

# **NEW YORK CITY'S FISCAL PROBLEM: Its Origins, Potential Repercussions, and Some Alternative Policy Responses**

**Background Paper No. 1  
October 10, 1975**



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Table 7 - New York City Compared to Other Large Central Cities

Page 16  
Column (4)  
Local Government Employment  
Per 10,000 Population 1974

City	Subcolumn (c) Common Municipal Functions***
New York	263.7
Boston	249.2
Chicago	250.1
Newark	304.6
Los Angeles	256.0
Philadelphia	301.5
San Francisco	244.4
New Orleans	271.3
St. Louis	227.8
Denver	280.9
Baltimore	312.5
Detroit	258.6

\*\*\*Common Municipal Functions include elementary and secondary education, highways, police, fire, sanitation, parks, general control and financial administration.

Page 17  
Column (5)  
Public Employee Average  
Salaries 1974\*\*\*\*

City	Subcolumn (a) Teacher
New York	\$17,018
Boston	13,938
Chicago	17,409
Newark	13,720
Los Angeles	13,058
Philadelphia	12,800
San Francisco	14,855
New Orleans	8,715
St. Louis	14,894
Denver	13,505
Baltimore	10,488
Detroit	18,836

\*\*\*\*Estimated from the October 1974 payroll per full time equivalent worker for each function. To the extent possible, Census estimates for teachers have been adjusted to reflect annual salaries whether payment is on a ten or twelve month basis.



## PREFACE

New York City's Fiscal Problem is the first in a series of Background Papers issued by the Congressional Budget Office. It was prepared in response to a request from Congressman Thomas L. Ashley of the House Committee on the Budget for background information on the problems confronting New York City and their national ramifications. It is anticipated that Background Papers dealing with topics that are of considerable interest to the Congress and that potentially could affect the economy or the federal budget will be issued at irregular intervals by the Congressional Budget Office. In keeping with CBO's mandate to provide nonpartisan analysis of policy options, the report contains no recommendations. This paper was prepared by Robert D. Reischauer, Peter K. Clark, and Peggy L. Cuciti.

Alice M. Rivlin  
Director

October 10, 1975

## SUMMARY

New York City's immediate crisis has been precipitated by its inability to borrow in the municipal bond market. Since April when this market closed for the city, a series of stopgap measures have provided the city with the funds it needed to avoid default. The aid provided by the latest of these measures -- the New York State Financial Emergency Act -- will run out in mid-December, if not before, and there are indications that the city and the state may be either unable or unwilling to take the drastic additional steps required to stave off default any longer.

New York must borrow now -- not because it requires funds to finance its long-term capital improvement program, but rather to refund its huge short-term debt. The bulk of this debt is attributable to deficits that the city has run in its expense budget over the past decade. It is estimated that the city's deficit for fiscal year 1976 alone will be over \$700 million.

With respect to the size of its short-term debt and its tendency to run current account deficits year in and year out, New York City is clearly unique. However, in other respects, New York resembles many of the other large cities of the northeast and northcentral regions. Like them, New York has been subject to pressures for increased spending while its tax base has eroded. However, unlike many of these jurisdictions, New York's revenues and expenditures are unusually sensitive to business cycles and the city has been required by New York State to shoulder an extremely high fraction of its welfare-related expenditures.

Discussion of the impacts of a default by the nation's largest city must be speculative both because there are no precedents for such a default and because much will depend upon the responses of public officials and investors. While severe national economic repercussions are possible if New York defaults, it is also possible that the effects outside of the New York area will be minor. The default procedures established by the New York State Financial Emergency Act call for the ultimate repayment of all principal and interest. In the period before a fiscal reorganization plan could be successfully implemented, some loss would be suffered by those who were forced to sell their New York City securities, but over the long-run the city's obligations are very likely to be met. The short-run impact of a default on banks would probably be moderated by the announced policies of the Federal Reserve System and the FDIC.

So far as other municipalities are concerned, the chief danger is that a default by New York could cause investors to desert the

municipal bond market. If this happened, other jurisdictions that rely on continued access to this market would have to pay higher interest rates and could be forced into temporary default as well. In addition, if New York State, by aiding the city, is forced into the city's predicament, the overall repercussions will be substantially greater.

There are a number of policies that could stave off a default by New York City, but these will require the participation of other levels of government. There is probably little New York City could do on its own that would restore investor confidence to the point that the city could soon reenter the municipal bond market. The state-dominated Emergency Financial Control Board has been given control over New York City's finances and is charged with presenting a three-year financial plan for the city which includes a balanced budget in fiscal 1978. This plan will undoubtedly call for sharp cuts in the city's budget -- cuts that themselves may cause substantial problems for the city and the long-run erosion of the tax base.

Since it seems unlikely that New York City or the Municipal Assistance Corporation will be able to reenter the bond market in December, only additional state or new federal actions will avoid a default. The state could provide the city with grants, borrow in the city's behalf or assume the responsibility for financing some programs such as welfare or higher education that are now borne by the city. The federal government could step in and provide immediate relief for the city through increased grants, direct loans to the city, bond guarantees, or bond reinsurance. Combinations of city, state, and federal policies are also possible.





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## 1. THE BACKGROUND

New York City's current budget problems have been precipitated by its inability to borrow money in the municipal bond market. Since March, when New York was last able to sell notes on its own behalf, a series of stopgap measures have been used to keep the city solvent. First the city was advanced some \$800 million in state aid that it was scheduled to receive after the start of the fiscal year in July. Next, on June 10, the state established the Municipal Assistance Corporation (MAC) to serve as an interim borrowing agency for the city, in order to transform much of New York's short-term debt into long-term obligations. Originally, MAC was authorized to borrow \$3 billion, an amount sufficient to tide the city over until October. It was hoped that by this time the city would be in a position to reenter the bond market on its own.

While new city securities were unmarketable, it was anticipated that MAC bonds would be viewed differently by investors: first, because they were being issued by an agency of the state and carried with them the "moral obligation" of the state to meet any shortfall in debt services;<sup>1</sup> second, because the revenues from the city's sales and stock transfer taxes were to be diverted directly to the corporation to cover its debt service costs; and finally, because the city was directed to reform its financial practices and balance its budget under a new, state-approved accounting system.

In spite of these assurances, MAC immediately encountered difficulty borrowing for the city. Although MAC's first issue bore unprecedented tax-exempt interest rates of up to 9.5 percent, it could be marketed only with difficulty, even after a number of banks and insurance companies agreed to buy two-thirds of the total. When these bonds were freed from the sales price restrictions placed on them by the underwriting syndicate, they immediately plummeted in value, confirming a lack of investor interest in MAC bonds. In August MAC was able to borrow less than half of its planned offering, even though the

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1. A "moral obligation" requires the governor to include in his proposed state budget funds sufficient to cover any shortfall in debt service. This does not legally bind the legislature to appropriate these funds as would be the case of shortfalls associated with securities backed by the state's "full faith and credit."

new issue carried interest rates of up to 11 percent.

As August wore on, the New York clearing house banks that usually market New York City offerings became more reluctant to underwrite new MAC issues because these institutions were experiencing increasing difficulties reselling the bonds they already held to other investors. They found themselves holding more city obligations than they considered to be prudent banking practice. Thus in September MAC found itself in the situation that had faced the city in April -- unable to find a syndicate that would underwrite its borrowing.

The next stopgap measure was the Financial Emergency Act, which was approved by a special session of the state legislature and signed by the governor on September 9. This legislation was part of a plan to provide the city with roughly \$2.3 billion -- enough to meet its cash requirements through early December, by which time it is hoped the other elements of the plan will allow the city to reenter the bond market on its own. The key element in the plan is the Emergency Financial Control Board which is dominated by state appointees and charged with administering the city's finances. By late October this board must approve a three-year financial plan that includes transition to a truly balanced budget by fiscal year 1978, a reduction in short-term city borrowing, the removal of expense items from the capital budget, and a growth in controllable spending (all but welfare, pensions and debt service) of not more than 2 percent per year. The board is also given the responsibility for estimating the city's revenues and keeping spending within these revenue limits; reviewing and approving major contracts; approving all city borrowing; extending, if necessary, the pay freeze on city employees through fiscal year 1977; and dispersing city revenues, but only after it is satisfied that the expenditures are consistent with the three-year fiscal plan. The powers of the board extend to the city's semi-independent agencies which provide elementary and secondary education, higher education, hospital, and other services.

