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Gotham's fiscal crisis: lessons unlearned

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IT IS certainly a memorable image: New York City mayor Abe Beame standing before the Wailing Wall in Jerusalem and leaving a plaintive, one-word note—"HELP." At that time, 30 years ago, the Big Apple needed all the help it could get. It was in the midst of a financial crisis the likes of which had rarely been seen in any American metropolis before. At that point, not even a spectacularly effective mayor could have pulled the city back from the brink, so all the spectacularly ineffective Beame could hope for was an answer to his prayer. He didn't get it.

Thirty years later, much has changed for the better in New York. But since the April 1975 fiscal crisis the world's financial capital has continued to lurch from one fiscal crunch to another, up to the present day. Sometimes the symptoms have been more obvious, but even when it has appeared healthy the city's disease has always been lurking there, just under the skin, waiting to flare up at any moment.

"Syndrome" might actually be a more apt description of the situation than "disease." New York's affliction has consisted of a complex web of different, but closely related, ailments. Dissecting Gotham's budget, it is hard to know where the malign influence of the city's over-powerful civil service unions leaves off and the crushing burden of its overgenerous social welfare spending takes up. The malevolent effects of City Hall's growth-stifling taxes and its cringe-inducing bonding practices are practically inseparable.

All of which might lull other civic leaders into a delightful bout of *Schadenfreude*. The only problem is that New York's syndrome is spreading, and not just to other cities and towns but to state capitals, as well. The news out of Albany and Sacramento these days sounds eerily similar to New York City's turbulent fiscal history. Therefore, with three decades of history under the Brooklyn Bridge it is now possible to put the Big Apple under the microscope. And with other cities and states starting down the same path to financial ruin, it is doubly important to analyze the New York experience—it provides a compelling cautionary tale for local leaders who care to listen.

A bad case of the "British disease"

New York City can be seen as the first large-scale American outbreak of what used to be called the "British disease" (France and Germany are also afflicted at the moment)—the economic sclerosis suffered by liberal democracies held hostage to the demands of politically powerful labor unions and social service providers. A more technical term for this is "distributional politics," and Mancur Olson has provided a particularly useful framework for understanding the nature of the problem. Relative prosperity and the illusion that a local economy can sustain the higher taxes that go with bigger government encourages weak government leaders to offer small concessions to special interests, such as municipal unions or vocal advocates for the poor. These concessions snowball over time, creating an ever-larger constituency for government spending and making it increasingly difficult to turn back the clock. New York is a classic example.

Gotham certainly has an overinflated social service network that contributes to its budget woes, but of the two elements of the "British disease," labor is the older and bigger problem. It results from a mix of ideology and a politics organized around the systematic purchase of votes. A string of New York mayors either found it convenient to expand the unionized municipal work force or wilted in the face of union strong-arm tactics.

The 1975 disaster did not materialize over night. The seeds were sown by Mayor Fiorello LaGuardia, who took the reins of a bankrupt city in 1933 and left behind a vastly increased city work force and budget when he ended his tenure in 1945. LaGuardia forged a partnership with President Franklin D. Roosevelt to create a local version of the New Deal in order to lift the city out of the Great Depression. Over the short term, it was a success: The city would emerge from World War II into an economic boom. But its long-term legacy was a municipal government incapable of supporting its oversized programs and, especially, its gargantuan city work force. This problem only grew worse under Mayor Robert Wagner, who granted collective bargaining rights to city employees in 1958.

On its face, Wagner's move does not strike a modern audience as particularly odd—it should not be surprising that a Democratic politician would favor union interests. But Wagner's move broke for good the power of the Tammany Hall machine that had long run the city's politics, and had been a bulwark of the Democratic party. Once they were able to use collective bargaining to harness the enormous size of the city payroll, the unions quickly supplanted Tammany as the dominant political force in the city. Wagner was reelected to a third term in 1961 by exploiting this unprecedented base of support.

