

THE FRAIL BONDS OF LIBERALISM: PENSIONS, SCHOOLS, AND THE UNRAVELING OF FISCAL MUTUALISM IN POSTWAR NEW YORK*

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Abstract

Between 1940 and 1965, state-level officials changed the relationship between two pillars of the postwar social contract: secure retirement and modern public schools. In the early twentieth-century United States, state pension managers, following an investment regime we call “fiscal mutualism,” funneled the savings of government workers into government securities. By purchasing municipal bonds, pension officials lowered the borrowing costs for local governments. We analyze this regime through a close examination of New York State’s pension fund. During the 1950s, the comptrollers who managed the New York State Employee Retirement System (NYSERS), the nation’s largest state pension, subsidized suburban school construction by purchasing the bond issues of local school districts. But as changes in the financial landscape made this arrangement less viable, New York Comptroller Arthur Levitt Sr. began lobbying for the liberalization of the pension’s investment powers. After state lawmakers approved the regulatory changes, Levitt disinvested from municipal bonds in favor of higher-yielding corporate securities. Pension liberalization secured higher returns for state retirees, but it also left school districts to navigate bond markets without the backstop of fiscal mutualism. As school budgets, and the property taxes supporting them, soared to repay the interest costs, tax revolts became a permanent response to the fiscal volatility. These transformations, we argue, stemmed from postwar liberalism’s dependence on financial markets to deliver retirement security, public education, and other social benefits.

Keywords

liberalism, federalism, financialization, pensions,
municipal debt, education, suburbanization, tax revolts

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In May 1959, New York State Comptroller Arthur Levitt Sr. met with a group of financial executives at the downtown office of Goldman Sachs & Company. This was the first meeting of the new Investment Advisory Council, which Levitt had assembled to guide him as he transformed the state's \$1.2 billion retirement portfolio. With the bankers' encouragement, he planned to sell the pension's extensive municipal bond holdings and to reinvest the receipts into corporate securities. The sell-off would have far-reaching consequences for school districts across the state. Over the previous decade, New York comptrollers had subsidized the construction of public schools by purchasing school bonds with pension funds. Following the advisers' counsel, the New York State Employee Retirement System (NYSERS) sold off most of its municipal bonds and increased its holdings corporate bonds and stocks. This shift in the investment strategy marked an abandonment of NYSERS's longstanding practice of using pension funds to subsidize public infrastructure, and a sharp turn toward prioritizing maximum returns to bolster the retirement savings of state employees.¹

The meeting thus marked a decisive change in priorities. Under the previous investment regime, which we call *fiscal mutualism*, state officials funneled pension savings into bonds issued by local governments, using these investments to underwrite infrastructure costs. Such recycling of public funds into local development was an enduring, if always contested, feature of United States political economy. With devices like publicly owned corporations and sinking funds, government officials had long used state assets to enhance state capacity. Yet over the twentieth century, as retirement systems accumulated the savings of government workers, pensions became an especially powerful tool for advancing public objectives. By the 1940s, pension trustees oversaw funds greater than those managed by all but the largest corporate firms. They used this robust buying power to lower borrowing costs for state and local governments by purchasing municipal bonds. In this way, public pensions indirectly subsidized the construction of roads, sewers, schools, and other infrastructure projects that relied on bond markets for capital financing. These investments, moreover, provided state pensioners with safe, consistent returns for their retirement savings. For a time, the political and economic logics of fiscal mutualism reinforced one another, and this was by design. Before World War II, nearly every state legally restricted public pension investments to federal, state, and local bonds.²

A governing practice rooted in federalist institutions, fiscal mutualism became essential to liberal statebuilding in postwar America, especially the development of all-white suburbia. At the national level, policymakers crafted "grand expectations" of abundant lifestyles for white, heterosexual, breadwinner families, but they delegated the policy implementation to local governments and the bond markets they depended upon. School construction, a quintessentially local function, is a case in point. While federal policies insured the home mortgages that deepened segregation and propelled white families to the metropolitan periphery, local governments remained responsible for public services in new, racially-exclusive suburbs like Levittown, New York. The costliest of these, public education, became an "unfunded mandate" that stretched the fiscal capacity of suburban districts. State officials initially managed the school-building crisis by turning to pension funds. During the 1950s, New York comptrollers purchased school bonds to subsidize school construction, leveraging the market power of

¹ New York State Department of Audit and Control Correspondence, Speech, and Report Files (hereafter: Levitt files), New York State Archives (hereafter: NYSA), Minutes, Meeting of Comptroller's Investment Advisory Council, May 27, 1959 and May 6, 1960, "Retirement—Investment Adv. Comm." folder, box 3.

² For an overview of state-led development, see Scheiber, "Government and the Economy." For the state pension figures, see Andrews, "Retirement Funds in the Financial Structure."

pension systems to hold down interest rates. Fiscal mutualism helped turn the lofty promises of suburbia into concrete realities. It underwrote the infrastructure that made white flight possible.³

But changes in national political economy, along with shifts in the ideology guiding pension stewardship, gradually eroded the structural conditions that enabled fiscal mutualism. During World War II, the combination of rising federal income tax rates and backlogged infrastructure caused the yields of tax-exempt municipal bonds to decline relative to taxable private securities. By 1945, municipal bonds offered less than half the returns of similar corporate bonds. In this context, the financial interests of schools and pensions diverged: whereas school districts sought the lowest possible interest rates on their bond issues, pensioners sought the highest possible yields for their retirement savings.⁴

In this new financial landscape, public pensions shifted their investment strategies. As Levitt complained to the Investment Advisory Council in 1959, the dual obligations of the comptroller—to local governments, as the state’s chief fiscal officer, and to retirees, as the trustee of their pensions—presented him with “perplexing questions of policy.” Levitt and other pension managers resolved this dilemma through the ideology of “fiduciary duty,” a legal concept that evolved in the postwar era to prioritize maximum returns over absolute safety. Faced with similar tensions, state officials across the country lobbied for the liberalization of public pensions, enabling pension managers to abandon local investment in favor of higher-yielding corporate securities. Whereas in 1942 municipal bonds comprised 70 percent of all state pension investments nationwide, by 1957 the figure had dropped to 19 percent. By 1972, it was less than 1 percent. In state after state, fiduciary duty overrode the obligations of local investment. From the perspective of state and local governments, so-called “financialization” did not appear in response to the 1970s economic crises, but unfolded as a continuous and accelerating process throughout the postwar era.⁵

In charting the rise and fall of fiscal mutualism, this article examines an underappreciated transition in how government officials delivered two key pillars of the postwar social contract: secure retirement and modern public schools. This offers a new perspective on the conflicts over public and private welfare provision at the heart of liberal statecraft in the United States.⁶ In postwar America, citizenship carried expectations of rising wages, subsidized homeownership, a

³ Patterson, *Grand Expectations*. On federal housing policies and racial segregation, see Jackson, *Crabgrass Frontier*; Sugrue, *Origins of the Urban Crisis*; Cohen, *A Consumer’s Republic*; Self, *American Babylon*; Freund, *Colored Property*; Connolly, *A World More Concrete*; Taylor, *Race for Profit*; Glotzer, *How the Suburbs Were Segregated*. On unfunded mandates, see Derthick, *Keeping the Compound Republic*, 43-55. In a recent pathbreaking account of municipal debt, historian Destin Jenkins argues that in the postwar era municipal bonds underwrote an “infrastructural investment in whiteness.” See Jenkins, *Bonds of Inequality*.

⁴ On the rise of the federal tax state, see Sparrow, *Warfare State*.

⁵ Levitt files, Minutes, Meeting of Comptroller’s Investment Advisory Council, May 27, 1959, “Retirement—Investment Adv. Comm.” folder, box 3; Andrews, “Retirement Funds in the Financial Structure,” 411-414; Tilove, *Public Employee Pension Funds*, 204-205. On the 1950s liberalization of pensions, see McCarthy, *Dismantling Solidarity*. The decline of fiscal mutualism runs parallel to, but is distinct from, the political conflicts over private pensions McCarthy documents, because public pensions were in the hands of fiduciaries from their inception and public-sector unions only became powerful in the 1960s, after the transition toward what McCarthy calls the financialization of the pension system was well underway. On “financialization,” see Davis and Kim, “Financialization of the Economy;” Krippner, *Capitalizing on Crisis*.

⁶ In the American historiography, liberalism is considered synonymous with the New Deal-era welfare state. Yet as a number of scholars have noted, from a comparative perspective the distinguishing features of the liberal state in the United States were its blending of public and private authority, its decentralized implementation, and its market-based allocation of social benefits. For comparative overviews of liberal statebuilding, see Esping-Andersen, *The Three Worlds of Welfare Capitalism*; Katz, *The Price of Citizenship*; Offner, *Sorting Out the Mixed Economy*.

lifestyle of bountiful consumption, and economic security in old age. To be sure, these benefits were only fully available to white male breadwinners, and scholars have analyzed how entire groups were excluded on the basis of race, gender, and sexuality. Still, less attention has been paid to the mechanisms that actually delivered those privileges. With its fusion of state pensions and local infrastructure, fiscal mutualism reveals how liberal state-builders, when faced with the structural constraints of federalism, relied on markets to allocate social benefits. Indeed, fiscal mutualism made use of markets; it did not supplant them. Although pensions were never the only buyer of municipal bonds, comptrollers acted decisively in bond markets, using them as a private means to support the public ends of school construction. Comptrollers wielded the purchasing power of pension funds to hold down school bond interest rates. In this way, they helped fulfill the grand expectations of postwar liberalism, albeit *through* markets.⁷

At first glance, the underwriting of school construction with pension funds might seem to demonstrate the effectiveness of what historian Brian Balogh calls “the associational order.” Under this arrangement, Balogh argues, American officials expanded governing capacity by appealing “to the logic of the market.” But the associational order was far more precarious than Balogh suggests. As we show, its dependence on markets ceded power to private actors, like the investment bankers at Goldman Sachs, who prioritized their own profits over social welfare provision. Furthermore, not all citizens benefited equally from these arrangements. When municipal bond yields stagnated in the 1950s, public pensions abandoned municipal bonds in search of higher returns. As a result, state pensioners reaped higher yields on their retirement savings, but local governments struggled with higher debt service costs. In short, state retirees benefited at the expense of local school districts.⁸

The unraveling of fiscal mutualism had immediate consequences. Taxpayers in suburban districts paid for their exposure to the bond market with higher property tax rates, driven in part by rising interest rates on municipal bonds. A direct response to the public dependence on private capital, school tax revolts, like the one that rocked New York in May 1959, became a permanent feature of suburban politics. While scholars have depicted suburban tax revolts as either a backlash against civil rights activism or a declaration of antistatist conservatism, we show that many suburbanites turned against the liberal state in response to its fiscal volatility during the prosperous 1950s. Whiteness alone, it turned out, could not protect homeowners from the discipline of creditors. To insulate districts from rising interest costs, New York lawmakers increased their state aid allocations. This promise, however, redirected anger at the state itself, setting the stage for even larger tax revolts in subsequent decades.⁹

⁷ For a useful theorization of governments as market actors, see Hockett and Omarova, “‘Private’ Means to ‘Public’ Ends.” For historical studies on the role of markets in American state development, see Brinkley, *End of Reform*; Balogh, *Government Out of Sight*; Radford, *Rise of the Public Authority*; Williams, *City of Ambition*; Cebul, “Creative Competition”; Jenkins, *Bonds of Inequality*. On the blended, federalist structure of the American welfare state, see Hacker, *Divided Welfare State*; Klein, *For All These Rights*; Steffes, *School, Society, and State*; Chapin, *Ensuring America’s Health*; Amsterdam, *Roaring Metropolis*; McCarthy, *Dismantling Solidarity*; Cebul, Tani, and Williams, “Clio and the Compound Republic.” On group-based exclusions from the New Deal welfare state, see Katznelson, *When Affirmative Action Was White*; Kessler-Harris, *In Pursuit of Equity*; Canaday, *Straight State*.

⁸ Balogh, *Associational State*, 139.

⁹ “Taxpayer Revolt Seen in L. I. Votes,” *New York Times*, May 8, 1959, p. 18. For these interpretations of the 1970s tax revolts, see Self, *American Babylon*; Kruse, *White Flight*; Martin, *Permanent Tax Revolt*; Michelsmore, *Tax and Spend*. For a recent account emphasizing the long-simmering discontent over the “pocketbook squeeze” that culminated in the tax revolts, see Mound, “Stirrings of Revolt.”

Some might question whether fiscal mutualism, as a generalized practice of financing social welfare through public investment, was ever sustainable, given its tenuous balance of competing priorities. Like all mechanisms for allocating social benefits, it involved complex trade-offs: between state retirees and local governments, secure pensions and new schools, future promises and present needs. Before World War II, when interest rates were low and the differential between taxable and non-taxable securities was negligible, the trade-offs remained acceptable for all parties. But as interest rates rose and the yield differential widened, the arrangement became less viable. The costs, to retirees in particular, appeared too high. In other words, fiscal mutualism was contingent. It “worked” in one context and broke down in another. Our interest here is with how policymakers continued relying on this mechanism, even when it no longer appeared viable, and the paths these actors took toward new governing priorities.