As with MAC, the emergency assistance plan ran into difficulties soon after it was put into effect, giving rise to concerns that this stopgap measure might not be sufficient to keep the city solvent even until December. Banks, insurance corporations, and private investors have not agreed to buy the full \$406 million in MAC bonds that the plan calls upon them to purchase. Some of the city and state pension funds, which are legislated to supply \$755 million of the \$2.3 billion total, have balked at investing in MAC bonds. The state pension funds have obtained a New York State Court of Appeals ruling, which states that, despite the provisions of the Financial Emergency Act, they cannot be required by legislation to purchase MAC bonds. Finally, the state, which has agreed to loan the city \$750 million, has encountered increasing difficulty in borrowing.

Although these notes were backed by the "full faith and credit" of the state, the state was forced to pay 8.7 percent on the first notes

issued to aid the city. Next, Standard and Poor's, which rates the risk associated with various municipal bonds, warned that, if the state extended more assistance to New York City than that called for in the emergency plan, it would be compromising its fiscal integrity and jeopardizing its high credit rating. Finally, Moody's Investors Service, another organization that rates bonds, withdrew its rating from the state's Housing Finance Agency, effectively squeezing this agency out of the municipal bond market and leaving it dependent upon the state for capital.

Moody's also lowered its rating of New York state and city securities. Thus it seems possible that, if it increases its support for the city, the state of New York may find itself in the same situation that faced the city in April and faced MAC in September. Yet, without further state involvement, it is unlikely that either MAC or the city will be able to market bonds after November. If this is the case, then for the third time this year New York City will be denied direct or indirect access to the municipal bond market. But why does the city need to borrow? And what would occur if continued access to the bond market were denied?

## II. THE CITY'S NEED TO BORROW

While most state and local governments borrow money, many can postpone issuing bonds or notes for a few months or even for an entire year if conditions in the municipal bond market appear to be adverse. However, New York City's situation makes such a delay impossible. In fiscal year 1976, the city's anticipated borrowing requirements are approximately \$8 billion. This borrowing has three different purposes.

Capital Projects. First, like almost all state and local governments, New York City borrows to finance capital projects. Generally long-term bonds are issued to pay for the construction of schools, public buildings, highways, sewers, and similar projects. The accepted rationale for financing such facilities with long-term debt is that all of the taxpayers who will benefit from such long-lived facilities should pay for them, and such payments should be made in installments during the facility's usable life span. As of June 1, 1975, New York City had \$9.4 billion outstanding in long-term debt, the great bulk of which was backed by the city's "full faith and credit" through a first lien on tax revenues. A small portion of the debt was offset by money deposited in sinking funds. This debt represents roughly 6 percent of the nation's total long-term municipal debt.

Short-term bond anticipation notes are used by some states and local governments to support the construction phase of a project or to avoid borrowing in the long-term market when interest rates are abnormally high. New York has depended heavily upon issuing such notes, \$1.6 billion of which it had outstanding on June 30, 1975. Frequently the city has made little or no effort to substitute long-term borrowing for such bond anticipation notes, preferring instead to "roll over" or refund these obligations periodically. This has made New York particularly dependent upon continued access to short-term credit markets.

While long- and short-term borrowing for capital projects is accepted practice, there is evidence that in recent years New York has misused such borrowing authority by placing approximately \$700 million worth of items, which appropriately belonged in its operating budget, into the capital budget. This was one of the "gimmicks" the city used to present a "balanced" operating budget.

According to the city's budget, it planned to issue roughly \$2 billion in new obligations to support capital projects and to "roll over" between \$1.2 and \$1.8 billion in bond anticipation notes in



fiscal year 1976. If the city were unable to borrow for these purposes, its large capital improvement and construction program would eventually grind to a halt, causing a general deterioration of the city's stock of public buildings and facilities and exacerbating unemployment in the construction industry. Possibly of more immediate significance would be the necessary termination of the operating budget items that have been hidden in the capital budget.

Expenditure and Revenue Flows. The second purpose for which New York borrows is to match its income flow to its expenditure pattern. Spending occurs at a fairly regular pace throughout the year, driven by payrolls and welfare payments that must be met bimonthly or monthly and by the steady purchase of the goods and services required to keep city programs operating. Revenues, on the other hand, come in at more infrequent intervals. For example, property taxes are collected quarterly, state and federal aid may be paid quarterly or even annually. Lacking large unencumbered cash balances, New York, like some other states and municipalities, issues tax and revenue anticipation notes to tide itself over until the taxes or other revenues are obtained. If it operated in a prudent fashion, New York could be expected to require approximately \$1.5 billion in short-term debt in fiscal year 1976 for "legitimate" revenue anticipation purposes ("legitimate" in the sense that these notes could be repaid by revenues collected during the fiscal year). Without access to such borrowing, the city would have to reshape its expenditure pattern to that of its receipts or to build up cash balances sufficient to tide itself over periods of low revenue inflow.

Short-term Notes for Deficit Financing. The final purpose for which New York City needs to borrow in fiscal year 1976 is to "roll over" or refund \$2.6 billion in outstanding short-term notes and to finance this year's \$726 million projected current account deficit. The \$2.6 billion represents the accumulation of the past decade's operating deficits which have been financed each year primarily by issuing more revenue and tax anticipation notes than could be covered through actual revenue collections. The existence of this large short-term debt and the magnitude of the current deficit mean that New York must borrow every month or so regardless of how unattractive market conditions may be to "roll over" the part of its short-term debt coming due and to finance its monthly shortfall between current revenues and expenditures. The only alternative would be to repay the principal and interest due out of current revenues. The impracticality of this approach can readily be seen by the fact that it would absorb roughly half of the city's annual tax revenues, leaving little to support essential public services.

New York City had \$5.3 billion of short-term notes -- 29 percent of the national total -- outstanding on June 1, 1975. Had the market not closed for the city, New York could have been expected to issue between 27 and 33 percent of 1975's total short-term municipal notes.

To summarize, New York's borrowing needs in fiscal year 1976 total some \$8 billion. Had a crisis of confidence not emerged, the city would have issued \$2 billion long-term securities and sought an additional \$6 billion in the short-term market. Instead, the market effectively closed to New York City in April. MAC, first on its own and then with the assistance of the state, has stepped in to borrow for the city. The strategy behind this intervention is to substitute long-term securities for short-term notes, thus providing the city with an opportunity to reform its fiscal practices and accumulate surpluses sufficient to repay its past deficit-related debts.

### III. CAUSES OF THE PROBLEM

A variety of factors have contributed to New York's current fiscal problems. It is useful to distinguish the short-term factors that are responsible for precipitating the immediate crisis from those longer-term trends that have contributed to the city's deteriorating fiscal position.

Short-term Factors. The immediate crisis stems from a loss of investor confidence in the credit worthiness of the city. To some extent the sudden shift in the attitudes of investors towards the city's ability to meet its obligations must be attributed to psychological factors for surely the city's long-run economic outlook, which is what determines its ability to pay off its debts, cannot be much different today than it was one or two years ago.

Any discussion of the factors that affect the psychological attitudes of investors must be speculative. It is possible that investor confidence was eroded by the public debate and confrontation politics that took place between the mayor, the city controller, and the governor over the city's fiscal year 1976 budget. It is also probable that the temporary default of the New York State's Urban Development Corporation and the memories of the Penn Central, Lockheed, and Franklin National Bank collapses have made investors increasingly skittish. Any hint of financial instability may send them scampering away. Investor uncertainty becomes a self-feeding process, for the fewer the number of persons willing to lend the city money, the greater the probability of default and the greater therefore the uncertainty, and indeed, the risk.

