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NEW YORK CITY'S FINANCIAL CRISIS

AN EVALUATION OF ITS ECONOMIC IMPACT AND OF PROPOSED POLICY SOLUTIONS

A STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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LETTER OF TRANSMITTAL

OCTOBER 31, 1975.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the Joint Economic Committee and other Members of Congress is a staff study entitled, "New York City's Financial Crisis: An Evaluation of its Economic Impact and of Proposed Policy Solutions." It is intended to provide analytical background on the economic effects of the financial crisis facing New York City. Since Congress is now confronted with complex and important decisions in this matter, it is essential that we do as much as we can to develop information on the subject. The study examines the current financial situation in New York, attempts to assess its financial consequences and sets forth policy alternatives for dealing with the problem.

The study was prepared by Mr. Ralph Schlosstein of the committee staff. Secretarial and statistical assistance was provided by Marie Cunningham.

The views expressed in this document do not necessarily represent the views of the members of the Joint Economic Committee or of the committee staff.

HUBERT H. HUMPHREY,
Chairman, Joint Economic Committee.

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INTRODUCTION

New York City's financial crisis has precipitated a considerable amount of debate about the ultimate economic and financial consequences that will result from a default by a major city. Undoubtedly, much of this disagreement results from the enormous uncertainty associated with any attempt to assess the consequences of default. There simply is no meaningful historical precedent on which to base sophisticated analysis. Nevertheless, since Congress will soon be confronted with a complex amd important decision, it is essential that the best information be made available. This study is designed to clarify to the extent possible, many of the issues that have been raised since New York City's financial crisis became a serious matter of national concern.

The study is divided into three separate sections. The first describes in detail the current fiscal position of New York City. It identifies the national and regional economic developments that have contributed to the present situation and analyzes the response by the City and State to these developments. The first section also compares New York City's fiscal problems with those experienced by other major urban centers.

The second section identifies and quantifies to the extent possible, the economic and financial consequences that have resulted or will result as New York's financial problems develop. Among the possible consequences discussed in this section of the report are the impact of New York's financial problems on: a) other borrowers in the municipal bond market; b) on the strength of the economic recovery; c) the economy of the New York region; d) the liquidity and solvency of various financial institutions; and e) the State of New York.

The final section of the report discusses in detail the policy alternatives available for averting default by New York City or mitigating the impact of default. It focuses first on possible actions that the State and the City could undertake immediately or over a period of time. It then discusses and evaluates three broad policy options available to the Federal government: 1) to provide no assistance; 2) to allow the city to default and to provide Federal assistance to maintain essential services; and 3) to provide sufficient Federal assistance to avert default and to maintain essential services.

THE CURRENT SITUATION

General Description:

The immediate budget crisis that New York City is currently experiencing results from the city's inability to borrow money at any price through the issuance of bonds or notes in the tax-exempt bond market. Like most large cities, New York is heavily dependent upon borrowing to insure the adequate and efficient provision of services. However, in order to better understand the problems associated with market inaccessibility, it is important to examine the purposes for which most cites borrow and to describe New York's unique borrowing requirements. A more detailed discussion of the city's borrowing needs and the problems associated with market inaccessibility appears on Page 24.

First, New York, like almost all State and local governments has borrowed to finance captial construction projects. Financing of capital improvements through long-term borrowing serves to stretch out the payments for capital construction over the life of the improvements requiring all citizens who benefit from the facility to pay a portion of its costs. Like some other governments, New York has also used short-term bond anticipation notes to fund capital construction. These notes are usually issued when long-term funding is not available at reasonable prices, but are later converted to long-term bonds when market conditions improve. If New York were unable to borrow for capital construction purposes, its capital improvement program would have to be gradually terminated causing a deterioration in the city's capital stock and a deepening of the

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recession in the construction industry.

New York, like most other large cities, must also borrow to prevent cash flow problems that inevitably result from uneven spending and revenue streams. While spending generally occurs at an even pace throughout the year, taxes and grants are received on a quarterly, semi-annual or annual basis. Even when the annual budget is balanced, this mismatch inevitably results in periods of 3 to 12 months in which revenues are significantly below expenditures. Most cities issue short-term, revenue anticipation notes over this period to fund a normal rate of expenditures. They then retire these notes as the revenues are received. If New York could not make its normal borrowings in anticipation of revenues, it would be forced to rearrange its expenditures to conform more closely with the revenue stream. At certain points in the year, this would require cutbacks in current services of as much as 25 percent, imposing a significant hardship on the residents and employees of the city.

In other respects, New York's borrowing requirements go far beyond those of other cities. Of major consequence is the large amount of short-term debt that the city must roll-over each year. This short term debt rollover has resulted from two basic developments. First, the city has consistently operated with budget deficits. These operating deficits from past years, totalling approximately $2.6 billion dollars, have been funded by issuing short-term notes which must be rolled over continually. Since the city also faces an operating deficit of approximately $700 million this year, the total borrowing necessary to finance past and present operating deficits is $3.3 billion.

Second, the rollover problem results from the large amount of outstanding bond anticipation notes which come due each year. The city has been reluctant or unable to convert its short-term bond anticipation notes into longer term securities.

While many of these short-term notes have been or will be converted into longer term MAC securites the city still must roll over $2.6 billion worth of notes from December 1, 1975 until June 30, 1976. If the city cannot borrow sufficient funds to roll the notes over, it will surely default.

Finally, New York has consistently funded operating expenditures in its capital budget. Expenditures for manpower training, planning and other programs, totalling as much as $700 million annually, have been funded up to now through the issuance of bonds or notes. If the city is unable to borrow, these expenditure or others will have to be eliminated too.

In summary, New York City will default and experience severe budget adjustments if it is unable to obtain credit from some source. The magnitude and severity of these adjustments will be discussed at a later point in this report.

While New York's immediate problem is obtaining market access, the borrowing problems of the City have been manifest for some time prior to March 1975, when the city was last able to market its own securities. Through the last half of 1974, New York City notes and bonds were issued to yield, at that time, unprecendented interest rates[1/] indicative of the market's inability to handle completely the bonds and notes issued by New York City. These high yields were a precursor of the market access problems that have existed since March 1975 and resulted from essentially the same combination of factors.

In fact, the major factors affecting the city's borrowings have not changed materially since last year. First the City issues a huge volume of bonds and notes annually, exceeding greatly the borrowing requirements of other major cities. Second, the City has chosen to issue an abnormally high amount of short-term notes. Since these notes must be rolled over continually, they contribute heavily to the large volume of New York City securities that are constantly being marketed. Finally, many of the City's questionable management and budgeting practices were beginning to come to public attention. Since many investors rightly perceived that these accumulated problems could seriously jeopardize the City's ability to meet future obligations, they demanded higher interest rates and ultimately in March, refused to invest at all.

Since March 1975, a series of emergency actions have been undertaken to avert a default by the City on its obligations. In early April, New York State borrowed $400 million, which was then transferred to the City as an advance on welfare

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1/ An issue of $615 million in notes yielded a record 8.34 percent on November 4, 1974, and an issue of $600 million in notes yielded a record 9.48 percent on December 2, 1974 payments due in June. In May, the State advanced the City an additional $400 million, this time on welfare funds originally scheduled for delivery in 1976. These state advances were made with the hope that investor confidence in the City's securities would soon be restored allowing the city to borrow for its own purposes.

However, when it became apparent in early June that New York City was still unable to market its own securities, the State created the Municipal Assistance Corporation (MAC). MAC was given the authority to issue up to $3 billion of its own securities, an amount sufficient to meet all of the city's obligations through October, at which time investor confidence in New York City securities would hopefully be restored. In the course of providing the City with a temporary source of credit, MAC also rolled over much of the City's short-term obligations into longer term MAC bonds with maturities of up to fifteen years. The purpose of restructuring the debt was to reduce the enormous volume of annual short-term borrowing that had originally contributed to the City's market access problems.

The State legislation that created MAC contained several specific provisions which made MAC securities more marketable than New York City securities. First, receipts from the city's stock transfer and sales taxes were segregated to meet all debt service payments on MAC securities. These receipts were channeled directly to MAC and not to the City Treasury. Second, MAC was a state agency whose securities were backed by the "moral obligation" of the state. Finally, the legislation required that the city achieve a balanced budget under accounting practices mandated by the State. These protections were recognized by the private bond rating service who rated MAC securities as a superior quality investment to New York City bonds and notes.[2/]

Despite these protections, MAC securities were not well received by the market. Although two-thirds of the $1 billion first issue was privately placed with insurance companies and banks, it still carried tax-exempt interest rates in excess of nine percent. In mid-July, when these securities were freed of underwriting restrictions and allowed to trade freely in the secondary market, yields quickly rose to 11 percent. No doubt, part of MAC's problems can be attributed to the size of its first issue[3/] but most of the corporation's market difficulties must be attributed directly to the fact that MAC's securities were perceived by the market to be tantamount to New York city issues.

By mid-July, major underwriters began to express their reticence to participate in further MAC issues. They pointed out that they were unable to resell issues that they had underwritten and were unwilling to accept the entire $1 billion issue themselves. MAC was able to complete another $1 billion issue,

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2/ Standard and Poors rated the MAC securities A+, although they had suspended New York City's rating 2 months earlier.

3/ The $1 billion issue was the largest tax-exempt issue ever.

but only with the participation of the City and State pension funds and with an advance from the State government.[4/] One week later half of the public offering remained unsold, causing underwriters to raise interest rates to 11 percent and to buy $61 million themselves to complete the package. At that point, the underwriters also suggested that it would be virtually impossible to market the final $1 billion MAC issue.

Faced with almost certain default by the City, the State legislature passed the Financial Emergency Act. This legislation pieced together a $2.3 billion financing package, sufficient to meet the City's financing needs through early December. In a move designed to bolster investor confidence, the legislation also created a seven-member Emergency Financial Control Board to administer the City's finances. The Board, dominated by State appointees, maintains almost complete control over the City's budget aggregates. The Board must adopt a three-year financial plan which moves the City toward a balanced budget by 1978. The Board must also approve plans for lessening the dependence of the City on short-term borrowing for removing operating expenditures from the capital budget, for controlling growth in expenditures and, if necessary, for freezing employee wages. In essence, the State, through the Financial Control Board, has taken over much of the financial management of the City.

