Fixing the Mess: Financial Management after the New York City Fiscal Crisis

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Abstract: In the years since the 1975 fiscal crisis, New York City has improved its financial practices, and now carries a AA rating from the credit rating agencies. This paper outlines economic, institutional and political factors that contributed to that recovery, showing operating results and changes in reserves under each mayor from Koch to Bloomberg.

Introduction

In October of 1975, Mayor Abraham D. Beame drafted a press release stating that the City had asked a bankruptcy judge to step in to help preserve the City's remaining assets from its creditors. For six months, the City had been managing its shrinking cash, triggered in April of 1975 when the City lost access to the public bond markets. Stated more concretely, the banks that usually bought the City's notes refused to bid on its most recent offering, and the City did not have the cash it needed to meet all its current obligations. New York, with its $11.9 billion budget, had borrowed more than $8 billion on a short-term basis during fiscal year 1975, which ended on June 30, 1975. At the end of the year, $4.5 billion in short term debt remained outstanding, and it needed cash to pay off those notes as they came due. The City was also issuing long-term debt to fund hundreds of millions of dollars of operating expenses. Cash for payroll and other necessities was also tight. In a bankruptcy proceeding, a judge would make decisions about who would or would not be paid.

If the judge decided that note- and bondholders would not get principal and interest payments on time, however, that default would badly damage the credit of the City, perhaps for many years. State officials were concerned about the possibility of default by the City, and afraid that the state's credit would suffer as well. The state was also dependent on issuance of short-term notes to fund its own cash flow needs, although its next large borrowing was not scheduled until the spring of 1976. So when the City lost market access in April of 1975, New York's Governor Hugh L. Carey stepped in to fashion a rescue package. The State accelerated payment of $400 million in state aid in April, and followed with an $800 million cash advance on State aid in June. These steps allowed the City to pay its bills for the rest of the 1975 fiscal year which ended on June 30.

On June 10, the State took its next step, the creation of the Municipal Assistance Corporation for New York City (MAC), a new financing mechanism designed to borrow $3 billion and organize other actions to refinance the City's debt. During the summer of 1975, market reaction made it clear that MAC could not fulfill its financing plan without additional State involvement and control over the City's finances. The governor and the state legislature government responded with other institutional and statutory actions, mostly importantly the Financial Emergency Act of 1975 (FEA), passed in special

session in September. The FEA created the Emergency Financial Control Board (EFCB), redesigned the City's budget process, and required the City to balance its budget according to generally accepted accounting principles (GAAP). These new controls and institutions helped MAC complete its refinancing of the City's short-term debt, and spurred agreements by the City's unions of purchases of City securities by the pension funds. Approval of a pension fund investment by Albert Shanker, the leader of the teachers' union, allowed City Hall to put that press release back in the files and avoid bankruptcy in October.

Although the City avoided court supervision, it soon resorted to another extreme remedy, the Emergency Moratorium Act, passed in special session by the state legislature in November of 1975. The moratorium allowed the City to conserve cash by suspending payments on its short-term debt. City creditors had the option to exchange up to $1.6 billion in notes for MAC bonds, or to hold on to their notes and receive an interest rate of not less than 6% for the rest of the holding period. Bankers and others reading this legislation were prone to substitute the more familiar word "default" for "moratorium."

By the end of 1975, the State had enacted a program of new taxes, the City had begun a large program of layoffs, City unions had agreed to freeze wages, and the Federal government had enacted a program of short-term loans for the City. During these perilous six months, the State and MAC rescued the City from bankruptcy, and the immediate crisis was past.

But the work-out had just begun. The State, through the new instrumentality of the EFCB, and the City labored over a period of many years to clean up the rest of the mess created during the fiscal crisis.

- Between 1976 and 1978, the EFCB controlled the City's finances through its initial three-year plan, and oversaw the creation of the City's first four year plan. The Federal government agreed to longer-term guarantees of some City securities. The State agreed to fund the court system in the City and the senior colleges of the City University of New York, and tuition was levied at CUNY for the first time. Finally, the City put in place new accounting systems which allowed it to issue its first externally audited financial statements after Fiscal year 1978.

- In 1978, the newly elected mayor, Edward I. Koch, and other City officials began to implement the first four year plan. The goal was to reach GAAP balance and eliminate debt financing of expense items within that period. In fact, the city balanced its budget in 1981, a year ahead of schedule, and has done so every year since.

- Between 1981 and 1986, the EFCB continued to review and approve the City's budgets, contracts and borrowing, but the improved condition of the City's finances was signaled and symbolized by a change in its name to the Financial Control Board (FCB).

- In 1986, the City reached a new milestone. After five years of balanced budgets and a series of other actions, the City met all the provisions of the law required to terminate the "control period," and the Financial Control Board officially went into "sunset." Since then, the small FCB staff has continued to review and comment on the City's financial plans, but the Control Board no longer approves budgets, borrowing or contracts. Under the FEA, a new control period could have been reinstituted if the City had closed its books with a GAAP deficit of more than $100 million, if the City had been denied market access again, or if the City had violated several technical requirements about its debt and debt service. However, the City has posted GAAP surpluses in every year since 1981, and the question of market access was never been at issue during this period. Indeed, the City's ratings, which reflected its market acceptance, continued to rise during the last two decades.[1]

Table 1

NYC General Obligation Bond Rating History

Updated 7/3/07		S & P	Moody's	Fitch
1975	**April**	**Suspended**	**A**	
	October 2		**Ba**	
	October 29		**Caa**	
1977	**May**		**B**	
1981	**March**	**BBB**		
	November		**Ba1**	
1983	**November**		**Baa**	
1985	**October**			
	July	**BBB+**		
	December		**Baa1**	
1987	**November**	**A-**		
1988	**May**		**A**	
	July			
1990	**July**			
1991	**February**		**Baa1**	
	April			
1993	**July**			**A-**
1995	**July**	**BBB+**		
1998	**February**		**A3**	
	July	**A-**		
1999	**March**			**A**
2000	**August**		**A2**	
	September	**A**		
	September			**A+**
2005	**April**		**A1**	
	May	**A+**		
2006	**May**	**AA-**		
2007	**June**	**AA**		
	June			**AA-**

[1] The data in this table was prepared by the Public Resources Advisory Group (PRAG) for its clients in New York City Government.

