Anatomy of a Fiscal Crisis

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The 1970s marked the beginning of a new era of austerity for the financial managers of our major cities. The economic boom of the 1960s and the enormous influx of state and federal dollars into the local public purse had come to an end. No longer could cities count on a continually expanding tax base or a new federal aid program to cover past excesses in public spending. For three cities—New York City, Cleveland and Philadelphia—the new reality proved harsh indeed. New York and Cleveland simply ran out of money and were unable to pay the required principal and interest due on city bonds. Philadelphia passed the single biggest tax increase in its history to avoid a similar fate. All three cities now seem on their way back from the edge of financial disaster, but the path has not been easy.

What pushed these three cities to the brink of fiscal collapse? Commenting on the events leading to New York's fiscal crisis of April 1975, then Deputy Mayor James Cavanagh said: "Maybe we were dumb, but nobody... seemed to have understood what was happening..."[1] Well, just what *was* happening? The story is not New York's, Cleveland's, or Philadelphia's alone. The same fundamental forces which pushed these cities to the edge are at work in all major U.S. cities. Today's most prosperous cities may well be the cities in need of tomorrow's state or federal bailout.

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[1]Quoted in Charles Morris, *The Costs of Good Intentions*, (N.Y., W.W. Norton, 1980) p. 239.

CORPORA DELICTI: THE BODIES POLITIC

New York. In April, 1975, New York City ran out of money. There simply was not enough cash to pay the bills that were coming due. The immediate cause was that the banks of New York were unwilling to continue their usual practice of lending the city money for the short-term—usually three to six months—while the city waited for tax revenues to be collected. The banks were nervous. They saw in the city's fiscal future a serious threat to its ability to repay those loans. The cash-squeeze problem was resolved when the state of New York agreed to advance the city $400 million in revenue-sharing funds due the city in June. But when the city tried to borrow from the banks in May, it was again rebuffed. Mayor Beame turned to the state for assistance once more. Governor Carey, now aware that the problem was not temporary, appointed a prestigious panel, headed by investment banker Felix Rohatyn, to advise him. The panel's recommendation was to create the Municipal Finance Assistance Corporation—locally know as "Big MAC"—to restructure the city's debt and to monitor the city's spending and accounting practices. Mayor Beame objected to the effective loss of control over the city's finances, but the necessity of state assistance was paramount. The summer of 1975 was long and difficult as MAC demanded a wage freeze for city workers, layoffs, an increase in the subway fare, and tuition at City University. By August all parties realized there was no choice: either the requirements of MAC were met, or the city stopped functioning. Over the following months, the debt repayment schedule of the city was restructured, state and federal assistance was provided, and the city's financial prospects assumed a measure of stability once again. Finally, four years later in early 1979, New York City issued and successfully marketed $125 million in short-term notes. The worst was over.[2]

[2]For an excellent history of the crisis and the political events leading to the financial fall of the city, see Morris, *The Costs of Good Intentions*. For an economic overview of the causes and consequences of the New York City crisis, see Edward Gramlich, "The New York City Fiscal Crisis: What Happened and What Is to be Done?" *American Economic Review*, (May, 1976), pp. 415-429.

Cleveland. On December 15, 1978 the City of Cleveland defaulted on $14 million in municipal bonds. The proximate cause of default was that the six Cleveland banks were unwilling to refinance city notes that were coming due on December 15. Just why the banks were reluctant to refinance may never be known, for the decision was made in the midst of a bitter political battle between then Mayor Dennis Kucinich and the Cleveland business community. The bone of contention was the city's ownership of an electric power system called MUNY. MUNY was viewed by its opponents, which included most of the major banks, as an antiquated, inefficient utility that drained the city's budget of funds needed for more crucial public services. The investment community saw the sale of MUNY as an immediate new source of needed cash, as well as a step towards long-run fiscal solvency. And if MUNY were sold, the banks might view the city's fiscal prospects more favorably and lend the needed dollars to avoid default. MUNY's proponents, led by Mayor Kucinich, stressed its importance as a competitor to the area's private utility, Cleveland Electric Illuminating Company.

