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**The Effects of the Fiscal Crisis on Local  
Governments in New York**

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*The Effects of the Fiscal Crisis on Local Governments in New York*

**I. The Fiscal Crisis**

The fiscal crisis in the municipal finance industry came in late 2007 when bond insurers were downgraded on account of declining values in their non-municipal portfolios. In most cases, municipal bond insurance was no longer accepted by the market. This, in turn, caused difficulties for insured “auction rate securities” (“ARS”) when auctions to establish new interest rates failed and securities became illiquid. With guidance and assistance from the IRS, many of these securities were refunded with long-term fixed rate bonds or variable rate demand bonds secured by bank letters of credit. Although the initial crisis in ARS was under control by the summer of 2008, the crisis in ARS is ongoing. There has been no federal bailout; market and regulatory forces have worked in tandem to stabilize the ARS market. But the ARS hiccup may be a prelude to a larger credit problem for local governments as the reality of massive state debt, declining government taxes and revenues visited by the recession, and the Legislature’s insatiable appetite to spend money with only scant attention to declining revenues, not likely to rebound any time soon<sup>1</sup>, seems determined to carry on unabated.

New York has all the signs of future fiscal difficulties for local governments in a prolonged recession. We now know, for example, that the MTA took on too much debt a few years ago. The gas price crisis in 2007-8 may have increased ridership, but the hemorrhaging on Wall Street leaves a lot of empty seats at rush hour these days. With \$54 billion in state debt (depending on how you count it), unlike the last fiscal crisis in the mid-1970s, it will be difficult for the State to finance its way out of the recession with more debt. And it doesn’t help that financial institutions have become picky about who they lend to, or that national credit ratings have become discredited by investors, or that municipal bond insurance has for the most part evaporated. The \$27 billion in Stimulus Act<sup>2</sup> funds directed to New York, by whatever allocation scheme it is distributed, will cover only part of the 2010 deficit and leave nothing for undoubted future year deficits. Solving the revenue shortfalls by raising property taxes and income tax rates on the “rich” will only leave those New Yorkers who have not moved their state tax venues elsewhere poorer.

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<sup>1</sup> See: Donald J. Boyd, *What Happens When the Money Runs Out?*, Rockefeller Institute of Government, February, 2009, Albany, NY.

<sup>2</sup> American Recovery and Reinvestment Act of 2009.

## II. Immediate Effects of the Fiscal Crisis

The seizure of global credit following the Lehman Brothers bankruptcy in September, 2008, put a halt to major economic development projects from municipal electric utility generators to grandiose mixed-use waterfront rehabilitation. Banks got TARP<sup>3</sup> funding but the lending window has remained closed. P3 projects<sup>4</sup> are fun to conjure but the lack of meaningful investment banker participation makes them interesting academic models for the moment. Municipalities and school districts, even with their generous State debt service subsidy, have put capital projects aside or proceeded largely pay-as-you-go for fear of loading up debt service in outyear budgets (the MTA's Achilles heel) where tax and revenue projections are headed south. While there are plenty of bidders for low-interest rate short-term notes<sup>5</sup>, the remaining financial institutions with several capital market pillars under one roof (JPMorgan Chase, Bank of America, TD Bank and Citigroup) just want to do "large deals." Government banking for the rest of the public sector is becoming a function of community and regional banks not infected with those toxic assets which brought Wall Street to its knees last year. Large tax-supported public sector debt can be sold but at higher rates as the tax-exempt bond investor pools slowly withers.

Last year saw unprecedented trauma in the destruction of public finance units in major financial institutions - and it is ongoing. Wachovia, Lehman Brothers, Bear Stearns, Merrill Lynch and our own First Albany have disappeared into units of other financial institutions. UBS, the heir to once mighty Paine Webber and Kidder Peabody, closed down altogether. And many bankers from these acquired entities have joined the unemployment lines. All major law firms have shrunk in size and some have disbanded altogether.

The silver lining to the trauma in the municipal securities industry may be the Stimulus Act provisions which effect state and local government finance. Seminars and webinars and inter-firm coordination meetings now abound as market participants consider the new tax credit bonds, taxable bonds, stripped credits, federal interest rate subsidies and the "guidance" and allocations the Fed will roll out, imposing a federal regulatory discipline, rather than a market discipline, on the new municipal securities industry. Had Congress really wanted to stimulate public sector borrowing for those "shovel ready" projects, it could have repealed large swaths of the 1986 Internal Revenue Code which have straight-jacketed public finance for two decades. Instead, we wait for the Fed to tell us which projects in which states will be favored to carry out underlying national (rather than state or local) purposes. For more of this in New York, check out [economicrecovery.ny.gov](http://economicrecovery.ny.gov).

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<sup>3</sup> Troubled Assets Relief Program of 2008 providing Federal government funds to financial institutions to strengthen their capital in light of the markdown in value of collateralized demand/mortgage obligations and credit default swaps included in the banks' capital.

<sup>4</sup> Public-private partnerships

<sup>5</sup> With 2-year Treasuries at about 0% a 2% tax-exempt short-term note looks like a good deal.