Since sunset, the FCB has increasingly settled into quiescence, and the City has worked its way through cyclical downturns which created visible but manageable levels of fiscal stress. The City has developed a new and workable method of reserving for operating needs, consistent with (or in spite of) the legal requirement for GAAP balance. After September 11, 2001, the City raised taxes and borrowed to fund some operating expenses. Operating results moved quickly back into the black, and today its reserves are strong and its very large debt load is manageable. In short, more than thirty years after the fiscal crisis, New York City's financial condition is strong, and most observers would agree that its financial management is now exemplary. The intervention that was led by Governor Carey and his colleagues has worked, behavior has changed, and the change has persisted.

Should we be surprised? Perhaps. In one of the most thoughtful analyses of the New York City fiscal crisis, Martin Shefter argued that the origins of the collapse were much deeper than the shifts in population and loss of manufacturing jobs that were often cited as root causes. Instead, argues Shefter:

> [T]he proximate causes and explanations of the 1975 fiscal crisis may be manifestations of recurring tensions in the city's political and economic systems….More generally, a brush with bankruptcy, the suspension of "politics as usual," … and, finally, a tacit agreement between supporters of these reform administrations and the machine politicians they had castigated for driving their city into ruin is a cyclical pattern that has characterized the history of other American cities. Indeed, these episodes occur with sufficient regularity that fiscal crises should be regarded not as aberrations, but as an integral part of American urban politics. [2]

According to Shefter, New York City suffered through six fiscal crises between 1856 and 1975, a mean distance between fiscal crises of about 24 years. By that logic, we might have predicted more financial turmoil by now.

Scholars often debate the efficacy of institutional and statutory factors in financial management. Was New York City an example of a successful intervention, and if so, which specific elements of the fiscal control apparatus contributed most to success? Alternatively, were the most important factors transformations in the political culture and political institutions of the City? Finally, might we attribute the positive outcome to other factors – for example, a growing population and an expanding economy in the City?

These are interesting and important questions in the abstract. They also have implications for policy makers in the near term. By June of 2008, all the bonds issued by the Municipal Assistance Corporation will be paid off, and that event will trigger the expiration of the Financial Emergency Act. At that point, what Robert Bailey[3] called New York's crisis regime will officially end. In anticipation of that milestone, officials

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[2] Shefter 1987, p. xxiii.
[3] Bailey 1984.

and scholars are quietly discussing which of the elements of the crisis regime should be retained, and which should not. Looking forward to the 2008 expiration of the Financial Emergency Act, the City acted two years ago to amend its charter, incorporating into it several provisions of the FEA. The new charter language mandated GAAP balance and the four year planning process, and strengthened existing charter provisions limiting short-term debt and mandating an annual audit.

The future status of the crisis regime is currently uncertain. In 2003, the State agreed to issue its own bonds to fund the last five years of outstanding MAC debt and relieve the City of the burden of MAC debt service. In the legislation authorizing that new stream of state aid, the termination provision of the FEA was restated, presumably to make it clear that economic defeasance of MAC's outstanding bonds would not trigger the termination of the Financial Emergency Act and the FCB ahead of its scheduled expiration on July 1 of 2008. However, the State also extended the life of the Financial Control Board beyond 2008, but without the current provision for reinstitution of a control period. If this legislative action is not changed, the FCB will continue as a monitor, but cannot reassume control of the City's finances. There is still confusion about this action and its implications for the other provisions of the Financial Emergency Act next summer.

Several other issues are still under discussion. The Speaker of the City Council has sketched out a proposal to create a rainy day fund. The future of the FCB staff and whether the City will continue funding for the FCB and for the State Comptroller's New York City office are also issues on the table. These issues are likely to be addressed in the next session of the State legislature, which begins next January.

Financial management before the fiscal crisis

Before the fiscal crisis, the City was spending more on operating costs than it was collecting in revenues. No one was quite sure how big that gap was, because the City was unable to produce financial data that could be audited by public accounting firms. This problem was a source of deep concern to Felix G. Rohatyn and the team of experts drafted by Governor Carey to work on the State rescue of the City. The numbers put forward by top City officials changed from day to day, often by many millions of dollars.[4] These data problems were complicated by slipshod or deceptive accounting practices which allowed receivables to remain on the books long after it was clear that the underlying revenue were uncollectible. As a matter of policy, the City also bonded out operating expenses every year, in amounts which grew steadily to nearly $600 million (or about 5% of the budget) in fiscal year 1975. The most infamous use for these borrowed funds was borrowing to pay for the operating expenses of the vocational schools, under the theory that the schools were building human capital.

These poor practices were compounded by an approach to budgeting that took no cognizance of limits. Fred Ferretti, a New York *Times* reporter who covered the fiscal

[4] Author's interview with Rohatyn. This interview and others are available through the online archives at Baruch College, at http://newman.baruch.cuny.edu/digital/2003/amfl/index.htm. The Archive also includes digital copies of all of MAC's archives, including minutes, annual reports and other materials.

crisis, stated the issue succinctly: "Never did a mayor or budget director say simply that there was this amount of money available, and therefore creation of a favored program was not economically possible or feasible."[5] After the Mayor proposed the executive budget, it was approved by the City's bicameral legislature, which consisted of:

- the City Council, a traditional legislative body, and
- the Board of Estimate, a body which combined executive and quasi-legislative elected officials, including the Mayor, the City Comptroller, the President of the City Council, and the five Borough Presidents.

All of these practices and institutions, colorfully documented in Ferretti's book length treatment of the fiscal crisis, contributed to a simple and dangerous result: the City regularly spent considerably more than its annual revenues, and borrowed billions of dollars to fund the cash deficit that resulted.[6]

Financial management after the fiscal crisis

As outlined above, the City has made steady progress in financial management, and that progress is neatly summarized by the improvement in its ratings. In 1975, the City's debt lost its investment grade rating, and it had to rely on the State to avoid default. In 2007, the City's bonds are rated AA, equivalent to the State's rating and the highest ratings for the City since the Great Depression. Since the City is still burdened by a heavy debt load, high levels of debt service, as well as high taxes and spending compared to other major cities, the ratings are truly a testament to the exemplary management of the City's finances by its professional staff and elected officials.

We will try to analyze this positive outcome from three different vantage points. First, we will look at some key economic and demographic data series, which serve as important building blocks of the City's recovery. Second, we will outline the institutional changes, some intentional, some not, which led to improved financial management. Finally, we will review the key political events of the period, and look for signs that the political culture that spawned the fiscal crisis may have changed.

This paper is a very earlier report on a longer and more detailed study of budgets and other key elements of the City's post-crisis financial management. That work has been made easier because the Independent Budget Office[7] has posted valuable time series data on spending and revenues on its website. Nonetheless, this study is still sketchy and incomplete, and does not give a complete picture of all the elements of financial management after the fiscal crisis. Important omissions include debt management practices, the development of financial systems, and the City's tactics in dealing with

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[5] Ferrety 1976, p. 31.

