How the Depression

Transformed

Newark City Government

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March 23, 2009

How the Depression
Transformed Newark City Government

On July 1, 1934, a hundred years after the charter was granted, Newark city government failed, and Newark city government as people then knew it ended. This wasn't a bloody failure like Lehman Brothers, but it wasn't as peaceful as the recent failure of Goldman Sachs, which managed to change from a swashbuckling investment bank to a regular regulated bank a few weeks before it would have been ruined. Probably the closest recent analogy would be Fannie Mae and Freddie Mac, but the names at the top did not change.

Newark city government failed in 1934 for the same reason that these companies are failing today: because it had enormous debts that the markets would not permit it to roll over. Today you often hear the aphorism that when the tide goes out you find out who's swimming naked. Thomas Raymond, Jerome Congleton and Louis Howe were swimming naked. But they didn't get caught; Meyer Ellenstein did.

Because of this failure, Newark city government today is not at all like Newark city government before 1934. The difference is profound. It's not like the difference between a 1920s house and a house built today; it's like the difference between a horse and a car. If you look in a 1920s house you will find doors, floors, ceilings, kitchens just as in a house built today, and you can use the same vocabulary. But if you look at a horse you won't find tires or a radiator or a carburetor. Thus when you look at pre-1934 city government with eyes trained in the current era you feel like an auto mechanic examining a horse.

Newark city government after 1934 bears at most a superficial resemblance to Newark city government before 1934; they are profoundly different organizations.

Three parts to my talk: why the old government failed; what the short-run consequences of the change were; and what the long-run consequences were.

Why the old government failed and disappeared

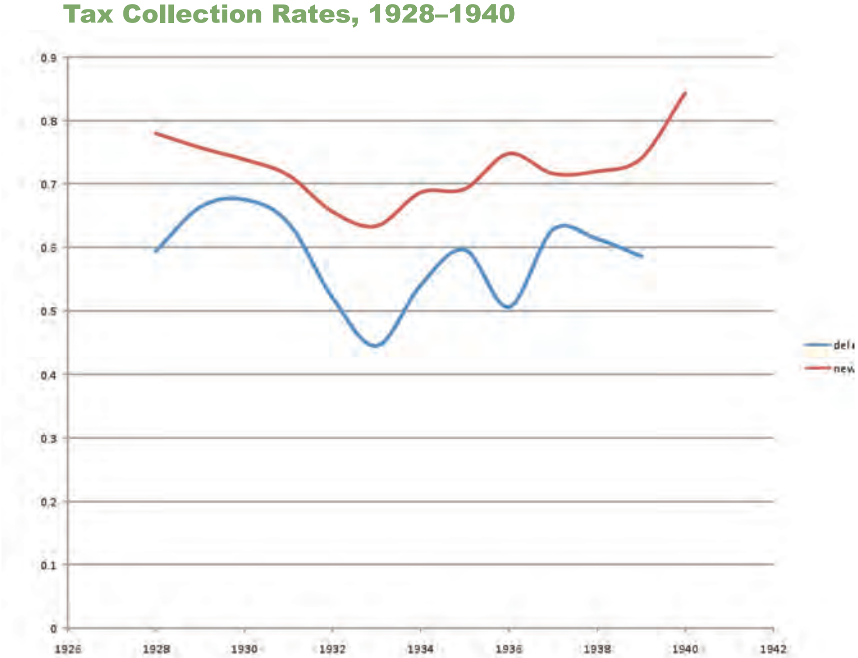
When it comes to modern-day city finances, I'm something of an amateur auto mechanic: I know what makes them tick, and how to make minor repairs. So I thought I could look at pre-1934 budgets and financial reports and understand what was happening. Paul Stellhorn had taught me that there had been a crash, and so I started, as a good auto mechanic would, by looking for the steering wheel and the seat-belts.

That's when I learned that horses don't have steering wheels or seat belts. Instead they have hooves and stirrups and things that we auto mechanics have never seen or heard of. The difference is not just an inconvenience; they operate differently.

When I talk about seat-belts in municipal finance, I mean how the city reacts to shortfalls in property tax collections. Suppose Newark sends out tax bills totaling $250 million, and it doesn't collect everything it billed. There are two ways of dealing with this shortfall. Today, the city has to maintain a reserve for uncollected taxes: it has to send out bills totaling $250 million in the reasonable hope of receiving the $200 million it needs to operate, and there are rules that the state enforces about how big a cushion it needs to put in its tax bills. So under the current system, this year's taxpayers are responsible for shortfalls in this year's tax collections. If this year's taxpayers pay up next year, that reduces next year's taxes.