However, it would be wrong to attribute all of the loss of investor confidence in New York to psychological factors. Objective market conditions should be considered as well. As Table 1 indicates, 1975 has proven to be an extremely heavy year for municipal borrowing. Therefore, New York has been forced to compete for funds with many other state and local governments with far sounder fiscal conditions as well as with the large borrowing requirements of the federal government. While the volume of issues has grown, the recession probably has diminished the desire and ability of banks, corporations, and individuals to buy tax-exempt bonds. This has clearly been the case with commercial banks; during the first quarter of 1975 they dropped out of the municipal bond market almost entirely (see Table 2).

With respect to individuals, it has been suggested that interest rates on municipal offerings have to be raised significantly to entice new buyers into the market. Such buyers must be drawn primarily from middle-income groups which benefit less from the tax-exempt status of municipal bond interest and are less capable of purchasing municipal bonds because these securities generally are available only in large denominations.

TABLE 1 -- Volume of Municipal Borrowing (1967-1975)  
(Amounts are par values in millions of dollars)

Year	Long-term	Short-term	Total
1967	14,300	8,000	22,300
1968	16,300	8,600	24,900
1969	11,700	11,700	23,400
1970	18,888	17,811	35,999
1971	25,006	26,259	51,265
1972	23,748	24,705	49,018
1973	23,957	24,705	48,662
1974	24,317	29,543	53,860
1975*	30,124	33,932	64,056

Source: Securities Industry Association, Municipal Market Developments.

\*Annual rate based on January - June volume.

TABLE 2 -- Annual Net Changes in Holdings of Municipal Securities  
by Major Holder Groups (1970-1975)

(Amounts are par values in billions of dollars)

Holder	1970	1971	1972	1973	1974	1975*	
						First quarter	Second quarter
Commercial banks	10.7	12.6	7.2	5.7	5.5	-2.7	6.9
Households	-.8	-.2	1.0	4.3	10.0	13.9	9.3
All other**	1.3	5.2	6.2	3.7	1.9	2.9	4.5
Total	11.2	17.6	14.4	13.7	17.4	14.0	20.7

Source: Unpublished flow of funds data from the Board of Governors of the Federal Reserve System (Processed: August 19, 1975)

\* Annual rate.

\*\* This includes corporate business, state and local general funds, mutual savings banks, insurance companies, state and local government retirement funds, and brokers and dealers.

Furthermore, the market for New York City securities is concentrated largely in New York State where the interest is exempt from not only federal but also state and local taxes. This market may be close to saturated by the large quantities of state and city securities outstanding. To broaden the market to nonstate residents would require interest rates sufficiently high to compensate for the fact that non-New York holders would have to pay state income taxes on the interest earned from their New York City securities.

The recession is a second short-term condition that has contributed to New York City's problems. Compared to other local governments, New York's revenue system is highly responsive to economic conditions because it relies heavily on cyclically sensitive sales and income taxes rather than on the more stable property tax. While property taxes accounted for 62 percent of the total revenues raised by the local governments serving metropolitan areas in fiscal year 1972-73, they accounted for only 43 percent of revenues raised by New York.

The recession's impact on New York's sales tax base is illustrated in Table 3. Despite a 9.3 percent increase in consumer prices in the year ending June 30, 1975, the volume of taxable sales in the city rose by only 1.7 percent. In New York even the property tax has proven to be unreliable. Delinquencies have risen rapidly from 4.2 percent of collections in fiscal year 1970 to 7.2 percent currently.

The recession has caused high unemployment and stationary incomes which have increased the city's expenditure requirements as well as undercut its expected revenue growth. Not only have the numbers of families eligible for welfare programs increased (see table 3), but it is also likely that the demand for other city services, such as hospitals, has been boosted by the recession because fewer city residents are able to afford the costs of the alternative private institutions.

The severe inflation of recent years has also had a negative effect on the fiscal position of New York. While in the long run, inflation may increase the value of the local tax base sufficiently to compensate for the decreased purchasing power of the tax dollar, in the short run, expenditure levels tend to be more responsive to inflationary pressures. This imbalance stems from the nature of property tax administration, for it is very difficult to reassess property rapidly enough to keep pace with the continually inflating market values of real estate.

Moreover, the situation is exacerbated by the long time period that transpires between the date at which the property tax levy is set and the dates on which the tax payments are due. In recent years a considerable amount of unanticipated inflation has occurred during these periods. It should be noted that New York's situation with respect to inflation may be better than that of other large cities, because of New York's heavy reliance on sales and income tax receipts which do respond quickly and automatically to price hikes and inflation-induced salary increases.

TABLE 3-- Measures of the Recession's Impact on New York City

Year	Unemployment Rate <sup>1</sup>	Welfare* Recipients <sup>2</sup>	Sales Tax* Base <sup>3</sup>
1970	4.8	101.5	78.1
1971	6.7	109.5	81.5
1972	7.0	112.9	NA
1973	6.0	106.4	91.9
1974	7.2	101.4	96.7
1974 June	6.9	100.0	100.0
July	7.3	100.2	100.4
Aug.	6.8	99.3	100.2
Sept.	7.3	100.5	99.1
Oct.	7.2	101.3	99.8
Nov.	7.4	101.3	99.6
Dec.	8.5	102.4	100.4
1975 Jan.	10.3	102.8	101.0
Feb.	10.2	102.5	101.0
Mar.	11.0	103.1	101.7
April	10.8	104.3	102.0
May	10.9	104.3	101.9
June	11.7	105.0	101.7
July	12.0		
Aug.	11.0		

Sources: 1. New York State, Department of Labor  
 2. New York State Department of Social Services  
 3. Annual figures from New York State Department of Taxation and Finance. Monthly figures from Municipal Assistance Corporation

\*Indexes use June 1974 as the base period (Sales Tax Base 100 = \$1.6 billion; Welfare Recipients 100 = 949,000). Sales Tax Base is equal to the total value of sales subject to taxation. Index is based on a twelve-month moving average to eliminate seasonal effects.

The Welfare index includes recipients under the AFDC and home relief programs.

Long-term Factors. The longer-term roots of New York's fiscal problem are both complex and difficult for the city to change. In part they represent the same forces that have buffeted the other large central cities of the northeast and north-central states. These cities have been called upon to assimilate a new wave of rural migrants into the industrial economy just when the industries offering employment opportunities are shifting their bases of operation out of the cities.

As a result of the immigration from the South, the out-migration to the suburbs, and the natural aging of the existing population, those more heavily dependent on city services -- the poor, the uneducated, the aged, the non-English speaking -- comprise an ever-increasing segment of the city's population. For example, between 1950 and 1970 the fraction of the city's population over 65 years of age has gone from 8.0 to 12.1 percent while the proportion of the city's families with incomes below the nation's median income level has risen from 36 to 49 percent.

The city's tax base has failed to grow as rapidly as its revenue requirements. This situation can be attributed to shifts in the location of economic activity as well as to the continued suburbanization of middle- and upper-income groups. Many industries are leaving the northeast altogether while others find it more profitable to operate in the suburbs or on the fringes of the metropolitan area. While its population has remained relatively constant, New York has lost jobs at a rapid rate over the last five years (see Table 4).

Year	Total Jobs <sup>1</sup>		Private Sector <sup>2</sup>		Population <sup>3</sup>	
	(in Thous.)	Index*	(in Thous.)	Index*	(in Thous.)	Index*
1960	3,538.4	94.5	3,130.2	98.4	7,782.0	98.6
1970	3,744.8	100.0	3,182.0	100.0	7,895.6	100.0
1971	3,609.4	96.4	3,040.2	95.5	7,886.6	99.9
1972	3,563.1	95.1	2,998.6	94.2	7,847.1	99.4
1973	3,538.4	94.5	2,964.0	93.1	7,664.4	97.1
1974	3,458.4	92.4	2,877.7	90.4	7,567.1	95.8
1975**	3,375.8	90.1	2,802.6	88.1	NA	NA

Sources: 1,2 -- Bureau of Labor Statistics

3 -- Bureau of the Census

\* Data Indexed using 1970 as base year.

\*\* January - June 1975

The city can exert little influence over either the population shifts or the tax base trends. Together they have produced a steady increase in city tax levels which has, in turn, probably affected the types of persons and businesses willing to remain in or move into the city (see Table 5).