The banks chose not to refinance based on their assessment of Cleveland's declining financial position. Indeed, Moody's downgraded the city's bond rating from A to Baa in June 1978 and again from Baa to Ba in July 1978. To Mayor Kucinich the decision not to refinance was an example of the banks' desire to manage the city to their own ends. The mayor contended that the implied link of the sale of MUNY to city bond refinancing was a business-led effort to establish a monopoly position for the private utility. He proposed instead to keep MUNY under city control and to increase the city's income tax by 50% to handle the financial crisis. The 50% taxe hike was imposed, but the issue of the sale of MUNY was not resolved, and no new bond financing was available for the remainder of Mayor Kucinich's term. In November, 1979, George Voinovich was elected Mayor with broad-based community support. A blue-ribbon team of financial experts was appointed to assist the city in re-organizing its system of financial accounts and to negotiate with the banks for refinancing the defaulted notes. The notes have since been refinanced, and Cleveland seems on the way back towards fiscal respectability. The city still owns MUNY.

Philadelphia. On July 1, 1976 the city of Philadelphia increased local taxes by 30 percent. The local wage tax rate rose from 3.3125% to 4.3125%, and the millage rate for property taxation (tax dollars per $1,000/assessed value) was increased from 19.75 to 32.75. The immediate cause was a projected deficit of over $100 million, on the heels of an actual deficit of $73 million in the previous year. Lying behind the deficits was a six-year period of rising spending and lagging tax revenues.[3] While the tax increase closed the projected gap, it signaled to the investment community a fundamental weakness in the city's fiscal base. Moody's lowered the city's bond rating from A to Baa.

In 1976, Philadelphia took one small step back from the edge of default, but at the price of pushing up local taxes enormously. It is not clear that the city again can muster—or afford—such a sizable tax increase.

New York, Cleveland, and Philadelphia are simply examples—prominent ones to be sure—of cities which can rightly be described as having suffered fiscal crises. No doubt other cities have faced similar pressures too. Just why do these crises arise?

THE HOWS AND WHYS OF A FISCAL CRISIS

Fiscal crisis in a city involves a complicated interplay of political and economic forces. Stagnant or declining private economies create unique pressures on local public officials: hard-pressed taxpayers, concerned investors, worried public employees, and needy residents each make their claim to a share of the shrinking real resource base. The politician's hope is to satisfy everyone, particularly the current voters. But when real resources are declining, someone is sure to lose. New money, money from outside the city, is required. Federal and state governments are one obvious and popular source of relief, but those dollars are limited. City officials have to tap sources other than the federal treasury. They have turned instead to the *taxpayers of the future* for assistance, and, without asking for approval, have taken money from their pockets to finance current services. How is that possible? By borrowing from future tax revenues through deficit financing, underfunding pensions, and allowing the public capital stock to depreciate. When these "borrowings" finally fall due—when investors and retirees want their money and when roadways collapse into the river—then we observe, with graphic and dramatic force, the fiscal crisis.[4]

How to Have a Fiscal Crisis. How does New York, Cleveland, Philadelphia, or any city, manage to borrow from the future when there are legal requirements in state charters to have a balanced budget? The answer is clever bookkeeping.[5] In most states the only formal checkpoint of a city's budget occurs when the city submits it *prospective* budget to the state. The *prospective* budget is always balanced. But the prospective budget need not be the actual, end-of-the-year budget. In the prospective budget, cities *estimate* revenues and expenditures. The temptation is always there to overestimate revenues—we *will* collect those delinquent taxes this year—and to underestimate expenses—didn't the *Farmer's Almanac* predict another mild winter? When these optimistic estimates fail to come true, a deficit results. How do cities fill the gap? The answer is to borrow money from one, or all, of the following three sources.

First, cities borrow from banks for periods of less than one year to cover the temporary mis-

[3] See N. Noto and D. Raiff, "Philadelphia's Fiscal Story: The City and the Schools," this *Business Review*, (March/April, 1977), pp. 3-47.

[4] The argument can be offered that these current borrowings used to finance current services will be "capitalized" into reduced land prices in anticipation of a fiscal crisis. If, as a new resident, I expect to have to pay $1,100 in taxes next year for a $1,000 worth of services delivered yesterday (which I did not receive), then I will demand that those selling me my new home take a $1,000 reduction in the home price, so that I might invest the $1,000 savings in a 10% Treasury bill to yield $1,100 next year which I will allocate to next year's taxes. When current borrowings for current services are fully capitalized into land prices, then a fiscal crisis need not occur. Future taxpayers have anticipated the crisis and have saved accordingly.