[6] See Ferretti 1976, especially Chapter entitled "Before the Year," pp. 21-83. Bailey, p. 3 cites 7 major studies arriving at the same simple conclusion.

[7] The website for the New York City Independent Budget Office can be found at http://www.ibo.nyc.ny.us/. The data archive is listed under City Revenue and Spending Since 1980.

financial problems in semi-independent agencies like the Health and Hospitals Corporation or the Board of Education.[8] Other institutional topics which deserve attention are the short history of the Legislative Office of Budget Review, and the much more positive contribution of the Independent Budget Office.

Operating Results and Reserves

Throughout the paper, we will refer to two data sets which were discussed in an earlier paper on the City's financial management: operating results, and the growth of the City's reserves.[9]

In most jurisdictions, operating results are clearly stated in the financial statements, and these are a helpful guide to the government's financial activities during the past year, and the ups and downs in a long series of operating results help an analyst understand the ability of the government to manage its finances under varying circumstances. Typically operating results are reported as the net change in fund balance of the General Fund, which is the bottom line of the Statement of Revenues, Expenditures and Changes in Fund Balances. In New York City, for every year since 1981, when the City's budget was first balanced under GAAP, the net change in fund balance has been $5 million, with the exception of fiscal year 1996, when it was $4 million. Obviously, these results are artificial, and the necessity to manage the change in fund balance is a response to the requirement in the Financial Emergency Act that the City balance its budget on GAAP each and every year, under threat of imposition of a new control period.

From a technical standpoint, a new control period is triggered if the change in net assets in the City's general fund is negative by more than $100 million. When other state and local governments run deficits, their bottom line is negative, and their fund balance falls or they reduce their rainy day fund, a reserve established to cushion against economic downturns and other possible causes of budget deficits. But typically there are no consequences to an operating deficit. In New York City under the Financial Emergency Act, the consequences are grave. The City also has cyclically sensitive tax sources, and one of its key industries – Wall Street – is famously cyclical, so under normal management practice the likelihood of negative operating results is quite high.

As we will see later, with an economically sensitive tax base, the economic cycle is and will remain an important test of the management of the City's finances. We will see evidence of the stress created by cyclical downturns in our discussion of mayoral management of the City's finances over the last thirty years. State governments use rainy day funds to deal with cyclical deficits and surpluses, and from time to time, commentators on City budgets suggest creation of a formal rainy day fund (RDF). However, funds drawn an RDF are not revenues under GAAP, since those dollars had been recognized and booked in earlier periods. Under the FEA framework, therefore, a

[8] See Viteritti, 1983, chapter 2 (pp. 31-98), for a description of what the author called "the battles of the budget" between the Board of Education and City Hall in the early post-fiscal crisis period.
[9] Forsythe 2006.

rainy day fund would not forestall a control period if the City drew on it for more than $100 million in any given year.

To respond to these problems, the City's financial managers have employed their considerable inventive talents to create what we might call synthetic reserves. What would have been a GAAP surplus above the $5 million level in any given year is rolled forward in what has been labeled the "surplus roll." In a good year, the roll grows by the amount of surplus above the $5 million benchmark. In a bad year, the roll shrinks by the amount of what would otherwise be the deficit, plus the $5 million. The surplus roll is therefore a cumulative amount, embodying the positive and negative results of prior periods since fiscal year 1981. Thus, it is functionally analogous to the general fund balance of a jurisdiction that does not feel compelled to manage earnings in this way.[10] In the rest of this paper, when I mention reserves, I will be referring to the level of the surplus roll or, in the very recent past, to the surplus roll and some new reserves structures created during the Bloomberg administration. In New York City, all decisions about the surplus roll and reserve levels are made unilaterally by the mayor and his Office of Management and Budget, with no participation from the City Council, the Comptroller or other City officials. Thus, this mechanism is an important tool for the mayor is managing the City's budget. The mayor's hand would be weaker if the City Council was able to secure a role in decision-making about a newly created rainy day fund.

[10] For a fuller treatment of the surplus roll and its components, see Forsythe, 2006.

Table 2

	Fiscal Year	Reserves
Koch (1978-89)	1981	358
	1982	338
	1983	473
	1984	494
	1985	558
	1986	416
	1987	559
	1988	215
	1989	403
Dinkins (1990-1993)	1990	248
	1991	22
	1992	566
	1993	407
Giuliani (1994-2001)	1994	67
	1995	66
	1996	224
	1997	1,362
	1998	2,081
	1999	2,615
	2000	3,187
	2001	2,944
Bloomberg (2002-2009)	2002	681
	2003	1,417
	2004	1,923
	2005	3,529
	2006	3,751
	2007	3,937

Although the City's financial statements do not report a number for operating results, it is possible to reconstruct a data series that would closely resemble operating results in other jurisdictions. In this effort, I am following the lead of the Office of Special Deputy Comptroller, which has constructed this data series for the last decade or so, and has been reporting on it for several years now. This year, the City Comptroller has also begun to report on operating results, although it defines them slightly differently than OSDC, whose data series I am employing and extending. For each fiscal year, OSDC calculates the year-to-year increase or decrease in the surplus roll. Added to this number, often called the "net roll," is the reported GAAP surplus, typically $5 million. Since fiscal year 2001, the calculation of this data series has become more complex, and these complicating factors will be discussed in the material that follows on the Bloomberg administration. In the rest of this paper, when I refer to operating results, I am using data from this construct. As suggested earlier, in a City with economically sensitive taxes, operating results are sometimes negative. Without the cushion of the surplus roll, operating deficits would have exceeded the FEA trigger of a $100 million deficit 9 times between 1981 and 2007, as outlined in Table 3.

Table 3
Operating Results, FY 1981-2007

	Fiscal Year	Operating Results
Koch (1978-89)	1981	363
	1982	(15)
	1983	140
	1984	26
	1985	69
	1986	(137)
	1987	148
	1988	(339)
	1989	193
Dinkins (1990-1993)	1990	(150)
	1991	(221)
	1992	549
	1993	(154)
Giuliani (1994-2001)	1994	(335)
	1995	4
	1996	163
	1997	1143
	1998	724
	1999	539
	2000	577
	2001	(238)
Bloomberg (2002-2009)	2002	(2,619)
	2003	(759)
	2004	511
	2005	1611
	2006	2,368
	2007	3,708

The Economic Explanation

Before and during the fiscal crisis, analysts pointed to demographic and economic factors as causal explanations for the City's fiscal problems.[11] These analyses blamed declining population, a shrinking job base, and a shift in City jobs away from the manufacturing sector for the City's fiscal woes.

