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New York City Independent Budget Office

Background Paper

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Dawn of a New Era: New York City Fiscal Policy After(?) the Financial Emergency Act

This paper provides background information for A Panel Discussion Presented by
The Center For New York City Affairs The New School
and
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THE FINANCIAL EMERGENCY ACT (FEA, or the act) was enacted in 1975 in response to New York City's historic financial crisis. After years of incurring substantial operating deficits, papered over with short-term borrowing, all masked by inadequate reporting and accounting controls, the city found itself unable to sell its short-term notes in the credit markets in the spring of 1975. The state's initial response to the crisis was the creation of the Municipal Assistance Corporation (MAC) to issue debt on behalf of the city, and of an Office of the Special Deputy Comptroller for New York City (OSDC) within the state Comptroller's office. But the credit markets remained reluctant to buy the MAC bonds until the Legislature enacted the Financial Emergency Act in the fall of 1975 in order to address the shortcomings of the city's financial management that had led to the crisis in the first place. Following this the banks, the municipal unions, and the federal government stepped in to help create a market for the MAC bonds.

The act addressed the city's financial management shortcomings by superimposing on the existing City Charter budget process a financial planning and management process. Most notably, the FEA created the Financial Control Board (FCB, or the board) consisting of the Governor, the Mayor, the city and state Comptrollers, and three public members appointed by the Governor.

The act imposed several important requirements on the city, including:

- a budget balanced in accordance with generally accepted accounting principles (GAAP), with an allowance for a maximum $100 million year-end operating deficit;
- a four-year financial plan for spending, revenues, cash flow and borrowing, updated quarterly;
- stricter limits on both the amount and term of short-term debt than what would normally be allowed under the state Local Finance Law;
- creation of a separate fund, overseen by the state Comptroller, for debt service on city bonds.

From 1975 through 1986, the city was in a control period, during which the FCB exercised the power to approve or disapprove the city's financial plans, contracts, and borrowing. Since fiscal year 1987, upon the city successfully meeting conditions spelled out in the act, the control period ended and the act has been in "sunset." During the sunset period, the control board's power to approve or disapprove financial plans, contracts, and borrowing, has been suspended.

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The board (along with OSDC, which was made permanent by law in 1986) now reviews the financial plan and the city's compliance with it, as well as its contracts and borrowing, and issues staff reports reviewing and commenting on each financial plan update. But the board must also make an annual determination (usually doing so at its annual meeting in July) as to whether certain "trigger" events have occurred or are likely to occur. The trigger events include the failure of the city to make debt service payments on time, a year-end operating deficit of more than $100 million, issuance of short-term debt not in conformity with the act, any violations of the act's provisions that would "impair" the city's ability to repay its debt or adhere to a balanced budget, or if the city and state Comptrollers are unable jointly to certify that the city was able to borrow in the public credit markets. If the board were to determine that any of these events had occurred or were likely to occur, a control period would be automatically re-imposed.

2003 EXTENSION OF THE FINANCIAL EMERGENCY ACT

The act, which was set to expire when the last Municipal Assistance Corporation bonds were retired in 2008, was extended in 2003 when the remaining outstanding MAC bonds were refunded with assistance from the state as a measure to help the city through a period of fiscal difficulty. The act now is set to expire in 2033. The act's requirements will remain in effect and the Financial Control Board in existence until that date; however, the act's provisions requiring imposition of a control period under the circumstances summarized above will expire next year as originally planned. It remains unclear whether the board would continue to make its annual determination; if it were to determine that one or more of the "trigger" events had occurred, it could recommend imposition of a control period to the Legislature, but it would not be automatically imposed. In addition, the funding for the FCB will also expire, and a new mechanism will have to be created to provide for its annual operating expenses.

THE 2005 CITY CHARTER REVISION

Most observers believe that the FEA "regime" has served the city well over the last three decades. In contemplating the act's expiration, the debate has often focused on whether there should continue to be a state Financial Control Board with the power to impose a control period. Some feel that the city has shown that it is capable of managing its finances responsibly on its own, and that existing financial accounting and reporting standards (which arose largely in response to the city's fiscal crisis) suffice. Others see in the threat of a control period a useful check on the city's financial management that should be continued. City budget directors, Mayors and even City Council Speakers have at times invoked the act in order to address fiscal pressures.

It is not necessary to resolve that question to still embrace other aspects of the FEA regime. This is in effect what the 2005 Charter Revision Commission did, by importing into the City Charter certain of the financial planning and management elements of the FEA. While it was clear that several members of the Charter Commission were opposed to continuation of the Financial Control Board, it was recognized that opinions differed and in any event that a mayoral commission had no jurisdiction over an oversight body with state membership.