4/ The second MAC offering was placed as follows:
$215 million - City and State Pension Funds
$275 million - Bonds sold to public
$120 million - State advance
$350 million - Bank purchase

The $2.3 billion financing package incorporated in the State legislation has beem implemented by MAC, but not without great difficulty. The city and State pension programs that were requested to purchase MAC securities have done so reluctantly. The State has also experienced great difficulty in borrowing the $750 million that it has committed to the financing package ($250 million for an advance to the city and $500 million to pruchase MAC securities). The first $250 million in state notes issued to purchase MAC securities bore an interest rate of 8.7 percent. Subsequent to this issue, Moody's investor Service lowered the rating of the State one grade. This will undoubtedly lead to further increases in interest rates and greater difficulty for the State in marketing its securities.

It now appears likely that the Municipal Assistance Corporation will be able to provide sufficient funds to meet the City's needs up to the first week in December. Beyond that point there is great uncertainty. The City, despite the austerity imposed by the Financial Control Board, will clearly be unable to market its securities in December. MAC can be expected to face the same market access problems. Even the state, according to recent market indications, seems to have exhausted its ability to borrow on behalf of the City. Since it is clearly impossible for the City and the State to develop any package of tax increases and expenditure cutbacks sufficient to meet the $4.2 billion in borrowing that the City must undertake for the remainder of the year, it appears inevitable that the City, absent Federal aid, will default on its obligations. That default is likely to occur in the first week in December.

The Underlying Causes:

New York, like many other major urban centers, has been confronted with significant changes in its economic base over the last fifteen years. These changes have partially eroded the revenue base of the city and increased the demand for the services that the city provides. However, these economic changes in manv respects are not unlike those that have developed in other central cities in the Northeast and Midwest.

From 1960 to 1973, many older Northeastern and Midwestern central cities experienced net declines in population.[5/] (Table I) These population declines resulted primarily from two factors: a) slower growth in these regions relative to other regions of the country and b) growth and migration patterns within these metropolitan areas which caused suburban areas to experience significant population growth while many central cities actually lost population. In the period from 1960 to 1973, New York experienced a net population loss of 1.7 percent. This population loss, while indicative of a stable or declining central city, was the smallest population loss experienced by any Northeastern city, and smaller than that experienced by all but two cities in the Midwest.[6/] In other words, New York's gross population changes indicate that it has experienced far less revenue

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5/ See Table I.

6/ Columbus, Ohio, which is a state capital and thus benefitted from growth in public sector employment and Indianapolis, which annexed significant population additions.

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TABLE I

Population of 24 Largest Cities
(thousands)

NORTHEAST	1973	1970	1960	Percent Change 1960 to 1973
Baltimore	878	906	939	-6.5
Boston	618	641	697	-11.3
New York	7647	7896	7782	-1.7
Philadelphia	1862	1950	2003	-7.0
Pittsburgh	479	520	604	-20.7
Washington	734	757	764	-3.5
MIDWEST				
Chicago 1/	3173	3369	3550	-10.6
Cleveland	679	751	876	-22.5
Columbus 2/	541	540	471	14.9
Detroit	1387	1514	1670	-16.9
Indianapolis 3/	728	733	476	52.9
Milwaukee 4/	691	717	741	-6.7
St. Louis	558	622	750	-25.6
SOUTH				
Dallas 5/	816	844	680	20.0
Houston	1320	1234	938	40.7
Jacksonville 6/	522	520	201	159.7
Memphis 7/	659	624	498	32.3
New Orleans	573	593	628	-8.8
San Antonio 8/	756	708	588	28.6
WEST				
Los Angeles 9/	2747	2812	2479	10.8
Phoenix 10/	637	587	439	45.0
San Diego 11/	757	697	573	32.1
San Francisco	687	716	740	-7.2
Seattle	503	531	557	-9.7

1973 Figures Include:

1/ Annexation of 4,737
2/ Annexation of 26, 293
3/ Annexation of 306,732
4/ Annexation of 6,923
5/ Annexation of 11,336
6/ Annexation of 364,643
7/ Annexation of 136,562
8/ Annexation of 14,456
9/ Annexation of 10,293
10/ Annexation of 64,478
11/ Annexation of 9,945

SOURCE: Bureau of the Census

base erosion due to population losses than other comparable central cities.

At the same time that many central cities were experiencing population losses, they were also experiencing significant reductions in private sector employment. These reductions resulted from a similar combination of factors that led to net population losses. Many industries were moving from the older regions of the country into the South and West where cheap land for modern one-story manufacturing plants is more readily available and where labor costs are lower. Within regions, employment opportunities have moved to suburban areas where employees now live and where land for expansion is more readily available. New York has been victimized by these shifts in employment opportunities, experiencing losses of private sector jobs equal to or in excess of losses experienced by other central cities (Table II). From 1970 to 1973, a period in which total employment grew 7.4 percent nationally, New York experienced a decline in total private sector employment of 6.2 percent. The magnitude of this decline was approximately equal to that experienced by other comparable central cities and was exceeded by only one Northeastern central city and one Midwestern central city. Clearly, New York's position is somewhat unique in that its population, and thus its service demands, have remained somewhat constant, while a portion of its revenue base has been eroded through losses in employment opportunities.

TABLE II

Total Private Sector Employment in
Selected Large Central Cities (thousands)

	1973	1970	Percent Change (1970 to 1973)
NORTHEAST			
Baltimore	328	348	-5.7
New York	2986	3182	-6.2
Philadelphia	709	777	-8.7
Washington	332	343	-3.2
MIDWEST			
Chicago	1271	1367	-7.0
Cleveland	234	203	15.0
Detroit	503	581	-13.4
Milwaukee	285	285	0
St. Louis	215	228	-5.7
SOUTH			
Dallas	394	386	2.0
Houston	581	549	5.8
WEST			
Los Angeles	1315	1281	2.6
San Francisco	409	451	-9.3

SOURCE: Bureau of Labor Statistics

This unique shift which has occurred over the last fifteen years is further documented by examining poverty population data for the largest central cities (Table III). From 1960 to 1970, the percent of the population below the poverty line nationally was reduced from 18.4 percent to 10.7 percent. At the same time, all central cities experienced declines in their poverty populations, but at rates nowhere near the decline nationally. In fact, only two cities reduced their poverty population from 1960 to 1970 at a rate equal to the national decline and both of these cities have benefitted from major annexations of surrounding suburban jurisdictions.[7/] In 1960, only four cities had poverty populations (as a percentage of total population) above the national average. By 1970, the number of cities with poverty populations above the national average had risen to fifteen. Thus, while significant reductions in poverty population have been made nationally, there has been a profound increase in the concentration of poverty populations in the Nation's largest central cities.

New York has been a major participant in this trend. In 1960, New York had one of the lowest poverty populations in the country, well below the national average. By 1970, New York's poverty population exceeded the national average, despite the fact that by Census definitions, it's poverty population had

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7/ Jacksonville, Florida and Indianapolis, Indiana.

TABLE III

Percent Of Population Below the Poverty Line[1/]
24 Largest Cities

	1960	1970	Percent Change (1960 to 1970)
Nation	18.4	10.7	-41.85
NORTHEAST			
Baltimore	17.9	14.0	-21.79
Boston	14.2	11.7	-17.61
New York	12.8	11.5	-10.16
Philadelphia	15.0	11.2	-25.33
Pittsburgh	16.0	11.2	-30.00
Washington	16.7	12.7	-23.95
MIDWEST			
Chicago	12.0	10.6	-11.67
Cleveland	14.9	13.5	-9.40
Columbus	14.2	9.8	-30.99
Detroit	16.9	11.3	-33.14
Indianapolis	13.7	7.1	-48.18
Milwaukee	9.2	8.1	-11.96
St. Louis	19.1	14.4	-24.61
SOUTH			
Dallas	16.7	10.1	-39.52
Houston	18.1	10.7	-40.88
Jacksonville	28.5	14.1	-50.53
Memphis	25.6	15.7	-38.67
New Orleans	25.6	21.6	-15.63
San Antonio	28.6	17.5	-38.81
WEST			
Los Angeles	11.6	9.7	-16.38
Phoenix	14.7	8.8	-40.14
San Diego	12.0	9.3	-22.50
San Francisco	12.1	10.7	-11.57
Seattle	8.6	6.0	-30.23

1/ Poverty line is defined as follows:

Family size	1960	1970
2	$1894	$2383
3	2324	2924
4	2973	3743
5	3506	4415
6	3944	4958
7	4849	6101

SOURCE: Bureau of the Census

been reduced over 10 percent. Clearly, New York's poverty population in 1970 did not exceed that of other comparable central cities. But the shift in its population from 1960 to 1970 has been more pronounced than for all other major central cities except Cleveland. Thus, while New York still does not have an unusually high percentage of total population below the poverty line, the growth in its poverty population from 1960 to 1970 has been the second most severe in the Nation.

Finally, when examining the city's recent economic changes, it is impossible to ignore the slow growth in New York's residential property tax rolls. While no comparable data exists for all large central cities, there is considerable evidence that the growth in the City's residential tax base has lagged behind growth in other comparable central city residential tax rolls. No doubt, much of this lag can be attributed to the economic decline affecting other sectors of New York's economy, but the effect of comprehensive rent control laws cannot be dismissed. The City's rent control legislation has already contributed to a rise in tax delinquencies as landlords willingly abandon properties that are marginal income producers. Over the long run, it will also affect the overall quality of the city's housing stock, as landlords allow properties to deteriorate because they are unable to pay for necessary rehabilitation with higher rents. Ultimately, this will lead to a further deterioration of the City's fiscal resources.