Indeed, the City's population had grown quickly during the twentieth century, increasing from 3.4 million in 1900 to 7.9 million in 1971. Between 1971 and 1980, the population fell to 7.1 million, a decline of 10.4%. As the population fell, so did employment. According to BEA data on total employment, jobs fell sharply from a peak of 4.3 million in 1969 to 3.7 million in 1977.

Looking forward from 1978, we see growth to 4.2 million in 1988. From 1988 to 1999, job growth was negative or stable, and the post-fiscal crisis peak in 1988 was not surpassed until 2000, when the City's job total was 4.5 million, peaking at a level 760,000 higher than the nadir in 1977. Employment in the City fell from 2001 to 2003, and began to grow slowly again in 2004. By 2005, the total was 87,000 higher than the previous peak in 2000.

Economists and revenue forecasters watch population growth and jobs carefully, but wages and personal income have a more direct relationship to several of the City's key tax sources, including the personal income tax and the sales tax.[12] In 1975, during the depths of the fiscal crisis, wage earnings in New York City were $34.4 billion. By 2006, wages had grown to $260.1 billion, a total increase of 656%, or an average annual increase of 6.7%. Similarly, City personal income in 1975 was $55.5 billion; by 2005, the last year of data available, it had grown to $343.4 billion, reflecting total growth of 519% or average annual growth of 6.3%. Of course, these increases were fueled by inflation, but budgeteers live and work in a world of nominal dollars, and that steady growth fueled increases in the City's economically sensitive taxes.

A more complete economic analysis would also look at the periods of slow growth and decline in these key variables, and see how City officials responded to those periods of economic stress.

A more complete analysis would also look at the growth of real estate values, which has been an important factor for New York City. Higher values fueled increases in real property assessments, which are one factor in the calculation of real property taxes. However, the City's real property tax is constrained by state law, so those increases in value are mitigated by caps and other limitations for some taxpayers. The City also benefits more directly from higher real estate prices from its mortgage recording tax and its real property transfer tax. These taxes, dating from 1971 and 1959 respectively, both

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[11] See, for example, Bahl, Campbell and Greytak, 1974.

[12] New York City OMB publishes an extensive annual review of its taxes and forecasting methodologies. The most recent version of *Tax Revenue Forecasting Documentation* can be found on its website at http://www.nyc.gov/html/omb/pdf/trfd8_07.pdf.

feature graduated rates, so the growth in mortgage sizes and real estate values has produced strong gains in these revenue sources.

The Institutional Explanation

An institutional explanation of New York City's return to fiscal health focuses on the curative powers of the institutions created during and shortly after the fiscal crisis, and ascribes to them the central role in remedying the City's problems. The first of these institutional innovations was the Municipal Assistance Corporation, popularly known as Big MAC or simply MAC. The first chairman of the Municipal Assistance Corporation was Thomas D. Flynn, a retired Arthur Anderson partner, and former head of the American Institute of CPAs. The most visible member, however, was Felix Rohatyn, the Lazard Frères investment banker who was a key advisor to Governor Carey on the fiscal crisis.[13] The first executive director of MAC was Herbert Elish, commissioner under former mayor John V. Lindsay who had left government in 1974 to work for First National City Bank.

MAC's purpose was straightforward; it was a new financing mechanism that could provide the cash needed to run the City and refinance its existing obligations. The statute which created MAC in June of 1975 repealed the City's existing sales tax, which had been increased from 3% to 4% in 1974, and replaced it with a special 4% state sales tax, collected only within the City's boundaries. Proceeds of that tax were dedicated to repayment of MAC bonds, along with the proceeds of the City's stock transfer tax. MAC remitted to the City for its operational purposes whatever remained after the payment of debt service on MAC bonds and the expenses incurred by MAC. These two tax sources provided very high levels of protection to bondholders. For later financings, MAC bondholders also had recourse to state aid, which was available to pay MAC bonds before it was turned over the state.

Even with extraordinary levels of coverage of debt service by pledged revenues, and even at tax-exempt interest rates of up to 9 ¼%, MAC's initial bond sale of $1 billion in June of 1975 was not successful. Underwriters ended up holding hundreds of millions of dollars worth of unsold bonds, and came away pessimistic about their ability to find potential investors for all the remaining $2 billion of bonds expected to be sold during the summer of 1975. They reported that investors were still unsure about the ability of New York City to manage its budget, and skeptical that MAC could bring about the necessary changes without additional powers.

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[13] Other members of the MAC board during its first year included: Francis J. Barry, CEO of the Circle Lines; George M. Brooker, president of the Harlem-based real estate firm, Webb & Brooker, and chair of the New York Urban League chair; John A. Coleman, of stock clearing firm Adler, Coleman & Co, and former chair of the New York Stock Exchange; William M. Ellinghaus, CEO of AT&T; George D. Gould, CEO of the Madison Fund; Dick Netzer, professor and dean, NYU; Donna E. Shalala, professor, Teachers College; Robert C. Weaver, professor at Hunter College and first Secretary of the US Department of Housing and Urban Development; and Simon H. Rifkind, partner at the law firm of Paul, Weiss, Rifkind, Wharton & Garrison.

In response, the State enacted a new statute called the Financial Emergency Act in September of 1975, passed with the reluctant acquiescence of the City. The centerpiece of the FEA was the Emergency Financial Control Board, which was chaired by the Governor. The six other members of the EFCB were the mayor of New York City, the State and City Comptrollers, and three so-called "private members" appointed by the Governor. The first appointees were William Ellinghaus, who was then serving as the second chair of MAC; Albert Casey, an airline executive; and David Margolis, the CEO of Colt Industries. The Governor appointed Herbert Elish, the former staff director of MAC, as the first executive director of the EFCB.

The Act established what was called a "control period" during which the EFCB had to review and approve all of the City's financial plans, budgets, contracts and labor agreements. The control period would remain in effect until the City's budget had been balanced for four years in a row, and that budget balance had to conform to the new benchmark of generally accepted accounting principles (GAAP).[14] In the past, the City's financial reports were based on an incomprehensible combination of cash accounting and accruals that could not be reviewed by an outside auditor. During the control period, the EFCB guaranteed the active involvement of the governor, and Carey and other members of the new board reviewed, debated and approved all key City financial documents and actions. The FEA also limited the City's short-term borrowing authority, and every City borrowing also required review and approval by the EFCB. This was a formidable array of controls and powers, and they were actively exercised.

