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STATE OVERSIGHT: THE NEW YORK APPROACH

The oversight mechanism in the proposed consent agreement developed by State Treasurer Andy Dillon and delivered to the Review Team and Detroit officials in March of 2012 was in large part modeled on the Emergency Financial Control Board established by New York State to resolve a financial emergency in New York City in 1975. This report describes that 1975 emergency and the New York State response, and draws comparisons to Detroit, and the initial proposal developed by State Treasurer Andy Dillon to address Detroit's fiscal crisis in 2012.

New York City in 1975

In October of 1975, as the City of New York neared default, a city attorney was ready to officially initiate the largest municipal bankruptcy case in history. A statement had been prepared announcing that the city had insufficient cash on hand to meet debt obligations.

The city's financial problems were attributed to loss of tax base, particularly manufacturing; rent control and tax exemptions; demographic changes; an oversized municipal workforce (340,000 municipal employees, including school and university personnel, in 1975) and generous collective bargaining agreements; generous welfare benefits, one-quarter of which were funded by the city, and growing welfare rolls (998,000 New Yorkers were on public assistance in November 1975); free tuition at city universities; uncompensated care at the extensive system of city hospitals; increasing tax rates and increasing reliance on borrowing; and a national recession caused by the oil embargo of 1973. The city government added to its problems by consistently overestimating revenues, underfunding pensions, employing deceptive accounting practices, using special revenue funds to balance budgets, engaging in excessive borrowing, and employing an array of other financial gimmicks.

In the years prior to 1975, New York City municipal government had reported substantial operating deficits, although the inadequate financial and accounting system left many wondering what the actual numbers were (a reported $600 million deficit was suspected to actually be about $2.2 billion). NYC's debt rating was downgraded in the mid 1960s, and the city had to pay high interest rates on its debt. Though the city had relied on short term borrowing for cash flow ($14 billion of outstanding debt included almost $6 billion of short-term notes), by the spring of 1975 it was unable to sell short-term debt. A sale of tax anticipation notes scheduled for February, 1975 had to be cancelled when the underwriter backed out, and banks began selling the city-issued notes that they had previously purchased.

Mayor Beame announced layoffs, then failed to fully implement them (the city's workforce actually expanded during an announced hiring freeze). The city also began to issue debt in small denominations, and small investors and retirees began purchasing comparatively large amounts of city debt that paid relatively high interest rates.

By March, underwriters (who themselves held large amounts of city debt) were so concerned about the city's tepid response to the financial problems and the increasing risks associated with the city's debt that they were unwilling to facilitate more note and bond sales. The city itself was trying to restructure outstanding debt and to establish a separate legal entity to hold its debt (this plan was successfully challenged as an unconstitutional attempt to avoid the debt limit). There was uncertainty about the rights bondholders would have if the city entered bankruptcy.

Underwriters tried to pressure the city to improve accounting and budgeting practices and to acknowledge large deficits. The mayor responded with a media campaign. In April, the city ran out of cash and received a three-day loan from banks and pension funds to make payroll and meet other critical obligations. The state advanced revenue sharing funds to the city to provide short term relief. The mayor asked city workers to forego a six percent wage increase that was scheduled to take effect July 1, 1975, and unionized workers responded with protests, sick-outs, strikes, and walkouts. Layoffs sparked more protests; laid off police officers blocked the Brooklyn Bridge.

The potential impact of a New York City bankruptcy on the city, state, nation, and beyond could not be predicted, but the effects were expected to be very serious. If bondholders prevailed, services would be devastated, potentially resulting in strikes and social disorder (the civil disorders of the late 1960s were a clear memory in 1975). If services were protected, bondholders would not be paid and the financial markets could be affected. The potentially ruinous effects of municipal bankruptcy convinced New York Governor Hugh Carey to seek alternative ways to address the city's financial crisis.

The New York State legislature created the Municipal Assistance Corporation (MAC) based on recommendations from an advisory committee appointed by the Governor to monitor the city's finances. MAC, an independent legal entity created by the state, was authorized to issue new debt for the city and to convert outstanding short-tem debt to more secure long-term debt. The majority of appointees on the MAC board were appointed by the Governor. The city's sales and stock transfer taxes were converted to state revenues and used to guarantee the MAC bonds. Over a number of months, obligated banks purchased new MAC bonds and agreed to renegotiate city debt to extend maturities and lower interest rates. Some city notes were exchanged for MAC securities. (MAC eventually sold over $10 billion of debt, serviced it all, and voted itself out of existence in 2008.)