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TABLE 5--The New York City Tax Burden

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Fiscal Year	Personal Income (\$ Billions)	Taxes* (\$ billions)	Taxes as Percent of Personal Income
1963-64	27	2.013	7.6
1964-65	28	2.193	7.9
1965-66	29	2.152	7.3
1966-67	31	2.410	7.7
1967-68	34	2.626	7.8
1968-69	37	2.802	7.6
1969-70	39	2.958	7.5
1970-71	41	3.178	7.7
1971-72	43	3.736	8.7
1972-73	45	4.017	8.9
1973-74	48	4.506	9.4
1974-75	50	5.111	10.2

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Source: New York City Finance Administration

\*Excludes fees and charges, stock transfer taxes and nonresident income taxes.

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An additional factor that has contributed materially to the city's fiscal problems is the manner in which the responsibility for providing welfare and health care services has been divided in New York state. New York is one of only twenty-one states that requires its local governments (e.g. counties) to contribute to the support of cash assistance for the aid to families with dependent children program (AFDC) or to Medicaid payments. Of these twenty-one states, the local share is the highest in New York, where it amounts to almost one quarter of the total or half of the nonfederal share (see Table 6).



TABLE 6 -- Fraction of AFDC Cash Assistance and Medicaid Payments Borne by Local Governments (Fiscal Year 1974)

State*	Percent
New York	23.0
Minnesota	21.8
Wyoming	18.5
California	14.5
Kansas	11.3
Colorado	9.4
Nebraska	8.8
Nevada	8.3
No. Carolina	8.3
Indiana	6.9
New Jersey	6.5
Iowa	4.8
No. Dakota	4.6
Maryland	4.2
Montana	2.8
Virginia	0.6
Utah	0.6
Louisiana	0.2
Oregon	0.1
New Hampshire	**
Mississippi	**

Source: Department of Health, Education, and Welfare, "State Expenditures for Public Assistance Programs."

\* States not listed do not require any local contribution.

\*\* Less than 0.1 percent.

While county governments in New York also must bear half of the cost of the Home Relief Program, New York State's relatively generous general assistance program, this division of responsibility does not differ from the pattern that prevails in the rest of the nation. All told, New York City's welfare-related expenditures amount to some \$3.5 billion, or approximately one third of its current spending. One billion dollars of this must be raised by the city. If the city constituted just part of a large county -- as is true of Los Angeles, Newark and all but a handful of the large cities located in the twenty-one states requiring local welfare contributions -- the costs of supporting the city's income security programs would be shared by some suburban jurisdictions. However, being a city-county, New York must bear the cost alone.

New York's long tradition of providing enriched levels of public services also has contributed to its current fiscal difficulties. The more obvious services in which New York far outdistances most other local

governments include the city university system, the municipal hospital system, the low- and middle-income housing programs, and the extensive public transportation network. For many years there seemed little doubt that the city's wealth was sufficient to support its chosen level of services. However, in recent years it has proved difficult politically to reduce services in line with the city's declining relative fiscal ability to afford them or to raise taxes and fees.

Finally, one cannot ignore the city's questionable accounting procedures and loose fiscal management in relation to the current crisis. These procedures masked the fact the New York officials were failing to make the difficult choices that were required if the city's expense budget was to be truly balanced as required by law.<sup>1</sup> The fault does not rest with the city alone. Many of the "gimmicks" which allowed the budget to appear balanced were tolerated or even suggested by state officials and were certainly not secrets to the banking community. These "gimmicks" produced small deficits which were allowed to accumulate and grow, producing a problem of large and unmanageable proportions.

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<sup>1</sup>"Annual budget and financial reports are filed with the Division of Municipal Affairs in the office of the State Comptroller. Budgets are reviewed in substance and legality.... Deficit financing is not recognized in the operation of units of Local Government in New York State and can only be legally validated by legislative enactment." Advisory Commission on Intergovernmental Relations, City Financial Emergency, Washington, D. C. 1973, p. 168.

#### IV. IS NEW YORK UNIQUE?

Are New York's problems simply of a larger magnitude or are they qualitatively different from those of other major cities? Much of the public discussion suggests that New York is very different from other cities, that it has an abnormally large welfare population, an unusually large and well-paid public labor force and has expenditure patterns that are significantly higher than other cities. At the same time, there is the belief that the fiscal crisis being visited upon New York soon will afflict other cities. Generally neither of those contradictory sets of impressions is valid.

In recent decades New York has been buffeted by the same socio-economic forces that have affected other large, older urban centers and has responded to these pressures in a fashion similar to that of other cities. According to most measures, New York's situation is far from the worst in the nation. One composite index of central city disadvantage shows New York in better shape than Newark, Baltimore, and Chicago as well as eight other large urban centers not included in Table 7 (see column 1). A smaller fraction of New York's population receives welfare than is the case in Philadelphia, Baltimore, Newark, or Boston (see Table 7, column 2).

Comparisons of the expenditure and employment patterns of New York City with those of other large municipal governments indicate that New York is far out of line with other jurisdictions (see Table 7, columns 3a and 4a). Yet this is a misleading conclusion which stems from the fact that New York City provides services that in other areas may be supplied by a county government, a school district, or another specialized government. If one compares the New York employment and spending patterns with those of all of the local governments providing services to the residents of other large cities, New York appears to be less extraordinary (see Table 7, columns 3b and 4b). While its per capita expenditure and public employment levels are above those of any other major city area, some of the differences with respect to such cities as Boston and Philadelphia can be explained by the fact that welfare is a state function in Massachusetts and Pennsylvania. While New York also spends a great deal more than other cities on higher education, hospitals, and mass transportation, its expenditure on the services commonly provided by municipalities is not out of line with those of other large cities (see Table 7, columns 3c and 4c). With respect to the salaries paid public employees, New York is generous but not the most generous of large cities (see Table 7, column 5). Considering that New York's cost of living -- as measured by the Bureau of Labor Statistics (BLS) intermediate family budget -- is

TABLE 7--New York City Compared  
To Other Large Central Cities

City	(1) Index of Central City Dis- advantage	(2) Fraction of Popu- lation Receiving Welfare Payments*	(3) Per Capita Expenditures 1972-1973			(4) Local Government Employment Per 10,000 Population 1974		
			(a) City Govern- ment	(c) *		(a) City Govern- ment	(c) *	
				(b) All Local Governments Serving Central County	Total		(b) All Local Governments Serving Central County	Common Municipal Functions***
New York City**	211	12.4	\$1,224	\$1,286	\$435	517.1	528.2	242.9
Boston	198	16.9	858	756	441	378.0	465.0	219.2
Chicago	245	11.1	267	600	383	140.0	352.5	208.4
Newark	422	14.4	692	827	449	391.1	421.5	258.2
Los Angeles	105	8.0	242	759	408	162.2	401.1	206.2
Philadelphia**	205	16.2	415	653	395	163.8	414.5	255.2
San Francisco**	105	9.1	751	1,073	488	312.5	488.3	224.6
New Orleans**	168	11.4	241	431	260	177.3	357.7	217.5
St. Louis**	231	15.8	310	610	360	241.9	424.6	214.2
Denver **	143	7.2	473	721	375	237.0	410.5	219.3
Baltimore**	256	16.3	806	814	470	434.1	434.1	260.1
Detroit	210	11.1	357	650	396	194.8	354.3	202.4

\* Central County.

\*\* Boundaries of the city are coterminous with those of the central county.