In what follows, we examine postwar liberalism from the perspective of the comptroller’s desk, where state officials tried to manage new problems with established governing practices. We begin by outlining the early twentieth century regime of fiscal mutualism, before showing how the suburban school construction crisis stretched this regime to its breaking point. From there, we examine the investment decisions of various New York comptrollers as they balanced the competing demands of pensions and schools. Faced with this dilemma, Comptroller Levitt followed the lead of other pension managers and began lobbying for the expansion of NYSERS’s investment powers. In the concluding sections we trace the consequences of pension liberalization for retirees, school districts, and the fate of the liberal state more broadly. Levitt did continue seeking liberal policy priorities, and state pensioners did benefit from higher returns. Nevertheless, state officials sacrificed their leverage in the bond market, leaving municipal borrowers to navigate its fluctuations on their own.

The Political and Economic Logics of Fiscal Mutualism

The New York State Employee Retirement System (NYSERS) emerged from efforts by Progressive Era reformers to provide civic employees with guaranteed retirement security. The state legislature created NYSERS in 1920 to replace a patchwork of state and municipal pension schemes. Lawmakers organized the plan on an actuarial reserve basis, collecting and investing funds in the present to meet pension obligations in the future. Public employee unions were still in their infancy, and the political conflicts initially centered on whether workers or governments would pay the up-front pension costs, not on the allocation of investments. The state accumulated matching employee and government-employer contributions, which the comptroller held in trust. The law guaranteed state employees—stenographers and civil engineers, social workers and claims examiners—a fixed return on their contributions, initially 4 percent annually. In years when the investments did not reach the return threshold, state and local governments were required to make “deficiency payments” to cover the difference. Although the actuarial math was complicated, policymakers aimed to provide retirees with approximately half-salary at age sixty. This guarantee became more substantial following a 1938 state constitutional amendment mandating that pension benefits, once established, could not be abridged.¹⁰

¹⁰ Clark, Craig, and Wilson, *History of Public Sector Pensions*, 167-202; State of New York, *Report of the Commission on Pensions*, Legislative Document No. 92 (Albany, 1920); Tilove, *Public Employee Pension Funds*, 290. On the origins of public pensions, see Clark, Craig, and Wilson, *History of Public Sector Pensions* and Sterett, *Public Pensions*. On public-sector unionization, see Slater, *Public Workers*; McCartin, “‘A Wagner Act for Public Employees’.”

Consistent with regulations governing most state and municipal pensions, New York's comptroller invested the funds according to a set of preexisting rules designed to encourage financial safety and subsidize local infrastructure. In the 1920s, New York law restricted state investments, including NYSERS's holdings, to U.S. government securities and the debt issues of the state and its political subdivisions. Within these limits, comptrollers invested almost entirely in municipal bonds. Morris S. Tremaine, comptroller from 1927 to 1941, described this strategy in his 1929 *Annual Report*: "I have continued the policy...of investing largely in the bonds of the municipalities of New York State," he wrote, "assisting them in procuring funds for needed improvements at a fair rate of interest when their financial condition warrants their borrowing." As the state's chief fiscal officer, Tremaine used his investment authority to support the municipal bond market while also supervising the borrowing governments. Fiscal mutualism thus contained a deeply political logic: it provided state officers with levers of control over smaller units in the federalist political structure.¹¹

Crucially, public officials never intended bond purchases as a fiscal stimulus. Pension managers needed secure investment outlets, and municipal bonds met this need while also allowing comptrollers to support public infrastructure. In other words, comptrollers did not purchase municipal bonds to create jobs for public sector workers or to stimulate the economy. As Tremaine indicated, he stood ready to support local borrowing only when that support was "needed." Public pensions did not initiate building projects; rather, state officials used pension funds to hold down the interest costs of projects already underway. Fiscal mutualism was, in this sense, pre-Keynesian and associational, a mode of state fiscal governance that appealed to traditions of limited government and market discipline.¹²

Through the end of World War II, state officials across the country shared a commitment to prudential investment and local development, prioritizing safe returns over maximum yields. Public officials and private financiers alike defended the efficacy of municipal bond investments through professional organizations such as the Municipal Finance Officers Association, and its journal, *Municipal Finance*. Pension beneficiaries "are the public officers and employees who can largely influence the fiscal policies of the debtor municipality," argued New York investment banker Cushman McGee in 1944. "Having a personal interest in the financial integrity of the municipality," he continued, "they will exert themselves toward the maintenance of its credit record so that it will pay its bonds." For McGee and others concerned with pension policy, "security of principal" remained the primary objective. Within this framework, pension trustees funneled pension funds into state and local securities, which comprised 70 percent of public pension assets nationwide in 1942, and 86 percent of those held by NYSERS.¹³

¹¹ Clark, Craig, and Wilson, *History of Public Sector Pensions*, 203-217; Calvert, *State Pension Funds*; New York State Comptroller's Office, *Annual Report of the Comptroller* (1930), xvii. Following *King v. Talbot*, 40 NY 76 (1869), New York restricted trustees to a "legal list" of investments. The legal list operated in distinction to the "prudent man rule," developed earlier in Massachusetts, *Harvard College v. Armory*, 26 Mass. (9 Pick.) 446 (1830). For useful overviews of this shift, see Stevenson, "Why the Prudent Man"; Sligh and Taylor, "Statutory Note: Trustee Investment—Legal List."

¹² Certainly, the case can be made that by holding down borrowing costs for local governments, fiscal mutualism encouraged infrastructure building at the margin, acting as an employment stimulus whether comptrollers intended it as such or not.

¹³ Clark, Craig, and Wilson, *History of Public Sector Pensions*, 203-217; Meriam, *Principals Governing the Retirement of Public Employees*, 101-102, 348, 354, 434-437; McGee, "Investments of Retirement Systems," 17; Andrews, "Retirement Funds in the Financial Structure," 411-414; *Annual Report of the Comptroller* (1941), Vol. II, 86-88.

For all its political and economic advantages, fiscal mutualism contained a structural vulnerability. Municipal bond interest payments are exempt from federal taxation, a feature codified with the establishment of the federal income tax in 1913. As a result, municipal bonds consistently offer less interest—and thus lower “yields”—than similarly risky private securities, like corporate bonds. Investors subject to federal income taxes, especially wealthy individuals and financial firms, accept the lower yields of municipal bonds in exchange for their tax benefits. As federal tax rates increase, demand for tax-free municipal bonds increases and yields decline. Public pensions, by contrast, are not taxed, meaning the benefits of tax exemption do not accrue to pensioners. Before the 1940s, when federal income tax rates were low, the difference between the yields on municipal and corporate bonds remained modest. By itself, the yield ratio was not enough to undermine policymakers’ commitment to fiscal mutualism.¹⁴

Nevertheless, fiscal mutualism was always a system under stress. By the mid-1930s, the economic catastrophe of the Great Depression drove down municipal bond yields—both absolutely, and in relation to similarly risky corporate securities—straining the symbiotic relationship between state investors and local borrowers. In New York, the state’s portfolio of local bonds had consistently returned around 4.5 percent through the early 1930s, allowing the comptroller to invest in local municipal bonds while still maintaining the state’s 4 percent guarantee to pensioners. But as municipal bond yields declined, from a nationwide average of 4.3 percent on high-grade issues during the 1920s to 3.36 percent in the 1930s, state officials recognized that the retirement system’s 4 percent guarantee could no longer be maintained with municipal investments alone.¹⁵ “We could foresee almost the exact day when the average yield would drop below the interest rate paid on member contributions,” Tremaine observed in 1939, reflecting on his effort to convince the legislature to liberalize his investment powers.¹⁶

In 1936, state lawmakers authorized NYSERS to invest in mortgages insured by the Federal Housing Administration (FHA), which Tremaine began purchasing the following year. The early spurt of racially exclusive housing development, underwritten by the federal government with FHA-insured mortgages, offered sufficient returns for Tremaine to meet the guarantee to retirees. Even with these new investments, Tremaine continued to portray his strategy as promoting local development, limiting his purchases of FHA mortgages to “property located within the state.”¹⁷

¹⁴ Robinson, *Postwar Market for State and Local Government Securities*, 3-4, 7-9; Homer, “Factors Determining Municipal Bond Yields,” 269-298; Romer and Romer, “Incentive Effects of Marginal Tax Rates,” 278-279; Clark, Craig, and Wilson, *History of Public Sector Pensions*, 205, 212.

¹⁵ Here and throughout, we use nominal yields, rather than inflation-adjusted, real yields. We do so to reflect the conditions as actors understood them at the time. Nominal figures allow for close analysis of how the changing interest rate environment interacted with existing legal and structural constraints. These constraints fall into three main categories. First, comptrollers responded to their legal obligation to exceed the state mandated 4-percent (later 3-percent) *nominal* return on pension investments. Second, pension trustees responded to the relative and absolute differences between taxable and non-taxable bonds. Trustees certainly sought higher yields because of inflation, but they did not calculate yield disparities in relation to inflation. Implicitly, the bond markets were doing that for them. Finally, we do report the real interest rates paid by municipalities, since this ultimately reflected the interest cost for school districts and the tax burden for local residents. In the long run, inflation minimized these costs relative to newer school construction, but Levittown residents and other disgruntled suburbanites could not predict that future.

¹⁶ Homer, “Factors Determining Municipal Bond Yields,” 277-279, 294-295; *Annual Report of the Comptroller* (1935), xx, 290-300; *Annual Report of the Comptroller* (1937), xxi, 292; Tremaine, “New York’s FHA Mortgage Investments,” 3-4; “State Funds Used For Insured Loans,” *New York Times*, Feb. 12, 1939, p. 149.

¹⁷ Tremaine, “New York’s FHA Mortgage Investments,” 3-4; “State Funds Used For Insured Loans”; New York Session Laws (1936), Ch. 354, p. 719-723; Ch. 717, p. 1579-1580; Ch. 805, p. 1705. On the white supremacist administration of the FHA, see Freund, *Colored Property*; Glotzer, *How the Suburbs Were Segregated*. On how the

The bright era of FHA-mortgage investments only lasted until the mobilization for World War II. Comptrollers in New York and elsewhere shifted pension assets into U.S. Treasury bonds, which offered both higher yields and the opportunity to maintain investments in state capacity, now with a national rather than a local emphasis. Federal bonds shot up from 1 percent of the NYSERS portfolio in 1942 to 20 percent by 1944, a trend which repeated across the country. Pension holdings of federal bonds rose from 20 percent of all state pension investments in 1942 to 40 percent in 1944. At the same time, in 1943 New York lawmakers lowered the benefit guarantee to retirees from 4 percent to 3 percent, since it appeared that higher yields would no longer be attainable.¹⁸

Pension managers looked hopefully to the postwar era, imagining that delayed infrastructure projects might generate new opportunities for local investment. But the demands of war finance had fundamentally challenged the economics of fiscal mutualism. During the war, Congress instituted mass income taxation, which hiked the rates paid by the nation's highest earners significantly. The new tax regime widened the gap between taxable and non-taxable securities. At the peak in 1945, the average high-grade municipal bond yielded just 1.2 percent annually, a mere 41 percent of similar corporate securities. The gap would later narrow, to about 75 percent by 1953, but in the postwar era of steeply progressive taxation, it would never close entirely. Into the 1950s, the yields for municipal bonds remained stubbornly below 2 percent. These low rates still appealed to investors in the highest tax brackets but stood far below state guarantees to pensioners.¹⁹

As a result of the widening yield gap, public pension trustees shifted away from municipal bonds, and, where authorized to do so, started investing in bonds issued by non-governmental entities. In New York, the comptroller returned to purchasing FHA-insured mortgages for the NYSERS portfolio, expanding holdings from less than 4 percent of the portfolio in 1948 to over 20 percent in 1951. Over the same period, nationwide non-governmental securities—primarily corporate bonds, but also mortgages, corporate stocks, and other private investments—jumped from 6 percent to 14 percent of public pension assets, beginning a trajectory that would accelerate in subsequent decades.²⁰

The same low interest rates that made municipal bonds unappealing for pension funds encouraged state and local governments to borrow, building widespread expectations for postwar abundance underwritten by cheap credit. Here, the demands of war finance also played a decisive role. Throughout the conflict, the Federal Reserve, in concert with the Treasury Department, held down interest rates to support the market for federal bonds. After the war, with inflation increasing as public and private borrowers competed for credit, the Federal Reserve extricated itself from the Treasury's grasp in March 1951. In the wake of this "Fed-Treasury Accord," the Federal Reserve reasserted its authority over inflation by deliberately hiking interest rates. As the