Unfortunately, the city itself continued to deny that there was a serious problem and failed to make the financial and operational changes needed to restore confidence. One consequence of the city's failure to make significant changes and of investors' discomfort with MAC was that MAC was initially only able to sell bonds worth $2 billion of the $3 billion goal, and only at a very high rate (11 percent; high grade municipals were selling at 6.89 percent). MAC insisted that the city freeze employee wages, lay off workers, increase subway fares, and institute tuition at city universities. These actions resulted in labor unrest during the summer of 1975. In 1975-76, however, city government expenditures were almost $700 million more than the authorized expense budget.

The New York State Legislature in special session in September adopted the Financial Emergency Act (FEA) to create the Emergency Financial Control Board (EFCB) composed of the Governor, Mayor, state and city Comptrollers, and three private industry experts. The EFCB had control of the city's bank accounts, could issue orders to city officials, and could remove city officials from office. It could review and reject the city's financial plan, operating and capital budgets, collective bargaining agreements, and borrowing. Most importantly, the EFCB forced city officials to take politically unpopular actions (and conveniently provided a scapegoat for those actions).

The state also created an Office of the Special Deputy Comptroller for New York City (OSDC) in the state Comptroller's Office to audit the city's books (this office was made permanent in 1986). A Mayor's Management Advisory Board composed of business representatives was created to advise the mayor on management practices and the new Commission on City Finances was established to advise on taxation and expenditure policies.

Eventually, with the assurance provided by establishment of the Financial Control Board that the city's finances would be brought under control, local banks, the federal government, and municipal unions created a market for MAC bonds. This kind of coalition of investors may well be less likely now than it was a generation ago: local banks in New York City, as in Detroit, were then much more likely to be headed by leaders who were personally and professionally invested in the community. Furthermore, many small investors had bought NYC debt, as had the state, so a municipal bankruptcy would have triggered an avalanche of other bankruptcies. And the size and prominence of New York City — the largest city in the U.S. and a world financial hub — meant that its crisis could have had international financial repercussions.

President Gerald Ford's initial threat to veto a federal bailout may have cost him the election (A *Daily News* headline screamed "Ford to City: Drop Dead"), but in December 1975, the President finally signed the New York City Seasonal Financing Act (passed in the House by only ten votes), which extended to the city a $2.3 billion line of credit each year through 1978. The interest rate was set at one percent above the cost of money to the federal government, assuring that the loan would be profitable to the federal government and unattractive to other municipalities that might be considering appealing to the federal government for assistance. These federal loans had to be repaid within the year they were made.

Requirements placed on the city included balancing its budget using generally accepted accounting principles by 1978 and fully funding the pension fund. The First Deputy Mayor, Deputy Mayor for Finance, and Budget Director were forced to resign and were replaced with officials deemed more trustworthy.

In New York as in Michigan, public pension benefits are effectively guaranteed by the state constitution. With their pension benefits guaranteed, knowing that any losses would have to be made up by the city, NYC municipal unions agreed to invest pension fund assets in MAC bonds. Eventually, up to 40 percent of city pension funds were invested in MAC bonds and the state pension fund also invested in MAC bonds ($2.7 billion of this debt was purchased by the pension funds).

The city government was forced to reduce expenditures: 60,000 municipal jobs were eliminated through layoffs, attrition, or transfer to the state payroll; a scheduled pay increase was deferred in 1976, and there was no base rate increase in 1977 or 1978. Inflation rates were relatively high in the 1970s, with inflation of 5.8 percent, 6.5 percent and 7.6 percent respectively, so the wage freezes reduced wages in real terms. Pension benefits, longevity raises, and cost-of-living increases were untouched, but work rules were made less restrictive. The city cut services, reduced welfare benefits, closed facilities, increased taxes by $200 million, and increased fees. Accounting systems and procedures were dramatically improved.

The high rates of inflation in the 1970s had the effect of increasing city revenues (by increasing wage rates, property values, and the city taxes based on them) and effectively reducing the relative size of the outstanding debt, but a 1976 court decision eliminated the debt moratorium and challenges by stakeholders continued for several years. The city was unable to access credit markets by 1978 (thereby violating one of the conditions of the federal loan) and asked for additional federal assistance. This was granted in exchange for extending the Financial Control Board until after 2000.