To support the Control Board in its review of the City's finances, the FEA also provided additional staff to the State Comptroller, in the form of a new Office of Special Deputy Comptroller for the City of New York. This staff was housed on the floor above the EFCB in a state office building overlooking City Hall, and was led by Sydney Schwarz. Funding for both the OSDC, as it came to be called, and for the EFCB staff came from MAC revenues, which also paid for MAC's debt service and its own staff.

The FEA also required the City to develop a three year plan leading toward budget balance in fiscal year 1978, and a rolling four year financial plan for the years that followed. The plans, which outlined revenues and expenditures in major functional categories, had to be modified and updated quarterly, and each modification was also reviewed and approved by the EFCB. In addition, the City's budget process was revised around this schedule of quarterly modifications and updates. The January modification was the basis for a new Preliminary Budget submitted to the City Council and Board of Estimate. This submission, like the executive budget submitted in the spring, triggered hearings by the legislative bodies and well as extensive reports by the EFCB staff, the staff of the City Comptroller, and OSDC. These three staffs now constituted a new

[14] There is considerable experience in American political history with short-lived institutions conceived and implemented during emergencies, like wars and depressions. See Forsythe, 1977, for a discussion of these dynamics in taxation in America between 1781 and 1833. Typically these new institutions disappear after the emergency, but sometimes prefigure more permanent changes to come. An example of the latter phenomenon is the income tax enacted during the Civil War. A permanent income tax was not a feature of the American system of taxation for another six decades.

community of budget monitors, and their reports were read with care by the rating agencies, the investment bankers, and the fiscal staffs of the City Council and members of the Board of Estimate.

Before long, this monitoring community was augmented by less formal and shorter-lived institutions. These included a new continuing discussion among academics and policy-makers academics, called Setting Municipal Priorities (SMP), run by Raymond Horton and Charles Brecher, professors at Columbia Business School and NYU, respectively. SMP commissioned papers, published edited volumes and convened conferences on issues and themes relating to the fiscal crisis. Another new voice was a newsletter called the *Fiscal Observer*. Funded by the Ford Foundation and other donors, the *Fiscal Observer* was housed at the New School for Social Research, and published from 1977 to 1979, concluding with a single issue in 1980. Prominent among of all these non-governmental institutions was the Citizens Budget Commission, a nonprofit founded in 1932 and backed primarily by corporate funding. CBC was a regular commentator on the City's fiscal affairs, and soon employed Horton and Brecher as staff members. Unlike SMP and the F*iscal Observer*, CBC continues in existence, reviewing City finances and more recently analyzing and commenting on New York State's financial management.

When the City developed the surplus roll after 1981, the tactic served not just as a device to build reserves, but also as a new and unanticipated element of conservatism in the City's financial planning process. Because the "roll" into the next year was a non-recurring resource, the following year in the four year plan had a projected deficit that grew as the "roll" increased. Mayors and monitors pointed to these out-year deficits as risks, and they were used to justify conservative revenue estimates and to jaw-bone legislators into keep spending increases small. Less frequently, when the "roll" declined year to year, poor economic performance increased the projected gaps between recurring revenues and expenditures, and so out-year deficits were still large and threatening.

As intended in the Financial Emergency Act, some of these institutions began to wither away as the City's financial performance improved. In 1981, the City was able to issue general obligation bonds in the public marketplace again, and by the end of 1984, all of MAC's authorized debt had been issued. The Corporation was not completely inactive, however. It did, of course, issue refunding bonds when interest rates were favorable, and MAC was also able to turn over surpluses from its reserves to support City spending from time to time. Discussions over the use of these surpluses led to complex negotiations between the governor, the mayor and the chairman of MAC.

As mentioned earlier, the Financial Control Board formally gave up its oversight powers on June 30, 1986, and entered a period of "sunset." In the law, sunset could take place after the City had met a series of criteria, including three GAAP-balanced budgets in a row; termination of all federal guarantees for City bonds; and certification by the State and City Comptrollers that the City had market access for long and short-term borrowing. Another institutional milestone is scheduled for July 1, 2008, when the last MAC bond is retired and the Municipal Assistance Corporation shuts down. That is also the scheduled

date when the FEA expires, and no automatic triggers for a control period will hang over the City's financial managers.

This review of institutional developments after the fiscal year has been sketchy. Any complete institutional explanation would also look at the powers and leadership of the City's Office of Management and Budget, which has played a central role in financial management since the fiscal crisis. My research in this important area has barely begun.

Finally, at least two other institutional features of financial management unrelated to the fiscal crisis of New York City government are important parts of the story.

As mentioned below, mayors of New York have complete control over revenue estimates under §1515 of the City Charter, which predates the fiscal crisis. This unusual degree of control has given mayors the upper hand in negotiating revenue levels with the City's legislators, and has even allowed Mayor Giuliani to brag about his deliberately "low-balled" revenue estimates.

As suggested above, a strong mayor has been a central feature of financial management after the fiscal crisis. One important change in the City's charter during this period was the elimination of the Board of Estimate, leaving only the City Council to negotiate the central features of the budget with the mayor. While this change strengthened the Council, it probably strengthened the mayor even more, by reducing the roles of the Comptroller, as well as the City Council President (now the City Advocate) and the Borough Presidents, in budget negotiations.[15] The Board of Estimate was abolished in 1990 after the U.S. Supreme Court[16] invalidated its voting system, which gave equal voting strength to the Borough Presidents of Staten Island and Brooklyn, although in 1989 Brooklyn's racially mixed population was more than six times larger than Staten Island's largely white population.

The Political Explanation

The City of Yonkers is located just north of New York City, on the south end of Westchester County on the banks of the Hudson River. Affected by many of the same economic and demographic problems as New York City, Yonkers suffered through its own fiscal crisis, and the State set up a Control Board to oversee Yonkers' finances. By almost any measure, financial management in Yonkers has not improved to the same extent as New York City, in spite of the strong family resemblance of the institutional features of their control regimes. If we can see similar institutional features in Yonkers, but a much less successful outcome, perhaps we need to look beyond the institutional framework to other factors. As you might suspect, Yonkers did not share in the economic and demographic growth that characterized New York City. But its political

[15] While the City Council after the fiscal crisis plays a stronger role in budget-making, mayors have hamstrung the Council year after year by eliminating all of the funding they have added to the budget the year before, and making them negotiate to put it back. Called the "budget dance" by Speaker Christine Quinn, this tactic should receive much fuller treatment as this study proceeds.

[16] Board of Estimate vs. Morris (489 U.S. 688) 1989.

system and culture were also very different from New York. In this section, we will review some of the political factors that affected the City's financial management, and see if they add to the explanatory power of our analysis.