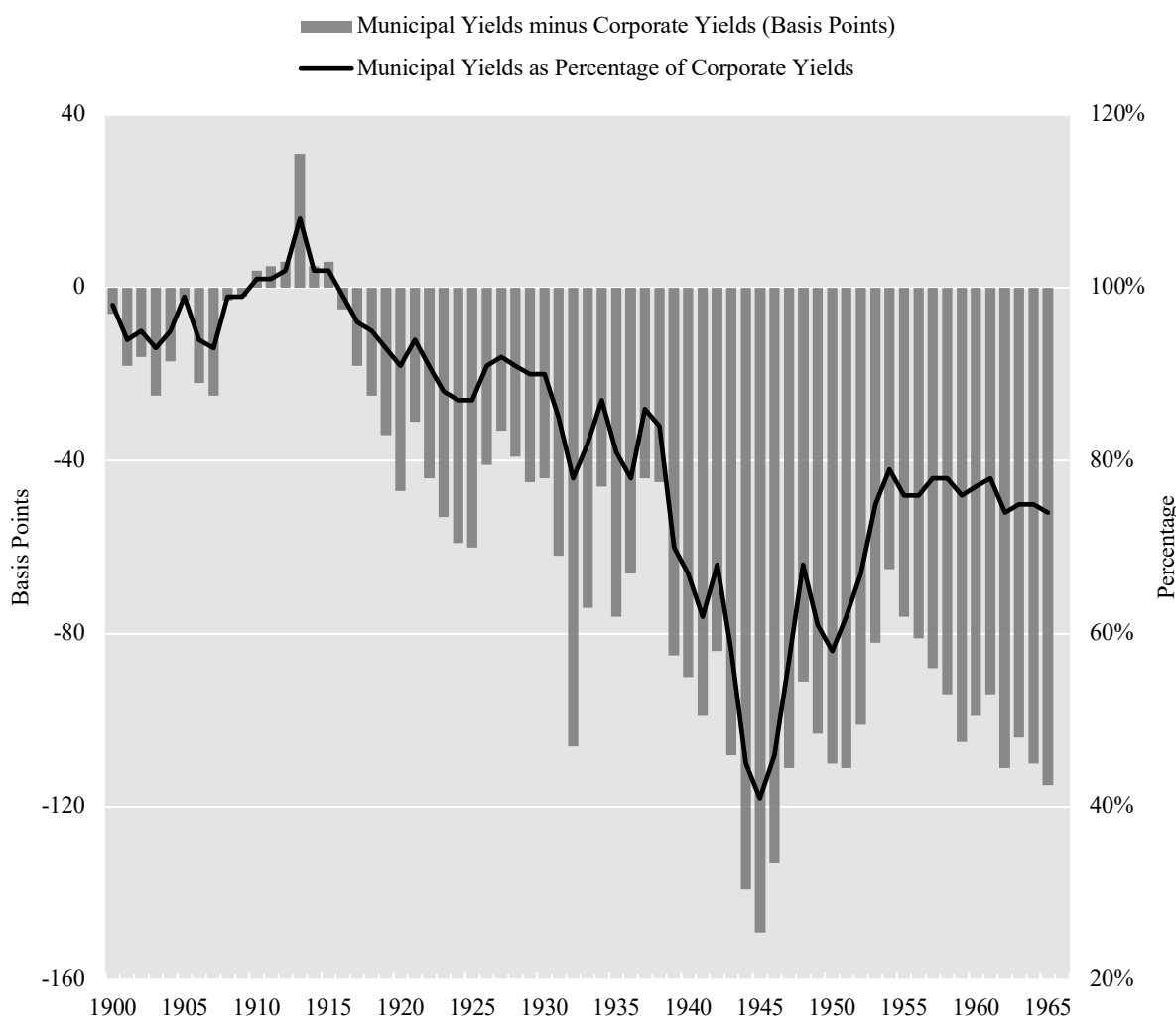
Depression changed trustee investment, see Grosh, "Trustee Investment: English Law and the American Prudent Man Rule."

¹⁸ Homer, "Factors Determining Municipal Bond Yields," 295; *Annual Report of the Comptroller*, 2 vols. (1941), 2:1; Andrews, "Retirement Funds in the Financial Structure," 414, 531; *Annual Report of the Comptroller*, 2 vols. (1944), 2:1-2.

¹⁹ Homer, "Factors Determining Municipal Bond Yields," 279-282, 294-296. On mass income taxation, see Sparrow, *Warfare State*.

²⁰ Clark, Craig, and Wilson, *History of Public Sector Pensions*, 209; *Annual Report of the Comptroller*, 2 vols. (1942), 2:1; *Annual Report of the Comptroller*, 2 vols. (1943), 2:1; *Annual Report of the Comptroller* (1945), 13; *Annual Report of the Comptroller* (1946), 12; Andrews, "Retirement Funds in the Financial Structure," 415, 432-436, 530; *Annual Report of the Comptroller* (1948), 98; *Annual Report of the Comptroller* (1951), 95.

Figure 1. Long-Term Prime Municipal Yields vs. Long-Term Prime Corporate Yields, 1900-1966



Source: Homer, "Factors Determining Municipal Bond Yields," 296.

Note: Before World War II, the relative and absolute differences between municipal and corporate bond yields remained modest. During the war, municipal yields declined sharply in relation to corporate yields. Once bond markets stabilized in the 1950s, the ratio of municipal to corporate yields held relatively steady at just below 80 percent. Nonetheless, the absolute difference between them grew considerably, due mainly to rising inflation and the restrictive monetary policies of the Federal Reserve.

Fed started to battle inflation in earnest, the cost of municipal borrowing increased, threatening the grand expectations for postwar prosperity.²¹

In sum, the war disrupted the *economic* logic of fiscal mutualism on two fronts. First, absolute yields on municipal bonds fell below the state guarantees. Second, municipal yields declined relative to comparable corporate securities. Although a rush of government borrowing would eventually drive municipal yields back up, thus narrowing the yield gap, the ratio of nominal municipal to corporate yields remained below 80 percent throughout the 1950s. Still, the *political* logic of fiscal mutualism remained sound; in fact, it grew stronger as the postwar boom

²¹ Friedman and Schwartz, *Monetary History of the United States*, 593-638, passim.

collided with higher borrowing costs. Public pensions continued to invest in local infrastructure, maintaining a sizeable share of the municipal bond market nationwide. But the shock of the war mobilization had displaced fiscal mutualism as the conventional wisdom. In its place emerged new ideas emphasizing maximum yields over safe returns.²²

Envelopes

One of the least appreciated steps in building a new school involved a pile of envelopes. On a Thursday morning in November 1956, the seven members of the Levittown Board of Education gathered around a conference table. For local government officials, this was what the municipal bond market looked like: a table filled with sealed envelopes, each one labeled “Proposal for Bonds” and carrying a return address from a Wall Street investment bank. In several referendum votes, Levittown taxpayers had authorized \$5.5 million in bond issues, and the proceeds would pay for a new high school and three elementary schools to accommodate the suburb’s rapidly growing population. Architects had drawn the blueprints, politicians had broken ground, and construction had already begun. But until those envelopes were opened, the district would not have the funds to pay the bills. When the board members simultaneously unsealed all of the envelopes, the lowest bid was for a jaw-dropping 4.3 percent interest.²³

The winning bid in Levittown was the highest rate for any school bond sold in New York that year. Just four years earlier, in 1952, the district had sold a \$2.4 million school bond issue for 2.7 percent interest. That difference in rates—between 2.7 percent in 1952 and 4.3 percent in 1956—meant that, over the course of the thirty-year loan, Levittown taxpayers would have to pay an additional \$1.4 million just on interest payments. According to calculations by the New York State Education Department, that sum was the equivalent price of a 900-pupil elementary school. Yet instead of paying for another school building, that \$1.4 million would be diverted to interest payments for bondholders. For Levittown and other rapidly growing municipalities across the country, rising interest rates amounted to a slow-motion disaster.²⁴

The postwar decade witnessed a flurry of new school construction across the United States, as the combination of rising birth rates, growing enrollments, and higher graduation rates stretched the nation’s schooling capacity. The problems, however, were most acute in greenfield suburbs where young white families rushed into new, federally-backed subdivisions. Between 1948 and 1953, the number of school-age children doubled in Nassau County, the Long Island county east of New York City. “Phenomenal growth” in suburban areas, warned the State Education Department, had created “one of the most serious school housing problems of our time.” Political fragmentation compounded the strain: Nassau County alone contained fifty-six separate districts, and each one had to manage the suburban boom independently.²⁵

Levittown remains an infamous example of the exclusionary policies and practices that enforced racial apartheid in new suburbs. The builders, Levitt & Sons, inserted restrictive covenants into every deed, prohibiting occupancy “by any person other than members of the Caucasian race.” Even though the Supreme Court ruled in *Shelley v. Kraemer* (1948) that racial

²² Andrews, “Retirement Funds in the Financial Structure,” 489-492.

²³ “Levittown Plans A \$5,554,000 Issue,” *New York Times*, Nov. 8, 1956, p. 60; Municipal Finance Commission, *Local Finance Law*, 20-21.

²⁴ “School Bond Sales, New York State, Oct. 1956-March 1957,” in *Federal Aid to States for School Construction*, 85 Cong. 1189 (1957); “School Costs Stir State,” *New York Herald Tribune*, Nov. 25, 1956, p. A6; “Interest Rise Deters School Building: Ave,” *Newsday*, Dec. 4, 1956, p. 38.

²⁵ New York State Education Department, *Forty-Eighth Annual Report* (1955), 41; Val Duncan, “LI Schools Face Teacher Shortage, Overcrowding,” *Newsday*, Sep. 3, 1953, p. 44.

Figure 2. Levittown school bond advertisement, 1956

Interest exempt from all present Federal and New York State Income Taxation.

\$5,554,000

**Union Free School District No. 5 of the
Town of Hempstead, New York**

4.30% Bonds

Due serially May 1, 1957 to 1986, inclusive

Legal Investment, in our opinion, for Savings Banks and Trust Funds in New York

These Bonds, to be issued for school purposes, in the opinion of counsel will constitute valid and legally binding obligations of Union Free School District No. 5, payable from ad valorem taxes levied against all the taxable real property therein without limitation as to rate or amount.

Amount	Maturity	Yield	Amount	Maturity	Yield
\$969,000	1957-62	Not Reoffered	\$ 860,000	1970-73	4.05%
515,000	1963-65	3.95%	860,000	1974-77	4.10
710,000	1966-69	4.00	1,640,000	1978-86	4.15

(accrued interest to be added)

These Bonds are offered when, as and if issued and received by us and subject to approval of legalists, by counsel, whose opinion will be furnished upon delivery. The offering circular may be obtained in any State in which this announcement is circulated from only such of the undersigned and other dealers as may lawfully offer these securities in such State.

HALSEY, STUART & CO. INC. GEO. B. GIBBONS & COMPANY <small>INCORPORATED</small> ROOSEVELT & CROSS <small>INCORPORATED</small> BACON, STEVENSON & CO. BLAIR & CO. <small>INCORPORATED</small> PAINE, WEBBER, JACKSON & CURTIS <small>INCORPORATED</small> COFFIN & BURR <small>INCORPORATED</small> R. D. WHITE & COMPANY	SALOMON BROS. & HUTZLER R. W. PRESSPRICH & CO. ADAMS, McENTEE & CO., INC. HORNBLOWER & WEEKS CHAS. E. WEIGOLD & CO. <small>INCORPORATED</small> FRANCIS I. duPONT & CO. FIRST OF MICHIGAN CORPORATION TILNEY AND COMPANY
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November 16 1956

Source: *Wall Street Journal*, Nov. 16, 1956, 16.

Note: This newspaper advertisement announced the sale of the municipal bonds issued by Levittown's school district. Investment bankers call these advertisements "tombstones," since at this point the issue had been purchased by a syndicate of municipal bond dealers, listed at the bottom. Those dealers now marketed pieces of the bond to individual and institutional investors. The interest rate of 4.30 percent was the highest for any school bond sold in New York that year, and it marked a significant increase from prior bond sales sold by Levittown.

covenants were judicially unenforceable and the FHA expunged the explicit racial references from its *Underwriting Manual*, the exclusionary practices continued. After federal officials approved the mortgage insurance for Levittown, many African American veterans waited in line to purchase an affordable home, only for the sales agents to tell them: "This is an all-white community." Civil rights organizations challenged the racist exclusions, but the Levitts and their federal underwriters refused to budge. The postwar era was a time, in the words of historian Arnold Hirsch, when federal officials repeatedly "chose segregation."²⁶

But in so emphasizing the exclusions keeping people out of new suburbs like Levittown, historians have overlooked how the contradictions of the liberal state led to utter chaos for the

²⁶ Biondi, *To Stand and Fight*, 229-233; Sugrue, *Sweet Land of Liberty*, 200-250; Hirsch, "Choosing Segregation."

residents. As they piled subdivisions atop former potato fields, Levitt & Sons prioritized short-term profits over long-term stability, and their shortcuts undermined the viability of the public infrastructure. The company installed individual cesspools rather than sewers, left trash removal to private contractors, and made no plans for a library, a firehouse, or a hospital. Public education, a constitutional obligation of local governments, proved the largest oversight. In full-page newspaper advertisements, the company had trumpeted “brand new schools” as one of the amenities included for “\$58 a month.” The assurance of “no extra charges for anything!” suggested the schools were already built. Upon arriving, people learned they would have to build the “new schools” themselves. As the district’s enrollment ballooned, from 38 pupils in 1947 to over 12,000 in 1953, classes met in church basements, partitioned auditoriums, and the living rooms of model Cape Cods. Instead cooperating to deliver suburban prosperity, the partners in associational governance pushed fiscal responsibility downwards. The federal government insured the mortgages, a private corporation built the houses, and local governments were left responsible for the public services that had been promised in the advertisements.²⁷

The dearth of school facilities was just as severe in other Nassau County districts. In Plainview, all 173 students shared one building: a rickety two-room schoolhouse built in 1898. In Massapequa, officials divided students into “double sessions,” with half attending in the morning and half in the afternoon; even with the staggered schedule, classes still overflowed into a former convent, a rectory, and a firehouse attic. In Wantagh, by the time the district unveiled a new 500-pupil elementary school, its enrollment had swelled to 1,500, requiring a triple-shift schedule on opening day. By 1953, Frederick Tilney, a school finance consultant, saw no end to the crisis: “With some 10,000 houses going up every year, we can expect an increase of 13,000 new kiddies annually.”²⁸

All the “new kiddies” needed new classrooms, but with little state aid and no federal aid available for school construction, districts were forced to rely almost entirely on the municipal bond market. As the New York State Board of Regents declared in 1950, “The problem of financing new school construction should be regarded as a local problem” with funds drawn “from local resources.” Like most other states, New York districts borrowed by issuing general obligation bonds, through which a district pledged all of its taxable real property as collateral for the loans. Before issuing the bond, state law required taxpayer authorization in a referendum. In these elections, voters consented to the property taxes that would repay the loan, plus interest, over an extended period, usually thirty years. Borrowing to build, voters mortgaged their future to pay for new schools in the present. But there was a hitch in the process. After voter approval, officials had two years to advertise the issue to investors, creating a window to float the bond when market conditions were most favorable. Voters thus had no idea what the final interest rate would be when they approved the loan. That came years later, sealed in envelopes.²⁹

Just as school officials turned to the bond market, the surging demand for credit pushed interest rates upwards. In the decade after World War II, the total amount of state and local

²⁷ Redfield, “Impact of Levittown on Local Government”; Patterson, *Grand Expectations*, 70-75; Levitt & Sons, “\$58!” advertisement, *New York Times*, Nov. 20, 1949, p. R3; Union Free School District 5 Minutes, Levittown Public Library, Eleanor K. Brownell, “Report to the Board at Regular Meeting,” Aug. 27, 1952, reel 1.