As problematic as the Tammany machine had been, New Yorkers might be forgiven if they soon started to miss it. For all its serious failings, at least Tammany had always tried to balance its labor support with the concerns of outer-borough homeowners sensitive to taxes. This balancing act had served as a de facto check on the unbridled expansion of city spending. However, on the heels of his union-backed third victory, Wagner threw caution to the wind. Spending grew twice as rapidly in his last four years as it had in his first eight, and much of that spending flowed to an ever-increasing municipal work force. That growing work force in turn created an even greater labor constituency than the one that had already propelled Wagner into office. Wagner's embrace of public-sector unionism, combined with existing civil service rules, provided tens of thousands of city residents with relatively well-paid jobs with virtual lifetime tenure, topped off with generous pensions.

The seeds Wagner had sown during his third term started to sprout almost immediately after his successor, John V. Lindsay, took office. Lindsay's first term began with a labor-relations debacle—a 10-day transit strike in January 1966. Lindsay's Protestant rectitude and denunciation of the Transit Workers' Union and its Irish-American leader Mike Quill butted up against Quill's outright contempt for the mayor. The result: The mayor ultimately threw in the towel, and transit workers enjoyed average annual raises of 9 percent for the next eight years.

Perhaps inspired by the success of their brethren in the transit union, sanitation workers and teachers soon went on strike, marking a pattern of labor unrest that would dog Lindsay throughout his first term. The mayor's almost gallic propensity for surrendering when the going got tough only fanned the flames of union activism. By the time his first reelection campaign rolled around in 1969, Lindsay was a different man. As election day neared, he dropped his adversarial stance against union "power brokers," ultimately winning their political support (if not their personal affection), albeit at the price of even more generous contracts.

Which is why Abraham Beame, Lindsay's colorless, diminutive successor, inherited a massive and growing budget deficit. Beame, however, was not entirely blameless. The Brooklyn clubhouse pol had been the elected city comptroller under Wagner, and again during Lindsay's second term. His mayoral campaign slogan was "Abe Beame knows the buck," so he should have known precisely how precarious the city's finances were when he took office in 1974. Yet he seemed as surprised as anyone when the house of cards began collapsing. A bloated army of city workers would be on hand to march all over the city's balance sheet as the national economy worsened and Gotham lurched towards insolvency during Beame's first term.

By the end of 1975 the city directly employed an astonishing 340,000 workers, an increase of 100,000 since 1959 alone. And that didn't include the 80,000 people who worked for the state Metropolitan Transportation Authority (which had absorbed the city-run transit system in 1969) or the bi-state Port Authority of New York and New Jersey, or the bevy of private firms supporting themselves almost solely on government contracts.

Thus, on the brink of ruin, city politics (and politicians) were dominated by extraordinarily large municipal unions. This had come about for several reasons, ranging from LaGuardia's expansive view of city government's responsibilities and the expansive work force that went with it, to Wagner's ploy to break Tammany by granting greater power to unions, to Lindsay's and Beame's weak temperaments in the face of aggressive unions. These mayors had let the union bull into the china shop, and in 1975 it would start thrashing around.

The welfare city

The enormous work force was symptomatic of another perilous condition—the city's utterly unsustainable rate of social service spending. As Wagner expressed it so elegantly when asking Albany to let him borrow more to finance city expenditures, "I do not propose to permit our fiscal problems to set the limits of our commitments to meet the essential needs of the people of the city." He said this with a straight face, and with a very generous notion of what the word "essential" meant.

LaGuardia had started the ball rolling during the New Deal by introducing a raft of programs to serve the city's poor residents. Wagner would take these programs to a whole new level, fully incorporating middle-class residents into the welfare state. Some of these programs took the form of indirect taxes and subsidies, such as rent control. Like many cities, New York had enacted rent control as an emergency measure during World War II. Unlike most others, the rent ceilings stayed after the war was over. But other programs required ongoing costs. The proliferation of low-cost housing (actually targeted at the lower middle class) under the 1955 Mitchell-Lama program, was just one example. Even municipal jobs became a form of welfare support for the middle classes.