In summary, this comparison of New York City's economic changes with those of other large central cities indicates that New York's economic resources are presently not out of line with those of other large central cities. In an absolute sense, it's poverty population is not excessive; its population losses have been moderate; and its job losses were not much worse than other comparable central cities. However, it is clear that the deterioration over time of its economic base and the shift toward a more service dependent population has occurred at a faster rate than for most other central cities.
This faster rate of decline has undoubtedly imposed a greater relative strain on the ability of the city to continue to finance its past levels of public services.

The Impact of the Recession:

In most large central cities, the long-run economic deterioration has been exacerbated by the recent recession. In general, high unemployment rates cause significant shortfalls in receipts from sales and income taxes because these taxes are directly tied to the level of economic activity.[8/] High unemployment also causes increases in the cost of unemployment related expenditures, such as welfare and public health. Thus, recession causes a combination of revenue shortfalls and expenditure

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8/ As unemployment rises, growth in real incomes and final sales are reduced, interrupting the growth in the income tax and sales tax bases. Property taxes are less sensitive to unemployment changes in the short run, except through increased delinquencies.

increases which greatly undermines the ability of local governments to maintain balanced budgets without raising taxes or cutting services.

Needless to say, all cities have not been affected equally by the current recession. Some have maintained unemployments rates below the national average. Others, that derive all of their revenues from property taxes, will experience minimal revenue shortfalls. In order to better understand the vulnerability of large central cities to the recession, it is necessary to evaluate the magnitude of economic decline caused by the recession and the vulnerability of the city's tax base and expenditures to changes in economic activity.

Probably the best single measure 9/ of the recession's impact on a central city economy is the change in its unemployment rate. (Table IV). Since rising unemployment will inevitably affect income and sales tax receipts, changes in unemployment can be used to measure the overall magnitude of decline in the central city's tax base. As of June 1975, New York's unemployment rate was higher than that of most other comparable cities. While a portion of this higher unemployment rate can no doubt be attributed to the higher pre-recession unemployment rate in New York, the predominant factor is the increase in New York's unemployment rate over the last year. In fact, New York's unemployment rate has increased 4.6 percentage points from June 1974 to June 1975, compared to an average increase of 3.4 percentage points for the other 24 largest cities. Since New York City's June 1974

9/ The only up-to-date measure of central city economic activity available.

TABLE IV

MEASURES OF THE RECESSION'S IMPACT ON THE 24 LARGEST CITIES

	Unemployment Rate June 1975	Unemployment Rate June 1974	Increase in Unemployment Rate (6/74-6/75)	Percent of the Total Taxes Derived from Recession Sensitive Taxes (1973-1974)[1/]
NORTHEAST				
Baltimore	9.2	5.2	4.0	16.3
Boston	12.8	7.5	5.3	0
New York	11.4	6.8	4.6	31.9
Philadelphia	11.4	6.4	5.0	67.2
Pittsburgh	9.4	5.9	3.5	0
Washington	6.7	5.0	1.7	51.5
MIDWEST				
Chicago	9.8	5.1	4.7	13.7
Cleveland	8.7	4.3	4.4	53.1
Columbus	7.4	3.7	3.7	79.4
Detroit	15.6	9.0	6.6	35.6
Indianapolis	8.6	5.2	3.4	0
Milwaukee	9.3	4.7	4.6	0
St. Louis	9.1	6.3	2.8	41.7
SOUTH				
Dallas	6.5	3.6	2.9	19.5
Houston	5.5	4.5	1.0	26.2
Jacksonville	8.3	6.5	1.8	0
Memphis	9.1	5.1	4.0	0
New Orleans	8.7	8.3	.4	40.4
San Antonio	10.0	6.0	4.0	28.6
WEST				
Los Angeles	11.0	7.0	4.0	20.3
Phoenix	12.5	5.9	6.6	44.6
San Diego	11.4	8.3	3.1	32.4
San Francisco	10.7	8.0	2.7	13.5
Seattle	9.9	7.1	2.8	15.0

1/ Recession sensitive taxes include income taxes and general sales and gross receipt taxes.

SOURCE: Bureau of Labor Statistics and Bureau of the Census.

June 1975, unemployment rate increase probably underestimates the impact of the recession on New York's economy,[10/] it is reasonable to assume that the New York economy has been more seriously affected by the recession than the economies of most other large central cities.

However, these large increases in the unemployment rate rate are partially offset by the average vulnerability to recession of New York City's tax base. (Table IV). Approximately 32 percent of the city's tax receipts are derived from sales and income taxes. While this percentage is slightly higher than the average for the 48 largest cities,[11/] it certainly does not compare to the sensitivity to recession of many other central city tax bases.

However, the significant increases in the unemployment rate more than offset the average vulnerability to recession of the city's tax base. In fact, New York has probably experienced greater revenue shortfalls than three-quarters of the 24 largest central cities.

The impact of the recession on expenditures is far more difficult to measure. It is extremely difficult to isolate

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10/ Recent cuts in public employment will undoubtedly exacerbate the recession related unemployment increase.

11/ 29 percent of their revenues are derived from sales and income taxes.

expenditures for recession sensitive purposes and even more difficult to get current information on the size of these expenditures. However, New York City's heavy responsibilities for welfare and health services will probably cause budget difficulties in excess of those experienced by comparable central cities.

In summary, it is reasonable to assume that the combination of high unemployment rates, heavy city government responsibility for welfare and health services, and a reasonably sensitive tax base have caused New York City to experience more serious recession-related budget difficulties than most other central cities.

The City's Response to Underlying Economic Developments:

Despite declining tax bases in many large central cities, the period from 1960 to 1974 was marked by a major expansion of the economic role of state and local governments. During these years, the functions of state and local government were broadened, employee compensation was improved and service levels were raised. In general, these burgeoning demands were met by increased revenues resulting from general economic prosperity and from tax rate increases.

New York City, despite its deteriorating fiscal base, was clearly one of the leaders in expanding the economic role of city government. From 1960 to 1974, the number of full-time and part-time New York City employees per 10,000 population increased 69.6 percent, (Table V) a rate of growth that

TABLE V

TOTAL NUMBER OF FULL-TIME AND PART-TIME CITY GOVERNMENT EMPLOYEES
(Per 10,000 Residents)

	1960	1970	1974	Percent Change 1960 to 1974	Percent Change 1970 to 1974
NORTHEAST					
Baltimore	285	418	455	59.6	8.9
Boston	303	388	442	45.9	13.9
New York	345	526	585	69.6	11.2
Philadelphia	145	183	206	42.1	12.6
Pittsburgh	117	141	126	7.7	-10.6
Washington	341	722	737	116.1	2.1
MIDWEST					
Chicago	105	135	143	36.2	5.9
Cleveland	159	215	198	24.5	-7.9
Columbus	88	103	119	35.2	15.5
Detroit	155	176	199	28.4	13.1
Indianapolis	82	83	138	68.3	66.3
Milwaukee	127	147	146	15.0	-0.7
St. Louis	184	225	252	37.0	12.0
SOUTH					
Dallas	108	136	164	51.8	20.6
Houston	90	85	92	2.2	8.2
Jacksonville	208	131	199	-4.3	51.9
Memphis	294	393	357	21.4	-9.2
New Orleans	150	173	179	19.3	3.5
San Antonio	108	121	142	31.5	17.4
WEST					
Los Angeles	144	154	164	13.9	6.5
Phoenix	74	99	120	62.2	21.2
San Diego	83	83	95	14.5	14.5
San Francisco	210	285	313	49.0	9.8
Seattle	158	205	201	27.2	-2.0

Source: Bureau of the Census.

exceeds every large central city but Washington, D.C. Since 1970, however, the city's growth in employment has been similar to that of other cities. From 1960 to 1974, public employment per 10,000 residents in the 24 largest cities increased only 36.5 percent, half the rate of growth in employment in New York City. Thus, while the population of New York City remained virtually constant, the total number of New York City employees increased almost 70 percent, mostly during the period from 1960 to 1970.

The growth in New York City's public employment over the past fifteen years is indicative of an unwillingness or inability on the part of the City's leadership to undertake the difficult austerity measures necessary to keep the budget in balance. Confronted with a deteriorating tax base and rising expenditure demands, New York simply did not make the difficult tradeoffs necessary to keep expenditure growth in line with tax receipts. Rather, the city resorted to a series of fiscal gimmicks and dubious management practices that are responsibile for much of the investor skepticism that New York is experiencing today. Deficits were funded by short-term borrowing in anticipation of revenues that did not exist. Operating expenditures were transferred into the capital budget and funded through long-term borrowing. And pension benefits, well in excess of the city's ability to pay, were made available. These dubious budgeting procedures contributed directly to the City's short-term borrowing problems and only postponed the need for later tax increases or expenditure cutbacks; a need that the City is facing today.

It should be pointed out, however, that the City continued its questionable budget practices with at least the tacit acquiescence of the State and the financial community. The State clearly failed to exercise the necessary oversight of the City's budget. And the financial community continued to provide New York City with credit long after it was aware of the questionable budget practices undertaken by the City. If the State or the financial community had required the City to adhere to legitimate budgeting techniques, the current market access crisis could conceivably have been avoided.

While the data in Table V correctly suggests a huge growth in the number of New York City employees, it partially misrepresents New York City's unique employment needs related to other cities. This misrepresentation occurs for two reasons. First, New York City is both a city and a county and thus makes expenditures for services that are normally provided by both levels of government. Other cities, which are located within a larger county usually have fewer responsibilities. Second, New York City has full or partial responsibility for many functions that most cities do not provide.

Some of these functions, particularly welfare, result from the division of responsibility between State and local governments in New York State. Others, such as the City University system, the housing construction program, the hospitals and the transit system are services which the City provides by choice.

Table VI adjusts for these two unique qualities of New York City. Column I adjusts for the fact that New York is both a City and a county. It shows the number of full-time equivalent employees of all local governments servicing the central city. Nevertheless, New York City's employment needs still exceed those of all other central cities, except Washington, D. C.