²⁸ “173 Enrolled in 1898 School Built for 20,” *Newsday*, Feb. 9, 1951, p. 7; Lewis A. Wilson, New York State Education Department Commissioner Subject Files, NYSA, Alfred G. Berner to James A. Webb, Oct. 19, 1951; Florence Virrick to Lewis E. Wilson, Oct. 27, 1951, both from folder 2, box 30; Val Duncan, “LI Schools Face Teacher Shortage, Overcrowding,” *Newsday*, Sep. 3, 1953, p. 44.

²⁹ New York State Commission on School Buildings, *School Building Problem in New York State*, 6-7; New York State Commission on School Buildings, *More Schools for Your Money*, 22-47; Sbragia, “Borrowing to Build.”

bonded debt tripled, from \$15.7 billion in 1945 to \$45.8 billion in 1955. These bonds financed the infrastructural foundation of modern America: roads and bridges, sewers and waterworks, parks and public housing. Education, however, accounted for the largest portion; by 1955, fully one-quarter of municipal bonds were for school construction.³⁰

Within the midcentury context of all-time-high income tax rates, municipal bonds served as tax shelters where the wealthiest Americans could park their wealth and collect tax-free interest payments. But as the total volume of bonds spiked, the supply of tax-free securities exceeded the tax-sheltering demands of wealthy investors, forcing municipal borrowers to pay higher rates to entice investors in lower tax brackets. School districts had to “compete in the open market for available funds,” Arthur Levitt explained in a speech to Long Island school officials, and “increased interest rates [were] the result.” Reflecting this mismatch, nominal yields on municipal bonds rose. In 1945, the average interest rate for a high-grade municipal bond was just 1.67 percent (even as inflation stood at 2.3 percent); by 1955, it had climbed to 2.53 percent (when inflation was slightly negative). In turn, the higher returns demanded by investors translated into significantly greater costs for municipal borrowers.³¹

Along with the secular rise in municipal borrowing costs, the rate an individual district paid depended on how investors evaluated its creditworthiness. Private rating agencies made risk assessments of borrowing districts, appraising everything from aggregate wealth to debt burdens, student enrollment levels to repayment history. This risk assessment process is best understood in comparative perspective. Two Nassau County districts, Levittown and Great Neck, floated bonds a day apart in May 1949, facing nearly identical market conditions. Moody’s Investor Services gave the bonds for Great Neck, one of the wealthiest in the state, an A rating since it was a “well developed...upper middle class community” with “no pressing problems.” Meanwhile, Moody’s rated Levittown, “an unseasoned residential area” that had “grown by leaps and bounds in the last few years,” one notch lower at Baa. In the eyes of investors, Levittown was riskier than Great Neck. As a result, Great Neck sold its \$2.47 million bond to a syndicate of six investment banks headed by the National City Bank of New York for 2.3 percent interest, while Levittown sold its \$1.17 million bond to Roosevelt & Cross, a municipal securities dealer, for 2.7 percent interest. While the difference in rates might seem modest, these inequalities would compound over time. Districts that received higher rates paid more in debt service; the higher repayment costs diminished their perceived creditworthiness, leading to even higher rates in future bond issues. Much as mortgage appraisers assigned letter grades to residential neighborhoods, marking areas as safe for investment based on their racial and ethnic composition, bond raters sorted municipalities into a wealth-based hierarchy. In both cases, risk assessments punished residents in places deemed uncreditworthy.³²

³⁰ United States Department of Commerce, Bureau of the Census, *Historical Statistics of the United States*, 973; Robinson, *Postwar Market for State and Local Government Securities*, 43.

³¹ Interest rates from United States Department of Commerce, Bureau of the Census, *Historical Statistics of the United States*, 1003. Inflation figures United States Bureau of Labor Statistics, “Consumer Price Index for All Urban Consumers.” Quote from New York State Assistant Secretary to the Governor Subject Files, NYSA (hereafter: Asst. Sec. Gov. files), Arthur Levitt, “Problems of School Financing,” speech, Dec. 6, 1956, 3, “Education—School Marketing Bonds,” folder, box 7. On how the tax-free status of municipal bonds facilitated an upward redistribution of wealth, see Jenkins, *Bonds of Inequality*.

³² Government Statistical Corporation, *School Districts of Nassau County*, 13; *Moody’s Bond Survey* 41, no. 20 (May 16, 1949), 470-71; “Providence Issue Goes to Syndicate,” *New York Times*, May 19, 1949, p. 48; “\$2,470,000 School District Serial Bonds for Union Free School District No. 7 of the Town of North Hempstead,” advertisement, *Wall Street Journal*, May 19, 1949, p. 8. On credit rating agencies, see Sinclair, *The New Masters of Capital*; Yinger, “Municipal Bond Ratings and Citizens’ Rights”; Biles, “Public Policy Made by Private Enterprise”; Jenkins,

Districts experienced rising interest rates as a local problem, but state officials sought to shield poorer districts from higher borrowing costs with increased aid payments. Indeed, states—which political scientist Martha Derthrick calls the essential “middle tier” in American federalism—stepped in to manage the conflict between expansive federal policies and the limited capacity of local governments. In 1950, the New York legislature established “Emergency School Building Aid.” Designed as a temporary measure, lawmakers renewed the program on a year-to-year basis before making it permanent in 1956. Under this program, the state reimbursed districts for any interest costs in excess of a baseline tax levy. The state grants effectively placed a ceiling on the amount of debt service each district paid, shifting much of the debt burden to the state. “The main loser on higher interest rates is not the local taxpayer,” concluded a group of consultants surveying Levittown, “but the State itself.” This makeshift arrangement created a direct incentive for the comptroller, as chief fiscal officer, to devise solutions to the problem of rising interest rates in the growing all-white suburbs.³³

School Finance from the Comptroller’s Desk

The strain of rising interest rates was a common experience across the United States. Following the Fed-Treasury Accord in 1951, the Federal Reserve raised interest rates to slow inflation, undercutting the expectations for national prosperity built on cheap credit. Even in the earliest years of the postwar economic boom, rising rates forced policymakers to grapple with the competing promises of postwar liberalism. On the local level, the rise exacerbated disparities between “well developed” communities like Great Neck and “unseasoned” ones like Levittown. It fell to state officials to manage the competing demands, and fiscal mutualism remained the prevailing framework for official market action. As the school construction crisis mounted, the use of pension fund investment to hold down municipal borrowing costs still made political sense.

New York’s patchwork school aid formula, which obliged the state to absorb the interest costs, encouraged Levitt’s predecessor, Comptroller J. Raymond McGovern, to continue investing in local school bonds. Due to “vast increases in school populations in suburban areas,” McGovern noted in 1954, the volume of school issues “was greater than the normal market would absorb.” To “establish an orderly school bond market,” McGovern began directly bidding on school bonds. Unlike the traditional practice of retail buying, where the comptroller purchased municipal securities from bond dealers, in direct bidding the comptroller could set the price by placing a state envelope on top of the pile. The first direct purchase was, fittingly, for Levittown. In the summer of 1953, a “market break” drove up interest rates just as the district floated a \$3.2 million bond. McGovern told the investment bankers that he intended to bid on the issue at 3.3 percent interest. Given the prevailing market conditions and Levittown’s shaky credit profile, the syndicates demurred, claiming they could not resell the bonds profitably at that price. With no other bids, McGovern’s was the only envelope on the table.³⁴

Bonds of Inequality. On a similar dynamic of compounding inequalities from tax preferences, see Ott, “Tax Preference As White Privilege.”

³³ Muriel and Julian Kane Collection, Stony Brook University Special Collections and University Archives (hereafter: Kane files), Government Statistical Corporation, *The History of Financing Education in the Levittown School District, 1947-48 to 1958-59* (1959), 6-7, folder 5, box 4; Temporary Commission on Educational Finances, *Final Report*, 166, 184-186; Derthrick, *Keeping the Compound Republic*, 43-55.

³⁴ *Annual Report of the Comptroller* (1954), 15-16; “State Pension Fund Buys Hempstead School Bonds,” *New York Times*, June 4, 1953, p. 48; “State Controller Wins School Issue,” *New York Times*, Dec. 23, 1953, p. 36.

The Levittown deal was the first of many direct bids by the comptroller. A few weeks later, NYSERS's bid won a \$3.28 million bond issue from a rural, upstate district by offering 3.4 percent interest, underbidding the next-lowest offer of 3.7 percent from a banking syndicate. Over the next year, McGovern directly bid on 228 school bond issues and won 34 of them. In doing so, McGovern enlarged the NYSERS holdings of school bonds from \$9 million in 1953 to \$44 million in 1954—an over fourfold expansion within a single year, which increased the pension's holdings of school bonds from 2 percent to 6 percent of the portfolio.³⁵

McGovern never publicly discussed these purchases, but observers recognized that direct bidding required a tradeoff between investment returns and interest costs. “By underbidding the banking syndicates the Controller is investing the pension fund money of...public employes [sic] at returns less than the going market,” the *New York Times* noted. “On the other hand,” the paper continued, “the under-the-market bidding reduces building costs for fast-growing school districts and thereby reduces, too, the amount of emergency state aid which the Controller must remit to such districts.” In the face of this apparent tension, McGovern remained committed to fiscal mutualism, balancing the competing promises of secure pensions for state workers and modern schools for suburbanites. Still, that balance grew more tenuous. If school bond interest rates rose too high, the comptroller would have to pay the excess interest costs with state construction aid. If rates fell too low, it meant lower returns for retirees, and the comptroller might then have to meet the pension's guarantee to workers with deficiency payments.³⁶

In January 1955, McGovern handed this dual responsibility to Arthur Levitt, who had been elected comptroller the previous November. Nationally, the 1954 midterm elections returned Democrats to control of Congress and several state legislatures following Dwight D. Eisenhower's sweeping victory two years earlier. In New York, the election ushered in the administration of Democrat W. Averell Harriman and, further down the ticket, Arthur Levitt. A career lawyer, Levitt volunteered for military service during World War II, rising to the rank of colonel in the Judge Advocate General Corps. After the war, Levitt dedicated himself to public service and the New York Democratic Club. In 1952 he was appointed to the New York City School Board, the largest system in the nation, and in 1954 he was elected its president. Levitt built his campaign for comptroller on his education experience, calling for increased state support of local schooling. These appeals resonated in strained suburbs, and local papers were quick to notice a connection. “Although his name is the same,” the *New York Times* reported, “the new candidate said he was not related to another Levitt family from Brooklyn—the one responsible for the construction of Levittown on Long Island.”³⁷

Although Levitt advocated for increased state aid on the campaign trail, he remained vague on the specifics. As comptroller, he continued purchasing school bonds with pension funds. But he did so to cultivate, rather than dominate, school bond markets. Unlike McGovern, who bid directly on school issues, Levitt made informal commitments to purchase the securities that investment bankers could not readily sell to other investors. In March 1955, mere months into his tenure, one Long Island district prepared an enormous \$15.5 million issue, the largest school bond ever floated in the state. The local school board urged Levitt to bid directly in order to prevent an exorbitant interest rate. Levitt declined the request, which would have consumed 2

³⁵ “State Controller Buys More Bonds,” *New York Times*, July 1, 1953, p. 44; Paul Heffernan, “Bond Issues Feed the School Plant,” *New York Times*, Sep. 19, 1954, p. F1; *Annual Report of the Comptroller* (1954), 15-16.

³⁶ “State Controller Wins School Issue,” 36.

