



Lessons from Past Recessions: Borrowing for Operations

Highlights

- New York City has requested authorization to borrow \$5 billion for operations (known as deficit financing), a practice that helped lead to the 1970s fiscal crisis.
- The last authorized borrowing, after 9/11, took place in an environment where the City did not have strong reserve positions. The City also exited 2003 with a \$1.4 billion surplus after receiving federal funding, implying the full amount borrowed was not actually needed.
- At the beginning of FY 2021, the City had a surplus roll and reserves exceeding 9 percent of total expenditures to help manage the abrupt impact of a minor recession, but the severity of the pandemic-driven recession and uncertainty about its duration warrant caution about how to manage gaps.
- Recent actions by the City and its financial profile entering FY 2021 provide it with some cushion to see what federal relief may be forthcoming, at what pace economic activity will return, and what the recession's impacts will have on the State's finances.
- The challenges the City is facing now require an updated, comprehensive plan to lay out, manage and monitor the fiscal and economic situation in order to right-size the evolving response.

The COVID-19 pandemic has created a fiscal emergency for the City of New York, creating significant revenue shortfalls and increased costs associated with managing the public health crisis. Federal relief funding has been inadequate in helping resolve the budget gaps emerging from the fiscal emergency. In response, the City has requested since May that its Transitional Finance Authority (TFA) be provided with authorization by the State Legislature to borrow up to \$5 billion to maintain spending and make up for lost revenues not reimbursed by the federal or State government, a practice referred to as borrowing for operations (i.e., deficit financing).

The reliance on borrowing for operations recalls stress points in the City's fiscal history and the use of debt to manage ongoing operating gaps, which, when coupled with the City's lack of financial management systems, policies, and procedures, and the economic environment at the time, led to the fiscal crisis of the 1970s. Despite five recessions since then, such borrowing has been used just once, in the aftermath of the terror attacks on September 11, 2001. At the time, the City had limited cash available, and the funds obtained were ultimately more than what was needed after federal funding helped cover cleanup costs, evidenced by the City's \$1.4 billion surplus in City fiscal year (FY) 2003. City taxpayers continue to pay back the costs of accumulating that surplus in the form of debt service.

The costs of debt service can mount quickly and have lasting economic impacts. Currently, the City, as a result of recent budget policy actions and a robust economy, enjoys reserves that it did not have in the past, and this allows for temperance in the City's approach to managing the crisis.

Given these factors, and the wide-ranging economic effects of COVID-19, the need, amount, and duration of repayment for any borrowing should be carefully considered in a comprehensive plan that aligns with the City's economic outlook and revenue and expenditure profile.

Any such plan should outline these parameters as a prerequisite in recognition of deficit financing as a bridge to structural balance, not a recurring revenue source. The plan should be based on realistic assumptions for the City's economic and financial outlook, and should incorporate continued monitoring of federal and State actions that may affect the City's finances. This review of prior recessions provides perspective on the City's financial strength when the COVID-19 recession began, illuminates the current recession's economic and revenue impacts, and offers lessons for eliminating gaps and avoiding the practice of deficit financing.

The Problem with Borrowing

Borrowing, on its own, is a necessary and appropriate public finance tool for investing in infrastructure and capital assets. Deficit financing, however, creates a long-term liability to manage short-term needs. This practice ends up creating more costly fixed expenses to pay for services already rendered, while adding to the City's debt burden and taking valuable funds away from long-term capital investments. Such practices, used on a recurring basis, become unsustainable. Deficit financing, a deteriorating local economic environment, and a lack of financial management systems, policies, and procedures were at the heart of the 1970s fiscal crisis.

At that time, the financial control period, created by the Financial Emergency Act, was a response to the City's fiscal crisis and lack of access to the credit markets, and resulted in control of the City's finances being exercised by an autonomous board. Since the end of the City's control period in June 1986, deficit financing has

been authorized only once, within two weeks of the 9/11 attacks, amid relatively low cash balances and questions over federal funding and cleanup costs associated with the disaster. The City was authorized to issue \$2.5 billion in deficit financing bonds, and used nearly \$1.9 billion of that amount.

Nearly two decades later, New Yorkers are still paying back this debt. In FY 2020, the City paid \$136 million for TFA Recovery Bonds issued after 9/11. More than \$420 million of the debt remains outstanding, which is expected to be retired in FY 2023.