The second column further adjusts for New York's unique responsibilities. It illustrates that New York City's employee needs for services commonly provided by a city government are not significantly in excess of the personnel needs of other cities for similar services. Thus, when only common municipal functions are considered, New York employee requirements, while still high, do not significantly exceed those of comparable large central cities.

In summary, from 1960 to 1974, New York consistently delayed tax increases and service cutbacks that were necessary to keep current expenditures equal to receipts from its declining revenue base. This delay of fiscal austerity measures was implemented by a series of questionable management practices and fiscal gimmickry. These gimmicks allowed New York to maintain service levels and levels of employment in excess of those maintained by other large cities and probably in excess of the city's own fiscal capacity. However, closer examination indicates that New York City's employee requirements for basic services do

TABLE VI

NUMBER OF FULL-TIME EQUIVALENT LOCAL GOVERNMENT EMPLOYEES PER 10,000 RESIDENTS FOR ALL LOCAL GOVERNMENTS SERVING CENTRAL COUNTY OF 24 LARGEST CITIES (1974)

	All Functions	Basic City Services 1/
NORTHEAST		
Baltimore	434.1	324.8
Boston	465.0	259.7
New York	528.2	300.8
Philadelphia	414.5	305.9
Pittsburgh	316.1	247.9
Washington	752.0	418.4
MIDWEST		
Chicago	352.5	269.9
Cleveland	383.2	278.6
Columbus	294.4	240.0
Detroit	354.3	266.1
Indianapolis	337.3	250.4
Milwaukee	381.7	287.3
St. Louis	424.6	286.3
SOUTH		
Dallas	343.7	267.3
Houston	306.9	258.3
Jacksonville	409.8	301.9
Memphis	416.0	275.1
New Orleans	357.7	274.3
San Antonio	359.5	256.1
WEST		
Los Angeles	401.1	274.8
Phoenix	356.0	275.5
San Diego	333.2	255.2
San Francisco	488.3	265.2
Seattle	360.2	272.3

1/ Basic City services includes education, highways, police, fire, sanitation, recreation, libraries, financial administration and general control.

SOURCE: Bureau of the Census.

not significantly exceed those of other large cities. Rather, its enormous personnel needs result directly from the wide range of non-municipal functions that the city chooses to or is forced to provide.

<u>The City's Response to the Recession</u>:

The severity of the current recession and the federal government's inability to reduce unemployment have forced many large central city governments to undertake significant budget adjustments this year. Typically, these budget adjustments take the form of tax increases, expenditure cutbacks and delays or cancellations of capital construction programs. They are necessary for cities to keep their budgets at or near balance in the face of revenue shortfalls and expenditure increases caused by the recession.

While New York City's response to long-term economic developments was in many ways inadequate, it's response to the current recession has generally exceeded the response of other large central cities. (Table VII). New York City's tax increases have exceeded the tax increases of most other central cities and its cuts in current service expenditures have been among the highest in the Nation. While it is more difficult to measure changes in local employment, earlier Joint Economic Committee surveys indicate that New York's payroll reductions through attrition and layoffs have probably been the most significant in the Nation. Thus, with the possible exception of Detroit and St. Louis, New York City's combination of tax increases, expenditure cutbacks and employee reductions has been the most

TABLE VII

RECESSION RELATED BUDGET ADJUSTMENTS FOR EIGHTEEN LARGE CITIES [1/]

	Tax Increases as a Percentage of Total Own Source Tax Receipts	Expenditure Cutbacks as a Percentage of Total Expenditures
Baltimore	.8	1.3
Boston	-	-
Cleveland	-	6.7
Columbus	-	.3
Detroit	4.9	9.4
Indianapolis	-	-
Jacksonville	-	-
Los Angeles	5.3	.9
Memphis	-	-
Milwaukee	6.5	-
New Orleans	-	-
New York	6.9	5.8
Philadelphia	7.4	-
Phoenix	10.7	3.8
Pittsburgh	-	2.9
St.Louis	6.5	5.8
San Francisco	7.4	-
Seattle	4.1	.8

1/ The data in this Table is based on a Joint Economic Committee Survey of State and local government finances. The survey was taken in April, so the budget adjustment data may not be completely current. The budget adjustments are for the third quarter 1975, at an annualized rate. See: The Current Fiscal Position of State and Local Governments.

expenditure cutbacks and employee reductions has been the most severe in the Nation.

No doubt, the size of New York's recession related budget adjustments is directly related to the City's inability to respond adequately to its longer-term economic developments. Had the City consistently reduced expenditures or raised taxes to balance the budget in previous years, it would not have been forced to undertake such large bydget adjustments this year. Nevertheless, the current recession has precipitated a series of major budget cutbacks by the City and probably acted as a major catalyst for the City's current market access problems.

The City's Response in the Future: The Three Year Financial Plan:

While the city of New York has enacted significant economies in the first nine months of this year, these actions are certainly not sufficient to offset the budget imbalances caused by past problems and the current recession. In recognition of these future budget difficulties, the State Emergency Financial Control Act established a Board to oversee the finances of the City. This Board has produced a plan pursuant to the requirements of the State Act, which moves the City toward a balanced budget by Fiscal Year 1977-1978. The following section examines the specific provisions of the three year plan.

There is no doubt that the three year plan proposed by the Financial Control Board will impose major reductions in current service levels, affecting both the residents and employees of the

City of New York. Some budget economies may be achieved through more efficient management, improved productivity and more effective revenue collection procedures, but the great majority of the expenditure modifications will result directly from a real reduction in the range and quality of services provided by the City.

As Table VIII shows, by fiscal year 1978, the City will be forced to make expenditure cuts of $724 million to balance the budget. At first glance, it might appear that a cut of $724 million in a $12 billion budget is not an extremely difficult accomplishment. However, like the Federal budget, a large portion of New York City's budget is uncontrollable.[12] Once debt service, state mandated welfare expenditures, pension payments and other uncontrollables are removed from the City's expenditures, only about $5.5 billion remains at the discretion of the City (Table IV). Since the dollar expenditures for the controllable portion of the budget will be held essentially constant through the life of the Financial Plan, the real value of these controllable expenditures will be reduced approximately $335 million[13] from FY 1976 to FY 1978. Thus, the real reduction in controllable expenditures by FY 1978 is approximately $1,050 million, or 18 percent of the projected controllable budget.

12/ Uncontrollables are defined as those expenditures that are mandated by State or Federal law, and thus not under the administrative control of the City.

13/ An assumption of a three percent annual inflation rate reduces the dollar value of constant controllable expenditures by $335 million.

TABLE VIII

NEW YORK CITY REVENUES
AND EXPENDITURES ($ MILLIONS)

	BALANCE OF FY 1976 (Oct 1 to June 30)	FY 1977	FY 1978
Revenues	8392	11992	12294
Expenditures (except debt service)	7479	10634	10697
Debt Service	1669	2190	2191
Reserves for Overruns	0	100	100
Total Expenditures (without budget cuts)	9148	12924	12988
Budget Cuts	-92	-462	-724
Total Expenditures	9056	12462	12264
Surplus or Deficit	-664	-470	+30
Capital Spending (Total)	1147	1100	930
Operating Items in Capital Budget	523	647	596
Real Capital Items	624	453	333

Source: Office of the Controller of New York City

TABLE IX

EXPENDITURE CUTS IN THE CONTROLLABLE PORTION OF NEW YORK CITY'S FY 1978 BUDGET

Total Controllable Spending in FY 1976	$5500 Million
Controllable Spending in FY 1978 (Projected)1/	$5835 Million
Budgeted Controllable Spending in FY 19782/	$5500 Million
Cuts in Real Services Due to Inflation From FY 1976 to FY 1978	$ 335 Million
Budget Cuts Mandated by Plan	$ 724 Million
Total Deflated Cuts	$1059 Million
Total Deflated Cuts in Real Services as a Percentage of FY 1978 Projected Controllable Budget	18.2 percent

1/ Includes 3 percent inflation factor.

2/ As it appears in the Financial Plan.

Source: Office of the Controller of New York City

A cut of this magnitude will constitute a significant reduction in the real level of services provided by the City of New York. Many programs will have to be sharply curtailed and others will, no doubt, have to be eliminated completely. In fact, few aspects of the City's budget will escape careful scrutiny under the new plan. Wages and salaries will be frozen for the two year period beginning July 1, 1976. All major new capital construction projects will be interrupted. Many projects already underway will have to be delayed. The City's housing construction program has already been discontinued. In short, New York will finally be taking the long delayed but necessary steps to put its budget in balance.

However, the budget balancing task is even tougher than it appears. Expenditure cuts and employee reductions will further undermine the city's employment base and thus directly affect the budget of the city. Employee reductions and expenditure cutbacks will lead to a further reduction in future city revenues and to an increase in unemployment related city expenditures. Without a meaningful recovery in the national economy, these cuts will only serve to move the City's budget further away from a balanced position, necessitating further cuts and greater hardships.

Moreover, it may be difficult to achieve the expenditure cuts necessary without directly affecting the flow of grants-in-aid from the State and Federal governments. Cuts in programs which have requirements that the city match funds from other levels of government, may also serve to lessen the flow of intergovernmental aid to the city, thus reducing its revenues. Thus, the combination of revenue and grants-in-aid reductions and expenditure increases may force New York to make cuts in excess of 18 percent of the controllables in order to truly balance the budget.

The financial plan also presents, for the first time, a detailed description of the City's borrowing needs over the next three years (Table X). This table shows that the city will have total borrowing needs of approximately $8.8 billion over the three year period (FY 1976 to FY 1978). Approximately $2.9 billion must be borrowed to roll over outstanding short-term debts maturing in FY 1976 and FY 1977. Another $1 billion must be borrowed to fund the operating deficits until the city's budget is brought into balance. $3 billion is necessary to fund the reduced capital budget and as much as $2 billion may be necessary to meet the city's cash flow problems.[14/] Clearly, the City will be heavily dependent upon access to some source of credit over the next three years. If this source of credit is not available, the city will have no option but to default on its obligations.