As outlined earlier, Governor Carey decided not to turn the financial problems of New York City over to a bankruptcy court, and chose instead to maintain political control of the work-out. Initially, the most visible players were the Governor and his brilliant "fixer," Felix Rohatyn. Leading the staff work inside State government were the equally brilliant budget director, Peter Goldmark, and the Governor's counsel, Judah Gribetz. As MAC and the EFCB, the appointed and staff leaders of these organizations were key members of the Governor's team.

On the City side, leadership was the problem, not the solution. Beame, a former budget director and comptroller of the City, was elected as a man who "knew the buck." A life-long product of the Brooklyn Democratic political machine, Beame proved to be a singularly ineffective mayor. In oratory and interviews, he was quiet, serious and far from inspirational. As a manager, he seemed unable to accomplish the budget-balancing actions he was forced to propose. Savings packages were announced with great fanfare, but as implementation approached, numbers changed, promised budget cuts were delayed, and layoffs failed to materialize. As Ferretti described it, "he had 'scheduled' and 'said' and 'planned to' and he had not done." [17] This was in fact a well-established tactic in New York City. Its mayors had often resorted to brinkmanship in their efforts to get additional federal or state aid. Like politicians everywhere, however, mayors and other elected officials much preferred to say "yes" instead of "no," so when the brink came near, they often stepped back. Working for the mayors were clever budget officials like James Cavanagh, promoted to first deputy mayor under Beame; Cavanagh and others helped devise fiscal gimmicks that avoided tough decisions. As Ferretti saw it, "Never did any mayor or budget director say simply that there was this amount of money available and therefore creation of a favored program was not economically possible or feasible."[18]

When the gimmicks ran out and market access disappeared, the politicians began to attack. By the summer of 1975, Beame was described by Robert T. Connor, the Republican Staten Island Borough President, as a man with "all the power of the mayor of Paris during the occupation,"[19] and labeled "a basket case" by Victor Gotbaum, head of one of the City's largest unions.[20] Even more damaging was the assessment of MAC's chairman, summarized in a letter to Governor Carey on August 25, 1975:

> Because of the confusion surrounding many of the Mayor's efforts and in spite of his repeated assurances that he is doing all in his power to put the City's fiscal house in order, the message from the marketplace is clear. The investing public apparently lacks confidence in the City's management and its ability to regain its

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[17] Ferretti, p. 209, emphasis in the original.
[18] Ibid, p. 31
[19] Ibid, p. 153.
[20] Ibid, p. 124

> solvency. There is a pervasive perception that City efforts at fiscal and management reform are not credible. For these reasons the cash necessary to meet the maturing obligations of the City and the operating expense requirements for September and beyond cannot be raised through the sale of MAC bonds.[21]

That same month, rumors emanating from Albany described the Governor as ready to try to force Beame out of office. The model was Governor Franklin D. Roosevelt, who had pressured Mayor Jimmy Walker to resign in 1932. In fact, Deputy Mayor Cavanagh, who had been first assistant budget director under Lindsay, was forced to resign, but Beame was saved from a similar fate by creation of EFCB, which eliminated the City's power to run its own finances so completely that removal was pointless.

Beame ran for reelection in 1977, and finished third in the Democratic primary. Since then, politicians have adopted the post-fiscal crisis rhetoric, and run as budget balancers. Once elected, mayors have also worked hard and usually effectively to keep the City's budget in balance, although fiscal stress is evident when the local economy turns down.

Congressman Edward I. Koch, who beat Beame in the primary, was elected mayor and took office on January 1, 1978. Koch, a reform Democratic from Manhattan, was a fiscal conservative in office. He was able to balance the City's budget in 1981, a year ahead of the schedule laid out in the first four year plan, and was reelected that fall. He ran on both the Democratic and Republic ballot lines, and won 75% of the vote.

Operating results were modestly negative in 1982, but positive again for the next three years, and at the end of 1985 the City had more than a half billion in reserves. These were sufficient to keep reported GAAP results positive in FY 1986, even though City's operating results were $137 million in the red. Note that without the rolled reserves, the City would have run a deficit that would exceed the $100 million trigger in the FEA. This also would have been the case in 1988.

During his first two terms, Ed Koch seemed to relish his new stance as a fiscal conservative. He said "no" to unions, programs and other demands with élan, and in June of 1986 was able to guide the City to its fifth balanced budget in a row. That accomplishment was highlighted that month when Koch hosted Governors Cuomo, Carey and a herd of other politicians on City Hall steps in a ceremony celebrating the end of the FCB control period.

[21] MAC Annual Report, 1976, p. 12.

Table 4
Operating Results and Reserves:
The Koch Years

Fiscal Year	Operating Results	Reserves
1981	363	358
1982	(15)	338
1983	140	473
1984	26	494
1985	69	558
1986	(137)	416
1987	148	559
1988	(339)	215
1989	193	403

Koch was reelected for a third term in 1985, and his alliances with machine politicians like Donald Manes and Stanley Friedman drew him into a series of corruption scandals. Weighed down by those burdens and by a slowing economy later in the 1980s, operating results were mixed in Koch's last budgets, and were marked by an operating deficit of $339 million in FY 1988.[22] Koch ran for reelection, and was defeated by David N. Dinkins, the Manhattan borough president. Dinkins defeated Rudolph Giuliani, who had run on the Republican and Liberal lines, and took office as the City's first African-American mayor in January of 1990.

Dinkins was a product of the Democratic Party organization in Harlem, and had served as City Clerk before winning election as Manhattan Borough President on his third attempt for that office. As director of the City's Office of Management and Budget, Dinkins selected Philip R. Michael, who had served under Cuomo as executive director of the Financial Control Board. Dinkins made it clear that the appointment was aimed at quieting concerns that Dinkins might not be up to the job of managing the City's finances. At the press conference where he announced the appointment, Dinkins stated that the naming of Mr. Michael "should send a strong signal to the business community, to the city's bondholders and to the taxpayers that we will not relax our vigilance over the bottom line, even in difficult times."[23] Before leading the staff of the FCB, Michael had served as Commissioner of the Department of Finance, the City's tax collection agency, but had never served in a budget position.

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[22] As outlined earlier, negative operating results in most organizations lead to unbalanced budgets. New York City's "surplus roll" creates a buffer that allows the City to show small GAAP surpluses even when operating results turn down.
[23] New York *Times*, 12/23/93.