Is there any persuasive evidence that past borrowings are actually capitalized? Not yet; see R.P. Inman, "Public Employee Pensions and the Local Labor Budget," *Journal of Public Economics*, (November 1982), particularly pp. 69-70.

[5] For an introduction to the accounting "games" that cities play, see N. Noto and D. Raiff, "Philadelphia's Fiscal Story: The City and the Schools," pp. 18-21.

match of expenditures (which occur weekly as pay checks and bills fall due) and revenues (which are collected quarterly or annually). These short-term borrowings are called tax-anticipation notes, and are to be paid back in full at the end of each fiscal year. But short-term loans often overlap fiscal years. Last year's debt can be carried into next year's budget. As debt is passed on from year to year, so, too, is the current account deficit that debt has financed.

Cities may also borrow to cover current expenditures by underfunding public-employee pension funds. This may reflect an explicit decision to postpone the required contribution to the pension fund, or it may occur because the required contribution, though paid, is an underestimate of the contribution likely to be needed in an inflationary economy. Regardless of the cause, the effect of underfunding pensions is to put off current expenditures until a later date, and thereby create a loan from future to current taxpayers.[6]

Cities can tap future tax dollars in a third way. Just as cities can put off current spending until some future date by failing to fund public employee pensions, cities also can shift current expenses onto future taxpayers by failing to maintain the present public infrastructure. Good financial management requires that as physical assets (such as city streets) wear out, they be expensed on the current accounts budget at an appropriate depreciation rate. These expenditures can then be allocated to maintain the decaying asset or to replace it at a later date. If maintenance funds are not allocated either directly or as capital debt retirement, a liability is created by current taxpayers which must be repaid by future residents. The size of this debt can be significant. A series of careful studies of the capital needs of six large U.S. cities by the Urban Institute has estimated that the required *annual* replacement costs of neglected public infrastructure over the next ten years will range from $15/resident to as much as $100/resident for these cities.[7]

The sum of the annual increase in short-term debt, unfunded pension obligations, and neglected replacement or maintenance expenditures constitutes the city's short-term deficit. Each form of borrowing is easy to do, but hard to detect. One needs to be an accountant, an actuary, and an engineer all at once. Barring such expert analysis, a simple early-warning device to signal a potential problem would be helpful. A working rule of thumb might be to compare the level of a city's current accounts surplus per capita to the *average* level of pension underfunding and infrastructure depreciation for large U.S. cities, which is $50/resident per year.[8] If the measured surplus exceeds this

[6] In a previous article for this *Business Review*, I have estimated the size of unfunded state and local public employee pension obligations in the United States at $500/person for the year 1976. There are good reasons to think this debt has grown even larger in recent years. See Robert P. Inman, "Paying for Public Pensions: Now or Later?" this *Business Review*. (November/December, 1980).

[7] Urban Institute, *America's Urban Capital Stock, Volumes 1-6:* New York City (vol. 1), Cleveland (vol. 2), Cincinnati (vol. 3), Dallas (vol. 4), Oakland (vol. 5), Boston (vol. 6), George Peterson, Project Director and General Editor, Washington, D.C., 1979-1981. The low cost cities are Cincinnati and Dallas while Boston, New York, and Cleveland are all near $100/resident.

Knowing that the public capital stock has declined is not by itself sufficient to conclude that the city has borrowed from the infrastructure to pay for current services. Long-term debt liabilities may have declined as well, so that the *net* wealth associated with the public capital stock (asset value minus debt liability) is unaffected. In fact, however, long-term debt liabilities in all five cities have *risen* over the past decade: Dallas (from $256/resident to $386/resident), Cincinnati (from $409/resident to $435/resident), Boston (from $371/resident to $963/resident), New York (from $744/resident to $1,072/resident), and Cleveland (from $338/resident to $346/resident).

[8] Recent work by Robert Inman for the Federal Reserve Bank of Philadelphia indicates that cities may fund only 1/3 to 1/2 of their annual pension obligations. (See R.P. Inman, "Public Employee Pensions and the Local Labor Budget.") If so, and if the typical city budget has an actual pension obligation of approximately 10 percent of its $300/capita public labor budget, an annual pension deficit of about $15.00 per resident results (= .5 × .10 × $300/capita).