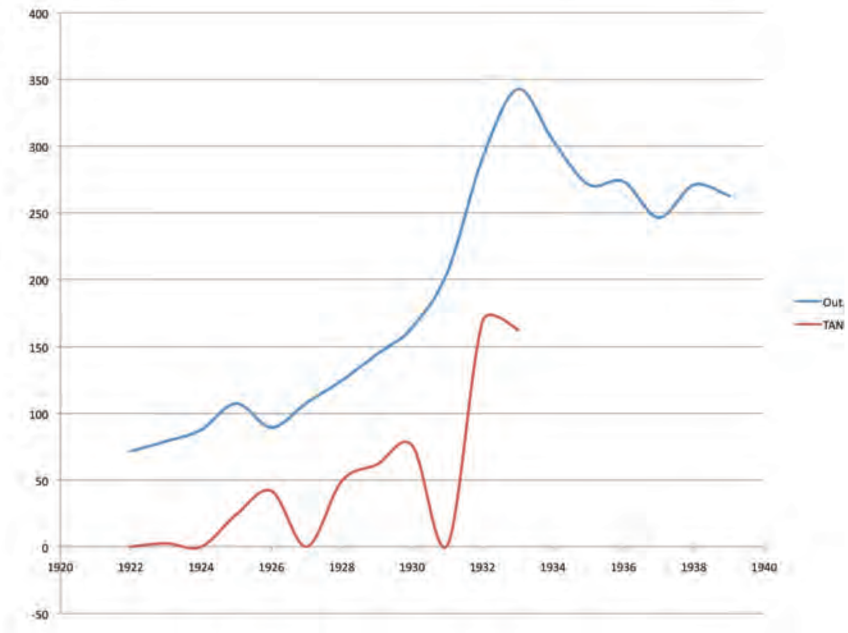
Before 1934, the system was different. The city would have sent out bills for $200 million rather than $250 million, and if a shortfall occurred, it would have borrowed short-term for $50 million. When the delinquent taxes came in next year, it would have paid off the loan

Tax Collection Rates, 1928–1940



Millions of 2009$

Outstanding Taxes and Tax Notes



with those taxes. So essentially, next year's taxpayers were responsible for shortfalls in this year's tax collections.

This system of borrowing short-term to make up for tax shortfalls instead of setting up a reserve was the proximate cause of Newark's failure. Collection rates on current taxes from fell from 78% in 1928 to 63% in 1933, and collection rates for delinquent taxes fell from 59% to 44%. Outstanding taxes rose from $8.9 million at the end of 1927 to $21.1 million at the end of 1933. Tax notes outstanding rose from possibly nothing at the end of 1927 to $10 million at the end of 1933. In today's money, outstanding taxes amounted to $343 million and outstanding tax notes were $162 million.

1933 was a perfect fiscal storm for Newark. As Professor Rockoff has pointed out, money was extremely tight. 1933 was also an election year. Election years in Newark mean two things: artificially low tax rates, and if the incumbents think they are likely to lose, looting. 4 out of 5 incumbent commissioners lost in 1933, including Mayor Congleton and Finance Commissioner Howe.

The 1933 budget was notable for two serious fiscal gimmicks. First, it anticipated receiving $1.5 million from the water system surplus. The problem with this was that water system was in deficit, since the breweries were not yet back in full operation, and the money never materialized. Second, it cut the city's contribution to the school board in half. Schools operate on a September-June year. Before 1933, the city gave the school board money for a full school year every September; thus when the next year started the January-June semester was already paid for. By funding only the September-December semester in 1933, the city got a one-shot infusion of revenue that could never be repeated. But instead of using this windfall to pay down the notes, the commission decided to cut taxes in a vain attempt to preserve their jobs. They cut the tax rate 14%.

When Ellenstein inherited this mess in 1933, nobody was willing to roll over this huge short term debt that his predecessors Raymond and Congleton had assembled. Stellhorn describes in fascinating detail the negotiations, explosions and machinations that followed. Eventually, the state stepped in, took over the supervision of Newark's finances, and created the fiscal system we have today. The state and the financiers then allowed Newark to convert the short-term debt into $16 million in long-term debt (about $250 million in today's money) at a high interest rate. The new Newark was in business.