\*\*\* Common Municipal Functions include elementary and secondary education, highways, police, fire, sanitation, parks, general control and financial administration.

continued

TABLE 7 -- (Continued) New York City Compared  
To Other Large Central Cities

City	(5) Public Employee Average Salaries 1974				(6) Cost of BLS's In- termedi- ate Family Budget (Index 1974)	(7) Debt Outstanding per capita 1972- 73*	
	(a) Teacher	(b) Police	(c) Fire	(d) Sanita- tion		(a) Total	(b) Short- term
New York City	\$17,440	\$14,666	\$16,964	\$15,924	116	\$1,676	\$352
Boston	16,726	14,352	13,844	10,666	117	1,385	334
Chicago	20,891	14,146	15,525	11,956	103	733	169
Newark	16,464	13,282	13,282	8,473	116	616	112
Los Angeles	15,670	15,833	21,180	13,168	98	650	14
Philadelphia	15,354	14,354	13,869	13,337	103	1,015	101
San Francisco	15,743	15,529	17,765	13,023	106	1,225	151
New Orleans	10,458	10,746	10,645	4,170	NA	770	39
St. Louis	17,545	11,748	13,185	9,593	97	731	49
Denver	13,505	12,907	14,198	10,258	95	786	52
Baltimore	12,727	10,098	10,980	8,126	100	609	45
Detroit	22,603	15,636	16,107	13,814	100	658	63

Sources:

1. Richard Nathan "The Record of the New Federalism: What It Means for the Nation's Cities." Brookings Institution, 1974.
2. Department of Health, Education and Welfare, Recipients of Public Assistance Money Payments and Amounts of Such Payments by Program, State, and County. February 1975 DHEW Pub. No. (SRS) 76-03105 NCSS Report A-8 (2/75). Includes AFDC and general assistance recipients.
- 3a. U.S. Bureau of the Census, "City Government Finances in 1972-73," GF73, No. 4.
- 3b,c,7 U.S. Bureau of the Census, "Local Government Finances in selected Metropolitan Areas and Large Counties 1972-73," GF 73, No. 6.
4. & 5. U.S. Bureau of the Census, "Local Government Employment in Selected Metropolitan Areas and Large Counties 1974," GE74, No. 3.
6. Bureau of Labor Statistics, "Autumn 1974 Urban Family Budgets and Comparative Indexes for Selected Urban Areas." (4-9-75).

\* Central County

higher than all but that of Boston, its wages are not particularly out of line (see Table 7, column 6).

However, it should be noted that what little reliable evidence there is seems to indicate that New York City provides its employees with considerably more in the way of fringe benefits--pensions, health insurance, etc.--than is offered the employees of other large cities.

While New York's situation in many ways does not differ markedly from that of other large central cities, some of its problems are clearly not shared with other cities. First there is New York's debt situation. On a per capita basis the city has far more debt outstanding than do the local governments providing services in the other central city areas (see Table 7, column 7). This is particularly true of short-term debt in which New York stands alone in its needs continually to enter the market to "roll over" large quantities of notes. Second, New York, as far as can be told, has been the only major city that has chronically run a large current operating deficit in both good and bad economic years. Finally, as was mentioned previously, New York revenues and expenditures are much more sensitive to the ups and downs of the business cycle. All of these peculiar aspects of New York's situation should make one pause before concluding that the city's crisis is but the forerunner of those that will occur widely elsewhere.

## V. THE EFFECTS OF DEFAULT

New York City is likely to default on its obligations if, as now seems probable, the city and the state or MAC acting in the city's behalf are unable to borrow large amounts of funds after the transfusion provided by the emergency assistance plan is used up. Just what form a default would take and what the repercussions of such an event would be cannot be predicted with any degree of certainty. While it is possible that the collapse of New York would precipitate a storm of bankruptcies in the private sector and a wave of municipal defaults, it is also possible that a default by the city would generate but a ripple on the nation's financial waters. Much would depend upon how public officials and policy makers chose to deal with the situation and how default would affect the psychological attitudes of investors.

The New York State Financial Emergency Act authorizes a procedure that would probably be followed in the event that the city were forced to default on its obligations. Under this procedure, no creditor would be permitted to seek ameliorative action in the courts for thirty days. During that time, the municipality or the Emergency Financial Control Board could file a voluntary petition to the state supreme court indicating its inability to pay its debts and stating its intention to file a repayment plan. On receipt of the petition, the court would stay individual court proceedings for an additional ninety days. The repayment plan would have to provide for the eventual payment of both principal and interest. This payment would have to be made as soon as possible, although consideration would be provided for the maintenance of essential public services. Any creditor who agreed to receive payments under the plan would be enjoined from further court actions.

It is important to recognize that the procedure outlined in the Financial Emergency Act is for default rather than bankruptcy; under the default procedure all debts must be paid eventually. The state law also permits the city, if it prefers, to file for bankruptcy under the Federal Bankruptcy Act. Under that law, 51 percent of all creditors must petition the court to initiate proceedings; creditors holding two-thirds of all outstanding debt must agree to a financial adjustment plan which spells out the timetable and extent to which creditors would be repaid. Since New York City issues "bearer" rather than "registered" obligations, no one has an exact fix on who the city's creditors are. Lacking this information, it may be impossibly complex for the city to use the procedures of the Federal Bankruptcy Act.<sup>1</sup>

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<sup>1</sup> Treasury Secretary William Simon, testifying before the Joint Economic Committee of Congress on September 24, 1975, indicated that the Administration soon would propose amendments to the Federal Bankruptcy Act that would make this Act more useful to local governments. A number of bills having this objective have been introduced by members of the Congress and hearings are scheduled or have taken place in both houses.

- Even a default under the Financial Emergency Act would, no doubt, involve some losses to holders of New York City debt. The bonds and notes would be relatively illiquid until the reorganization plan was approved and the city showed that it could meet the repayment schedule. Debtholders forced to sell their bonds or notes during this period of illiquidity could suffer substantial losses. Debtholders who were able to maintain their position until the repayment plan proved workable might not sustain any loss if market rates of interest were paid for the extended payment period. In fact, holders of city securities that were purchased during the period of uncertainty when yields were high might reap large capital gains, if the city showed an ability to meet the repayment schedule and if this pushed the interest rates the city had to pay for new borrowing below the levels of the past six months.

The extent to which the value of bonds in default would be depressed would be related to the market's assessment of the repayment plan and New York's ability to meet it. Certainly the bonds would not become worthless, but the losses could significantly affect the behavior of their holders. While no one can provide a precise figure, banks hold a substantial amount of New York's securities. It has been estimated that the large New York City banks hold roughly \$2 billion of the \$14.6 billion in outstanding debt. Two billion dollars represents less than 25 percent of the equity capital of these banks and something under 5 percent of their total assets. Other banks throughout the nation also hold New York securities. A recent survey by the Federal Deposit Insurance Corporation (FDIC) of the roughly 9,000 banks that are not members of the Federal Reserve System indicated that approximately sixty had more than half of their capital in New York City securities; another 200 had between 20 and 50 percent of their capital invested in such bonds and notes. Probably a similar proportion of the approximately 5,000 banks that are members of the Federal Reserve System have large holdings of New York City securities.

Banks holding large amounts of city securities would not be unscathed if New York's bonds and notes plummeted in value because of a default. However, the impact would be lessened by the Federal Reserve's stated willingness to both lend funds to member and nonmember banks whose solvency would be jeopardized by a city default and to permit banks to value city securities at their predefault levels. The FDIC's contingency plan to lend funds to banks caught by a municipal default rather than forcing these institutions into receivership would have a similar effect. Under such conditions it is doubtful that any banks would be forced into bankruptcy if the restructuring of the city's fiscal situation is accomplished in a reasonable period of time. In any case it should be noted that the FDIC would protect all but the largest depositors from suffering any loss should there be any bank failures.



Insurance companies and individuals also hold a large portion of New York City's debt. It is unlikely that the former would be seriously affected because their payout streams are generally very uniform and they usually have highly diversified sources of income. Individuals would be hurt to the extent that the market value of the defaulted bonds fell, but the vast majority of such holders are high-income persons who have been attracted to municipal bonds by the tax-exempt status of the interest. Most such persons presumably have other resources to fall back on if their interest earnings and assets from New York City shrink.

The impact of a New York City default on the municipal bond market is much more hazardous to predict. To date, the evidence indicates that New York's problems have had little, if any, impact on the situation facing most municipal borrowers. Yields on municipal issues have maintained their historic relationships to those on corporate issues of comparable maturity and quality (see Table 8). While municipal rates have edged up recently, so too have the rates for corporate and federal securities. Of course, it is possible that when more recent data are processed, they will show that a dramatic shift has taken place.