³⁷ David Beetle, “Comptroller-Elect Cited Many Times for School Board Work,” *Ithaca Journal*, Dec. 9, 1954, p. 10; “Levitt Proposes More School Aid,” *New York Times*, Oct. 1, 1954, p. 14.

percent of the entire NYSERS portfolio. Instead, he held private discussions with the investment bankers organizing a bid for the issue. In advance of the offering, Levitt agreed to purchase \$3 million of the longest-dated, least-desirable securities with pension funds, which helped hold down the final price. A syndicate of thirty-one investment banks purchased the issue for 3.1 percent interest, an outcome that reportedly made the school officials “very happy.”³⁸

The comptroller thus continued to invest pension funds in local school bonds, and in this way adhere to the political obligations of fiscal mutualism. But under Levitt, local school boards could no longer expect an envelope from the state of New York. “I avoided fixing the price,” Levitt told *The Bond Buyer*. “Instead of freezing entire issues in the retirement system’s portfolio,” he explained, “I accomplished the objective of maintaining a market without placing myself in the position of open competition with the investment fraternity.” Levitt’s pivot reflected practical necessity. Even with NYSERS’s assets nearing \$1 billion, he could not finance the entire school boom on his own. He needed the cooperation of Wall Street’s investment banking fraternity, who became more influential as pension assets grew and allocation decisions became more complicated. Levitt nevertheless remained committed to supporting school construction with pension funds. Through purchase commitments, Levitt acquired an additional \$110 million worth of school bonds during his first two years as comptroller, expanding school bond holdings to 8 percent of the portfolio by 1956.³⁹

The rising interest costs, however, became an unavoidable problem. With the economy booming, Federal Reserve officials continued to battle inflation by tightening monetary policy, raising the central bank’s discount rate in April 1956, and then again in August. When these rate hikes pushed interest rates to their highest levels since the 1930s, Democratic politicians lashed out at the policy of “Tight Money.” Monetary austerity, Democrats argued, fundamentally threatened the public priorities that relied on private capital.⁴⁰

Tight Money certainly shocked the school finance system, driving up the price of borrowing at the height of the construction boom. In New York, school bond interest rates soared in 1956, from a statewide average of 2.91 percent in May to 4.08 percent in November. The massive Levittown issue that year punctuated the upsurge. At the sky-high rate of 4.30 percent, it revealed the inadequacy of previous attempts to control interest costs. And it was not an outlier. In the six months surrounding the Levittown deal, sixty-six districts sold a total of \$96 million in school bonds, many of them carrying interest rates over 4 percent. Working within the bond markets, the comptroller could subsidize school construction one envelope or one backroom deal at a time, but he could not halt the secular rise in interest rates. Doing so would require either changing federal monetary policy or reforming the school finance structure.⁴¹

Levitt became an outspoken opponent of Tight Money because, in his view, Federal Reserve policy favored private over public borrowers. He laid out his criticism before Congress’s Joint Economic Committee, which convened in 1956 to interrogate the monetary policies of the Federal Reserve. As interest rates shot up, Levitt observed, local governments bore the extra costs. “The quality of education will suffer,” he warned the committee. Pointing to the debacle in

³⁸ “Levitt Letter ‘Censored’: NHP Civics,” *Newsday*, April 19, 1955, p. 25; “Record School Bonds Sold By District; Board ‘Happy,’” *Newsday*, March 4, 1955, p. 32.

³⁹ “Regional Marketing of N.Y. School District Bonds Under Study,” *The Bond Buyer*, Jan. 12, 1957, p. 4; *Annual Report of the Comptroller* (1956), 15.

⁴⁰ *Conflicting Official Views on Monetary Policy: April 1956*, 84 Cong. (1956).

⁴¹ Asst. Sec. Gov. files, “Average Interest Rates on School District Bond Issues for Upstate New York and Nassau and Suffolk Counties,” April 3, 1957, “Education—School Marketing Bonds” folder, box 7; “School Bond Sales, New York State, Oct. 1956-March 1957,” in *Federal Aid to States for School Construction*, 85 Cong. 1189 (1957).

Levittown, he continued, “when [Levittown] has to pay \$2 million more interest, it means that taxpayers...must dig out of their pockets \$2 million more to pay the cost of the new school building.” Whereas a business or a homebuyer might postpone their borrowing until interest rates dropped, school districts could not wait for more favorable terms. By the time school officials entered the bond market, construction was usually already underway. They did not have the option of holding out for more favorable market conditions.⁴²

While a fierce critic of Tight Money, Levitt hedged on whether public pensions should be part of the solution. As interest rates kept rising, Levitt began to openly articulate the fundamental tension: that the interests of schools and pensioners were in conflict. Levitt promised that he remained “prepared to make emergency purchases” of school bonds, but he also claimed “his duty as the sole trustee of the [retirement] fund made it incumbent on him to obtain the highest return possible.” At a luncheon of the New York State Citizens Committee for the Public Schools, Levitt expanded on this position. The attendees urged Levitt to purchase more school bonds, to which he responded: “I...intervene directly in instances when no bids are anticipated, or when bids are properly rejected as grossly inadequate.” Doing so, he explained, “accomplished the objective of maintaining a market” for school bonds. But he also tempered expectations, stressing his dual responsibility. “I am always mindful,” he added, “of my obligation to the members of the Retirement System to make investments at the highest rates afforded by the market.”⁴³ For pension managers like Levitt, restrictive monetary policy called into question the prudence of municipal bond investments.

Public Employee Pensions and the Quasi-Public Welfare State

Levitt’s call to secure “the highest rates afforded by the market” also reflected disagreement among state policymakers over the purpose of public employee pensions. In the early postwar years, state fiscal officers across the country chafed under investment restrictions crafted to encourage fiscal mutualism. Then, in 1954, Congress extended Social Security coverage to state and local government employees, which forced a reckoning with the “publicness” of state pension benefits in the context of federal social insurance. For Levitt, who had built his reputation as a champion of public education, retirement became a second calling. Before the large-scale growth of public employee unionization in the 1960s, Democratic politicians like Levitt positioned themselves as the elected representatives of state workers. In deliberations about social security extension, Levitt and his colleagues reconceptualized state pension benefits as rewards for individual service rather than social welfare provision, and in doing so they embraced maximum financial returns as the essence of fiduciary duty.⁴⁴

State employee pensions had always been an ambiguous mix of public and private social provision. By the 1950s, many believed New York’s hybrid system, which sought both to reward loyal service and to protect against penury in old age, did not accomplish either. Eager to extend federal benefits to state workers, policymakers began drawing sharp distinctions between federal

⁴² “U.S. Credit Policy Held School Curb,” *New York Times*, April 30, 1956, p. 1; *Monetary Policy: 1955-56*, 84 Cong. 24, 26 (1956) (Statement of Arthur Levitt, Comptroller of the State of New York).

⁴³ Albert Kraus, “State Is Studying School Cost Cuts,” *New York Times*, Oct. 27, 1956, p. 28; “Regional Marketing Of N.Y. School District Bonds Under Study,” 4.

⁴⁴ For the place of public employee unions within state policy debates, compare late 1950s Governors Committee on the Vesting of Pensions and Governor’s Committee on Investment of Public Pension Funds with late 1960s Governor’s Commission on State Employee Retirement System. Levitt files, “Retirement – Vesting Committee” folder; “Kaplan Committee on Pension Funds” folder; “Governor’s Comm. On State Empl. Retire. Syst. (Moore Com.) 1966-1968” folder, box 4.

Social Security and state pensions. In a 1955 report, the State Commission on Pensions argued that Social Security emphasized “social adequacy” by protecting workers and their dependents from destitution. State pensions, by contrast, “deal with each member on an individual basis,” providing benefits for service to an employer. Separating these functions represented a crucial ideological step, allowing policymakers to reconceptualize the purpose of the state retirement system. Levitt sold the proposal by emphasizing that extending Social Security would raise retirement income “in almost every instance.” In doing so, he shifted the rationale for pensions from adequacy to maximization, a strategy that implied maximizing returns on its investments.⁴⁵

The reconceptualization of state pensions as akin to private retirement benefits made it easier to distance pensions from the obligations of fiscal mutualism. As such, the goal of raising retirement benefits dovetailed with pension liberalization. Here, NYSERS was a relative latecomer. Many states already allowed their pension systems to invest some of their assets in private securities, usually conforming to the legal lists authorized for state-regulated financial institutions, such as insurance companies or savings banks. Where allowed, pension trustees diversified into private securities during World War II, when rising federal tax rates widened the yield gap between taxable and non-taxable bonds. Other states responded to low municipal yields by expanding pension investment powers in the early 1950s. New Jersey authorized corporate bond purchases “to obtain investments with a higher rate of return,” while Pennsylvania did so “to meet the state’s guarantee of 4 [percent] interest on pension funds.” New York City followed the same path, in 1953 authorizing the city comptroller to invest in corporate bonds. As public pension managers shifted into corporate assets, they followed the lead of private pensions, which faced fewer regulatory restrictions or pretensions of public service. By the early 1950s, private pensions held virtually no municipal securities and were transitioning their holdings from corporate bonds to common stocks. Public and private pensions were undergoing, as one commentator observed in 1953, “something like a revolution.”⁴⁶

To spark this revolution in New York, Levitt began lobbying for statutory changes that would broaden his investment powers. At his urging, New York lawmakers introduced a bill in 1956 to liberalize NYSERS’s investment authority, allowing the fund to invest 15 percent of its assets in the bonds of highly-rated corporations, like railroads and utility companies, that offered higher yields than municipal bonds. The New York City employee pension and the state teachers’ pension—both institutionally separate from NYSERS—could already invest in certain corporate securities, and the legislature readily adopted the bill. However, Governor Harriman vetoed it. Since the constitution prohibited the state from making loans to private corporations, Harriman worried that the law might be unconstitutional.⁴⁷

Levitt proved more successful in extending Social Security to state employees. After months of internal debate, the Harriman administration put forward Levitt’s bill in November

⁴⁵ Hacker, *Divided Welfare State*, 126-129, 138; State of New York Commission on Pensions, *Report of the State Commission on Pensions*, 17; “Controller Urges Combined Pensions,” *New York Times*, May 16, 1956, p. 37.

⁴⁶ Andrews, “Retirement Funds in the Financial Structure,” 404-408, 414; “Pennsylvania Invests Pension Funds in Corporate Bonds,” *Wall Street Journal*, Jan. 20, 1954, p. 13; “Investments Lift Jersey Funds’ Value by \$88,000,000 in Year,” *New York Herald Tribune*, March 11, 1952, p. 28; Paul Crowell, “City Pension Fund Gets Wider Power,” *New York Times*, May 17, 1954, p. 16; Stevenson, “Why the Prudent Man,” 74. For a contemporary examination of private pension plans, see Committee on Labor and Public Welfare, *Welfare and Pension Plans Investigation*, S. Rep. No. 84-1734 (1956).

⁴⁷ “Bill Would Ease Funds’ Investing,” *New York Times*, Feb. 11, 1956, p. 32; Paul Heffernan, “Huge Funds Tap at Market Door,” *New York Times*, April 1, 1956, p. 131; Paul Heffernan, “Pension Investing Raises Questions On Status of Funds,” *New York Times*, May 20, 1956, p. 171.

1956, which extended social security coverage to state and local government workers. In April 1957, the legislature adopted the plan. With Social Security providing a new benefits floor for state workers, Levitt could seek greater rewards for pensioners. His advocacy, then, for “the highest rates afforded by the market,” reflected at once the failure of pension liberalization and the success of Social Security extension. It also embraced a growing consensus among state fiscal officers—and the investment bankers who increasingly advised them—that fiscal mutualism no longer offered a viable rubric for pension investment. As Wisconsin’s Investment Commissioner explained to a group of state officials at a 1957 conference, “one group suffers at the expense of the other, and my personal inclination is toward the belief that the pension funds do most of the suffering.” Levitt, a keen observer of these debates, was inclined to agree.⁴⁸

The School Financing Authority

Even as Levitt pursued higher returns, he grasped for a durable solution to the school construction crisis. After the Levittown debacle in November 1956, Governor Harriman appointed a committee of state officials and financial executives to study the problem of rising interest rates, naming Levitt its chairman. Ostensibly, the Committee on the Marketing of School Bonds was tasked with developing policy proposals by drawing on the experiences of other states, especially places like California and Pennsylvania that financed school construction with state-backed bonds. As the Committee examined alternatives, however, its deliberations became a forum for assessing the merits of fiscal mutualism.⁴⁹

In January 1957, the committee put forward a plan to restructure the school bond market in New York. The committee proposed a new “State School Financing Authority,” which would purchase the issues of individual districts, bundle them, and then market them together in several large offerings each year. The committee predicted that the combination of risk pooling and increased liquidity that came with larger bond issues would make the Authority bonds more appealing to investors. In this way, explained bond dealer Cushman McGee, “The market can be widened.” The plan proposed a fundamental change in the state’s relationship to bond markets. Under fiscal mutualism, the state used its buying power to shape market demand by purchasing bonds; with the School Financing Authority, it would instead use its selling power to shape market supply by selling bonds in bulk. Under the proposed arrangement, Levitt estimated that the Authority would pay interest rates one whole percentage point lower than the current average. With some back-of-the-napkin math, he predicted \$15 million in interest savings over five years, including \$10 million in Long Island alone.⁵⁰

Not everyone agreed with the committee’s projections. In a memo to high-ranking state officials, the Investment Bankers of America argued that the Authority would, in effect, create a pool of high-risk bonds. Since wealthy districts could obtain lower rates on their own, they had

⁴⁸ “Social Security Bill Covers State Aides,” *New York Times*, Nov. 29, 1956, p. 19; J. E. McMahon, “Pension Law Aids Public Employees,” *New York Times*, April 23, 1957, p. 24; Charles Jacobson, “State Laws Governing the Investment of State Pension Funds,” *Report of the Forty-Second Annual Convention of the National Association of State Auditors, Comptrollers, and Treasurers* (Sept. 1957), 102.