The Urban Institute studies of city capital needs estimate additional annual expenditures ranging from $15/resident per year to $100/resident per year for their sample cities to replace neglected capital stock. See footnote 7. A conservative estimate of capital budget needs in most large cities is probably nearer to $35/resident per year. A reasonable guess as to the average annual deficit from neglected pension and infrastructure financing in large U.S. cities is therefore about $50/resident per year (× $15/resident + $35/resident).

How do the budgets of Philadelphia, New York City, and Cleveland stand up against this simple test? For the pre-crisis period, 1970-1976, each city was right at the critical threshold. Philadelphia averaged an annual current accounts surplus of $70/resident. New York City averaged an annual current

critical threshold, the city passes this rough test for fiscal soundness. If the measured surplus falls short of the critical threshold of $50/resident, then the city fails the working test. The city *may* be accumulating serious short-term deficits, and a detailed look at the city's current accounts budget, and its pension and capital financing programs is in order. Such cities may be on the edge of a fiscal crisis.

Why There is a Fiscal Crisis. Cities are driven to the brink of bankruptcy by two different sets of forces, one political and the other economic. When the political environment encourages a shortsighted, "what have you done for me lately" mentality, and when economic fortunes stagnate or decline, then we are on our way to a fiscal crisis.

City budgets are political statements. They reflect the judgments of elected officials about the needs of their voting constituents for public services and their tolerance for taxes. Two facts about voting behavior shed light on the rationale of city politicans when they set the city's budget. First, an average U.S. urban household moves once every five years. To be sure, some families remain in the same location for twenty years, but then four other families move once every one or two years. Families move for a variety of reasons: new jobs, transfers, children get older, children move away. When families move they take their votes with them; so old favors and long-run promises are politically useless in a mobile society. Second, some evidence on voting behavior in response to economic policy suggests that even for those voters who stay put, *current* services and incomes appear to be all that matter.[9] When voting, we simply ask: "what have you done for me lately?" The combined effect of a mobile population and myopic voters creates pressure on those who set the city budget to "deliver" today. Politicians seeking re-election really have only two concerns: *today's* services and *today's* taxes. The future, even the five- or ten-year future, is politically irrelevant.

The budgetary myopia encouraged by the local political process has little consequence for an economy with adequate and constantly expanding real resources. In high growth regions, "overdoing it today" can be paid for from future growth dividends. It is in stagnant or declining local economies that political reality and economic reality collide.

Cities whose private economies are in decline, or in transition to a new economic base, face a unique set of conflicting demands on their public budgets. As tax revenues are falling, spending needs are rising. As existing economic activity declines—manufacturing usually leads the way—jobs and residents leave the city. The city's tax base consequently declines. Closed firms no longer pay property taxes and departed workers don't pay wage or sales taxes. Those are the direct losses, and they have been most evident in Philadelphia and Cleveland. There are secondary effects as well. The demand for commercial and residential property in the city declines, and this naturally lowers the price at which those properties sell. This general fall in property values may also reduce the city's tax base.

Economic stagnation also creates pressure to increase city spending. A significant fraction of most large city budgets is allocated towards services that assist low and modest income families. Public housing, public health and hospital services, and public welfare are now in greater demand. Philadelphia, for example, allocates 18 percent of the city's budget to such services. As the city's economy declines, the pressure to increase spending for these services increases. Economic stagnation creates indirect pressure on spending, too. Rising unemployment often leads to rising crime rates, which, in turn, requires more police spending. In addition, maintenance of household and commercial structures will fall, producing increased fire protection expenditures and sanitation costs in the declining neighborhoods. Finally, education expenditures may rise as the city responds to unemployment with training programs.

accounts surplus of about $95/resident, but it should be remembered New York's capital and pension account needs were well over $100/resident per year (see fn. 7). It is easy to see why the New York banks were nervous about additional short-term credit. Finally, Cleveland averaged $60/resident in the annual current accounts surplus for this period, but Cleveland too has an estimated annual deficit of over $100/resident on the capital and pension accounts (see fn. 7).

[9]See Ray Fair, "The Effect of Economic Events on Votes for President," *Review of Economics and Statistics*, (May, 1978), pp. 159-173.