There are some significant exceptions to these generalizations. Investors have clearly started to shy away from low quality municipal offerings. However, the extent to which this is the by-product of New York's difficulties rather than the competition from an unusually large quantity of high quality municipal and treasury offerings cannot be determined with precision. Some large, older cities, especially those in the eastern and northcentral areas, have been forced to pay unusually high rates of interest, probably because of their superficial fiscal resemblance to New York. For example, the rate paid by Philadelphia rose from 6.5 percent in February to 8.5 percent in July. Detroit, partly because of its extremely high unemployment rate and its budgetary problems, has been forced to pay roughly 9 percent throughout 1975. The specter of a city default dragging down the state has forced New York State's rate up to 8.7 percent. It also should be noted that certain borrowing agencies such as the Housing Financing Agency in New York and its sister organization in Massachusetts, both of which relied on rolling over short-term notes to avoid the high rates associated with long-term borrowing, have been forced out of the market completely because no syndicate will underwrite their bonds.

A default by New York City could cause this situation to become more widespread. Banks, individuals, and insurance companies may be unwilling to risk new capital in the municipal market until the dust from the city's default settles. Fiduciaries may shy away from this market out of a fear that they would be liable for investing in risky securities. If such a reaction occurs, it would cause a widespread crisis among the states and localities that depend upon access to credit.

TABLE 8 -- Ratio of Yield on Long-term, Tax-exempt Municipal Securities to Yield on Long-term, Taxable Corporate Securities (1960-1975)  
(Tax-exempt as a Percent of Taxable Yield)\*

Year	High Quality (Aaa) (Monthly Range)	Lower Quality (Baa) (Monthly Range)
1960	.717 - .757	.790 - .830
1961	.729 - .774	.774 - .819
1962	.680 - .726	.707 - .789
1963	.701 - .732	.725 - .748
1964	.678 - .717	.729 - .744
1965	.670 - .726	.715 - .753
1966	.698 - .736	.694 - .773
1967	.657 - .708	.658 - .712
1968	.664 - .709	.681 - .716
1969	.695 - .842	.730 - .817
1970	.682 - .826	.636 - .816
1971	.642 - .758	.634 - .737
1972	.673 - .725	.667 - .703
1973	.638 - .699	.631 - .694
1974	.642 - .748	.639 - .743
1975 Jan.	.724	.702
Feb.	.691	.674
Mar.	.724	.705
Apr.	.722	.719
May	.721	.715
June	.716	.720
July	.723	.736
Aug.	.715	.745

Source: Federal Reserve Bulletin, monthly indexes of daily data compiled by Moody's Investors Service.

\*Ratios were calculated for each month. The highest and lowest (monthly) ratios are reported for years 1960-1974.

No one knows how many jurisdictions can avoid borrowing for a period of months, but undoubtedly a number of large cities and states would be forced into default, at least temporarily, if they were denied access to the bond market. For the most part these jurisdictions would be those that had counted on rolling over or refinancing their bond anticipation notes. Those governments that depend upon revenue or tax anticipation borrowing need not default; rather they would have to restructure suddenly their expenditure pattern to conform to their inflow of revenues. In some cases this would entail severe temporary service cutbacks. For the governments that borrow for long-term capital construction, a temporary closing of the credit market would mean a postponement of building schedules which would affect the level of activity in the construction industry.

It is also possible that the municipal bond market is fairly sophisticated and that it has differentiated on objective grounds the situation facing New York and a few other jurisdictions from that facing the vast majority of other municipal borrowers. In fact it has been suggested that the possibility of a default by the city may be largely or even fully discounted by the market already. If this is true, the major repercussion may well be a general feeling of relief that default, like impeachment, is a storm that can be weathered. A new sense of stability could return to the municipal market, especially if the city were able to reorganize its debt quickly and prove that it could meet the payment schedule on its restructured obligations.

Default would have a profound effect on New York City. Some city services could be temporarily disrupted if city employees, fearing that they will not be compensated, refused to work or if vendors and contractors refused to provide the city with goods and services except on a cash basis. The reorganization plan that would result from a default would probably call for an approximate balance between receipts and expenditures, a goal that according to current plans won't be attained until fiscal year 1978. This would be a difficult undertaking. The city's budget for fiscal year 1976 is \$12.3 billion, with the deficit estimated at \$726 million. Almost one-half of this budget is comprised of items such as welfare, pensions, and debt service that are relatively uncontrollable. Balancing the city's budget would involve either massive cuts in employment and services in other areas or sizable increases in taxes. The city's dilemma is obvious. Cuts in employment and wage rates are likely to be unacceptable to the city's employees, while tax increases are likely to further erode the tax base. New York has managed to maintain a high level of public services only by running large deficits each year. It may be impossible to maintain these services on a pay-as-you-go basis when corporations and middle class taxpayers have the option of relocating to avoid higher taxation. On the other hand, from a political standpoint it may be impossible to cut these service levels.

A large expenditure cutback by New York City would have a noticeable impact on the federal budget. Crude estimates suggest that were the city to balance its budget by cutting its spending by \$726 million, the federal government's deficit could rise by somewhere between \$300 million and \$400 million. This would occur partially because federal tax receipts would fall when city and private sector workers lost their jobs because of the cutback and partially because these individuals and their families, to some extent, would rely on unemployment, welfare, food stamps, medicaid, and other benefits that are totally or partially supported by federal expenditures. Yet, it should be noted that such a cutback would represent a net reduction of \$200 million to \$300 million in the total deficit of the public sector -- while New York's deficit would be reduced by \$726 million, the federal deficit would rise by roughly half that amount. It should also be noted that both the city and state budgets would be impacted in a similar way -- tax revenues would fall while expenditures would be forced up. This suggests that a slightly larger cutback than \$726 million would be needed to truly balance the city's budget.

## VI. POLICY ALTERNATIVES

Four questions must be addressed in any discussion of the policy options for dealing with New York's financial crisis: First, what level of government should act? Second, what action should be taken? Third, who should bear the costs, if any, of the policy? Fourth, should the policy be tailored exclusively for New York or should it apply to a broader group of jurisdictions? The policy options open to each level of government -- New York City, New York State, and the federal government -- are discussed in turn.

New York City. At this advanced state of the financial crisis, few, if any, options remain open to the city acting alone. The only obvious course of action would be the immediate institution of draconian budget cuts and sharply higher taxes, so that the city would operate with a sizable budget surplus that could be earmarked for the rapid liquidation of the city's deficit related short-term debt. The three-year fiscal plan required by the Financial Emergency Act should encompass some actions along these lines. The difficulties and possible repercussions of this approach were discussed in the previous section.

The basic case for requiring the city to "save" itself rests on the widespread feeling that most of the "blame" for the city's current situation must rest with the past "irresponsible" behavior of city officials. Moreover, there is an understandable reluctance of persons from outside of the New York area to assist the city when their localities provide neither the range nor levels of services offered New York's citizens.

The basic reason for not requiring the city to attempt to "save" itself is that it is probable that nothing the city can do quickly and on its own would be sufficient to restore investor confidence. Balancing the budget by means of large service cuts and tax increases may be impossible from a political perspective. To a majority of New Yorkers, default may be a preferable alternative, one that may involve less drastic reductions in services and a more gradual increase in taxes. From the perspective of the investor who is being asked to loan the city capital over a long period of time, drastic fiscal reforms instituted by the city may not be credible. There may remain a fear that as soon as the spotlight of public attention had been turned off, the city would return to its old ways.

From a technical standpoint, it is unlikely that the city could make the sudden and drastic reductions in expenditures that would be required. Like the federal budget, much of the city's expenditures fall into the category of "relatively uncontrollable" (welfare, debt service, pensions, etc.). Significant reductions in overall spending would, therefore, require the gutting of many of the remaining "controllable," basic services

and deep cuts in personnel. MAC has estimated that roughly 46,000 employees -- or 15 percent of the work force of the city and its semi-independent agencies -- would have to be laid off just to balance the budget. To accumulate a sizable budget surplus would require deeper cuts. Finally, a drastic reduction in services could undercut the local economy to such a degree that the welfare-related service demands placed on the city would be increased significantly and tax revenues decreased, thus counteracting some of the anticipated savings.