In 1979, New York City was able to sell short-term bonds in the seasonal bond market and in 1981 the city sold long-term bonds, received an investment grade bond rating, and had a balanced budget.

In 1986, the city met the conditions for ending the control period and the FCB's ability to approve or disapprove financial plans, contracts, and borrowing was suspended.

In 2003, the Financial Emergency Act was extended until 2033. Also in 2003, outstanding MAC bonds were refunded with state assistance to address the city's fiscal problem. In 2005, a city charter revision incorporated many of the provisions of the state law into the city charter:

- Requirement to end the fiscal year with a balanced budget, with no provision for a deficit.
- A four-year financial plan reflecting the FCB standards, to be updated quarterly.
- An annual audit in accordance with generally accepted auditing standards.
- Restrictions on short-term debt (Tax Anticipation Notes and Revenue Anticipation Notess can be no more than 90 percent of expected revenues; short-term debt must be retired in the same fiscal year as issued).

The New York State Financial Control Board still has the responsibility to review and oversee the financial management of New York City and related public authorities. The city is required to submit a four-year financial plan to the Board every year. The Board makes an annual determination on whether trigger events have occurred or are likely to occur. The board is required to reimpose a control period if the city does any of the following:

- Fails to pay debt service when due,
- Incurs an operating deficit of more than $100 million during a fiscal year,
- Issues notes in violation of the act,
- Violates a provision of the act that substantially impairs its ability to repay notes or bonds or its ability to adopt or adhere to a balanced budget, or
- The state and city Comptrollers cannot make the joint certification that the city is in conformance with the provisions of the act.

Mayor Beame and subsequent NYC mayors undeniably chaffed under the oversight of the Financial Control Board. Former New York City Mayor Edward Koch once described the city as an "indentured servant" of the FCB. But even though its city charter now includes strict financial management criteria, it is the state-imposed Financial Control Board that is widely credited with New York City's current good financial management and balanced budgets.

Similarities between New York City in 1975 and Detroit in 2012

There are crucial similarities and differences between New York City in 1975 and Detroit in 2012. In addition to facing a financial crisis, both cities were losing population in the 1970s. New York City had 7.9 million residents in 1970 and 7.1 million in 1980, but subsequently reversed the population loss and had grown to 8.2 million residents in 2010. Detroit's population declined from 1.5 million in 1970 to 1.2 million in 1980, and continued to decline to 713,777 in 2010.

Inflation is much lower now, and wage freezes such as those proposed for Detroit uniformed employees have lower real term values. New York City provided a much wider range of services (K-12 schools, universities, hospitals, etc.), and had more options for cuts than Detroit has (services proposed to be offloaded by Detroit tend to be grant funded, which would have limited or no effect on the general fund deficit). The New York City employee pension fund invested heavily in guaranteed, high interest MAC bonds, but Detroit's pension systems are burdened with a substantial amount of questionable and illiquid assets. Furthermore, the federal government offered a line of credit to NYC, but is unlikely to extend such an offer to Detroit.

Both crises were triggered by cash flow insolvency. The most important similarity between New York City's recovery and the State Treasurer's original proposal for Detroit governance is the long-term transfer of power to a state-dominated board with extensive authority over city finances and operations: that transfer is credited with the success of the strategy in NYC. In both the actual New York City strategy and the Treasurer's proposed Detroit plan, the oversight boards included both state and local officials and highly qualified appointees with relevant expertise. In the 1975 New York City bailout, the city's top three appointed financial officers were replaced; in the Treasurer's original proposal for Detroit, the city's Chief Operating Officer, Chief Financial Officer, and Human Resources Director would be appointed by the Financial Advisory Board. Both plans included decreasing the number of municipal employees, increasing tax rates, improving various operations, and improving budgeting and accounting practices. The Michigan State Treasurer's proposal, as in the New York City model, provides for long-term oversight: the Financial Control Board established in 1975 did not surrender its ability to approve financial plans, contracts, and borrowing until 1986; still reviews New York City's financial plans; and has the obligation to reassert control if specified trigger events occur.

At the time this report was written, it was unknown what form the resolution of Detroit's fiscal crisis would take, but is clear that the New York City model of state involvement in a financial oversight board with substantial authority was successful in correcting long standing problems in budgeting and financial management in the nation's largest city.

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