The economic pressures on city tax base and city spending created by a declining local economy are the root causes of local fiscal problems. A beleaguered city can adopt one of three fiscal strategies. The first is to raise tax rates on the existing tax base, but this may well accelerate the decline. Increased taxation is likely to further discourage firm and housing investment in the city. For example, recent estimates by the staff at the Federal Reserve Bank of Philadelphia predict that for every 10% rise in Philadelphia's wage tax, between *8,000* and *32,000* jobs will be lost to the city.[10] And, the response is likely to occur quickly in our mobile society. Both economically and politically, a tax increase is an unappealing option.

The second strategy is to reduce spending. Here the city may have very little leeway in the short-run. Labor expenses compose more than 70 percent of most cities' non-capital expenditures, and most labor costs are determined through city-employee bargaining over wages *and* employment levels. Politicians can try to convince city unions of the need to control spending through modest wage settlements and flexible, efficient staffing procedures. This may be politically difficult to achieve, however, especially if public employee unions are strong.[11] Nevertheless, it is important to strive for efficiency in the provision of local services, not just to avoid fiscal dilemmas, but also to allow cities to be viable competitors for new firms or new residents. There appears to be substantial variability across cities in efficiency in providing public services (see THE TAX PRICE INDEX).

This leaves city officials with the third strategy: to run a deficit. As the tax base declines and as spending obligations rise, the temptation is to pay for current services by borrowing against the future. When voters are myopic, accurate accounting is difficult, and when politicians have very short horizons, deficits emerge as the most attractive strategy. The debt will not fall due until current residents and current political leaders have long since left the scene.

Fiscal crises do not just happen, nor are they planned. The long-run economic forces of change and transition have forced the private economies of many urban areas into periods of stagnation and decline. Politics is more likely to contribute to the problem than to solve it. Rather than isolated events, the fiscal crises of New York City, Cleveland, and Philadelphia may be the first of many in the local public sector—unless, of course, we head them off.

WHAT CAN BE DONE?

There is no easy deterrent to the threat of an urban fiscal crisis. The strategy of borrowing against future wealth through short-term deficit financing only *postpones* the inevitable need to conserve resources in declining or changing urban economies. Furthermore, the presence of such deficits may weaken the chances for a successful transition to renewed strength in the private sector. A history of deficit financing may dissuade firms and households from moving into the city. No one wants to be around when the fiscal crisis finally erupts.

The solution in the past has been to look to Washington or the state capital for financial assistance. While federal and state grants-in-aid have helped on occasion, cities cannot count on these monies in the future. Fiscal conservatism at the federal and state level has slowed the growth of these programs, and a decline in the real value of assistance for cities is likely. This will increase, not lessen, the pressure to run local deficits.[12]

A sensible strategy involves sound fiscal management and a local program for new economic

[10] See John Gruenstein, "Jobs in the City: Can Philadelphia Afford to Raise Taxes?" this *Business Review,* (May/June, 1980), pp. 3-11 For related work, see Ronald Grieson "Theoretical Analysis and Empirical Measurement of the Effects of the Philadelphia Income Tax," *Journal of Urban Economics,* (July, 1980), pp. 123-137; and Ronald Grieson, et al., "The Effect of Business Taxation on the Location of Industry," *Journal of Urban Economics,* (April, 1977), pp. 170-185.

[11] Edward Gramlich, "The New York City Fiscal Crisis," p. 417, has estimated that if each member of a public union in New York City could persuade two other voters (for example, a spouse and a friend) to support the union position, public unions would control over 30 percent of the voters in New York City. It is easy to see why this second strategy did not work in New York City.

[12] For estimates of the effects of President Reagan's new federalism on local budgets, see S.G. Craig and R.P. Inman, "Federal Aid and Public Education: An Empirical Look at the New Fiscal Federalism," *Review of Economics and Statistics,* (November, 1982), pp. 541-552.