The City entered FY 2020 with debt metrics that were much improved compared to those before 9/11 and the Great Recession, following a period of slow growth in debt service as a result of lower-than-expected interest rates and capital expenditures, as well as an improving economic picture. In FY 2021, the City's outstanding debt as a share of the market value of taxable real estate is expected to be 3.3 percent, which is relatively low. This figure excludes debt issued by the Municipal Water Finance Authority. Debt service costs in FY 2021 as a share of taxes is expected to be 12.6 percent, also manageable.

After seven years of not reaching the FY 2010 level of capital commitments, the City reached that level in FY 2018, maintained commitments at about the same level over the next two years, and is anticipating a ramp-up of debt issuance in future years. With a slowdown in City revenue as a result of pandemic-related closures and employment decline, the projected issuance and debt service associated with borrowing \$5 billion would increase carrying costs to more than 13 percent of City fund revenues. This threshold was last exceeded during the Great Recession, when debt service reached 13.7 percent in FY2010.

OSC calculates the cost of borrowing \$5 billion could increase debt service by \$350 million per year at a fixed rate to be paid off by 2050, based on the City's current interest rate assumptions for

TFA debt.¹ By way of illustration, \$5 billion in capital spending would provide enough funding to bring all bridges, highways, streets, and traffic lighting to a state of good repair through 2024.²

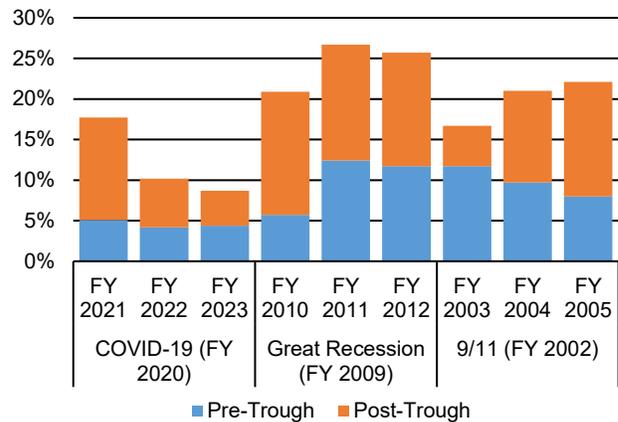
Origin of the Gaps

According to the National Bureau of Economic Research, the City has experienced four recessions (including the current one) since the end of the financial control period in 1986. Each posed varied economic and fiscal challenges. With the notable exception of the 2001 recession, however, the City has been able to balance its budget without the need to borrow for operating purposes. As a result of changes in the City’s management of reserves over time, as well as data availability, this report analyzes the City’s finances during the lowest point of three business cycles after 2000.

While the exact impact of recessionary events on the City’s budget cannot be isolated, it is useful to examine historical changes to the City’s financial condition during recessions. OSC examined the fiscal year period around each recessionary trough,³ and included a review of City fund revenues, expenditures and the size of the City’s budget gaps. Each change, its composition, and the City’s budget policy response are instructive for understanding the City’s current predicament. OSC identified the third quarter of 2001 (FY 2002) and the third quarter of 2009 (FY 2010) as prior economic troughs for assessing the impacted budget years.⁴

As part of its regular budgeting process since the advent of the Financial Control Board, the City of New York includes a four-year financial plan which identifies future (“out-year”) budget gaps. The requirement for a multiyear plan to identify and mitigate budget gaps was a key achievement of the control period (along with an update to the City’s accounting systems), imposing discipline and foresight in the City’s budget planning.

FIGURE 1
OSC-Projected Baseline Budget Gaps as Share of City Fund Revenue, Pre- and Post-Trough Financial Plans



Sources: NYC Office of Management and Budget; OSC analysis

In each year, the City proposes a balanced budget as part of its preliminary budget plan and identifies the impact of recurring gap-closing actions on the size of future-year gaps. Figure 1 shows the OSC-projected baseline budget gaps as a share of City fund revenues before reflecting the benefit of gap-closing actions, as of the budgets adopted prior to the recession troughs and the changes to the financial plan condition one year later.⁵ The baseline gaps prior to the

¹ OSC assumes a 5.8 percent interest rate, with \$1 billion issued in FY 2021 and \$4 billion issued in FY 2022.

² The City of New York, *Asset Information Management System (AIMS) Report*, Fiscal Year 2020, at <https://www1.nyc.gov/assets/omb/downloads/pdf/as12-19.pdf>.

³ A recessionary trough is defined as the bottoming out of economic activity during a business cycle as measured by gross city product.

⁴ In order to identify the impacted budget years, OSC isolated the economic trough during each downturn. An examination of New York City’s gross city product helps identify the business cycle gyrations.