After Wagner's tenure, however, New Yorkers were not quite ready for what awaited them on Lindsay's watch. The tall, telegenic Lindsay was viewed as the "great white hope" of American urban liberalism. He rode into office trumpeting a compassionate concern for blacks that led to comparisons with Robert Kennedy. The mayor's efforts at racial reform made him a favorite of the *New York Times* and landed him on the covers of *Time* and *Newsweek*. His name appeared on vague lists of potential presidential contenders.

As primary author of the Kerner Commission report on the Watts Riots that had riled Los Angeles in 1965, Lindsay was a leading proponent of the claim that American racism blocked the conventional paths of upward mobility for African Americans, never mind compelling evidence of black economic progress in the 1960s. In Lindsay's view, it was up to the government to create state-sponsored paths of social mobility for racial minorities. Thus, even at a time when the black male unemployment rate in New York was 4 percent and there were long columns of help-wanted ads for unskilled laborers in the Big Apple, Lindsay managed to double the welfare rolls to over one million. In doing so, he killed two birds with one stone, creating jobs for thousands of middle-class social workers. This would not have been so bad except that, in a condition unique to New York City, the state requires Gotham to foot one quarter of the bill for public income assistance and Medicaid.

Lindsay would dig the hole even deeper after the Detroit and Newark race riots of 1967 and 1968. He became convinced that further social spending was the only sure way to avoid racial violence in New York. Maybe he was right, and maybe he wasn't—at least New York was spared large-scale problems, although there were numerous small riots and a massive increase in violent crime that amounted to an ongoing rolling riot. But this relative stability had come at a steep price: Although its population was shrinking, and although spending on core services like police, fire, and sanitation declined as a percentage of overall expenditures, New York City's budget grew by 125 percent during Lindsay's tenure.

Footing the bill

The only thing more destructive than such a wholesale expansion in city spending was the way in which Lindsay and his successors set about funding it. To pay for both the union contracts and the vastly augmented welfare population, New York City raised taxes with reckless abandon, while also mortgaging itself far into the future by issuing one wave of municipal bonds after another.

The sharp up-tick in taxation started soon after Lindsay took office, when the mayor persuaded Albany to levy the city's first personal income tax and a commuter tax (a levy on people who worked, but didn't live, in the city). He also revamped the business income tax. The immediate effects of these tax hikes on individuals and businesses were masked by an economic boom, but as soon as the national economy soured in 1969 major cracks began to appear. In response to mounting job losses, Lindsay increased the city's personal income tax 75 percent, hiked the sales tax by one penny on every dollar, and expanded the reach of the business tax to include the partnership profits of physicians, lawyers, and other professionals. To make matters worse, Governor Nelson Rockefeller was increasing these same taxes at the state level. By 1975 the marginal state and local income tax rate in New York City was more then 18 percent, while neighboring New Jersey and Connecticut still imposed no taxes on wage income. To a certain extent the tax increases did work—net city tax receipts rose by 53 percent (12 percent in real terms) between fiscal 1970 and 1975. But the city was hemorrhaging private-sector jobs, and this revenue growth wasn't nearly enough to keep up with the growth in the budget, which expanded by an incredible 80 percent (28 percent in real terms) in the same period.

Not to be outdone by Wagner's iron-willed determination to spend without a thought for revenue constraints, Lindsay turned to the bond markets. To make ends meet, he vastly expanded the city's reliance on short-term debt, which rose from $1.3 billion in 1970 to over $3.4 billion in 1974 in nominal terms. To an increasing degree, however, the city was borrowing just to keep its head above water—using the proceeds of short-term notes to meet current operating expenses and to pay off other notes issued to cover prior expenses. This marked a significant difference from how municipalities are supposed to use borrowing—issuing bonds to cover capital expenses such as infrastructure investment or individual construction projects. In such cases, the worst that can happen if the bond market heads downhill is that a school project doesn't get started, or a road repaving project is delayed for another year. But Lindsay was playing an extremely dangerous financial shell game. If the bond markets moved in an unfavorable direction, the ability of city government to carry out its normal day-to-day functions would be in jeopardy.

Collapse

It was only a matter of time before this house of cards collapsed, and although Lindsay managed to avoid getting hit by the falling sword, his successor, Beame, wasn't so lucky.