Would this failure have occurred if Newark had been operating under current rules, where you have to put the cushion in up front? I think not. Last week I simulated how Newark city government would have operated between 1928 and 1934 if today's budget rules applied. I found that revenues would have increased by about $10 million over this period with the biggest increase coming in 1929, another election year. Newark would still have been in trouble in 1933, but it would have been able to roll over its debt. Then with the end of Prohibition and the gradual improvement in the economy, it would have made it through the Depression. The failure was caused by poor fiscal management under Raymond and Congleton, starting in the 1920s.

The problems with short-term debt were compounded by a vast expansion of long-term debt starting with Raymond's return to the mayoralty in 1925. The city was issuing bonds at a rate of about $3.5 million a year before that. In his first term, Raymond almost doubled that rate; and Congleton tripled it. Even in 1932, the city sold $9 million of bonds unrelated to the Depression. This debt overhang and the huge debt service it required contributed a lot to the unwillingness of investors to continue pouring money into city coffers in 1933 and 1934.

It is easy to see the illusion that led to the Raymond-Congleton borrowing binge. Newark is financed by a property tax, not a land tax, and before 1947, the base included business personal as well as real property. The tax base was expanding at a rate of about 7.5% a year in the 1920s. That meant that any current property-owner's share of any debt was falling at a rate of about 7.5% a year; debt was not a burden to current taxpayers because growth assured that other people would pay it off. The picture changes when growth stops. Holders of residential mortgage-backed securities and people who invested with Bernie Madoff are well-aware of this dynamic now.

As part of the creation of the new Newark, the state enacted limits on long-term borrowing, and Newark was well above them.

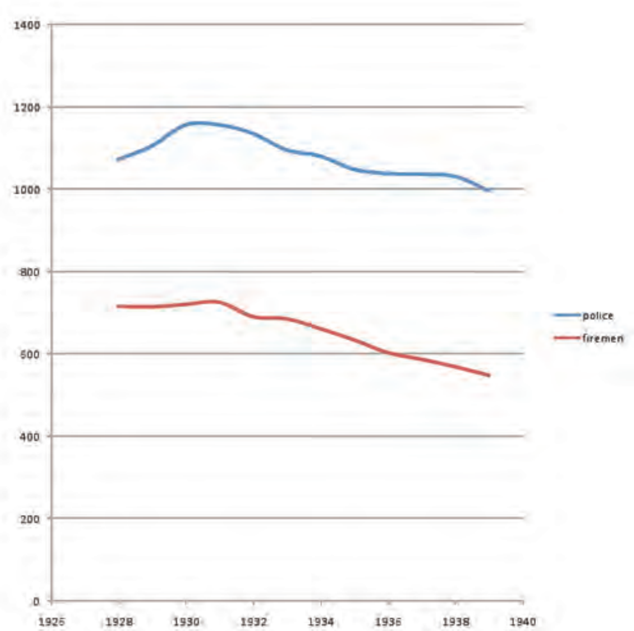
What about relief? Most stories of this period imply that Newark was crushed by the burden of vast expenditures to keep the unemployed from starving. I disagree. Relief payments of course hurt Newark's finances, but they were not a big problem. My simulations showing Newark getting through 1934 if it followed current budget rules assume actual relief payments.

Relief expenditures were small in the scheme of things before 1934, even though there was a lot done, as Warren has explained. On the current budget, Newark spent cumulatively only about $248,000 more for the Overseer of the Poor between 1929 and 1933 than if it had maintained the 1928 expenditure rate; expenditures for the almshouse show essentially no change. The city sold emergency notes for poor relief of $265,000 in 1930 and $1.4 million in 1931. The big relevant amounts are bond issues totaling about $2 million in 1932. Contrast these amounts with the $10 million in tax notes outstanding. Considerably larger amounts were spent on relief in the late 1930s after the failure.

Short-term consequences of the failure

The immediate consequences of this huge change were almost indiscernible. City government kept on operating as it had been operating. The number of police officers hit an all-time high of 1156 in 1931 and slowly declined to 996 in 1939; firefighters fell from 726 in 1931 to 549 in 1939. All the divisions and branches of city government that were around in 1928 were still there in 1940. Except for spikes caused by relief spending and state negotiations, the level of city spending stayed about the same through the end of the decade.