### **III. Lasting Effects of the Fiscal Crisis**

Without reinstating Federal general revenue sharing for states and local governments, their taxes, fees and service revenues will need to rise on top of already burdensome government costs. In addition, unless they rise fast, structural deficits will start appearing in local government financial statements in 2010 and thereafter. Looking to Albany for local government aid is not likely to produce the desired results - the State has its own structural deficit of staggering proportions. Finally, efforts to reduce government costs – pension benefits, workforce overtime, prevailing wage requirements, Wicks Law requirements, reductions in the number of governmental units – are not likely to happen quickly or at all. Government cost savings won't happen in the state with the most powerful government employee unions in the nation and a government controlled by one party – the one supported by the unions. None of this bodes well for New York's future in the global economy.

The Legislature can tax the rich all it wants – all they have to do is move away and telecommute. The Internet has made geography irrelevant to the workings of private sector capital. That's true also for the productive activities of smart people. The “brain drain” in Upstate over the past 30 years will replicate itself in metropolitan New York City beginning with the demise of Wall Street as we knew it. It is a financial and economic disaster in the making if New York – a state whose constitution commands that the state tend to the health and welfare of its residents – continues expanding government spending while private sector capital moves elsewhere.

An attractive opiate to quickly increasing revenues is to sell government assets - a pawn shop maneuver masquerading as P3. True P3 projects put private capital at risk constructing or performing public functions and facilities. But selling or “privatizing” state facilities and functions - bridges, jails, utility services - amounts at best to a budgetary “one shot” and puts the public at risk for delivery of governmental services without strict government oversight.

For the moment, the government pawn shop is closed because private sector capital is a scare resource and returns on investments in government assets and functions are historically low. But when the credit markets unfreeze, particularly if those markets are then owned or controlled by the Fed, the shop will be open for business and the state and its political subdivisions risk losing effective control of their jurisdictions.

### **IV. Steps in the Right Direction**

Not all is gloom and doom. The Legislature could take action to reform New York's laws to address current economic conditions and increase governmental efficiency and competitiveness<sup>6</sup>. The list of reforms is doubtless long, but a few are generally agreed upon by reform-minded persons:

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<sup>6</sup> Ironically, the NYS Commission on Local Government Efficiency and Competitiveness established by Governor Spitzer in 2007, produced a lengthy report in 2008 on intergovernmental cost sharing and consolidation, but recently expired.

Modernization of Procurement and Borrower Laws – Competitive bidding in procurement and borrowing should be optional with the unit of government. The Wicks Law has proven for many years to increase the cost of everything. Competitive bidding in borrowing is an arcane prophylactic against abusive interest rates in the age of the Internet transparency. Revenue bonds should be re-authorized and regional utility improvement districts created so that local governments can participate in the generation, transmission and distribution of “green” energy for which the Fed is committing billions of dollars in the near future.

Modernize the Structure of Local Government – The Village of Sinclairville<sup>7</sup> should be a state historical road marker, not an incorporated municipality. Other similar examples are legion. Many well-intended plans for government consolidation have been offered. But none will happen when these governments themselves are the major employers in the area (along with schools and hospitals). Any plan of consolidation will have to be mandated by the Legislature along with a steep price tag for buying out the compensation and benefits of those “laid off” from consolidation. No state or nation has ever enacted or retained New York’s intact 19<sup>th</sup> century river town local government system. New York can only succeed in economic development in the global market when private capital needs to obtain approvals from one regional government not 15 local ones.

Enact a State-Wide Stimulus Act – Several proposed laws would stimulate economic development but none have made it past both houses of the Legislature. Here is a sampling: (i) Schimminger-Stachowski – a bill to permit school districts to participate in tax-increment financing and modernize TIF deal structures;<sup>8</sup> (ii) “civic facilities” legislation to re-authorize industrial development agencies to finance not-for-profit health care and educational facilities without prevailing wage requirements, (iii) trust authorization legislation to permit local governments to actuarially fund retiree health insurance without handing the money over to their regulator and supervisor – the Office of the State Comptroller; (iv) general legislation authorizing impact fees so new developments are required to contribute to the cost of new public infrastructure they mandate; (iv) turn-key legislation for all major infrastructure projects so that contractors are at risk for producing timely and quality results and financing can be arranged through negotiation using the new tax credit bond regime of the Stimulus Act; and (v) legislation to cap state mandates uniformly throughout local governments – placing the burden to find revenues and reduce expenses for State functions back on State government.

Amend the State Constitution – Enacting laws to get around or take advantage of arcane provisions in an organic law document written in the 1870s has become ridiculous. The State constitution was last overhauled in 1938 and a few things have changed since. In an economy where all ships are sinking, no one has that much to protect by maintaining the constitutional status quo. If the Legislature won’t act, the people of New York should rise up and petition for a constitutional convention.

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<sup>7</sup> Sinclairville is a village in Chautauqua County with a population of 651 according to the 2000 census.

<sup>8</sup> Assembly Bill No. 2378, Senate Bill No. 1716. In the 2007 -2008 legislature, this bill was Assembly Bill No, 2358 by Assemblyman Schimminger and Senate Bill No. 37 by Senator Young.

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