⁴⁹ “Ave Moves to Cut Cost of New Schools,” *Newsday*, Nov. 28, 1956, p. 7; James E. Allen, New York State Education Department Commissioner Subject Files, NYSA (hereafter Allen files), John K. Weiss to Governor’s Committee on Marketing School Bonds, Memo: “Report of Progress as of January 4, 1957,” 10-14, folder 10, box 48.

⁵⁰ Governor’s Committee on the Marketing of School Bond, *Schools for New York*, 13-20; Allen files, Cushman McGee, Memo: “State Authority Plan,” Jan. 25, 1957, folder 10, box 47; Asst. Sec. Gov. files, “Estimated Cost of Construction, 1957-1959, By County,” “Education—School Marketing Bonds” folder, box 7.

no incentive to sell to the Authority. Only the neediest districts would utilize it, and a portfolio of bonds from only the least-wealthy districts would negate any savings. Commercial bankers also objected, though for different reasons. Federal regulations prohibited commercial banks from purchasing the obligations of public authorities. At the time, commercial banks were the fastest-growing purchasers of municipal bonds and shifting school bonds to a public authority would cut them out of the market. With fewer potential investors, a group of legislators concluded, “it is not improbable that the net result of the [Authority] would be to *increase* the overall cost of school financing.” Swayed by these objections, lawmakers never allowed for a hearing, let alone a chamber-wide vote. “School Bond Plan Dies in Committee,” read the headlines.⁵¹

Although the committee never addressed fiscal mutualism publicly, behind closed doors they debated the merits of public pensions buying school bonds. Of all the topics discussed, the anonymized meeting minutes emphasized, “convictions run more strongly on this particular subject than almost any other.” For their part, advocates of fiscal mutualism argued that pension funds “must be invested somewhere and that the public interest is best served by investing them in obligations of New York State and its local jurisdictions.” For the opponents, however, it was “amoral” for the comptroller to “underbid the market” since he “depriv[ed] the State employees of their rightful return on their retirement funds.” The meetings underscored the comptroller’s dilemma. As local officials and state retirees both made claims on NYSERS’s funds, the question could no longer be avoided: Whose interest, the schools or the retirees, was the public interest?⁵²

For the time being, Levitt maintained an unsteady middle course. With the School Bond Authority scuttled and interest rates still climbing, he continued purchasing school bonds, investing an additional \$40 million over the next two years. By 1958, school bonds comprised fully 11 percent of NYSERS’s portfolio. But these purchases, Levitt emphasized at a conference of the Municipal Finance Officers Association of the United States, were merely an “expedient.” While the purchase commitments helped “encourage the submission of bids” from banking syndicates “on issues that would otherwise have gone unsold,” he still refrained from bidding directly. “As sole trustee of the Retirement System,” he avowed, “I am duty bound to seek the highest return the market affords.” Given the persistent yield gap between municipal and corporate bonds, the prevailing ideology now dictated that it was the “fiduciary duty” of trustees to seek the highest investment returns available in the marketplace.⁵³

Despite the wavering rhetoric, therefore, Levitt pursued fiscal mutualism up until the 1958 election. This decision reflected both a pragmatic response to the school construction crisis and calculated support for the Harriman administration. Even as Levitt attempted to extricate NYSERS from these conflicting obligations, he made lower school interest costs and higher pension benefits twin pillars of his reelection bid. Many observers concluded that his thwarted campaign for the School Bond Authority proved decisive in his surviving the Republican wave that swept Governor Nelson Rockefeller and a slate of new legislators into office. Like all Democrats in 1958, Levitt lost in the suburbs; he only managed to not lose as badly as Harriman.⁵⁴

⁵¹ Allen files, Municipal Securities Committee, New York Group, Investment Bankers of America, “Memo re: Committee on the Marketing of School Bonds,” March 20, 1957, 12-13, folder 10, box 48; Memo: “New York State School Financing Authority” [emphasis added], March 30, 1957, 7-8, 10, folder 10, box 47; “Banking Opposition Perils School Bond Plan,” *Newsday*, March 19, 1957, p. 7; “School Bond Plan Dies in Committee,” *Newsday*, March 30, 1957, p. 1.

⁵² Allen files, Weiss, “Report of Progress as of Jan. 4, 1957,” Jan. 7, 1957, 13-14, folder 10, box 47.

⁵³ *Annual Report of the Comptroller (1959)*, 15; Levitt, “Tight Money and Municipal Borrowing,” 21.

⁵⁴ “Arthur Levitt’s Victory,” *Newsday*, Nov. 7, 1958, p. 41.

Fiduciary Finance and Pension Liberalization

Rockefeller's victory backed Levitt into a corner. He survived the election on the strength of his school bond proposal and, as the sole statewide Democratic official, stood poised to lead his party. Still, he needed a broader base of support, and for this he turned to pension liberalization. While the incoming Rockefeller administration sought assistance for gubernatorial projects, Levitt renewed his campaign to expand NYSERS's investment powers. In doing so, he shrouded a potent ideological transformation in the neutral rhetoric of nonpartisan expertise and fiduciary duty. "When you deal with money and investments, political considerations play no part," he said in the days after the election. "It involves personal integrity, skill, devotion to duty. Not politics." He was posturing, of course. Fiduciary language fit the new political landscape. Under a Democratic governor, Levitt had embraced the political logic of fiscal mutualism, even as the economic logic became less tenable. Facing new political calculations under Rockefeller, Levitt became the dour face of market discipline, and this disposition would lead him to the doorstep of Goldman Sachs.⁵⁵

With Rockefeller in office, Levitt continued his campaign to liberalize NYSERS's investment powers. In 1959, the legislature adopted a Levitt-authored bill authorizing NYSERS to invest up to 20 percent of its assets in the bonds of corporations, railroads, and public utilities. Seeking Rockefeller's signature, Levitt emphasized the plan's fiscal advantages. The bill, Levitt argued, would "increase the income to the Retirement System," which "may well lead to the reduction of contributions...[by] the State, as well as an increase in the retirement benefits to our members." The Civil Service Employees Association, the state's main public employee union, endorsed the legislation, which aligned NYSERS's powers with those of other large pension systems. Eighteen states already allowed corporate investments, including Wisconsin, whose state pension held over half of its assets in corporate bonds, and one-fifth in corporate stocks. New York remained a follower in pension liberalization.⁵⁶

The only direct opposition came from local school officials, who recognized that corporate securities would likely replace school bonds in the NYSERS portfolio. The New York State School Boards Association, in a missive to Governor Rockefeller, protested that the legislation "did not [offer] any relief for the high interest rates on school district bonds." Instead, they continued, "the bill...might have the effect of reducing the amount of retirement funds which the comptroller presently invests in school district bonds." As the school officials recognized, liberalization would remove the backstop of state investment.⁵⁷

As the school officials anticipated, Levitt immediately began pursuing higher returns for NYSERS portfolio. To do so, he assembled a new Investment Advisory Council. Comprised of leading financial executives, including Richard S. Perkins of First National City Bank and Charles S. Dickey of Morgan Guarantee Trust Company, Levitt brought the group together to provide "counsel...in the conduct of the System's investment programs." The leader of the group, Goldman Sachs Senior Partner Sidney J. Weinberg, was perhaps the most influential

⁵⁵ Arthur Levitt Oral History Project, Hamilton University Special Collections, John Jay Feeney, "Reminiscences of John Jay Feeney," oral history transcript, 1984, p. 10; Stan Hinden, "On the Inside of Politics," *Newsday*, March 5, 1959, p. 7C; "3 Albany Bills Curb Democrats," *New York Times*, March 14, 1959, p. 15; Arnold Brophy, "A Newsday Profile: The Dems' Sole Survivor," *Newsday*, Nov. 11, 1958, p. 26.

⁵⁶ Warren Weaver, Jr., "Levitt Proposes Own List of Bills for Legislature," *New York Times*, Dec. 15, 1958, p. D1; John T. DeGraff to Roswell B. Perkins, 31 March 1959, at 5; Arthur Levitt to Nelson A. Rockefeller, 7 April 1959, at 14; NYSA, Arthur Levitt to Roswell B. Perkins, 9 April 1959, at 15, bill jacket, L. 1959, ch. 833.

⁵⁷ NYSA, Everett R. Dyer to Nelson Rockefeller, 13 April 1959, at 4, bill jacket, L. 1959, ch. 833.

financier in postwar America. Known as “Mr. Wall Street,” Weinberg advised every president from Franklin Roosevelt to Lyndon Johnson.⁵⁸

Levitt arrived at Goldman’s downtown offices in May 1959 eager to offload the low-yielding municipal bonds. The financiers, however, worked to manage his expectations. “Maximum yield should not be the determining factor at all times,” the bankers told him. They impressed the importance of long-term diversification, emphasizing that the transition to higher-yielding assets would take time. “The diversification of a Fund of this size cannot as a practical matter be changed abruptly,” the committee emphasized. Disinvestment needed to be gradual and strategic. With the school crisis ongoing, the committee recommended maintaining 10 percent of pension assets in school bonds. Given that school bonds still comprised 11 percent the portfolio, the bankers were not advising more purchases. They were simply urging that Levitt take his time with the sell-off.⁵⁹

In addition to investment guidance, the Advisory Council furnished a shield against the Rockefeller administration’s calls to maintain fiscal mutualism. Rockefeller entered office with ambitions for new infrastructure projects in transportation, affordable housing, higher education, and an expanded state office complex in Albany. Each of these ventures required borrowed funds. When Rockefeller’s advisors solicited pension investments, Levitt replied that any loans from NYSERS would have to reflect current market conditions, a stance that his advisors encouraged. In early 1960, for example, Rockefeller requested below-market loans to finance the construction of new state office buildings. Levitt, citing his advisors, responded that “this method of financing” was no longer “advantageous to...the Retirement System.” Snubbed by the pension, Rockefeller turned to unconventional financing techniques, including “moral obligation” bonds and lease-purchase agreements, that carried higher interest costs.⁶⁰

In state capitols across the nation, fiscal officers attempted to extricate themselves from fiscal mutualism’s competing priorities. As state pensions continued to grow, governors and legislators coveted their investment funds, and pension managers found themselves torn between contradictory positions: as pension trustees *and* state officials. At the 1958 Convention of the National Association of State Auditors, Frank S. Szymanski, Michigan’s state auditor, explained how the state’s legislature wanted the pension to finance a new office building at below-market rates. “We have a conflict of interest,” he explained. Other attendees reported similar pressures. Although they expressed support for essential projects like school construction, public investment decisions had been reduced, as one delegate put it, to “the question of yield.” If the returns were in line with alternative outlets, then such financing would be acceptable. Ultimately, most state officers agreed that governors and lawmakers should stop putting them in this position at all. “I think they would be better off,” Szymanski concluded, “if they went into the open market.”⁶¹

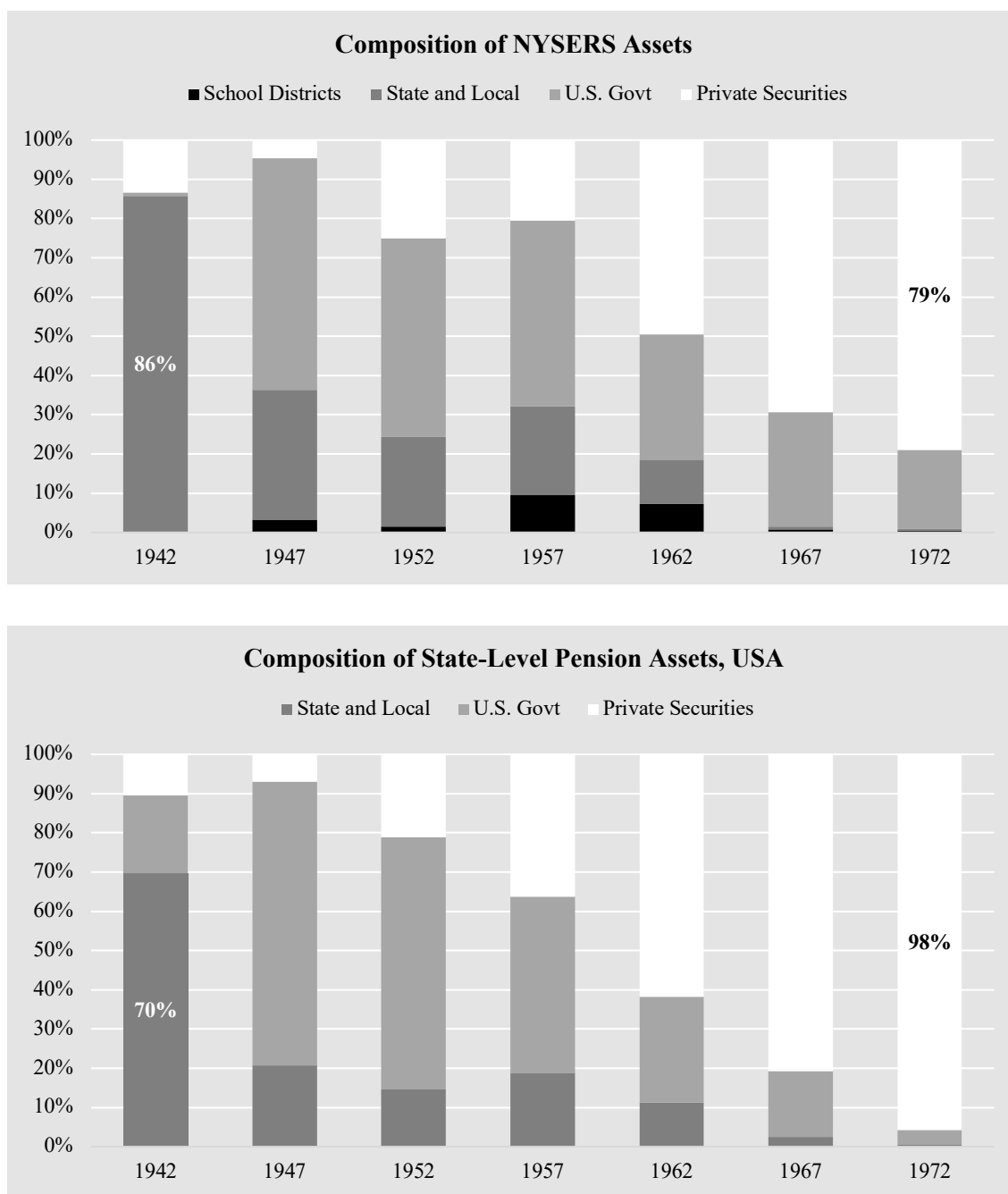
⁵⁸ Levitt files, Press Release, March 18, 1959, “Retirement—Retirement Adv. Comm.” folder; Press Release, May 1, 1959, “Retirement—Investment Adv. Comm.” folder, box 3; Alden Whitman, “Sidney J. Weinberg Dies at 77; ‘Mr. Wall Street’ of Finance,” *New York Times*, July 24, 1969, p. 1.

