After assuming office last January, New York's Governor Hugh Carey surveyed the finances of the state and (especially) the city of New York, and announced, "The days of wine and roses are over." The nation's largest city—and the largest factor in the state-local financing equation—is encountering serious problems in placing its debt, which in fiscal 1976 could total as much as $14 billion. (The debt-service charge alone could approach $1 1/2 billion, an amount equal to the city's total budget 15 years ago.) Thus, New York's near-bankruptcy has impacted as severely on the municipal-bond market as the Con Edison crisis did on the utilities market a year ago.

Still, New York's problems are different only in magnitude, not in scope, from those of many other state and big-city governments. Surprisingly, the predicament could not have been foreseen two or three years ago. Just as the Vietnam peace dividend was supposed to ease the Federal government's financing problems, so was the revenue-sharing dividend supposed to solve the problems of state-local government finance. Surpluses were projected—and for a brief time actually realized—because of increased aid from Washington, increased revenues from tax boosts at the state-local level, and decreased demand for certain services such as primary education.

Buildup of deficits
The financial situation has now altered considerably. State-local expenditures have risen sharply because of the impact of inflation on costs, because of the demands of strong public-employee unions for inflation-offsetting wage increases, and because of the recession-related rise in demand for local services. Revenues meanwhile have failed to keep pace. Inflation has reduced the real impact of the massive $30-billion Federal revenue-sharing program. Inflation also has meant a loss in revenues, in real terms, from that half of the state-local tax structure that responds slowly or not at all to rising prices—primarily property taxes and gasoline and liquor taxes. Meanwhile, the recession slowdown in income and sales has meant a slower flow of revenues from these major tax sources.

The magnitude of these deficits tends to be masked by the steady increase in the surpluses of state-local social-insurance funds. Unlike their Federal counterparts, these surpluses generally are not available to finance capital-spending projects or operating deficits. State and local governments have been running operating deficits for the last several decades, except for the initial revenue-sharing period of fiscal 1973—and they are now running an overall deficit even with the inclusion of social-insurance.
funds, despite legal or traditional rules against deficit financing. State-local operating budgets shifted from a $10-billion surplus to an $11-billion deficit between the fourth quarter of 1972 and the first quarter of 1975.

The severe deficit position has led to cutbacks in capital spending and other projects. The situation has been aggravated by a shift in direction of revenue-sharing funds. According to Commerce Dept. estimates, about half of the first revenue-sharing payments went for new construction and equipment purchases, but payments today are more likely to go for current operations, partly because of the budget squeeze.

Market pressures Given this shift, state and local governments are forced to turn increasingly for capital funds to their traditional source, the tax-exempt municipal bond market. Cyclical forces are also likely to bring about greater dependence on this source, as governmental units which failed to find long-term financing in 1974's tight-money period rush to market to seek accommodation under today's easier conditions, just as they did in earlier recession years. Consequently, new security issues this year could exceed the 1971 peak figure of $25.0 billion, after three intervening years of about $24.0 billion in annual sales. The 1975 total would probably be considerably higher, were it not for the high interest costs which still confront borrowers.

General-obligation bonds, backed by the "full faith and credit" of the issuer, have accounted for a little more than half of total bond issues in the past several years, compared with a two-thirds share at the beginning of the decade. Governments instead have relied more heavily on revenue bonds, which are backed by specific bond-financed activities (e.g., subway fares or stadium fees)—and especially "moral obligation" revenue bonds, which carry the state or municipality's tacit assurance that the issuing authority's obligations will be met. When the New York State Urban Development Corporation failed to redeem $105 million of such securities this February, investors became wary of all moral-obligation issues. When New York City meanwhile showed increasing signs of inability to meet any of its obligations, the entire tax-exempt market came under pressure.

Capital market yields generally have remained high, partly because of investor demands for a significant inflation premium, and partly because of the heavy borrowing demands of corporations and (especially) the Federal government. Still, the pressures undoubtedly are greater in the municipal market than elsewhere, as exemplified by a relatively smaller drop in municipal yields...
since the 1974 peak. Moreover, a
two-tier market has developed
here (as in other markets) with
investors turning their backs on
lower-quality issues; thus, while
the spread between Aaa and Baa
tax-exempt yields averaged about
60 basis points in earlier years, this
spring it has widened to about 100
basis points. (One percentage
point equals 100 basis points.) In
one extreme case, New York City
this March was forced to pay an
unparalleled 8.69 percent for $537
million of bond-anticipation notes,
or about 200 basis points more
than the average tax-exempt yield
at that time.

Disappearing buyers
Some investors have been drop­
ning out of the municipal market,
primarily the commercial banks.
At the beginning of the decade,
the banks took down more than
two-thirds of all new issues, but last
year their share dwindled to about
one-fourth of the total, and this
year they have been net liquidators
tax exempts. Banks, by sub­
stantially raising their loan-loss
reserves in this recession period,
now have sufficient offsets to
taxable income, and do not need
tax-exempt income from such
sources as municipal securities.
Moreover, banks prefer to re­
build their portfolios with the
safest possible investment, U.S.
Treasuries, rather than lower-
quality municipals—especially
when Treasuries are in such large
supply as they are now. Also, bank
holding companies engaged in
leasing activities are able to gener­
ate large depreciation expenses,
while those banks with established
foreign branches are able to
generate foreign tax credits, in
both cases further limiting their
need for tax-exempt income.