New York State. The state represents the second possible source of policies that could alleviate the city's fiscal crisis. The basic reason for advocating state action is that, traditionally and legally, the responsibility for dealing with the problems of cities, and local governments in general, has been a state one. Furthermore, several of the city's current problems can be traced to state policies. First, the state acquiesced to the budget "gimickry" that permitted the city to build up its huge short-term debt.

Second, and more fundamentally, the division of service responsibility between the city and the state has contributed to the long-run causes of the city's dilemma. Since some other states keep a closer reign on the fiscal behavior of their cities and most do not place such heavy welfare burdens on their cities, political leaders elsewhere are likely to view New York City's problems as primarily a state responsibility. To this case for state action can be added the probability that the state could initiate new policies sooner than could the federal government and that state policies would be better tailored to fit the special needs of the city than would be programs developed from a federal perspective. Already the state, through the Financial Emergency Act, has put in motion a strict program of fiscal reforms for the city, one that for all practical purposes shifts the locus of fiscal decision making from the city to the Emergency Financial Control Board.

The case against relying on the state to act is that it may be beyond the state's fiscal capacity or current ability. In fact, it has been argued that the city may well prove to be an albatross that brings down the state, forcing it to default as well. Already without assisting the city, New York State is expected to incur an operating budget deficit of over \$600 million in fiscal year 1976. Furthermore, despite the Financial Emergency Act, implementation of strict or costly state measures to control the city's finances may be as politically infeasible as local reforms. The significant fraction of the state's voters who live in New York City may oppose harsh measures, while many of those living in the remainder of the state may be unwilling to support costly state assistance.

There are several conceivable types of action that the state might take to aid the city. First, should investors still be unwilling to purchase city or MAC securities in December, the state could extend additional amounts of aid to the city by borrowing in its behalf. As has already been mentioned, it is possible that this avenue may be closed if

investors begin to react to state securities as they have to city and MAC issues. The high rates of interest charged the state in September suggest that this process may be beginning. Of course the state need not borrow; it could raise its taxes sharply to generate the necessary revenue. However, to raise the \$3.5 billion needed by New York City between mid-December and the end of the city's fiscal year would require roughly a one-third surcharge on all state taxes and fees.

The second approach that the state might take would be to assume the responsibility for one or more of the services currently being provided by the city. Welfare services are the most obvious candidate for such a shift in responsibility. Under federal law the state determines eligibility requirements and benefit levels; therefore, the city already has virtually no control over its welfare budget although it must pay one-fourth of the cost. State assumption of welfare-related services would provide the city with a net saving of some \$900 million per year, more than enough to balance its budget. Furthermore, it would reduce the total spending of the city by roughly one-third. Of course, from the state's standpoint, the takeover of welfare would be more costly because Albany would have to assume the local welfare burden in the remainder of the state as well. All told this would add about \$1.2 billion to the state budget.

The City University system is another candidate for a state takeover. Currently the city spends approximately \$500 million for its four year colleges and graduate programs, 40 percent of which is contributed by state or federal aid. Therefore, a state takeover of the University would save the city roughly \$300 million. The cost to the state of such an action need not be as great as the savings to the city if the state integrates the City University into the state education system and institutes its tuition and fee schedules. Moreover, in contrast to the situation with respect to welfare, the state would not have to assume a similar burden from other local governments because no other localities in the state support extensive systems of higher education. Mass transit, courts, pensions, and elementary and secondary education represent other service areas for which the state could either assume direct fiscal responsibility or contribute an increased amount of state aid.

It is important to realize that any of these alternatives would necessitate sharply higher state taxes. The net benefit to New York City's taxpayers would depend upon which service was assumed by the state and<sup>1</sup> what mechanism was used by the state to raise the necessary revenues. It is possible to make city taxpayers worse off in an absolute sense with the state assumption of certain services. This possibility was demonstrated by the Fleischmann Commission's plan which called for state assumption of the fiscal burden of elementary and secondary education and imposition of a uniform state level property tax.<sup>1</sup>

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1. Report of the New York State Commission on the Quality, Cost and Financing of Elementary and Secondary Education. (The Commission, 1972, Vol. 1.)

The Federal Government. The federal government clearly has the resources to stave off a city default. It also has the clout to ensure that there is a real restructuring of New York's fiscal practices. As has been mentioned, any plan put forward by either city or state officials may be crippled by political considerations. Some fear that, despite the Financial Emergency Act, the environment that allowed the accumulation of \$3.3 billion in deficits still exists; city and state officials will still be sensitive to these pressures and may be unable to devise and implement a plan that can balance the city's budget and reduce its debt.

The rationale for federal intervention rests on the belief that New York plays a vital role in the national and world economies and, therefore, its fiscal health is an issue that transcends the responsibility of any one state. Moreover, the possibility that the city's default would adversely affect national money markets and the economic recovery would seem to argue for federal policy initiatives. The arguments against federal action are three-fold: first, that it is not the place of the federal government to intervene in the detailed operation of a local government's finances; second, that on distributional grounds the federal government should not be helping an area with above average public services support those services when it does nothing for jurisdictions with less adequate services; and finally, that any federal policy would have to include many other units of local government and thus would result in too large an increase in federal government activity.

To date, the federal government has refrained from active participation in New York City's financial problems. Since the current stopgap solution provides relief only through mid-December, the federal government will have to decide soon whether to intervene actively in the next crisis, or remain in its present passive posture.

The present federal policy is one that could be continued. Chairman Burns has stated that the Federal Reserve System stands ready to lend money to banks which encounter cash-flow problems due to default on city or state bonds. This reduces, if not eliminates, the possibility that banks will fail in domino fashion as they try to meet their temporary cash demands. This policy and the existence of the Federal Deposit Insurance Corporation makes a "run" on banks holding defaulted bonds and notes extremely unlikely. As has been mentioned previously, default is likely to involve delayed payments rather than a total write-off of principal and interest. Banks which are large holders of New York City securities can, in the worst of circumstances, envisage a short-term cash flow problem.

Direct Assistance. Direct assistance in the form of a new grant or advance payment of existing grants, at most, would postpone the city's financial problems for a short period unless a massive grant designed exclusively for New York City could be legislated. Presently, the only new grant program which both would provide a significant amount of aid to New York and which has even the remotest chance of quick legislative approval is the Intergovernmental Anti-Recession Assistance Act of 1975 (S. 1359) which was passed by the Senate in July. This program would partially protect



New York City as well as other local governments and states from recession induced revenue shortfalls and expenditure increases. However, under current economic conditions this program, if fully funded, would provide New York with only \$138 million, enough to cover one-fifth of its current deficit or its average short-term borrowing needs for two weeks.

Advanced payment of existing grant-in-aid monies (revenue sharing, Medicaid, state school aid, etc.) is also not likely to help out much. Secretary Simon estimated that at most, approximately \$200 million could be advanced to New York City from federal programs.<sup>1</sup> Considering that the state has already advanced New York much of its state aid, this route to temporary fiscal salvation does not look promising at the state level either. In any case if New York City were advanced its federal grant monies, it is likely that other cities and states would demand equal treatment. If this were granted, the Treasury would be forced to increase its short-term borrowing and the interest associated with this action would add marginally to the federal deficit.

Purchase of New York City Debt. At present, the Federal Reserve System (Fed) is the only federal entity that could buy municipal debt without new enabling legislation. However, the Fed interprets its power to do so to be valid only in cases in which the problem is a temporary one and only when the Fed is certain of prompt repayment.<sup>2</sup> Since it is the Fed's opinion that neither of these two criteria is met by the New York City situation, it has not shown a willingness to provide assistance.

There are other federal or quasi-federal agencies that buy obligations and issue their own debt. FNMA and GNMA provide a secondary market for mortgages and mortgage commitments. The Federal Financing Bank (FFB) purchases the debt of some federal agencies as well as some nonfederal debt that has been federally-guaranteed. The FFB currently pays for these with money that it borrows from the Treasury at slightly over the market rate for Treasury bonds. None of these agencies can buy New York City obligations under current law.