14/ This intra-year debt will be retired within the fiscal year and thus, does not have to be rolled over.

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TABLE X

BORROWING NEEDS OF THE CITY ($ MILLIONS)

	FY 1976 (Dec 1 to June 30)	FY 1977	FY 1978	TOTAL
Debt Rollover[1]	2560	4068	5938	
New Rollover		300		2860
Operating Deficit	516	470	+30	956
Capital Program	992	1100	930	3022
Intra-Year Borrowing	2000	2000	2000	2000
Total	6068	7938	8838	8838

[1] Figures for debt rollover assume that notes issued to fund maturing debts, capital construction and the operating deficit carry maturities of only one year and thus must be rolled over in each ensuing year. If these obligations are funded with longer-term bonds, the borrowing requirements of the City in FY 1977 and FY 1978 would be greatly reduced.

Source: Office of the Controller of the City of New York

THE ECONOMIC EFFECT OF A DEFAULT BY NEW YORK CITY

Definitive conclusions about the economic and financial consequences of a default by New York City cannot realistically be presented. The uncertainties about investor reactions and governmental responses are just too great. However, it is possible to analyze in detail economic and financial developments in the past six to eighteen months and to use this analysis to formulate credible assumptions about future developments. These assumptions can then be used to reach conclusions about some of the possible consequences of default.

THE STATE AND ITS AGENCIES

Much of the concern about the default of New York City revolves around the increasing involvement of the State of New York in the City's financial affairs. Some of this concern centers on a real financial commitment by the State to the City of New York. The State has already loaned the City $250 million and by December 1 will have purchased $500 million worth of MAC securities. The MAC securities are a relatively secure commitment but a default by the City on its own obligations would ubdoubtedly jeopardize quick repayment of the $250 million loan from the State. A default by the City on that loan, combined with a State budget deficit of approximately $600 million, would give the State a total budget imbalance of $800-900 million for FY 1976. While this is undoubtedly a large deficit, it is not significantly out of proportion with budget imbalances experienced by other Northeastern and Midwestern states that have experienced significant recession related unemployment rate increases. Thus, the State's deficit and real financial commitment to the City, are not by themselves sufficient to undermine, significantly, the State's ability to meet its obligations.

However, the involvement of the State in the City's affairs goes well beyond the real financial commitment of the State. Of far greater significance is the questionable, but nevertheless, very real perception by investors that New York State's ability to meet its obligations is directly tied to the ultimate fate of the City. Even before default, this perceived reduction in the State's credit worthiness has imposed very real costs on the State and its agencies.

The State agencies have encountered most severe market resistance. Their securities, which are backed only by the "moral obligation" of the State, have been victimized by the tendency of investors to respond to uncertainty by seeking only investments that are perceived as being perfectly secure. Thus, investors have exercised their preference for top quality general obligation issues, while spurning the less secure moral obligation bonds. As Table XI shows, the State agencies will have average monthly borrowing needs of almost $200 million through June.

TABLE XI

NEW YORK STATE BORROWING REQUIREMENTS ($ MILLIONS)

FY 1976	STATE	STATE AGENCIES[1]	TOTAL
November	--	249	249
December	30	292	332
January	6	218	224
February	--	221	221
March	153	179	332
FY 1977			
April	800*(800)	165	965(800)*
May	800	85	885
June	950	158	1108
TOTAL	2739*(800)	1567	4316(800)*

[1] Does not include the Municipal Assistance Corporation.

*In FY 1976, the State advanced the City $800 million in grants that would have been received later in the year. If this procedure is followed again in FY 1977 the State's borrowing requirements in April and May will be increased $800 million.

Source: Office of the Controller of the State of New York

One of these agencies, the State's Housing Finance Agency, barely averted default in October, but only temporarily. At that point, the private market was completely closed to the State Agencies. However, the State Housing Finance Agency must borrow over $100 million a month in each of the next six months. Even with the backing of the full faith and credit of the State, this would be an extremely difficult task. However, without this commitment by the State, the Housing Finance Agency will almost certainly default.

But the State's full faith and credit securities have not escaped investor skepticism. The last issue of State general obligation rates carried a net interest cost of 8.7 percent. While this $250 million issue was made in behalf of New York City, and thus may have been perceived to be strongly associated with the City, it was indicative of the market's reaction to any security with the name New York on it. Fortunately, the State does not have great borrowing needs until the second quarter of 1976. However, in that three month period, the State will have to borrow $2.7 billion to $3.5 billion (Table XI). These notes are issued in the first three months of the State's fiscal year (April, May and June) so that the State can distribute State assistance to all the local governments within the State. Without the immediate distribution of this state aid, most New York local governments will be forced to default.[15/]

It is impossible to ascertain how investors will receive New York State's general obligation notes in April if the City defaults

15/ Most New York local governments borrow at the beginning of their fiscal years (July 1) in anticipation of the State aid that is forthcoming in April, May and June, or at the end of their fiscal year. If this State aid is not forthcoming, they will be forced to default.

in December. Many investors could express their concern about the relationship between the City and the State by refusing to buy State State securities at all. Others may conclude that the act of default by New York City has removed a great financial strain from State resources. However, the uncertainty is so great that one cannot ignore the possibility that a default by New York City could cause severe market access problems for the State and many other local governments within the State.

Finally, one cannot ignore the impact that New York City's financial crisis will have on the budget of the State of New York. Significant employee reductions and expenditure cutbacks within the City will quickly have an effect on the State's tax receipts. Revenues from the state income and sales taxes will decline as unemployed public employees and construction workers suffer declining real incomes. Ultimately, state expenditures for welfare and other related expenditures may also be increased. While it is difficult to measure the precise impact of the City's expenditure reductions on state receipts and expenditures, crude estimates suggest that the total effect may be between $100 million and $150 million. Thus, the economies undertaken by New York City whether it defaults or not, will lead to a widening of the State's budget deficit by $100 million to $150 million.

THE IMPACT ON FINANCIAL INSTITUTIONS AND OTHER INVESTORS:

Default, even under the best of circumstances, will lead to an immediate reduction in the market value of outstanding New York City securities. The secondary market for these securities will probably deteriorate greatly until the uncertainty about repayment is resolved and any investors who are forced to liquidate their holdings during this period will no doubt experience large losses.

However, the value of these securities subsequent to this period of uncertainty is much more difficult to predict. If a reasonable repayment plan is developed, it is conceivable that New York securities could be valued near pre-default levels. But, if the City's resources are inadequate to meet all principal payments within a reasonable period of time and it does not pay market interest rates on delayed principal payments, the value of New York's outstanding securities could be reduced significantly below already depressed pre-default levels. There is no doubt, however, that a default by New York City will affect the behavior of major investors in New York securities.

Since banks are heavy investors in the municipal bond market, holding almost 50 percent of the outstanding securities, it is important to ascertain the impact of default on the banking system and on individual banks that are large holders. Under current bank examination practices, the bank regulatory agencies allow banks to carry assets at book value rather than market value. A default by New York City would necessitate an alteration in this practice as the regulatory agencies require banks to write down the value of defaulted securities to market values over a period of approximately six months. These write-downs will reduce the capital positions of the banks that are large holders of City securities.

Recent surveys by the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) have identified the number of banks that are potentially vulnerable to a default by New York City. The FDIC survey indicates that 56 of the 8,606 banks reporting, had holdings of New York City securities in excess of 50 percent of their net worth. (Table XII). However, most of these banks are small and well capitalized, so there is little danger of default precipitating a major bank failure among the non-member banks. The Federal Reserve's survey of member banks reached similar conclusions. It discovered only six banks whose holdings of New York City securities exceeded 50 percent of their capital.

Moreover, the Chairman of the Federal Reserve Board has made it clear that the Board will take whatever actions are necessary to preserve the stability of viable banking institutions. First, the FED is prepared to lend unlimited funds through the Federal Reserve discount window to any member or non-member bank that needs assistance to meet its temporary liquidity needs. Second, the bank regulatory agencies will allow banks to suspend the write-down of defaulted assets for a period of six months. This will provide banks some time to rebuild their capital positions and also allow the market to stabilize so that the bank regulators will value these securities at their true post-default value. Finally, the FDIC is prepared to assist insured banks that require temporary infusions of new capital. These three actions are sufficiently comprehensive to prevent any bank from going into receivership as a result of a New York City default.

TABLE XII

NON-MEMBER BANK HOLDINGS OF NEW YORK CITY OBLIGATIONS

Current book value as % of Net Worth:	Number of Banks	Notes	Bonds	Total
20% to 30%	125	$24,550	$53,325	$77,875
30% to 40%	54	3,120	22,223	25,343
40% to 50%	36	5,837	18,357	24,094
50% to 70%	36	19,007	16,589	35,596
Over 70%	20	69,101	32,629	101,730
	271	$121,615	$143,123	$264,638

The 271 nonmember banks reflected in the above table are located in 34 states, with ten or more located in Alabama, Arkansas, Florida, Illinois, Louisiana, Missouri, New York, Tennessee and Texas. The 56 nonmember banks reporting the largest concentrations of New York City obligations, i.e. 50% or more of their net worth, are located in 18 States, with only 5 States having 4 or more such nonmembers (Arkansas, Florida, Illinois, Missouri, and New York).

Source: Federal Deposit Insurance Corporation

However, the fact that no major bank will become insolvent does not imply that banking practices will not be affected by a default. Many banks, particularly, clearinghouse banks in New York, have already suffered a depletion in capital from REIT loan losses, the W. T. Grant bankruptcy and other loans which have not been repaid promptly. A default by New York City, on top of these other loan losses, will only serve to make bank lending practices more conservative than they are already. This will result in further reductions in the growth in new bank loans, a development that will affect the strength of the recovery.

In addition to exercising greater caution, many banks will choose to demand somewhat higher interest rates on their loans. Higher interest rates will be necessary to improve the return a bank receives on its loans and thus to strengthen the banks' ability to rebuild capital.