⁵ City-reported budget gaps are smaller than the OSC-projected baseline gaps because the reported gaps include the benefit of gap-closing actions, which helped to close the gaps in the current year and budget year and to narrow the out-year budget gaps over the balance of the financial plan period.

COVID-19 pandemic were much smaller than those prior to the Great Recession or 9/11. On average, the pre-pandemic gaps were under 5 percent, compared to 10 percent preceding each of the Great Recession and 9/11 troughs. The City experienced healthy revenue growth in the years leading up to the pandemic. Expenditure rate growth in the three years prior to FY 2021 was slightly below the rate prior to FY 2010 and well below the rate prior to FY 2003.

After accounting for the pandemic's arrival in New York City and its effects on the local economy, the projected budget gaps remain lower than the prior two recessions. Underpinning current projections is the expectation of a sharp rebound in growth and associated revenues in fiscal years 2022 and 2023, when the City anticipates a return to normal economic activity. As a result of this anticipated rebound, OSC projects the gaps to average 12 percent through FY 2023 before gap-closing actions, smaller than during the Great Recession and after 9/11. Budget gaps for fiscal years 2010 through 2012 were projected to average approximately 25 percent for the three years following the trough, and gap projections for fiscal years 2003 through 2005 averaged just under 21 percent of City fund revenues.

However, there are risks that could greatly increase the size of the projected budget gaps. For example, in our August 2020 report, OSC previously quantified budget risks of \$1.8 billion in FY 2021 and more than \$2.3 billion in subsequent years, which could increase the FY 2022 budget gap from \$4.2 billion to \$6.5 billion.⁶

It also remains to be seen whether the City's revenue forecasts are sufficiently conservative. The recovery may be slower than anticipated, and the pace of the recovery will also depend on other factors, such as the severity of a potential second wave of the novel coronavirus, the availability of a vaccine or effective treatments,

and long-term changes in social and business practices.

It is worth noting that the City's budget gaps after 9/11 were driven mostly by unplanned spending (mainly for pension and health insurance costs), an issue it has not experienced during the current recession despite some stock market volatility.

While the City has locked in health insurance premium rate increases until FY 2022, health care costs associated with COVID-19 could result in larger-than-planned rate increases in future years. In addition, the City's pension funds earned an estimated 4.4 percent on their investments in FY 2020, less than the actuarial target of 7 percent. As a result, pension contributions could be higher than planned beginning in FY 2022.

Finally, a unique issue facing New York City during this recession is the State's fiscal challenges. New York City has already noted a delay of payment from the State of about \$800 million as of September 2020, and this amount may continue to grow or payments may even be withheld permanently if federal funding is not forthcoming and if economic growth remains relatively slower than in the nation overall.

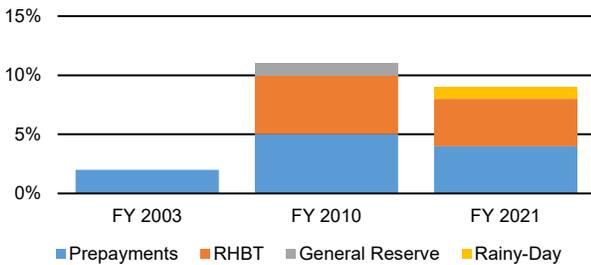
Closing the Gaps

While the City faced large budget gaps in the wake of previous recessions, these gaps were closed through a combination of revenue-generating and cost-cutting actions within the annual gap-closing program. Resources generated from gap-closing actions can be recurring, reducing gaps over time, or nonrecurring, closing the current-year gaps but creating uncertainty in future years.

⁶ Office of the State Deputy Comptroller, Report 2-2021, *Review of the Financial Plan of the City of New York*, August 2020.

Reserve and surplus levels going into the pandemic were among the highest on record, as a result of robust economic and revenue growth and a commitment from the administration and City Council to boost reserve levels after the Great Recession (see Figure 2). As a share of expenditures, reserves were slightly below the levels attained going into FY 2010. It is worth noting that the City drew down \$1 billion from its Retiree Health Benefits Trust (RHBT) in FY 2020, after the initial impact of the pandemic on the City in March. Reserves are significantly higher than in FY 2003.