With the commercial banks on
the sidelines, and with fire-and
casualty-insurance firms limiting
their commitments because of
recent unprofitable operations, the
municipal market has been
forced to rely heavily on the
relatively small number of wealthy
individual investors for whom
the tax-exemption feature is an
advantage. These individuals act
only at unusually attractive yields, as
in 1969 and 1974-75. With such a
narrow base, the market apparent­
ly needs restructuring to attract
more types of investors. Tax­
exempt bond funds may be one
solution, especially for the large
number of individuals who have
relatively high incomes but not
much wealth; these funds help
avoid the usual muni-bond
drawbacks such as high minimum
purchase requirements and lack
of portfolio diversity. Taxable
municipals might be yet another
solution, especially for those
investors who are uninterested in
the tax-exempt feature—mostly
pension funds and life-insurance
companies. But a broadened
market for municipal securities is
only one facet of the desperately
needed cure for state-local
financing problems.

William Burke
BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

<table>
<thead>
<tr>
<th>Selected Assets and Liabilities</th>
<th>Amount Outstanding</th>
<th>Amount Change from</th>
<th>Change from year ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Commercial Banks</td>
<td>5/14/75</td>
<td>5/07/75</td>
<td>Dollar</td>
</tr>
<tr>
<td>Loans (gross, adjusted) and investments*</td>
<td>84,753</td>
<td>-620</td>
<td>+2,056</td>
</tr>
<tr>
<td>Loans (gross, adjusted)—total</td>
<td>64,438</td>
<td>-621</td>
<td>+101</td>
</tr>
<tr>
<td>Security loans</td>
<td>957</td>
<td>-302</td>
<td>-294</td>
</tr>
<tr>
<td>Commercial and industrial</td>
<td>23,918</td>
<td>-97</td>
<td>+696</td>
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<tr>
<td>Real estate</td>
<td>19,529</td>
<td>+2</td>
<td>+412</td>
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<tr>
<td>Consumer instalment</td>
<td>9,817</td>
<td>-14</td>
<td>+542</td>
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<tr>
<td>U.S. Treasury securities</td>
<td>7,885</td>
<td>-16</td>
<td>+2,743</td>
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<tr>
<td>Other securities</td>
<td>12,430</td>
<td>+17</td>
<td>-788</td>
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<tr>
<td>Deposits (less cash items)—total*</td>
<td>84,792</td>
<td>+529</td>
<td>+6,123</td>
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<td>Demand deposits (adjusted)</td>
<td>22,993</td>
<td>-17</td>
<td>+1,053</td>
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<tr>
<td>U.S. Government deposits</td>
<td>304</td>
<td>-132</td>
<td>-435</td>
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<tr>
<td>Time deposits—total*</td>
<td>60,190</td>
<td>+669</td>
<td>+5,443</td>
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<tr>
<td>States and political subdivisions</td>
<td>7,585</td>
<td>-22</td>
<td>+346</td>
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<tr>
<td>Savings deposits</td>
<td>19,615</td>
<td>+101</td>
<td>+1,709</td>
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<tr>
<td>Other time deposits</td>
<td>29,434</td>
<td>+565</td>
<td>+2,481</td>
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<tr>
<td>Large negotiable CD's</td>
<td>16,086</td>
<td>+530</td>
<td>+2,262</td>
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</table>

Weekly Averages of Daily Figures

<table>
<thead>
<tr>
<th>Member Bank Reserve Position</th>
<th>Amount Outstanding</th>
<th>Amount Change from</th>
<th>Change from year ago</th>
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</thead>
<tbody>
<tr>
<td>Excess Reserves</td>
<td>33</td>
<td>54</td>
<td>30</td>
</tr>
<tr>
<td>Borrowings</td>
<td>0</td>
<td>1</td>
<td>109</td>
</tr>
<tr>
<td>Net free (+) / Net borrowed (-)</td>
<td>+33</td>
<td>+53</td>
<td>-78</td>
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</tbody>
</table>

Federal Funds—Seven Large Banks

<table>
<thead>
<tr>
<th>Transactions of U.S. security dealers</th>
<th>Amount Outstanding</th>
<th>Amount Change from</th>
<th>Change from year ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net purchases (+) / Net sales (-)</td>
<td>+1,399</td>
<td>+2,023</td>
<td>+886</td>
</tr>
<tr>
<td>Net loans (+) / Net borrowings (-)</td>
<td>+383</td>
<td>+570</td>
<td>+308</td>
</tr>
</tbody>
</table>

*Includes items not shown separately. †Individuals, partnerships and corporations.

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Phone (415) 397-1137.