Finally, it is possible that large uninsured depositors, out of concern about the solvency of specific banks, will exercise greater caution in placing their deposits in particular banks. This could cause a temporary flow of funds away from banks that are perceived as vulnerable to default (i.e., the New York City clearinghouse banks) and toward less vulnerable regional banks. A similar development may occur internationally as Eurodollar deposits are shifted from foreign branches of U. S. Banks that have large holdings of New York City bonds to foreign branches of other U. S. banks or to other international banks.

A combination of a withdrawal of large uninsured deposits and of Eurodollar deposits from foreign branches could increase the temporary liquidity strains on individual banks necessitating a further increase in the size of Federal Reserve discount window loans.

Finally, it should be pointed out that if the State and its agencies also default, the liquidity strains on the banking system will be far greater. New York City securities, because they are a lower quality issue, are as commonly held by banks as higher grade municipal bonds and notes. Bank holdings of New York State and New York State Agency issues are, undoubtedly much higher. Thus, any series of developments which jeopardize the State's own ability to meet its obligations will significantly increase the liquidity strains on the financial system.

In summary, a default by New York City is unlikely to cause any major solvency problems for the banking system. However, a default could lead to slightly higher interest rates, to somewhat reduced bank lending activity and to temporary liquidity strains--all of which could weaken the strength of the recovery.

THE MUNICIPAL BOND MARKET

Since August, the municipal bond market has been characterized by considerable stress and strain, indicative of the increased uncertainty surrounding New York's unresolved financial crisis. Institutional investors have sought to control increases in their holdings of tax-exempts in an attempt to minimize their vulnerability to losses. Underwriters have reduced their participation in new offerings, resulting in a larger share of new issues being sold through negotiated rather than competitive bids. And activity in the secondary market for outstanding tax-exempts has slowed as investors hold back until the uncertainty is resolved.

These factors have also contributed heavily to a significant rise in the yields on tax exempt securities, both absolutely and relative to yields in other markets. As Table XIII indicates, the ratio of tax-exempt to taxable yields has risen consistently throughout the course of the year. This means that interest rates on tax-exempt securities are moving closer to interest rates on taxable securities, indicative of a decline in the value of tax exemption. The increase in relative yields clearly has affected the entire tax exempt market as relative yields on high rated securities (AAA) have increased almost as much as relative yields on low rated (BAA) securities. Clearly, the increases are particularly precipitous in September and October, when the concerns about a default by New York City reached a peak.

This rise in tax-exempt yields relative to taxable yields cannot be attributed solely to New York City's financial difficulties. Some of the rise in relative yields probably results from the large volume of tax-exempt issues marketed this year. (Table XIV) This increase in supply, combined with an increasing reticence by banks to purchase new tax-exempts has created supply and demand pressures that probably would have caused some increase in tax-exempt yields anyway.

TABLE XIII

RATIO OF YIELDS ON LONG-TERM TAX-EXEMPT SECURITIES TO YIELDS ON LONG-TERM TAXABLE CORPORATE SECURITIES

	TOTAL[1]	Aaa	Baa
1970	.754	.761	.741
1971	.708	.706	.688
1972	.695	.699	.686
1973	.669	.671	.666
1974	.689	.687	.687
1975 (average of first nine months)	.733	.721	.720
1974			
September	.700	.702	.709
October	.669	.670	.671
November	.681	.682	.668
December	.736	.748	.711
1975			
January	.721	.724	.702
February	.686	.691	.674
March	.722	.724	.705
April	.732	.722	.719
May	.728	.721	.715
June	.737	.716	.720
July	.750	.723	.736
August	.749	.715	.745
September	.775	.751	.767
October (first 3 weeks)	.784	.762	.778
Week Ending			
September 6	.765	.746	.757
September 13	.770	.745	.764
September 20	.779	.753	.771
September 27	.784	.759	.775
October 4	.797	.780	.789
October 11	.787	.761	.782
October 18	.769	.745	.764

1/ Includes bonds that are rated Aa and A.

Source; Federal Reserve Bulletin

TABLE XIV

TOTAL VOLUME OF TAX-EXEMPT BORROWING ($ MILLIONS)

	LONG-TERM	SHORT-TERM	TOTAL
1970	$18,188	$17,811	$35,999
1971	25,006	26,259	51,265
1972	23,748	25,270	49,018
1973	23,957	24,705	48,662
1974	24,317	29,543	53,860
1975*	31,995	31,757	63,752

*Annual rate based on January to July volume

Source: Securities Industry Association

However, these supply and demand pressures were present earlier in 1975, when the ratio of tax-exempt to taxable yields was more in line with historical trends. For this reason, it is reasonable to conclude that the large increases in relative yields in the last three to four months results primarily from the uncertainty created by the New York City financial crisis.

In order to evaluate the dollar value of these increased yields, it is necessary to ascertain what tax-exempt yields would have been had New York City's financial problems not precipitated upward pressure on tax-exempt interest rates. If it is assumed, that supply and demand pressures would have pushed the ratio of tax-exempt yields to taxable yields up to .733 (the average for 1975),[16/] it is clear that there is a five percentage point premium[17/] in the yield ratio due to New York City. Since the Average yield on all corporate bonds for October was 9.54 percent, a 5 percentage point reduction in the ratio of tax-exempt yields to taxable yields results in a 48 basis point reduction (approximately .5 percentage points) in the yield on tax-exempts. If one assumes an average maturity of ten years on the $32 billion worth of long term bonds issued this year, the cost to all state and local governments is approximately $150 million a year for ten years, or a total of $1.5 billion. Discounted to the present, the real increase in interest costs is probably closer to $1 billion, depending upon the discount rate one assumes. In addition, if relative yields remain at their October levels,

16 / This is a conservative assumption, since the average tax exempt/taxable yield ratio in the last five years was .703.

17 / The ratio for October (.784) minus the ratio for the year (.733) equals .051, or five percentage points.

at their October levels, an additional annual interest cost of $150 million will be incurred on short-term tax exempts. Thus, if yields remain at existing high levels, the total costs in added interest charges to all issuers is approximately $300 million this year and $150 million for each of the nine following years.

While, yields in the entire municipal market are clearly rising relative to yields in other markets, there are also important changes occurring within the municipal market. Most significant among these changes is a trend toward greater selectivity with regard to the quality of the issue. Table XV clearly indicates that the gap between the yields on high quality (Aaa) and low quality (Baa) municipals is widening. For the first nine months of 1975, the yield spread between Aaa and Baa municipals was 112 basis points, almost double the yield spread of 64 basis points in 1974. This move to quality by investors probably began as a result of the financial problems experienced by the New York State Urban Development Corporation, but New York City's financial difficulties have certainly served to sustain and extend this trend.

This trend toward greater investor selectivity could be viewed as a positive development if it encourages states, cities and other governmental units to manage their budgets more efficiently. However, the credit ratings used to measure the quality of the investment do not focus particularly on the management of a unit of government. Rather, these credit ratings are based primarily on the government's long term ability to meet its obligations Thus, many well managed governments and public agencies that serve areas with declining revenue bases will pay penalty interest costs.

TABLE XV

YIELD SPREAD BETWEEN HIGH QUALITY (Aaa)
AND LOW QUALITY (Baa) LONG-TERM TAX-EXEMPT SECURITIES

1970	.63
1971	.77
1972	.56
1973	.50
1974	.64
1975 (Average of first nine months)	1.12
1974	
September	.69
October	.78
November	.95
December	.85
1975	
January	1.06
February	1.07
March	.97
April	.97
May	1.06
June	1.20
July	1.21
August	1.31
September	1.24
October (first three weeks)	1.27

Source: Federal Reserve Bulletin.

If this development continues, many soundly managed communities may well have difficulty marketing their securities at a reasonable and affordable interest rate.

Finally, the unique difficulties experienced by all units of government within New York State cannot be ignored. The State is seemingly unable to market its own securities, even at penalty interest rates. The State agencies, even those that are efficiently managed such as the Housing Finance Agency, are unable to obtain credit. Small and medium sized cities and counties within the State are experiencing great difficulty and paying high costs to market bonds or notes. Even the City of Rochester with its Aaa rating was forced to pay a net interest cost of 6.8 percent for one-year notes that in any other state would have received bids as much as 200 basis points lower. In short, New York City's problems clearly have affected other borrowers that are associated with the City by virtue of geographic location.

The developments within the last three months, particularly the rising tax-exempt yields and the increased investor selectivity, suggest that the market has already discounted, to a certain extent, a default by New York City. If this proves to be true, a default could conceivably lead to a reduction in uncertainty and thus to a return to stability in the municipal bond market. Howeveer it is just as conceivable that a default could cause further rises in municipal bond yields and lead to a greater skepticism on the part of investors. Fiduciaries could become reluctant to invest in municipal bonds for fear of violating prudent investment practices. Banks and individual investors might be unwilling to invest new capital. In short, the problems currently being experienced by a small groups of municipal borrowers may only be a precursor of more widespread difficulties after default.

THE NATIONAL ECONOMY

While it is difficult to ascertain precisely how New York's financial crisis will effect the national economy, it is very possible that a default could weaken the strength of the economic recovery. The major factor in a weaker economic outlook would be a significant reduction in the rate of growth in State and local government expenditures. This reduction in state and local government spending will result primarily from higher borrowing costs and reduced access to the municipal bond market.

First, high interest rates, effectively prevent many state and local governments from borrowing for capital construction or other purposes. Thirty-eight states have statutory or constitutional provisions that limit the rate of interest that a state, its agencies or its local governments can pay on bonds or notes. While the specific provisions vary considerably from State to State, most of the interest rate limitations prohibit the payment of interest in excess of 7 to 8 percent. Since many states and localities are now paying interest costs close to or in excess of these limitations, it is probable that some states and localities will be effectively excluded from the market by their own laws.

Second, many state and local governments/are reticent to fund major capital construction projects as long as interest rates are at record levels. Marginal projects may go unfunded and delays and cancellations of major programs may result. In fact, the rise in tax-exempt yields has already created difficult problems for many State housing agencies that depend on credit at reasonable interest rates to fund viable projects.