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1. Statement of Treasury Secretary William E. Simon, before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Governmental Operations, June 26, 1975.
  2. See the statement by George W. Mitchell before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Governmental Operations, June 25, 1975, for an explicit treatment of the Federal Reserve System's authority.

Federal purchases of New York City debt, whether by the Fed, some existing federal agency acting under new legislation, or a new federal agency, amounts to refunding the city debt by increasing the obligations of the U. S. Government.<sup>1</sup> Such a scheme has the attractive feature that the interest income from the bonds or notes issued would be taxable, thereby reducing the loss of federal income tax revenue associated with tax-exempt municipal bonds. The net cost to the federal government of a refunding operation that transforms New York city debt into federal debt would have three components: first, a gain due to the increase in tax receipts stemming from the taxable nature of the interest income on federal bonds; second, an "expected" loss due to the possibility that New York City may not repay the federal government; and finally, a gain amounting to any premium that the federal government decided to charge the city over the prevailing Treasury bond rates.

The cost to New York city would obviously be the Treasury bond rate plus any premium charged by the Fed or other agency. If the probability that New York City will have to delay or skip payments on its notes is high, the premium that would have to be imposed to make the program costless to the federal government might be fairly high. Even if this risk is ignored, the federal government may want to charge a relatively high premium to discourage other potential claimants on this refunding service. From the standpoint of the city, the resulting rates may be desirable since they would doubtlessly be lower than those currently being paid. Another advantage of a plan involving direct purchase of the city notes by the federal government would be that the loan could be maintained as a short-term obligation which could be shifted quickly back into long-term municipal bonds when investor confidence in the city was rebuilt. The period of intervention in the city's affairs by higher levels of government thereby could be minimized.

Bond Guarantees. Another policy option that is very similar to the refunding operation just discussed is federal guarantees for New York City bonds and notes. This option would involve no additional tax expenditure costs because the federal government receives no tax on interest income from New York City debt whether or not it is guaranteed. The extra expenditure in this option essentially would be an insurance premium, stemming from the possibility that the federal government might have to pay off New York City's debt if the city was unable to meet its obligations. Of course, the federal government could charge New York City for this guarantee in much the same way the FHA or FDIC charges its clients. But again, without assurances of fiscal responsibility, this surcharge might need to be quite high.

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1. Alternatively the Federal Reserve could finance such purchases by increasing the money supply.

Without any sort of premium charged for these guarantees, the market rate of interest on federally-guaranteed, tax-exempt bonds or notes would be significantly lower than the rate now paid by even the highest rated (Aaa) municipalities. Therefore, it could be expected that all jurisdictions would want to avail themselves of this guarantee unless rather stringent conditions were placed on those governments receiving the benefit. Yet, such restrictions might be viewed as inequitable, because fiscally "responsible" jurisdictions would be forced to pay higher rates than those that had proven to be "irresponsible" and, thus, received the guarantee.

On the other hand, if all jurisdictions could obtain the guarantee, there might be a dramatic increase in municipal borrowing since the demand by municipalities for funds increases as interest rates decline. This would increase the inefficiency already caused by the artificially low price paid by municipalities for capital. A guarantee "premium" or a requirement that federally-guaranteed debt be taxable or a combination of both would increase the cost of borrowing to municipalities, thereby reducing demand for this mechanism and counteracting any temptation to borrow for projects with a low rate of return.

It is important to realize that federal bond guarantees, an agreement to federally-refund New York's debt or other similar policies could provide large capital gains to present bondholders. New York City securities have been discounted by the market to the point that they now have tax-exempt yields of approximately 11 percent. The rate of return on federally-guaranteed, tax-exempt issues would be less than 5 percent. Hence, the market value of long-term New York bonds could roughly double as soon as either federal plan were put into effect. With capital gains (or reduced capital losses) on the order of \$5 billion at stake, it is clear that the pressure for federal guarantees or refunding will be great from those who stand to benefit. One way of eliminating such gains -- if that were considered desirable -- would be to require that all New York City bonds be replaced with new issues that yielded a return of 5 to 7 percent after taxes on their purchase price (not face value). Of course, such a requirement would deny recent bond purchasers the profit most expected from risking their capital in a very uncertain security.

Reinsurance of Municipal Debt. Another suggestion for federal government action is the establishment of a federal reinsurance agency to guarantee all or part of the losses that bondholders would incur from default on state or local bonds. One current proposal would establish a federal insurance agency that would reinsure bonds that have already been insured by private bond insurance companies and insure bonds of state local assistance agencies.<sup>1</sup> It is the second of these provisions

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1. See S. 2372.



that would be relevant for New York City, since MAC fits the definition of a state local assistance agency. Since the proposal provides that insurance will be for only 75 percent of losses, it would amount to a partial guarantee of MAC bonds, but one that significantly reduces their riskiness. This reduced risk presumably would allow MAC to reenter the market and float bonds at lower rates of interest. This scheme would represent a less favorable alternative from the municipalities' standpoint than a bond guarantee in two respects. First, the municipality would have to set up a state local assistance agency to gain access to the federal guarantees; this would probably involve some loss of local control over finances. Second, partial guarantee of losses would result in a higher rate of interest than a total guarantee. It should be realized that most of the discussion dealing with federal guarantees applies equally to federally-insured debt and visa versa. For example, federal guarantees can be partial and large capital gains could result from a reinsurance program.

Given the experience of the last ten years, during which time New York City has accumulated \$3.3 billion in operating deficits, any decision to refund, guarantee, or reinsure city debts would probably be accompanied by some control -- directly or indirectly through the state -- over the city's expenditures and revenues. Without such control, this financial help might be considered a license for further deficits by city officials, and at the very minimum an invitation for other cities to build up deficits for the federal government to assume. Furthermore, federal intervention in the issues of local taxation and expenditures violate a long-standing tradition of separation of responsibilities. Therefore, the expected consequences of the laissez faire stance now taken by the federal government must be considered sufficiently serious to warrant changes in that stance and the inevitable federal involvement in New York City's politics and budgetary decisions.

Shifting Financial Responsibilities. A final set of policy alternatives that could help New York City would be to shift some major fiscal responsibility now borne by the city to the federal government. The most frequently mentioned options along these lines are a federal takeover of welfare and replacement of the Medicaid system with a National Health Insurance Program. Realistically, these alternatives must be looked upon as options that could assist the city over the long run but could not provide salvation from its immediate problems. Any effort along these lines would entail complex nation-wide shifts and would involve higher federal taxes.

Summary. The policy alternatives have been discussed in this report, but they could, of course, be combined with each other to form a package of programs that would assist the city. In fact city, state and federal programs that individually might offer inadequate assistance can be grouped together in ways that provide realistic solutions to the



## VII. CONCLUSION

The focus of this paper has been largely on the immediate crisis facing New York City and the alternative policy responses to this situation. However, the crisis will only be delayed temporarily unless the underlying causes of the city's fiscal difficulties are addressed. While it may be comforting to believe that these problems can be handled by the city alone, this probably is not the case. Certainly efficient management, strict accounting procedures, and the introduction of new technology can help, but such measures alone will not balance New York's budget and pay off a substantial portion of its accumulated short-term debt. Substantial service cutbacks and tax increases will be required to accomplish these objectives. Yet such actions will make the city a less attractive place in which to live and probably will hasten the exodus of middle- and upper-income families and commercial and industrial establishments. This, in turn, will undercut the city's ability to support even a reduced level of services.

Given these forces, it is probable that the underlying problems facing New York, as well as a number of other large, aging cities, can be dealt with effectively only by the state or by the federal government. Unless one is willing to consider policies that would redistribute the low-income populations among other jurisdictions, or would redraw city boundaries so as to encompass suburban areas, or that would radically equalize income, the main alternative left for addressing the cities' problems is to relieve the city of some major portions of its current fiscal responsibility. As has been mentioned previously, New York City's situation would be aided immensely if the state or the federal government assumed the burden now borne by the city for welfare and related services to the poor.