Table 5
Operating Results and Reserves:
The Dinkins Years

Fiscal Year	Operating Results	Reserves
1990	(150)	248
1991	(221)	22
1992	549	566
1993	(154)	407

Dinkins struggled with financial management as mayor, in part because Koch had bequeathed him a FY 1990 budget in trouble, in part because economic growth was weak and state aid was cut during his period in office. Dinkins' major fiscal accomplishment in office was passage of the Safe Streets, Safe City Act, which created a temporary surcharge on the City income tax. The funds were dedicated to increasing the police force, however, and Dinkins still struggled to balance the rest of the budget. At one time, he inquired of then Governor Cuomo whether it might be possible under the Financial Emergency Act to borrow to pay for operating expenses again.[24] Cuomo said no, and Dinkins ended fiscal year 1991 with only $22 million in reserves. Operating results were much stronger in 1992, and Dinkins managed to make it through his four year term without stumbling into fiscal catastrophe. While running for office in 1993, Dinkins found himself in the unhappy position of requesting the resignation of his budget director, who was accused of showing favoritism to a company seeking a City contract to collect parking fines. Earlier in the election year, Dinkins had appointed a three-person panel to review budget options for consideration during his second term.[25] The panel was attacked as a delaying stratagem by Giuliani, who beat Dinkins in a close election.

Giuliani took office in 1994. He was the first Republican to be elected since John V. Lindsay left office in 1974, and also ran on the Liberal Party line again. During Giuliani's tenure in office, term limits were added to the City Charter, limiting Giuliani and subsequent mayors to two-four year terms. Dinkins had left him with a large hole in the FY 1994 budget, but reserves were large enough to scrape by without threatening a GAAP deficit. The local economy improved later in his first term, and Giuliani was able to balance the budget, develop innovative strategies for using the additional police hired by Dinkins, and reduce taxes. He defeated Democrat Ruth Messinger, former Manhattan Borough President, by a wide margin in his race for reelection in 1997.

[24] The author was state budget director at the time, and the question was relayed to him for staff review.
[25] The author was also a member of this panel. Its report was sometimes called the Kummerfeld Report after Donald Kummerfeld, the other active member of the panel. The report recommended a number of politically difficult fiscal actions, including higher taxes on one- and two-family homes and tolls on the East River bridges. Presented shortly after Election Day, it was dismissed by mayor-elect Giuliani as "old thinking." See Forsythe and Kummerfeld, 1993.

Table 6
Operating Results and Reserves:
The Giuliani Years

Fiscal Year	Operating Results	Reserves
1994	(335)	67
1995	4	66
1996	163	224
1997	1,143	1,362
1998	724	2,081
1999	539	2,615
2000	577	3,187
2001	(238)	2,944

During Giuliani's second term, the City's economy was stronger, although it weakened in early 2001. One innovative tactic adopted by Giuliani was deliberately low-balled estimates of the City's tax collection. This choice, made possible by the mayor's unilateral charter control of revenue estimates, help to build reserves during his second term. He ended fiscal year 2000 with more than $3 billion in reserves, a sharp turnaround from the modest levels of the first term.

The last few months of Giuliani's term-limited tenure in office was dominated by the attacks of September 11, 2001, and their aftermath. As Giuliani left the mayoralty, operating results had turned sharply negative and the City was in recession, a downturn exacerbated by the economic impact of September 11th.

Giuliani's successor was Michael R. Bloomberg, an entrepreneur and former bond trader who had built a multi-billion corporation based on the provision of specialized financial information to the securities industry. He knew Wall Street, knew finances, and could and did spend unprecedented amounts in the fall of 2001 to get elected.

Table 7
Operating Results and Reserves:
The Bloomberg Years

Fiscal Year	Operating Results	Reserves
2002	(2,619)	681
2003	(759)	1,417
2004	511	1,923
2005	1,611	3,529
2006	2,368	3,751
2007	3,708	3,937

In fiscal year 2002, which covered the last six months of Giuliani's term in office, and the first six months of Bloomberg, the City ran an operating deficit of more than $2.6 billion. Contributing factors were the attacks of September 11th, which increases expenditures and depressed tax collections, but the City was also struggling through an economic downturn that had begun well before September 11th. Another operating deficit, this

time of $759 million, followed in fiscal year 2003. The cash impact of these deficits was partially offset by almost $2 billion in borrowing to pay for operating expenditures. This cash helped to keep the surplus roll positive during that period. Moreover, because the borrowing instrumentality was outside of the general fund, the auditors and overseers were able to look the other way, and the City still managed to book its $5 million GAAP surpluses.

By fiscal year 2004, a combination of a stronger economy and the proceeds from tax increases brought the City back into the black, and its operating results since then have been very strong. In FYs 2006 and 2007, Mayor Bloomberg began to build reserves outside the surplus roll structure, by prefunding a new Retirees Health Benefits Trust Fund, increasing reserves for disallowances, and deferring anticipating revenues from tobacco companies. Because of these Actions, the surplus roll did not grow by the full amount of the net roll, and the determination of an estimate of operating results was more complex.

From Koch on, the picture that emerges is of a new political culture that rewards a mayor for strong fiscal management, and punishes candidates and incumbents who seem not to manifest that characteristic. Two illustrations of behavior by pioneering politicians many years apart may help illustrate these changes.

When Koch ran for mayor in 1977, the Democratic candidate for City Council President was Carol Bellamy, a young liberal politician from Brooklyn. She was elected with a wide margin, and took office in January of 1978 as the first woman elected to city-wide office. As a member of the board of Estimate, Bellamy had a role in the budget process, and she hired as a staffer a junior professor from Columbia specifically to help her learn about fiscal issues, and prepare speeches to the Citizens Budget Commission, the Association for a Better New York, and other business-oriented groups.[26] This was a significant investment of resources from her own limited departmental budget, but the fiscal crisis was sufficiently fresh in memory that Bellamy believed that credibility about fiscal affairs was a key to her future. Indeed, about six months into her first term, the newspapers mentioned that she had finally been critical of Ed Koch, reporting on a complaint that his financial plan was not conservative enough. Before the fiscal crisis, a similarly situated politician would have been more likely to complain about failure to include funding for a pet program in the budget.

Even now, nearly thirty years after Bellamy's first days in office, politicians preparing to run for mayor still find it necessary to position themselves as fiscal conservatives, and are rewarded for that stance by positive editorials which they hope will enhance their political credibility and support. A timely example is the Speaker of the New York City Council. The first female and first openly gay Speaker, Quinn recently made a speech on fiscal matters to the Association for a Better New York (ABNY). The speech, which advocated a new rainy day fund and four other fiscal reforms and controls, was widely reported in the daily press and on local television. It also occasioned a positive New York *Times* editorial on October 14. The last sentences of the editorial stated:

[26] The author was the junior professor Bellamy hired.