Finally, some State and local governments may be forced to reduce their operating expenditures and bring their budgets into balance. The recession has caused some State and local governments to borrow this year to fund small deficits, in the hope that the recovery will generate sufficient revenues next year to return their budgets to balance. If these governments are denied access to the credit markets they will be unable to fund their deficits and forced to adopt some combination of expenditure cuts and tax increases to bring their bduegts into balance.

A second factor which could impair the recovery process is a reduction in activity by financial institutions. Banks that are large holders of defaulted securities will undoubtedly reduce their expected loan growth in an attempt to avert temporary liquidity strains. These cautious lending practices may weaken business investment and will probably reduce consumer loans. Interest rates can be expected to rise as banks seek a high return on their investments in an attempt to rebuild their capital positions.

In order to ascertain the precise impact of these developments on the overall economy several assumptions have been made. First it is assumed that total state and local spending will be cut \$2 billion per quarter for each of the next four quarters. Second, it is assumed that the Federal Reserve will allow increases in borrowed reserves to whatever level is necessary to stabilize the banking system. In essence, these assumptions suggest that default will precipitate an adjustment in state and local expenditures and major dislocations in the financial system. Assessment of the economic impact of these developments was carried out with the assistance of the Wharton econometric model.

The result of this econometric analysis, modified by staff judgements, suggests that a default by New York City could have a meaningful effect on the recovery process. The combination of a reduction in state and local government expenditures and a slight increase in interest rates could reduce the growth rate in real Gross National Product by approximately one percentage point by the fourth quarter of 1976. A reduction in real output of this magnitude will lead to an increase in the national unemployment rate of about .3 of a percentage point above expected levels -- an increase in the total number of unemployed persons of 300,000 above expected levels.

Slower growth rates and higher unemployment rates would also lead to an enlargement of the Federal government's budget deficit. Receipts would be reduced by approximately $3.5 billion; and expenditures for unemployment compensation, food stamps and other related programs would rise by more than $.5 billion. Thus, the total addition to the Federal deficit resulting from one reasonable default scenario is approximately $4 billion.

THE REGION AND THE CITY

The greatest costs associated with the City's financial crisis will undoubtedly be borne by the City itself. Any expenditure cutbacks or tax increases that the City enacts are bound to further erode the City's tax base and accelerate the flight of jobs and middle income people to the surrounding suburbs or to other regions of the country.

In the short run, the reduction in public and private sector jobs resulting from the fiscal crisis will prevent the city from experiencing any improvement in total employment as the national economy begins to recover. Approximately, 30,000 public employees have already been removed from the City's payroll. A similar number will probably be eliminated as the city moves toward a balanced budget. In addition, the City's housing construction program, which produced approximately 15,000 new units a year and provided approximately 20,000 to 24,000 construction jobs annually has been eliminated. And capital construction program, which provided further construction employment has been severely reduced. In fact, approximately 100,000 jobs will be lost as a direct result of the budget economies that will be achieved in the next two years.

Moreover, many of these cuts may turn out to be counter-productive. Large cuts in employment will probably lead to a decline in receipts for the City and to increased expenditures for welfare, medicaid and other unemployment related expenditures. These additional budget pressures will ultimately lead to a need for more expenditure cuts or tax increases to keep the budget in balance.

Over the long run, tough decisions which the city is making now may ultimately undermine the viability of the city's economic base. Reductions in the capital budget are just one example of cutbacks that are necessary to reduce expenditures and to lessen the City's borrowing needs. However, many of the projects that are being indefinitely delayed or postponed would ultimately have created new private sector jobs in the City and taxable property to enlarge the City's fiscal base.

Clearly, the City and the region face several years of further job losses, eroding tax bases and increases in dependent population. But, it is certainly difficult to ascertain any actions which the City could take to avert or mitigate this downward trend.

POLICY OPTIONS

Before the Federal government makes a decision about whether to involve itself directly in the finances of a state or local government, it is essential that the assisted government has exhausted all possible local and state remedies to its financial problems. Thus, in the case of New York, Congress should be convinced that every conceivable state or local mechanism for relieving the crisis has been enacted and that the resources of the City and the State simply are not sufficient to meet total needs.

The City's Role

At this late stage in New York City's financial crisis, there are very few options available to the City acting on its own behalf. At present the city has no direct or indirect access to any source of credit. Nor does it seem conceivable, even if the budget were completely balanced, that the City could return to the market immediately.

Thus, if the City is required to avert default through the use of its own resources, sufficient funds will have to be diverted from the operating budget, either through tax increases or expenditure cutbacks. A brief look at Tables IX and X reveals that this is a totally unrealistic alternative. The City's total borrowing needs from December 1 through June 30, even without intra-year borrowing to smooth out cash flows, are approximately $4 billion.

However, the controllable portion of the City's budget for the remaining seven months of the fiscal year is only $3.2 billion.[18/] Thus, even if the City were to suspend all of its police, fire, sanitation and other controllable expenditures, it still would not have sufficient funds to avert default.

THE STATE'S ROLE

Since local governments, under our Federal system, are legal creatures of the States, the Federal government should not consider assisting a local government until all reasonable state remedies have also been exhausted. The State of New York, although it is already heavily committed to New York City, theoretically has several options available which could be used to avert default.

First, the State could make further attempts to borrow on behalf of the City. Unless market conditions shift dramatically, this alternative appears to be totally unrealistic. At present, it appears that the State of New York is unable to borrow the $250 million it needs to complete the assistance package in the Financial Emergency Act. And this $250 million issue is backed by the full faith and credit of the State. If the State were to commit itself to borrowing the $4 billion necessary to keep the City from defaulting, it would have to be done through a MAC-type agency, which would only be backed by the moral obligation of the State.[19/] Since the State is currently unable to market a small amount of general obligation bonds on behalf of a state Agency (MAC) it clearly will not

18/ 7/12 of the $5,500 million controllable budget.

19/ The State constitution requires that significant increases in the volume of outstanding general obligation State bonds be approved by a public referendum.

be able to market a large volume of moral obligation bonds for the benefit of the City.

A second form of state assistance would be to accept responsibility for funding some of the services currently provided by the city. Clearly, there is some justification for this approach, because the division of responsibility that currently prevails within the State has contributed significantly to the City's current crisis. The two major functions that realistically could be assumed by the State are welfare services and the City university system. State assumption of responsibility for the welfare system could save the city about $1 billion while a state takeover of the higher education system could transfer an additional $300 million to the State's budget. Clearly, these adjustments are not sufficient to solve the City's immediate financial crisis, but they may be necessary and advisable if the City is expected to balance its budget in the next two years.

It must be recognized, however, that any assumption of City functions by the State will necessitate a significant increase in tax levies on all residents of the State, including the residents of New York City. The net benefit to the residents of the city would clearly depend on the responsibilities that were assumed and upon the method that the State used to raise the necessary revenues. However, the government of the City would clearly benefit from the reduction in expenditure pressures on its own budget.

The final method of assistance that the state could undertake is a grant-in-aid sufficient to meet the borrowing requirements of the City. This would necessitate a $4 billion state tax increase over a seven month period, equivalent to a surcharge of 65 percent on all State taxes and fees. Clearly, this would also be an unacceptable alternative.

While the State realistically does not have sufficient resources to avert a default by the City, this should not imply that the State could not increase its participation in an assistance program if the Federal government does decide to prevent a default. Some modest and reasonable increase in the State's commitment, through one of the mechanisms described in this section, would be a reasonable quid pro quo for Federal assistance in averting default.

THE FEDERAL ROLE

Since it is clear that the resources of the City and the State of New York are not sufficient to meet the City's cash needs through the remainder of the fiscal year, two broad policy decisions confront the Congress. First, Congress must decide whether it will provide assistance to New York City, either to avert default or to mitigate the consequences. Second, if assistance is to be provided, Congress obviously must decide on the type, scope and magnitude of the aid.

Conformity with existing principles of intergovernmental relations would clearly indicate that the following principles govern federal participation.

First, any action by the Congress will have to include some provisions for maintaining reasonable levels of public services for the citizens of New York. Any solution that does not meet this basic criteria must be judged as totally unacceptable. Second, the decision that Congress makes should be, to the extent feasible, consistent with the principles embodied in our Federal system of government. The solution should minimize the length and scope of the Federal involvement and incorporate strong provisions for State participation. Third, the Congressional decision should avoid, to the extent possible, increasing the borrowing costs of other state and local governments and the Federal Treasury. Fourth, the solution offered should minimize the risks of damage to the economic recovery now underway. Fifth, any solution offered should aggravate as little as possible the market access problems of New York State. And finally, the Congressional decision should preserve the risk element in the private investment decision. Investors who have received interest premiums associated with higher risks should not have their investments made whole.

This section of the report will discuss and evaluate, on the basis of the above criteria, three broad policy options available to Congress. The three options are: (1) "Federal Non-involvement" -- this policy would involve a restructuring of the provisions in the Federal Bankruptcy statutes dealing with municipal defaults, but would involve no Federal assistance in obtaining credit subsequent to bankruptcy; (2) "Default with Subsequent Aid" -- this option would allow the City to follow the same bankruptcy procedures as the "Non-involvement" policy, but would provide some mechanism for obtaining credit subsequent to default; (3) "Prevention of Default" -- this policy would extend a line of credit to New York City through some Federal mechanism, sufficient to avert default. While there are many mechanisms which could be used to implement a Federal commitment (i.e. direct loans, bond guarantees, insurance, etc.) These will be discussed only as they affect a broad policy options' ability to meet the criteria set forth in this section.

It is assumed for the purposes of this evaluation that any option involving Federal participation will include;

a) strict requirements that the City maintain a balanced operating budget;

b) significant restrictions on the borrowing requirements of the City;

c) State control over the City's financial affairs;

d) a forfeiture of state and city grants-in-aid if principal and interest payments are not met; and

e) other requirements that will limit eligibility to only those governments that are totally excluded from the credit markets.