By 1973, all of the ingredients for disaster were in place. Ornery unions were hovering over the mayor's shoulder, confident in their own ability to strong-arm City Hall in any contract negotiation. The city was overextended when it came to providing social services, and its welfare liabilities only expanded as misguided tax policies scared off businesses and a recession generated longer unemployment lines. And despite those higher taxes, the city had been resorting to increasingly risky methods for financing its obligations. The Arab oil embargo of 1973 was enough to push Gotham over the edge.

That embargo and the recession it sparked caused an overall worsening of the city's economy, and thus its tax base. At the same time, it led to a general tightening in the broader market for municipal bonds. The bean-counters did the best they could to keep the situation under control, but by the spring of 1975 the game was up. The city could not find any takers for yet another seasonal offering of tax anticipation notes (a type of short-term bond designed to tide the city over until its next round of tax revenues starts pouring in). Beame was forced to plead publicly for investors to buy the notes. When that didn't work, Gotham was officially flat broke, and there was a danger that the city would simply default on its debts. Something had to be done.

But what? The city had no hope of growing its way out of the hole. Burdened with backbreaking taxes, the city's economy had been in free-fall since 1969. Between that year and 1977, an astounding 570,000 private-sector jobs disappeared. The only real growth industry was government—even as its balance sheet was spiraling into oblivion, its work force was expanding by 100,000. Meanwhile, getting labor concessions proved nearly impossible. The unions would eventually make limited concessions, but for a time it looked like they would sink the city with a general strike and mob violence. When Beame called for city workers to forgo a 6 percent pay increase scheduled for July 1, 1975, the city's Municipal Labor Coalition responded by bringing tens of thousands of protestors into the narrow canyons of lower Manhattan in a raucous protest against the First National Bank (later CitiBank), which union leaders and liberal politicians had declared "the number one enemy" because, as a major bondholder, it had expressed doubts about the city's solvency. Beame's program of limited layoffs sparked a wave of sick-outs, protest strikes, and walkouts by workers performing essential services such as sanitation. City Hall itself came under siege as the pink slips started issuing forth, and laid-off cops blockaded the nearby Brooklyn Bridge, hurling beer cans at their still uniformed brethren and letting the air out of tires to create a giant traffic jam.

The more radical labor leaders wanted a general strike, but it quickly became apparent that the federal government was not going to offer a bailout. This forced the unions to confront a frightening possibility: With no federal help forthcoming (remember Gerald Ford's famous "Drop Dead" speech in the fall of 1975), the city could go bankrupt. And if that happened, City Hall would be in a position to scratch all the generous labor contracts and start over. This threat ultimately led the union leadership to rethink their position.

How *not* to fix a city budget

The city's fiscal rescue was financed by the Municipal Assistance Corporation (MAC), created by governor Hugh L. Carey. It would prove only a partial cure: Statutory reforms achieved fiscal transparency and improved financial planning, but left the city's propensity for excessive spending largely unchanged. MAC was a state entity handed a dedicated tax revenue stream to allow it to convert the city's short-term debt into more secure long-term bonds. Financially, MAC, chaired by Lazard Freres banker Felix Rohatyn, was a success. But ironically, that very success reduced the pressure to address the city's underlying problem—that it was spending beyond its means. It was as if a high-living homebuyer had, among his spending excesses, purchased a house that was too expensive for him given his income. But rather than scaling down his spending, he instead went in search of an accommodating bank that would allow him to stretch out the refinancing of his mortgage on slightly more favorable terms.

MAC also had a second, more subtle irony. It ultimately provided a convenient opportunity for the unions to win easy political points without making significant concessions. They could do this by agreeing to let the city pension plans purchase MAC bonds. They had initially resisted the idea when they were first dragged ever-so-reluctantly to the negotiating table. However, they eventually "gave in," as soon, cynics might argue, as labor leaders realized they had nothing to lose and everything to gain.