THE TAX PRICE INDEX

The *tax price index* (TPI) is a price index which measures the relative cost in tax dollars of providing a unit of public service facilities to households and firms within a city. The index has two components: (1) an index of local government labor and material input costs to measure the relative costliness of providing local government service inputs, and (2) an index of the relative share of these input costs which must be paid by households and firms within the city. The second component is important because a significant fraction of local governments' costs are now paid by state and federal governments. The TPI allows us to compare the costliness to residents of purchasing a bundle of local service inputs in one city to the costliness of purchasing that identical bundle in another city. The higher the TPI, the more costly it is to buy the bundle of public service inputs. The TPI compares each city to a "base" city, which, for this index, is that city with the national average public employee wage structure, the average cost of materials, and the average level of state and federal support for local services. A TPI of 100 means the sample city can provide local services at the same per unit costs as the nation's average city; a TPI of 120 means the sample city must pay 20 percent more than the average city for its local service inputs. All data are for the fiscal year 1979-80, the most recent year for which comparative data are available.

When using TPI for comparisons, we must be careful on two points. First, the TPI only measures the relative cost of labor and material inputs. TPI does not include a measure of the relative costs of public capital nor does it measure the cost of providing a standard unit of public *output*, such as school test scores or the prevention of a highway accident, a fire, or a robbery. It is only an index of current account input costs. TPI measures an important part of local government efficiency but it is not the whole story. Second, a high value of TPI alone does not signal a fiscal crisis. Though some cities may have costly public services they may also be rich in taxable resources to pay the cost. Los Angeles and San Diego are examples. Alternatively cities may be relatively inexpensive when it comes to providing local services, but they may also be very poor in taxable resources. Cleveland is an example. In summary, the TPI tells an important part of the story of a fiscal crisis, but it clearly does not tell the whole story.

	Index of Labor and Material Costs	Index of Own Revenue Contribution	TPI
Baltimore	87.3	79.7	69.6
Chicago	116.7	68.3	79.7
Cleveland	104.3	90.3	91.0
Detroit	115.3	79.5	91.6
Houston	96.1	126.0	121.1
Los Angeles	124.9	95.1	118.8
Minneapolis	113.2	81.1	92.0
New York	109.0	114.8	125.2
Philadelphia	109.2	111.4	121.7
Pittsburgh	101.0	110.3	111.5
San Diego	115.3	103.6	119.5
Washington D.C.	115.0	87.3	100.4
National Average	**100.0**	**100.0**	**100.0**

The index of labor and material costs is described in detail in R.P. Inman, "Dissecting The Urban Crisis: Facts and Counterfacts," *National Tax Journal* (June, 1979).

The index of own revenue contributions is the ratio of the share of current expenditure from own revenues for the sample city to the share of current expenditures from own revenues for the national average city.

TPI is calculated as the product of columns (1) and (2) for the sample city divided by the product of columns (1) and (2) for the national average city and then returned to index form by multiplying by 100.

development. Efficiencies in public service provision must be exploited when they are available.[13] Negotiated public wage increases must be fair but consistent with the economic trends within the region. Cities must begin to fund public employee pensions and maintain public infrastructures. Services elsewhere in the budget may have to be curtailed to help reduce past deficits. Such stringent budgetary measures will require strong political resolve and an ability to convince current residents of the long-run economic advantages of sound fiscal performance.

Both the resolve and the promise of long-run economic benefits are enhanced if the city has a clear program for reversing the downward trend in its local economy. The objective of any development strategy must be the full utilization of the city's people, its capital, and its natural resources. In Philadelphia, this means developing the port, encouraging tourism and convention business, and expanding business activities that complement the city's strong health-care system and its medical and scientific research centers.[14]

The city's political leadership can, and must, play a role in the development of a long-run economic strategy, but the city government cannot, and should not, become an active investor in the private sector. There is no convincing evidence that large tax breaks attract many new jobs or that city governments are particularly adept at spotting leading firms in high growth industries. Investment decisions are best left to private investors. What city governments can do, in addition to ensuring a stable long-run tax environment, is to assist new firms through the many local regulations which often stand in their way of actually doing business. But top priority should go to keeping the city's financial affairs in order. The promise of sound fiscal management and administrative assistance for new establishments may be the most effective contribution that local governments can make to the revitalization of the private sector.

[13]The use of contracting local public service provision to private, competitive firms is one avenue which must be explored. See E.S. Savas, *Privatizing the Public Sector*, (New York: Chatham House Publishers, 1982).

[14]For some recent evidence that these sectors are the likely leaders in Philadelphia's economic revitalization, see John Gruenstein, "Can Services Sustain a Regional Economy?" this *Business Review*, (July/August, 1981).