"Federal Non-Involvement": This option would require Congressional amendments to the Federal Bankruptcy statutes to allow a city to file for bankruptcy without the morass of legal complications that would ensue under existing statutes. The primary element of this revision would give the court power to allow priority claim on revenues for expenditures necessary to maintain essential services. Thus, employee wages and purchases of goods and services necessary to the maintenance of health, safety and public welfare would be paid before obligations to existing bondholders.

The first and most important question that must be raised about this option is will the City have sufficient funds available to fund basic city services? If we make the optimistic assumption that the court will temporarily suspend all debt service payments (both principal and interest) it is possible to analyze the monthly receipts and expenditures of the City to determine if sufficient funds are available to maintain basic services. As Table XVI illustrates, the monthly shortfall of the city from December through March averages $305 million. Thus, during this time period the City would have to reduce monthly expenditures by an average of $305 million a month. These cuts would be necessary because the City would have no access to the credit markets, and thus would have no choice but to operate with a balanced budget.

While the city does expect to receive offsetting revenues in the final three months of the Fiscal Year, the result of these draconian cuts in the period from December to March will truly be chaotic. Payrolls will be missed, massive layoffs will be required and public assistance checks would have to be withheld. A $305 million cut in the controllable portion of the budget would represent a cut in current controllable services of approximately 50 percent.

Clearly, the "Federal Non-Involvement" option has such a devastating effect on basic city services that it cannot realistically be considered a viable option.

TABLE XVI

MONTHLY CASH NEEDS OF THE CITY
(EXCLUDING DEBT SERVICE) ($ MILLIONS)

MONTH	REVENUES	EXPENDITURES	NET DEFICIT OR SURPLUS	CUMULATIVE DEFICIT OR SURPLUS
December 1975	589.2	978.6	-389	-389
January 1976	749.5	1078.9	-329	-718
February 1976	858.6	980.6	-122	-840
March 1976	730.4	1110.1	-380	-1220
April 1976	1085.3	1067.2	18	-1202
May 1976	1140.0	860.6	279	-923
June 1976	1478.4	946.1	532	-391

Source: Office of the Controller of the City of New York.

"Default with Subsequent Aid:" This option allows the City to file for bankruptcy, but then provides some mechanism for obtaining credit subsequent to default. The advantage of this procedure is that it gives a bankruptcy court the opportunity to restructure the debt of the City, reducing the borrowing needs of the city by lengthening the maturities of the short-term notes that come due. The court could also work out a reasonable repayment plan under which the city will eventually pay all of its creditors. Finally, this procedure gives the court an opportunity to restructure certain employee benefits that may have onerous consequences for the future financial viability of the City.

The principal advantage of this proposal over the first option,is that it gives the City some access to the credit markets,and thus averts draconian expenditure reductions. Since the City will be in default[20] under this proposal, the Federal government will have to make some mechanism (i.e. guarantees, loans, insurance, etc) available to allow the City to enter the credit markets.When a market access mechanism is made available the City can continue to borrow to fund its operating deficit until its budget is balanced pursuant to the provisions of the financial plan; it can continue to borrow to smooth out its cash flow problem; and it can continue to borrow for essential capital construction. Opening the credit markets to the City insures the continued provision of basic services and preserves its capital stock until the City can once again borrow on its own behalf.

20/ It will have no access to the credit markets.

While this policy option requires a Federal mechanism to give the City access to the bond markets, it does not have to seriously disrupt the Federal system of government. If the Federal credit access mechanism is provided to the State, which would then use that mechanism to make credit available to the City, the traditional relationship between the state and local government could be largely preserved. However, there will undoubtedly be a need for some Federal oversight which ultimately could lead to a direct Federal involvement in the City's affairs.

It is probable that the act of default might lengthen the period of time that New York is unable to market its own securities. Fiduciaries and banks would certainly be very cautious about investing in the obligations of a city that had defaulted so recently . Underwriters would also be reluctant to participate in new syndicates. However, it is also conceivable that the prevention option will be perceived as tantamount to default, and thus, cause the same investor skepticism.

Nevertheless, in the event of default there may be serious legal constraints to market reentry. State laws in 34 states instruct banks, insurance companies, fiduciaries and other agents about the types of securities that are permissable investments. These laws often preclude investments in securities of an issuer that has been in default recently. Some of these statutes prohibit investment for periods up to ten years. In California, for instance, a default would preclude California commercial banks from purchasing New York securities for a period of ten years after default. Thus, it is possible that the combination of legal restraints on permissable investments and investor skepticism about defaulted securities could cause a longer, if not larger Federal involvement than a "prevention of default" option.

The effect of this policy option on other borrowers depends greatly on the mechanism used for assistance. If the Federal government guarantees a tax-exempt issue, that security will immediately be elevated to a position of preeminence in the market. This will undoubtedly effect adversely the borrowing costs of other governments in the tax-exempt market. Their securities will be viewed as inferior because they carry no Federal guarantee. On the other hand, if the guaranteed security is taxable, other tax-exempt issuers will benefit in two ways. First, the source of greatest uncertainty will be temporarily removed from the tax-exempt market. And second, the largest borrower (New York) will be temporarily borrowing in the taxable market, partially reducing the supply and demand pressures in the tax-exempt market alluded to earlier.

A guaranteed taxable bond would affect the Federal treasury in three respects. First, the Treasury will gain additional receipts because interest on New York securities will no longer be tax-exempt. Ultimately, this would yield a revenue gain of $30 million to $40 million for each $1 billion of guaranteed taxable securities. Second, the Treasury will undoubtedly receive a guarantee fee. On the other hand, this guaranteed taxable bond will be perceived by credit markets as a Federal government issue, and thus will increase supply-demand pressures in the Treasury market, possibly leading to increases in Treasury borrowing costs of as high as ten basis points.

It is more difficult to ascertain the precise impact of this proposal on the economic recovery. State and local spending probably will be reduced, even if the City does not default. But bank lending practices and interest rates would undoubtedly remain more stable if default is avoided. Thus, this policy option carries with it the possibility that default could weaken the recovery now underway.

Concern must also be expressed about the possible market access problems that the State could experience subsequent to a City default. If current investor attitudes toward State securities are indicative of a perceived link between the State and the city, a default could easily serve to worsen this skepticism.

Finally, this option has the clear advantage of imposing on investors the full costs of the investment risk they have taken. It will not relieve investors of losses resulting from risks that were undertaken in their quest for higher yields.

In considering this option, two additional points must be made--one relating specifically to New York City and one relating to the overall municipal bond market. With respect to New York, there is a very real possibility that the act of default by New York could significantly undermine the property tax receipts of the City. The State constitution prohibits taxation in excess of 2.5 percent of total assessed valuation unless the additional receipts are used to meet debt service payments. If the City was in default and thus not meeting debt service payments, it is possible that the City would have to forfeit the $1.4 billion in property tax receipts that it received in excess of the 2.5 percent limitation.

With respect to the entire municipal bond market, it must be recognized that any alteration in the bankruptcy statutes that gives operating expenditures priority over debt service will constitute a weakening in the perceived security of a general obligation bond. Up to now, a major attraction of municipal bonds was that they were considered second in security to Treasury bonds because they were backed by the full faith and credit of a State or City. This pledge of full faith and credit has traditionally been interpreted to mean that bondholders have first access to city revenues in the event of a default. A change in the bankruptcy laws which weakens the position of bondholders relative to other creditors will probably serve to dilute the meaning of the words "full faith and credit" and could lead to higher interest rates as investors perceive a higher risk.

"Prevention of Default:" This option is designed to avert a default by New York City and any of the consequences that might ensue. It would provide a temporary source of credit to fund the City's $4 billion borrowing needs this year. Additional funds would be made available to meet intra-year borrowing requirements, to fund the deficit until the budget is balanced, and to support essential capital construction projects.

One principal difference between this option and the second option is the manner in which the bondholders are treated.

Under option 2, the bondholders will be forced to take whatever compensation the court decides is equitable. At the very least, the court will probably impose significant delays in principal payments on maturing securities. These delays will lead to a reduction in the value of these securities and render New York's bonds extremely illiquid assets.

Under the prevention option, the bondholders will be bailed out. They will receive full principal and interest payments when their outstanding obligations mature. In essence, they will be rewarded for their risk taking with both high interest rates and full and guaranteed payment on principal.

Without a doubt, a solution which awards payment to the bondholders while city residents and city employees are experiencing major cutbacks contains a great deal of inequity. In fact on an ability to pay basis, the bondholders are probably more capable of handling their losses than the city employees or the city residents. However, short of a voluntary restructuring of the debt, there is no solution that avoids default and also requires the bondholders to bear some of the burden.

Another distinctive feature of the prevention option is that the elected officials of the State and the City will still be responsible for the management of the City. Some have suggested that such a situation, particularly after Federal aid has been initiated, could weaken the resolve of the City and State to make the tough decisions that must be made. It has also been suggested that other cities may be tempted to manage their affairs irresponsibly, knowing that Federal aid would always be forthcoming. While these factors warrant careful consideration, they could conceivably be met if legislation were structured to make the Federal assistance as undesirable as possible.

Offsetting these disadvantages is the fact that the preventive option completely avoids the uncertainty and possible adverse consequences that surround a default. The City, at least in a legal sense, will experience less resistance when it returns to the market to sell bonds and notes on its own behalf. The State government will be relieved of the pressure that a prospective City default had placed on the State's own market accessibility. Other municipalities would no longer be confronted with the prospect that an uncertain and disrupted post-default market might not be able to absorb their securities. Banks could avoid making the adjustments that default would necessitate and thus will be in a better position to finance a vigorous recovery. And perhaps most important, the uncertainty about default would finally be resolved.

Clearly, the central issue that Congress must examine is whether to provide a source of credit before or after default. On the one hand, if Congress opts for preventing default, the Federal government will be temporarily involved in the City's affairs and the bondholders will be rescued. On the other hand, if Congress opts for "Subsequent Aid," the City will undoubtedly default and all of the adverse consequences of default will ensue. It is a difficult decision--filled with uncertainty--but a decision that must be made.

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