Specifically, the Charter revisions approved by voters on Nov. 8, 2005 made the following changes to the Charter, largely consistent with the language and practice of the FEA:

- Requirement to end the year with a GAAP-basis balanced budgeted (the Charter previously only required *adoption* of a balanced budget), with no provision for an operating deficit of any size;
- A four-year financial plan, updated quarterly, incorporating in the Charter the FEA standards for the financial plan and modifications;
- An annual audit in accordance with generally accepted auditing standards (a standard not specified in the Charter before);
- Restrictions on short-term debt issuance consistent with the FEA's provisions, which limit tax and revenue anticipation notes to no more than 90 percent of the projected revenues in question, and require retirement of short-term debt in the same fiscal year it is issued in most instances.

The Charter Revision Commission deferred recommendations on several other financial management issues, including establishment of a "rainy day" fund and changes in budget presentation.

In addition to the revisions to the City Charter, the city introduced legislation in Albany to establish the statutory lien on real property tax and other revenues in favor of city bondholders, but this legislation has not been reintroduced.

WHERE DOES THIS LEAVE US?

In sum, if no further action were taken between now and next July 1st, the following would be the situation:

- The Financial Emergency Act would remain in effect, and the Financial Control Board would continue

July 1, 2008: An Opportunity for a New Framework

As things stand now, the Financial Emergency Act and the Financial Control Board are set to remain in existence for another quarter century, although without the threat of automatic imposition of a control period. Is this the state of affairs that will best serve the city's interests in the long run? What are the possibilities between the two extremes of restoring the FCB's power to impose a control period on the one hand, and repealing the FEA and eliminating the FCB, on the other? What possible changes to the act and/or the City Charter could help preserve the city's record of fiscal stability while addressing other challenges?

Among the possible issues for consideration are the following:

- Balancing the budget according to generally accepted accounting principles is usually interpreted to mean that current-year revenues must meet current-year expenses—that is, there can be no operating deficit or surplus.
    - Is the requirement for a budget balanced in accordance with GAAP too restrictive? Does it preclude some prudent financial and budgeting practices? What unintended consequences does it have? For example, most observers agree that a rainy day fund, in the usual sense of the term, is currently prohibited.
    - Do other cities (and states) operate under this constraint? If not, why not, and how do they ensure prudent financial management?
- Many observers have criticized the lack of transparency and measurement distortions created by the city's current practice of the "surplus roll," under which the city prepays in one year expenses coming due in the next year in order to move surplus funds from one year into the next without violating the GAAP balance restriction. Should the city create a rainy day fund, or allow the existing Budget Stabilization Account to be "rolled over" by appropriation into the subsequent year? Would this require state law? If so, should it be written into the FEA? Into the City Charter?
- Is an FCB that has only a review role (assuming it has funding) worth keeping? Are there additional roles or responsibilities that the FCB could assume? What might those be?
- The City Council Speaker recently proposed enhanced reporting requirements for the so-called "covered organizations" such as Health and Hospital Corporation, Transitional Finance Authority, New York City Transit, Battery Park City Authority, and New York City Housing Authority, and other independent city agencies. What form should future oversight of these entities take? What about other city-created entities such as the Economic Development Corporation, the Water Authority, or the Hudson Yards Development Corporation, that are "off-budget" but to whose fates the city is in many respects much more closely tied than to some of the traditional covered organizations?
- What, if any, additional measures might be necessary to ensure the uninterrupted future flow of financial and other information if the FCB were eliminated?

Finally, beyond the measures designed to ensure ongoing prudent long-term fiscal management, what other budgetary and financial management "best practices" could/should the city adopt? For example, many states and cities have moved to performance-based program budgeting, which attempts to more closely align budget allocation decisions to service delivery outcomes. While this and other recent developments in budgeting and financial management are not strictly tied to the immediate questions raised by the pending changes in the FEA, the moment seems propitious to at least begin consideration of ways that the city's budget processes might be improved.

in existence. As state law, the act's provisions would continue to supersede the new Charter sections approved in 2005.

- However, the Financial Control Board would have no funding source for its staff.
- Although the Financial Control Board could continue to meet annually, or otherwise make a determination as to whether the city had failed any of the statutory tests, such a finding would not result in automatic state takeover through the board. The board presumably could make a recommendation to the Legislature to reimpose a control period.
- Finally, the city's sales tax would revert from 4 percent to 3 percent, costing the city approximately $1.2 billion annually in lost revenues.

In sum, what many have viewed as a key element in the City's fiscal management over the last three decades—the threat of automatic state takeover—will lapse, while many of the act's requirements remain in place (both in the FEA and in the City Charter). This state of affairs would seem to call for a thoughtful public discussion of the consequences of leaving things as they are, and careful consideration of the alternatives.