⁵⁹ Levitt files, Minutes, Meeting of Comptroller’s Investment Advisory Council, May 27, 1959, “Retirement—Investment Adv. Comm.” folder, box 3.

⁶⁰ Levitt files, Minutes, Advisory Council Meeting, September 22, 1959 and May 6, 1960, “Retirement—Investment Adv. Comm.” folder, box 3; Arthur Levitt to T. Norman Hurd, Oct. 11, 1960; T. M. Whalen to Arthur Levitt, Jan. 8, 1964, “Retirement—Constr. State Bldgs with Fund,” folder, box 8; Frank Lynn, “The Rockefeller Years: Governor Hates a Vacant Lot,” *Newsday*, April 16, 1969, p. 10. On the creative financing of these state infrastructure projects, see Bloom, *How States Shaped Postwar America*.

⁶¹ Ottaviano, “Investment of Trust and Pension Funds,” 163.

Figure 3. Public Pension Diversification, New York and USA, 1942-1972



Source: *Annual Report of the Comptroller* (various years); Andrews, “Noninsured Corporate and State and Local Government Retirement Funds in the Financial Structure,” 529-531; Tilove, *Public Employee Pension Funds*, 205.

Note: In New York and in state pension funds across the country, private securities replaced municipal bonds as the dominant asset from 1942 to 1972. In both series, municipal bond holdings increased during the suburban infrastructure boom of the mid-1950s and then declined thereafter. Disaggregated school bond figures are not available in the national data, meaning school bonds are part of the larger category of “State and Local” in the national figure. For the sake of readability, both figures (and associated text) exclude cash assets, which accounted for between 1 and 3 percent of state pension assets throughout the postwar era.

Following the lead of other states, Levitt sought to further liberalize NYSERS's investment powers. In 1960, the legislature acquiesced, authorizing NYSERS to invest in commercial mortgages not insured by the FHA and to place up to 10 percent of its assets in common stocks. "The day when pension systems automatically filled their portfolio by the purchase of government securities and political subdivisions of the State is long past," Levitt wrote in support of the law. Instead, "modern techniques, modern precautions and modern safeguards can well permit the wise pension trustee to diversify considerably and safely to radically raise the income of a public pension system." Fiduciary duty supplanted fiscal mutualism as the guiding ideology of pension investment. With the municipal bond sell-off, New York, like other states, decoupled state investment from local financing, removing one dilemma of postwar liberalism from the comptroller's desk.⁶²

With the 1960 legislation approved, Levitt began remaking the NYSERS portfolio. At their next meeting, the Investment Advisory Council prepared to rid the retirement system of municipal bonds. After reviewing the "sizeable" municipal bond holdings, the Council decided that "since the Retirement Fund does not benefit from tax exemption afforded by these bonds...their retention was not particularly appropriate." The comptroller should dispose of these securities, the Council advised, and "the proceeds of these sales be reinvested in higher yielding taxable bonds and mortgages." Though it would take time to fully disinvest the portfolio, the meeting effectively spelled the end of fiscal mutualism in New York.⁶³

The Permanent Tax Revolt

Just as Levitt began unwinding fiscal mutualism, suburban taxpayers reached their breaking point. In May 1959, the voters of thirty-four districts throughout New York, including twelve in Long Island, rejected their annual school budgets, inciting panic among state officials. While the tally of rejections amounted to only 3 percent of all budget votes statewide, it was still the largest number in the state's history. Levittown encapsulated the frustrations behind the rebellion. Between 1948 and 1959, Levittown taxpayers had authorized ten bond issues to finance eleven new schools, for a total bonded indebtedness of more than \$18 million. Over that decade, the property tax rate had more than tripled—from \$1.80 per \$100 of assessed valuation in 1948 to \$5.88 in 1959—to cover the attendant costs. Even with the additional state aid for debt service, about fourteen cents of every tax dollar still went to repaying bondholders—and not to current expenses, like teacher salaries, classroom supplies, or extracurricular activities. Despite the enormous debt load and the spiraling tax rates, in 1959 every student in first through third grade still attended school in half-day shifts due to a chronic lack of classroom space. The new schools simply could not be built fast enough. Levittown residents had little control over the market fluctuations that added unexpected costs to school construction. They did, however, possess the power to vote "no" on the budget.⁶⁴

The school tax revolt is best understood as a grassroots revolt against the fiscal volatility of the liberal state. Despite their attempts to control interest rates, state officials had failed to

⁶² NYSA, Letter from Department of Audit and Control, April 7, 1960, at 18; Letter from John T. DeGraff to Robert MacCrate, April 12, 1960, at 12, bill jacket, L. 1960, ch. 817.

⁶³ Levitt files, Minutes, Advisory Council Meeting, May 6, 1960, "Retirement—Investment Adv. Comm." folder, box 3.

⁶⁴ "12 LI School Districts Kill Budgets," *Newsday*, May 7, 1959, p. 3; New York State Education Department Division of Research, *School District Voting*, 13; Nassau County Comptroller's Office, *Five Year Cumulative Report*, 49, 52; New York University, *Levittown's Schools and the Future of the Community*, 264, 445; Kane files, District 5 Board of Education, "Fact Sheet on the Site Proposition to be Voted Upon May 6, 1958," folder 3, box 2.

shield suburbanites from fluctuations in bond markets. Comptroller Levitt admitted as much. “This was not a vote against education,” he told reporters as the rejections piled up. It was “a revolt over the rising costs of local government.” A flyer circulated by a slate of school board candidates in Levittown captured the logic behind the protest votes. At the center, the flyer depicted an exasperated taxpayer with money flowing out of both pockets—one for local property taxes, the other for state income and sales taxes—to pay for the glamorous “New Schools” in the background. At the bottom, it asked, “Who *Really* Pays for the Schools?” The flier expressed, in picture form, the popular discontent with the unfunded mandate of school construction. Although the candidates presented no alternatives for how the schools might be financed, they did offer weary taxpayers an outlet for their rage. A vote for them, and against the budget, would supposedly “Stop Wasteful Spending of *Your* Money!” As Salomon Brothers partner Sidney Homer acknowledged, reflecting on the turmoil of the 1950s, “a new school...costs taxpayers dearly, and they know it.”⁶⁵

In the wake of the revolt, state officials instituted several reforms to help districts cope with the still-climbing interest rates. In the immediate aftermath, Levitt announced a new “financial advisory service,” which would help districts participate more shrewdly in bond markets. Local officials could now consult professional investment bankers when preparing bond prospectuses and planning the timing of their issues. Legislators also added another category of state aid to reimburse school districts for “excessively high interest costs.” The legislation defined an “excessive” rate as the statewide average plus one-quarter of one percent; for any interest payments above this level, the state would reimburse the costs. While the reforms offered relief to struggling districts, they pegged compensatory payments to fluctuations in bond markets. Wherever interest rates moved, so moved the definition of “excessive.”⁶⁶

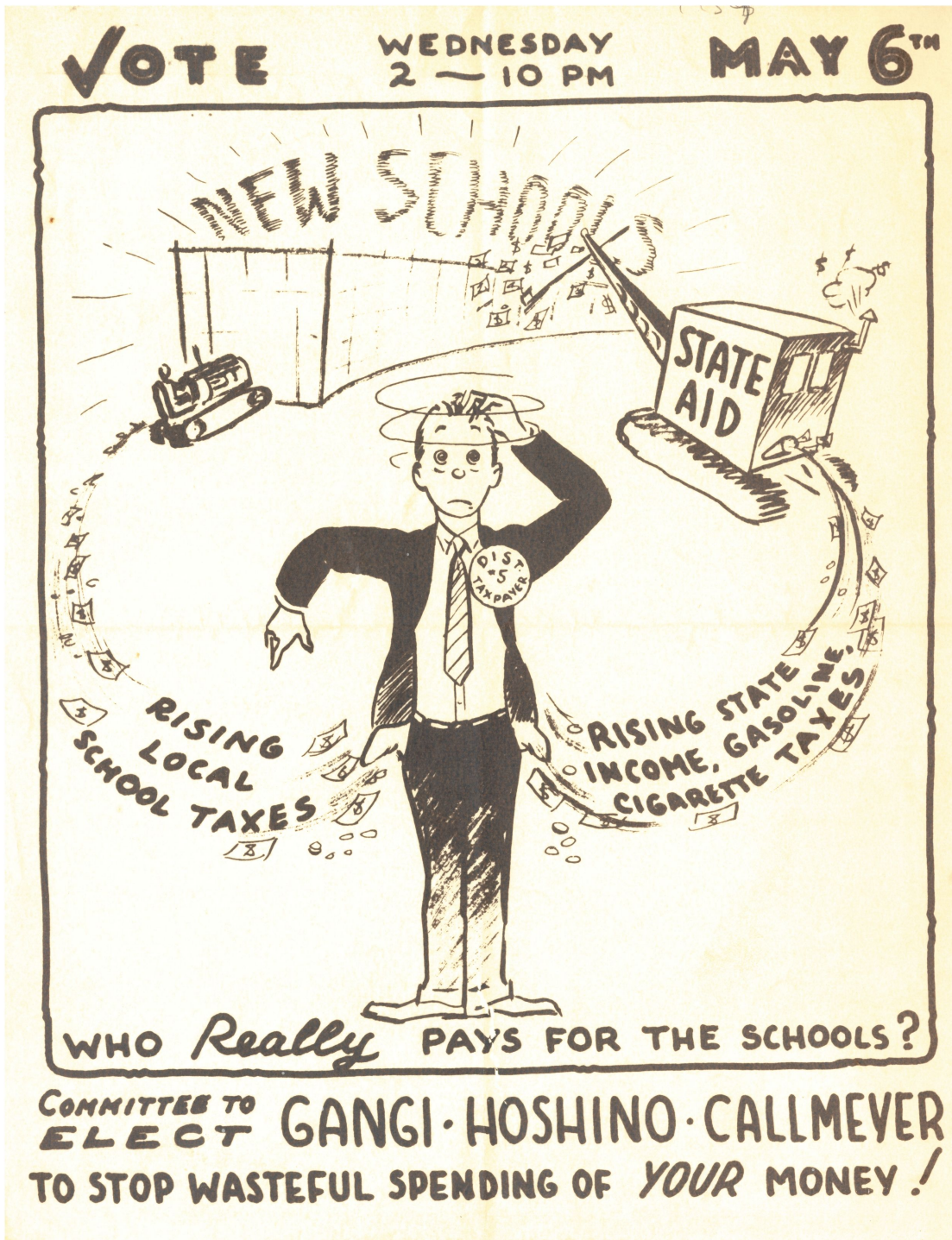
Together, the emergency construction aid, the demise of the School Bond Authority, and the excess interest payments amounted to a state surrender to the bond market. The shift was subtle, though ultimately consequential. Under fiscal mutualism, the state held a direct stake in public infrastructure. Officials used pension investments to shape the bond market. Through risk pooling, the School Bond Authority had aimed to enhance the position of districts with weak credit ratings. State aid payments took a different approach. Rather than attempting to influence the bond market, officials compensated for its fluctuations. Rather than capping interest rates, they absorbed the increases. The combined state aid programs basically promised school districts that the state would insulate them from rising interest costs.

This fiscal volatility was not confined to the suburbs. In New York City, too, the collapse of fiscal mutualism incited panic. Following the liberalization of its investment powers in 1953, the city’s employee pension shifted into private securities. In 1959, 78 percent of its assets were invested in New York City bonds; by 1965, the figure had plunged to 35 percent. The sell-off coincided with the spike in interest rates. During a bond sale in the spring of 1966, the lowest bid the city received was for the steep price of 4.2 percent interest. Writing to the city comptroller, State Assemblyman Bertram Podell requested that the city pension reinvest in city bonds, so as to “give the Banking Monopoly second thoughts as to how far they can milk the people of our

⁶⁵ Frank Johnson, “Say Tax Revolt Shows Need for School Study,” *Newsday*, May 8, 1959, p. 7; Kane files, Information and Education Committee, “VOTE, May 6th,” flyer, folder 2, box 4; Homer, “Factors Determining Municipal Bond Yields,” 276.