Police and Firefighters, 1928–1939



Newark city government before the fall was remarkably gentle, and old habits of mind change slowly. There were no layoffs at any time during the Depression. Wages were cut across the board on a few occasions, but the first wage cut came until the middle of 1932, three years into the Depression. The commissioners essentially went three years without doing anything to raise revenues or decrease expenditures. As far as I can tell, there were no tax liens before 1934, and while there were tax liens after, hardly any properties were taken for failure to pay taxes—about a dozen or two. You can be very nice when you don't have a budget constraint.

The big change in the 1930s was something that didn't happen, rather than something that did happen. After Arts High and Weequahic High were completed, school construction stopped. The last school bond issue was 1931; the next one was sometime after the war. Nationally, high school enrollment grew throughout the 1930s, but Newark was unprepared to respond. If city government had not failed and Newark had entered the 1950s with another Arts or another Weequahic, that decade may have played out quite differently.

Long term consequences

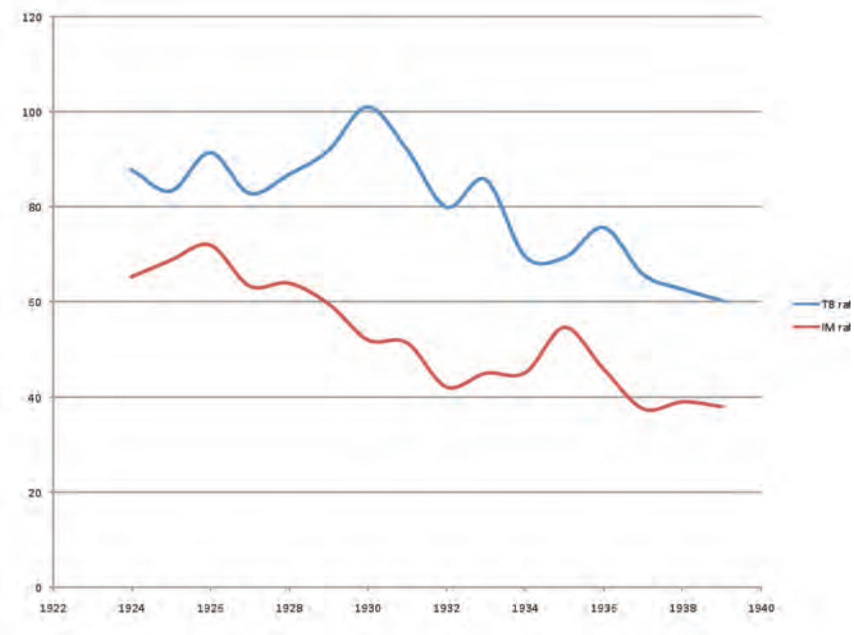
Newark of 1939 was not in good shape. Debt service amounted to $9.4 million a year ($143 million in current dollars); the police and fire departments combined spent only $5.7 million. Outstanding debt was $1.9 million in 2009 dollars (as opposed to about $500 million today, including the arena), and the real estate tax rate was about 67-100% higher than today's tax rate, depending on how accurate the assessments were. Personal property taxes hit businesses for another $100-150 million a year in current dollars.

Because it could no longer borrow easily and because of the debt overhang, Newark city government had to shrink. All the major projects for which Raymond borrowed money ended up being spun off: the city subway to Public Service, the Wanaque Reservoir to North Jersey District Water Supply Commission, the seaport and airport to the Port Authority. The city hospital, the center market, the city home, the public outing ground, the almshouse, the Bureau of Smoke Abatement, and even the Overseer of the Poor are also now gone. A city that did not have a debt overhang would at least have been able to negotiate better terms.

The relationship with the state also changed. In 1929, the city contributed money to the state, not the other way around. By the late 1930s the net direction of money flow had changed. Today, money flows from the state government to the city government, not the other way around.

Newarkers came out of the Depression as people who were much healthier and much better educated than the people who went into the Depression. Between 1928 and 1939, the infant mortality rate fell 40% (it fell 45% for African-Americans) and the TB death rate fell

Health in Newark, 1924–1939



31%. Diphtheria was eradicated. These strong, smart people defeated Hitler, created postwar prosperity, and launched the civil rights movement. Health and education were the city government's responsibility in the 1930s, and the new model of city government did its job well. The swashbuckling old model failed when it was needed most and left behind a legacy that weighed on the city for decades. I am not nostalgic (even if I am the only person alive who half-understands the 1929 financial report). ■

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