Then, as now, public pension benefits in New York were effectively guaranteed by the state's constitution. City taxpayers were ultimately responsible for making good on earlier poorly considered pension promises to the unions. So despite their high-minded talk of heroic self-sacrifice in taking a risk and purchasing the new MAC bonds, the unions were "gambling" with house money. They would get their pension benefits no matter what. But they did gain something from their so-called concession—they created the public perception that they were trying to play nice with the city.

Such ploys, combined with Beame's apparent inability to push a hard bargain with labor, paved the way for more aggressive union tactics as the crisis wore on. Barry Feinstein, leader of a Teamsters local involved in the negotiations, knew how to play rough. In 1971, his union members had released raw sewage into the city's waterways during a contract negotiation. He later compared the unions' strategy during the fiscal crisis to "guerilla warfare." And it worked. Considering what could have happened, the unions fared quite well. Although 60,000 city jobs were eliminated, this was accomplished mostly through attrition or transfer to state payrolls rather than through layoffs. A scheduled 1976 pay increase was deferred, and there was no base increase at all in 1977 and 1978. The city withdrew half its subsidy on employee pension contributions, representing a small cut in take-home pay for many of the remaining workers. But the pensions themselves remained untouched, as were longevity raises and cost-of-living increases. By 1978, the unions were negotiating for pay increases again, and over the next four years base pay increased by a compounded rate of 26 percent. During the period from 1975 to 1983, the number of city workers was cut by 20 percent. But total compensation costs per worker for the rest actually increased 4 percent after inflation.

What ultimately saved the city was a "happy" coincidence. The misery-inducing inflation of the late 1970s translated into a faster growth in the city's tax receipts, while effectively reducing the relative size of the city's overhanging fixed-interest debt and pension obligations. Third-world countries typically run afoul of the International Monetary Fund when they resort to such tactics—creating inflation to evade creditors. In New York City's case, it just happened by accident.

Perhaps this is why few outside the circle of professional fiscal monitors cared at the time that the politicians had almost completely dropped the ball when it came to reform. Certainly, they had managed to push through a new Financial Control Board (FCB) to oversee every aspect of the city's budget. And the FCB and MAC between them managed to force austerity measure on Beame and his tougher successor, Edward Koch. But by 1978, with President Ford's "Drop Dead" talk in the past, the federal government stepped in first with a raft of emergency loans and then a federal loan guarantee to back up city debt.

And, by the early 1980s, even Koch's fiscal tough talk had largely fallen by the wayside. Buoyed by state cuts in income tax rates between 1978 and 1981, and Reagan's tax cuts in 1981, the stock market started to soar again. In a city whose budget is largely dependent on this enormous sector of its economy, good times on Wall Street cleared the way for a return to the *status quo ante*. Between 1980 and 1989, the city budget nearly doubled in size, growing almost as rapidly in absolute terms, and relative to private value added, as it did in the 1960s. Koch added 57,000 full-time positions to the city payroll, more than offsetting the job cuts instituted during the crisis. By 1990, when Koch was succeeded by David Dinkins, the size and cost of municipal government was as big as it had ever been.

There were occasional stretches of fiscal constraint. On the basis of his campaign rhetoric, Rudy Giuliani, Dinkins's successor, seemed likely to be another story. He pointedly refused to rule out layoffs in his initial budget message, putting the unions on the defense. He sold off assets like the city's radio and TV stations, tried to start selling the city hospitals (until he was blocked by the courts), and encouraged—with mixed success—competitive contracting of some services. He was particularly successful in contracting out social service programs to nonprofit agencies. Facing a cash shortfall and desperate to reduce costs lest the city be taken over by the financial control board, Giuliani made welfare reduction a top budgetary priority. Trumpeting the theme of work, he split the labor-liberal coalition by enlisting the public-sector middle class in support of welfare reform. The strategy worked, and in one of his signal achievements Giuliani began to sharply reduce the rolls even before federal welfare reform legislation was enacted.

But in doing so, he also perpetuated the unsustainable costs of the city's public-sector work force. His last financial plan, adopted just two months before September 11, 2001, contained what amounted to a $2 billion operating deficit covered with surplus funds from prior years. Giuliani effectively mortgaged a portion of the city's future economic growth to make good on promises to city workers.

