city was on the brink of bankruptcy to upgrade their rating. Fitch Investor's Service had lowered their rating in October 1974. Both Moody's and Standard and Poor's were criticized in the SEC report.

Conclusion:
In 1979, the city was able to enter seasonal financing markets and sell some short-term notes. In 1981, the city sold a small issue of long-term bonds and for the first time in many year ran a balanced budget based on generally accepted accounting principles. In that same year, the city had a bond issue that received an investment grade. By 1985, the city no longer needed assistance from the Municipal Assistance Corporation.

Post Script:
New York City has had a long history of fiscal crisis. It was a fiscal crisis in 1871 that brought down boss William Tweed of Tammany Hall fame. During the depression, Mayor LaGuardia had to act to protect the city from looming bankruptcy.

This long history appears to be continuing. In mid-January, Standard and Poor's accused New York City of using "one-shot gimmicks" to cure its financial problems and threatened to downgrade $23 billion of outstanding debt. The mayor has been trying to balance the budget by cutting public sector jobs.

As one Wall Street analyst commented,

> "New York is a credit that one is always worried about,...But the level of worry has ratcheted up a bit in the past six months."

For more information, please contact Roger Dunstan, at the California Research Bureau, California State Library (916) 653-9254

Appendix A
Adjusting for Inflation

The first paragraph of this report states, in part, that:

> "...New York City and its subdivisions had $14 billion of debt outstanding of which almost $6 billion was short-term. The city admitted to an operating deficit of at least $600 million, although honest accounting techniques would have made it more like $2.2 billion and the city found itself shut out from credit markets."

These figures are all in 1975 dollars. Because there has been a fair amount of inflation, I adjusted the numbers for inflation. In 1995 dollars, this is almost $40 billion of debt of which $17 billion is short-term debt. The city's operating deficit ranges from $1.7 billion to $6.3 billion in 1995 dollars.

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