> The speaker's subject matter, and the fact that she delivered her thoughts to an audience of influentials, stoked speculation about her mayoral ambitions. But such speculation, while inevitable, should not overtake the larger, important message that fiscal responsibility should be a requirement for anyone elected to lead the city. Ms. Quinn's proposed reforms need fleshing out, but she has made a good start at identifying potential problems and their solutions.[27]

It was not surprising to see this new emphasis on fiscal conservatism immediately after the fiscal crisis. However, the durable character of this change in the political culture is striking. Looking at financial management practices in the states, we see wide variation in financial management practices, as well as divergent goals about their credit ratings. Some aspire to AAA standing, others are satisfied with much lower ratings. These differences suggest that the culture of financial management in a political jurisdiction does tend to endure. In New York City, the expectation that mayors will be strong financial managers seems settled in the political culture, and likely to persist.

Conclusion

As I have said several times, there is much more work to be done on this study. This interim report suggests that all of the factors outlined above contribute to a more complete understanding of how the City cleaned up the mess after this fiscal crisis. A growing population and economy was a big boost. When the economy dipped during this period, fiscal stress was evident, but manageable. In the period immediately following the fiscal crisis, new institutions and controls, especially MAC and the EFCB, were vitally important. As time passed, the City's ability to manage its own budget became more evident. Some of this new-found ability came from new tools created during the fiscal crisis, like stricter accounting rules and systems. Some resulted from new institutions that developed unexpectedly, like the City's "surplus roll." But other changes unrelated to the fiscal crisis helped strengthen the mayor's hand in the budget process, including the elimination of the Board of Estimate. After Beame's public humiliation and Koch's successful transformation into a fiscal conservative, City politicians began to appreciate the value of this new stance, and at this point it seems embedded durably in the City's political culture.

It would be easy to overstate the value of this analysis for policy-makers. In my view, it provides only limited help in answering questions about specific changes in the City's financial management in 2008 or thereafter. Should the FCB persist beyond 2008, and who should pay for its staff? How much impact has the FCB had since sunset, and how much can it have without triggers to reestablish a control period? Should the City create a rainy day fund, which would certainly make budgeting more transparent, or would the loss of mayor power make it more difficult to maintain the City's high standards of financial management? While the analysis can't answer those questions, I hope it can help participants remember the fiscal crisis and its aftermath, providing useful background and context for the debate.

[27] New York *Times,* October 14, 2007.

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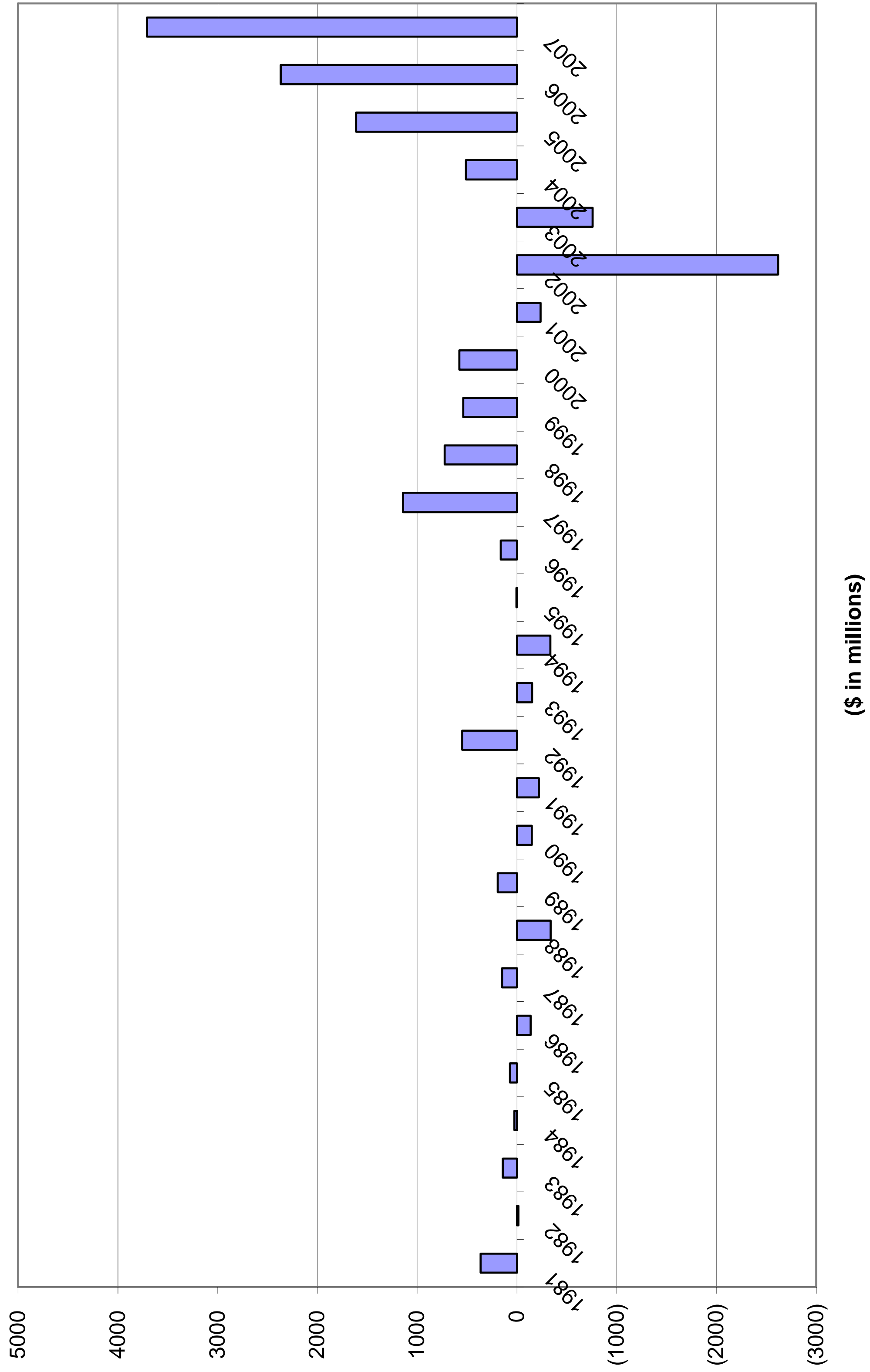
Operating Results
New York City Fiscal Years 1981-2007
5000
4000
3000
2000
1000
0
(1000)
(2000)
(3000)
1981
1982
1983
1984
1985
1986
1987
1988
1989
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1991
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1997
1998
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2001
2002
2003
2004
2005
2006
2007
($ in millions)