⁶⁶ “Levitt to Counsel Schools on Bonds,” *New York Times*, May 14, 1959, p. 50; Subject Files Concerning State Financial Aid for Education, NYSA, Division of the Budget, Research and Fiscal Planning Unit, Memo: “Interest Costs on School District Bonds,” April 15, 1966, 5, “State Aid—Local School Construction,” folder, box 6.

Figure 4. Levittown school board election flier, May 1959



Source: From box 4, folder 2, Muriel and Julian Kane Collection, Special Collections and University Archives, Stony Brook University. Used with permission.

City.” Podell implored, “I believe trustees of union pension funds would also find such City bonds attractive investments.” The city comptroller replied with a curt message: “municipal tax-exempt [bonds] of no value to these funds!!” Podell begged for a revival of fiscal mutualism, but fiduciary duty dictated otherwise.⁶⁷

The Promise of Financial Liberalism

Abandoning fiscal mutualism reconfigured the relationships between school districts, the state government, and bond markets. With investment returns soaring, state officials reimagined the benefits that pensions could offer to employees. Levitt continued to pursue, as he put it in his 1960 *Annual Report*, “maximum yield for the Fund,” selling off municipal bonds and reinvesting the receipts in private mortgages and corporate securities. Moreover, Levitt began campaigning to make NYSERS a completely non-contributory plan. Instead of workers and government employers paying equally into the retirement fund, state and local governments would pick up the entire tab. Higher investment returns created even grander expectations, broadening the public promises of postwar liberalism through the power of financial markets.⁶⁸

The search for higher returns quickly became self-reinforcing. As Levitt offloaded municipal bonds for private securities, NYSERS aggregate yields rose, from 3.35 percent in 1959 to 4.33 percent in 1965. By 1962, the state no longer had to make deficiency payments. Many observers attributed this to liberalization. “Albany has been able to catch up on the pension problem,” the *New York Times* reported, “because of the steps taken...to liberalize the investment powers of the state retirement system.” Higher returns encouraged further regulatory changes. In 1964, the legislature increased the legal limit for corporate bond investments from 20 percent to 40 percent of the total assets. “Higher investment yields...have eliminated the necessity for additional employer contributions,” Levitt argued in support of the legislation. “It is important,” he impressed, “that the present overall investment yield...be assured of continuance insofar as it is possible.”⁶⁹

Even while discarding fiscal mutualism, Levitt hinted that the pension system might still intervene in bond markets. “We don’t intend to get rid of all our municipals,” Levitt told the *Wall Street Journal* in 1962. Despite these reservations, the sell-off proceeded at a brisk pace. In 1958, NYSERS held more than \$350 million in municipal securities; by 1966, it held just \$40 million, all in the high-risk school bonds that Levitt had purchased to buttress the market over the previous decade. In the short run, any further intervention proved unnecessary. During the 1960s, commercial banks surpassed wealthy individuals as the largest buyer of municipal bonds, with many of the bankers represented on Levitt’s Investment Advisory Council bidding on the pension’s bond sales. While interest rates never returned to their postwar lows, this influx of capital steadied the bond market during the 1960s. Because of their tax advantages, Salomon’s Sidney Homer explained in 1966, “municipals were and are a veritable bonanza for all investor

⁶⁷ *State and Local Public Facility Needs and Financing* 89 Cong. 404 (1966); Bertram L. Podell papers, M.E. Grenander Department of Special Collections and Archives, University at Albany, Bertram L. Podell to Mario Procaccino, May 2, 1966, Folder 23, box 1.

⁶⁸ *Annual Report of the Comptroller* (1960), 38.

⁶⁹ *Annual Report of the Comptroller* (1965), 29; “Municipal, School Bonds Awarded by New York State Pension Unit,” *Wall Street Journal*, May 7, 1962, p. 17; “Issues Are Placed by Pension System,” *New York Times*, Nov. 22, 1962, p. 61; “New York Employees Fund Sells \$16,754,000 Of Outstanding Bonds,” *Wall Street Journal*, Nov. 23, 1962, p. 15; Paul Heffernan, “Financing Gains on Pension Funds,” *New York Times*, Feb. 11, 1962, p. 133; NYSA, Arthur Levitt to Sol Neil Corbin, 19 March 1964, at 14, bill jacket, L. 1964, ch. 369.

groups in the corporate [tax] bracket or higher.” But municipal bonds were only “bonanzas” for investors subject to high income taxes, not for tax-exempt public pensions.⁷⁰

With NYSERS yields steadily rising, Levitt began arguing that the retirement system could operate without any cost to workers whatsoever. In 1960, Levitt told a group of public employees that “a pension system entirely paid for by the employer” was an achievable goal. This was a utopian vision, one imagined through markets. After Levitt won reelection in 1962, his advisors urged him to make the non-contributory pension his “No. 1 proposal.” Although the policy took time to enact and implement, by 1966 NYSERS had become a fully non-contributory system. No longer would state workers need to fund their retirement. Instead, financial markets would guarantee their future economic security.⁷¹

As Levitt reconstituted the NYSERS portfolio, state workers ratified the new investment regime. “This is a knotty subject,” one civil service employee wrote Levitt in the spring of 1965, since “the average person has a mystical fear of ‘stocks,’ ‘investment,’ and ‘speculation.’” Nonetheless, after learning about the shift into private securities, many employees grew impatient at the gradual pace of change. Despite the 1960 legislation permitting NYSERS to invest up to 10 percent of its assets in common stocks, by 1965 stocks still accounted for only 3.5 percent of the portfolio. Included with the letter was a petition, titled “To Mr. Arthur Levitt,” and it carried hundreds of signatures. “We, the undersigned participants in the New York State Employee Retirement System,” the petition declared, “strongly urge the investment of at least ten percent of our contributions in common stocks.” This shift in assets, the employees predicted, “will result in considerably enlarging our retirement benefits.”⁷²

Of course, the practice of using pension funds for public priorities never entirely disappeared. Most famously, at the height of the 1970s fiscal crisis in New York City, the public employees bailed out the city by purchasing the debt issues of the Municipal Assistance Corporation (MAC) with their retirement funds. By 1978, the six major city pensions held fully two-fifths of their assets in MAC bonds. These investments kept the city running and held down borrowing costs. Yet since the city pensions did not pay income taxes, the massive holdings of tax-exempt bonds diminished the investment returns for retirees. “It was blackmail and unfair,” declared Albert Shanker, head of the city teachers union, “but the price of not acceding [to the pension bailout] would have been the destruction of the city.” Whereas the city pensions had once funneled the bulk of their assets into city bonds, Shanker’s anger is a testament to how, following pension liberalization, workers demanded maximum returns for their retirement savings. Anything less was “unfair.” Meanwhile Levitt, who remained in office until 1978, resisted investing any NYSERS money in the city bailout, returning again and again to the ideology of fiduciary duty. “We do not buy ta[x]-exempt bonds,” he scoffed.⁷³

⁷⁰ “New York Employees Fund Sells \$16,754,000 Of Outstanding Bonds,” 15; “New York Pension System Sells \$24,982,000 of Bonds,” *Wall Street Journal*, Dec. 12, 1963, p. 24; Martin Arnold, “Battle Waged in Albany to Control Pension Funds,” *New York Times*, March 14, 1966, p. 1; Crowder and Wohar, “Changing Long-Run Linkage between Yields,” 107; Homer, “Factors Determining Municipal Bond Yields,” 271, 274.

⁷¹ “Pension Gain Sought,” *New York Times*, Sep. 2, 1960, p. 6; Levitt files, I. S. Hungerford to Advisory Council, Nov. 28, 1960, “Retirement—Retirement Adv. Comm.” folder, box 3; Leon Braun to Arthur Levitt, Dec. 4, 1962, “Braun, Leon,” folder, box 1; “Battle Waged in Albany to Control Pension Funds,” 1.

⁷² Levitt files, Paul Payne to Arthur Levitt, March 27, 1965; “To Mr. Arthur Levitt,” petition, [n.d.], box 2.

⁷³ Freeman, *Working-Class New York*, 267-270, Shanker quote on 268; Steven R. Weisman, “A Quandary for Levitt,” *New York Times*, Oct. 2, 1975, p. 1; Levitt quote from Linda Greenhouse, “Levitt Vetoes M.A.C. Sales to State’s Pension System,” *New York Times*, July 25, 1975, p. 36. For a comprehensive account of the New York City fiscal crisis, see Phillips-Fein, *Fear City*.

Conclusion

When NYSERS was established in 1920, political conflict centered on employee contributions. Would retirement be financed from the take-home pay of workers or directly from the state budget? The investment function was taken for granted. Through legally prescribed investment powers, the state channeled pension funds into municipal bonds. Balancing the interests of state retirees and governmental borrowers, comptrollers subsidized public infrastructure. For nearly three decades, fiscal mutualism satisfied a range of constituencies by prioritizing public investment and the safety of invested principal, rather than maximum returns to the pension portfolio. But as political and economic conditions changed, this arrangement unraveled. In the mid-1960s, with the mutualist regulations stripped away, pension conflict shifted from who should make contributions to who should reap the gains of riskier investments. The expansion of public sector unions and new collective bargaining rules only increased the incentives for employers to resolve present disputes by making promises about the future. With the reconstitution of NYSERS as a contribution-free system, officials and pensioners depended on markets to deliver on those promises. Indeed, workers came to demand it.

The demise of fiscal mutualism produced divergent outcomes for public pensions and public schools. After a period of lower interest rates in the early 1960s, school bond rates shot up even higher, from a nationwide average of 3.67 percent in 1965 to 6.39 percent in 1969. The state, however, was no longer an active player in bond markets; the districts had to pay the going interest rate. State officials felt powerless. “[T]here is not very much we can do to lower interest costs,” a Rockefeller aide complained in a 1969 memo. To help districts meet these costs—as well as rising salaries and operating expenses—lawmakers increased state school aid, which by 1970 accounted for over one-third of the state budget. But the state’s support of local schooling did not extinguish the tax revolts. Instead, it inflamed them, as overstretched taxpayers directed their rage at Albany lawmakers. In what became an annual plea for greater state aid, about one-fifth of school districts rejected their budgets every spring through the 1970s. “The problems encountered today in attempting to finance an educational system...are not new,” Levitt sighed in 1971, “but they are growing more complex each year.”⁷⁴

Levitt’s exasperation at the education system’s market dependence contrasts sharply with his enthusiasm for NYSERS’s position as a powerful market actor. This enthusiasm proved consistent with broader efforts to reimagine the social contract with capital at its center. To circumvent stockbrokers and their high trading fees, Levitt sought a seat on the New York Stock Exchange in 1971. Although unsuccessful, the move helped precipitate the deregulation of brokerage commissions, part of the gradual reordering of the financial system around the interests of large, institutional investors—including the pensions of public-sector workers. Across the country, pension managers employed similarly aggressive tactics, seeking to maximize returns by broadening their investment strategies. Like private corporations, “shareholder value” became their primary responsibility. Despite the immense power of large pensions like NYSERS, the retirement security of individual pensioners became tethered to unpredictable financial currents. As went the stock market, so went their retirement portfolios.

⁷⁴ United States Department of Health, Education, and Welfare, *School Bond Sales for Public Purposes*, 11; Robert R. Douglass Files, Series 10, Rockefeller Archive Center, Lewis Bart Stone to Robert R. Douglass, Memo: “State Bonding Authority for School District Bonds,” 2, Oct. 2, 1969, folder 162, box 15; New York State Commission on the Quality, Cost and Financing of Elementary and Secondary Education, *Final Report*, 2D.2, 2.65-2.67; New York Department of Audit and Control, *Financial Data for School Districts* (1971), v.

Ultimately, deregulation has largely delivered for New York pensioners, though not always for the retirees in other systems. NYSERS has so far avoided the chronic underfunding and high-risk investments that have led many public pensions into crisis.⁷⁵

Instead of being tied together in a shared project of social welfare provision, pensions and schools both grew more dependent on financial markets during the postwar era. Their fates diverged, as the liberalization of pension investment benefited state retirees at the expense of perpetually indebted school districts. This divergence was a long-term process, the culmination of choices made during the prosperous 1950s, well before the overlapping crises of the 1970s. In this light, later events, like the New York City fiscal crisis, which are often depicted as signaling the arrival of a new neoliberal era, are better understood as the outgrowth of gradual institutional changes. In other words, the fiscal crisis did not create the public dependence on private capital. It merely revealed the dependence that had been growing for decades. Excavating the regime of fiscal mutualism, then, is a call for scholars to look more closely at liberalism when it seemed to be functioning as they seek to explain why many of its promises have since collapsed.⁷⁶

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⁷⁵ Richard Phalon, "State Pension Fund Wants Stock Seat," *New York Times*, Mar. 3, 1971, p. 57; "A Report on Ten Other State Pension Funds," *Institutional Investor* (Feb. 1970), 45-47; Munnell, *State and Local Pensions*. On the rise of "shareholder value," see Davis, *Managed by the Markets*.

⁷⁶ On the New York City fiscal crisis, see Phillips-Fein, *Fear City*. For a similar argument about long-term processes, see Cebul, Geismer, and Williams, "Beyond Red and Blue."

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