FIGURE 2
Prepayment and Reserves as a Share of Expenditures (Total Funds Basis)



Sources: NYC Comptroller; NYC Office of Management and Budget; OSC analysis

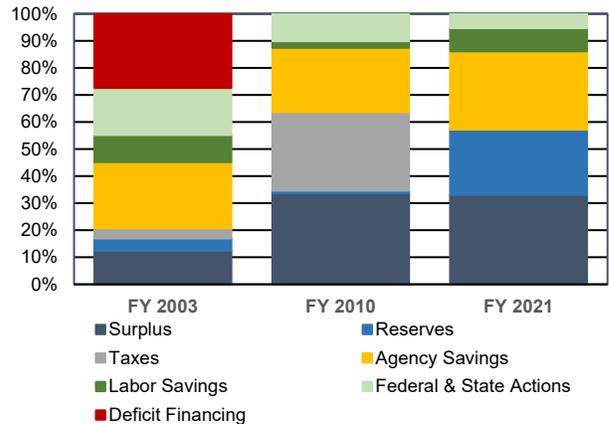
The surplus roll, which includes prepayments of obligations to be paid in future years such as debt service, acts as another buffer going into the current fiscal year. The City carried a surplus of approximately 4 percent into FY 2021.

Reserves and the City’s surplus make up more than half of the resources anticipated from the gap-closing program for FY 2021, compared to 34 percent in FY 2010 and 5 percent in FY 2003 (see Figure 3).

In addition, the latest revenue estimates for the last quarter of FY 2020 suggest the City will experience an improvement of more than \$1 billion in unanticipated tax revenues attributable to prior-year results, which are otherwise not captured in the City’s latest plan documents. This amount would be nearly six times the highest level of unanticipated revenues

collected over the past six fiscal years. These funds could be used to offset additional revenue shortfalls or spending increases.

FIGURE 3
Gap-Closing Programs in Fiscal Year After Recessionary Trough Since 2000



Note: Results are based on anticipated resources from gap-closing actions. Sources: NYC Office of Management and Budget; OSC analysis

Taxes played a more significant role in the gap-closing plan in FY 2010, whereas federal funds and borrowing were more significant components in FY 2003. It should be noted, however, that the City enacted a large property tax increase in FY 2003, which helped buoy revenues during the financial plan period beginning in that fiscal year.

While the City made use of borrowing in FY 2003 and proposed raising taxes in FY 2010 to help close the budget gaps in those years, the one constant among each recession has been the use of agency savings to help close gaps. Agency actions have made up at least 24 percent of the gap-closing program in all three years shown in Figure 3, reaching 29 percent for FY 2021. Savings from agency actions during the past two recessions were mostly recurring, with at least 82 percent of the full amount recurring over the next two years. Although the FY 2020 citywide savings program is expected to generate \$3.3 billion in FY 2021, the recurring value falls to an average of less than \$1.8 billion annually over the next two years, almost half of the FY 2021 amount.

The June Plan anticipates the receipt of nearly \$5 billion in federal assistance from previously approved COVID-19 relief bills. Of this amount, \$3 billion will be used to cover costs associated with the pandemic and nearly \$1.7 billion will be used to balance the budget.

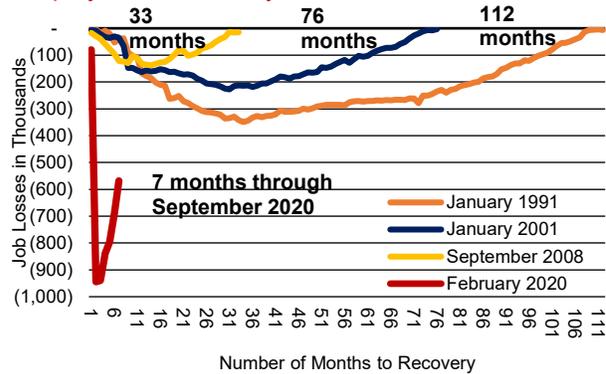
Extraordinary federal aid (including temporary increases to the federal share of Medicaid), when expressed as a share of total spending over a three-year period following the recession trough, averaged 3 percent of spending in the wake of the Great Recession and 1 percent of spending post-9/11. By comparison, anticipated federal assistance for COVID-19 would support 0.3 percent of spending over the next three years.

The X Factor: Economic Outlook

When the City created its economic and revenue projections in spring 2020, it assumed a quick recovery amid unprecedented federal stimulus aid and hopes for the swift production of a safe and widely distributable vaccine. As federal stimulus has dried up and fears of a second coronavirus wave increase, the anticipated recovery has slowed.

New York City employment has experienced its most severe decline on record, with a loss of 944,000 jobs in March and April. The pandemic's severity and duration are unique, and a return to prior-year employment is generally expected to be quicker than in past recessions. However, the timeline of prior recoveries shows recent recessions took at least three years to return to prerecession levels (see Figure 4). The City currently projects a return to prerecession employment in 11 quarters, or 33 months, after the first quarter of 2020. An updated projection of the economic recovery, with a conservative approach to managing the uncertain outlook, is needed to understand the magnitude and duration of potential revenue shortfalls, and should be a prerequisite for considering deficit financing as a revenue source.