Whoever succeeded Giuliani was destined to inherit an unbalanced budget; the World Trade Center attack simply blew the hole about 50 percent bigger. Michael Bloomberg has relied heavily on tax increases and borrowing to close a budget gap that reached $6 billion early in his tenure. His unwillingness to challenge New York's distributional politics and entitlement culture virtually ensures a continued long-term decline in New York's relative economic growth. Giuliani's achievements notwithstanding, it still seems like city leaders are acting as if they have learned nothing from the experience of 1975.

One-party dangers

At a remove of three decades, the fiscal crisis can seem like nothing but a distant tragedy. And yet if one looks at the current trials and tribulations of a certain large, West-coast state, all of a sudden the lessons of the New York debacle take on a new importance.

What are those lessons? First, it's not the economy, stupid—it's politics. Rereading the history of the Big Apple's fiscal crisis, one of the most striking aspects of the sad story is that the decline into chaos was more or less gradual, starting back in the 1930s and only culminating 40 years later. This is an important point: Normal economic cycles were not ultimately to blame for New York's fiscal crisis, or for its recurring problems since then. A particular economic event—the oil embargo—might have been the straw that broke the camel's back. But the camel was already badly in need of a chiropractor. What made the camel vulnerable was its long history of distributional public-sector politics that took the private sector for granted. The motivation for such policies did not matter—Wagner's grant of collective bargaining rights as a calculated ploy to break Tammany was just as destructive as Lindsay's high-minded, but woefully misguided, effort to solve racism by putting much of the city's African-American community on to the dole, which in turn was just as damaging as Beame's lack of leadership in the face of mounting budgetary danger.

It is worth considering New York's particular brand of distributional politics. As Olson's generalized theory would predict, the city's death spiral was made possible by the fact that it was a largely affluent place to begin with, and boasted a comparative advantage in several highly lucrative sectors, an advantage that would help mask the deleterious effects of redistributionist policies at the start by attracting similar businesses despite the tax rates. All a politician needed was to create a steeply progressive income tax and he would be good to go.

A lack of political competition is crucial, too. Despite the election of three at least nominally Republican mayors in the last 40 years, the Republican party has virtually ceased to exist as an organized political force outside the smallest borough, Staten Island. The city's 1992 term-limit law brought a predictable termination date to the Giuliani era (a period of relative budgetary restraint), but has made no difference in the overwhelmingly Democratic makeup of the city council. This means that even the most irresponsible politicians have a high likelihood of retaining their seats, since as long as they squeak through a party primary they are unlikely to face a serious challenge in the general election.

Coming soon to a state near you

The most frightening aspect of New York City's 1975 crisis and its incomplete recovery is that the city has proven to be not an outlier but a front-runner. That is, it was not the exception so much as it was the first occurrence of what could become the rule.

Consider California. Its comparative advantage in high-tech industries led computer entrepreneurs and "dot-com" millionaires to flock to Silicon Valley, a region that provided a seemingly limitless supply of new revenue during the expansion of California's distributionist politics in the 1990s. As a result, wealthy California satisfied its highly organized public-sector interests by spending the state into near bankruptcy. In real terms, the state's general fund increased 68 percent from 1994 to 2001, thanks in large measure to skyrocketing personal income tax receipts from stock options and capital gains, which reached a full one-quarter of general fund revenues. This meant that California was exceptionally vulnerable to a stock-market downturn. Innovations in public financing, some of them pioneered during Gotham's 1970s bailout, helped California dig its way out of its hole for a time, but unless structural reforms are forthcoming, and soon, the Golden State will merely lurch from one bout of near-insolvency to the next, just as New York City has for most of its post-crisis history.

In short, it can happen again. It could happen in New York state. It is still too soon to say whether it will happen in California, although Californians may now have, in Arnold Schwarzenegger, a governor who might avoid the political timidity that plagued New York. The problem is political, not financial or economic. As the state- and local-government share of an economy continues to expand, such crises will become more common. Carried by irresponsible politicians, the disease of New York City-style public-sector politics can spread elsewhere.