FIGURE 4
Employment Recovery Timelines



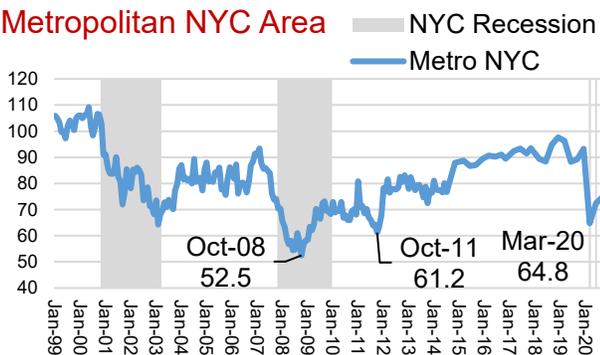
Sources: NYS Department of Labor, Current Employment Statistics, seasonally adjusted; OMB projections; OSC analysis

Questions continue to plague the City's forecasts, including vacancies in the residential and commercial real estate markets, the return of economic activity from office workers and tourists, and additional stimulus to allow businesses to maintain operations, make payroll, and pay bills. Employment, residential and commercial vacancy rates, mortgage and rent payment delinquencies, and international tourism all remain weaker than before the pandemic, with little clarity on the pace of rebound. Consumer confidence remains the lowest since 2011 (see Figure 5, next page). A full return of economic activities also remains reliant on stemming the public health risk through the wide dissemination of an effective vaccine and new treatments.

This uncertainty, which is compounded by the economic outlook and associated revenue effect on New York State, is a key reason for the City to use caution before tapping borrowed resources to manage its operations, and to be sure to reformulate projections to align with economic activity on the ground.

If the length of time before returning to economic activity that approximates pre-pandemic levels is drawn out as a result of public health, economic, or other behavioral trends, gaps could worsen.

FIGURE 5
Consumer Sentiment Index for Metropolitan NYC Area



Note: After 2013, consumer sentiment data was released quarterly instead of monthly.

Source: Siena College Research Institute; OSC analysis

One prevailing theme of past recessions after the financial control period has been that the City's conservative revenue estimates have supported unanticipated revenue growth, helping to close gaps faster than expected. While FY 2021 projections are generally in line with actual results through the first quarter, uncertainty about the out-years, not just for the City but also for the State, could buck the trend, resulting in the unexpected widening of gaps and the need for emergency financing tools to manage the repercussions.

Borrowing as a Last Resort?

The scope and devastation of the COVID-19 pandemic has created a significant loss in revenue for the City to manage, while increasing certain expenses associated with management of the virus that further pressure the City's budget. While the challenges are daunting, they are mitigated in the short term by the City's stronger-than-usual reserves entering the recession and a one-time infusion of federal funding, including stimulus aid that undergirds tax revenues from business activity.

New York City, among other state and local governments, needs additional relief and clarity from the federal government. Past recessions highlight the role of federal assistance, not just in

the worst years but in a managed ramping down of relief over multiple years, to bridge a return to pre-trough economic activity. The level of federal support to New York State will also have considerable influence on what the State will need to withhold or withdraw from New York City in order to manage its own budget, creating significant financial uncertainty for the City. Federal funding bills in Congress, if passed, would provide clarity on federal support, enabling additional gap reductions through direct funds and reducing uncertainty associated with economic projections through additional stimulus.

The Office of the State Comptroller has made clear that deficit financing should be treated as a true last resort in ordinary times, an option only when all others have been exhausted. However, these are extraordinary times, and the City's overall economic competitiveness may be at stake. In considering new revenues and cost savings, the City must not disturb its delicate economic recovery or allow quality of life to deteriorate. The uncertainty created by the current economic outlook, State and federal responses, and larger behavioral questions that could affect the City's residential, commercial, and tourism-reliant economies may linger and result in a longer-than-projected return to normal. This scenario calls for a cautious approach to leveraging nonrecurring resources and for careful evaluation of the decisions to bring the City to structural balance in a new environment.

The challenges the City is facing now require an updated, comprehensive plan to lay out, manage and monitor the fiscal and economic situation in order to right-size the evolving response. The plan should avoid issuing debt for operations while exploring other means for closing budget gaps. A historical review of past recessions suggests the City's projected gaps and reserve levels going into the recession provide time for it to develop and consider all options, in order to identify if and when deficit financing is truly needed.

Prepared by the Office of the State Deputy Comptroller for the City of New York

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