THE ENVIRONMENT FOR MUNICIPAL FINANCING

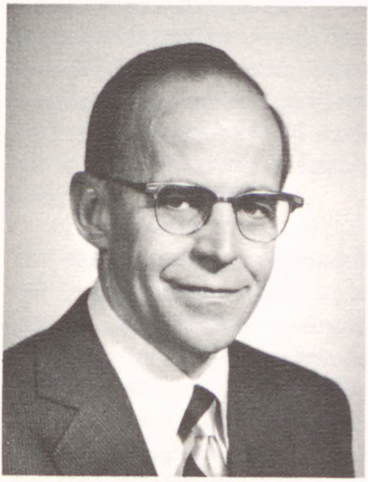
REMARKS BY

John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

Municipal Treasurers
Association Convention
Honolulu, Hawaii
August 12, 1975

.2567
3A2
1,12/75



John J. Balles

I am delighted to join you here today for a discussion of the economic and financial factors that will affect your activities in the year ahead. I would add, however, that a better location for this particular session might be Pali Pass. For those who are unfamiliar with Hawaiian history, that's the spot where a hard-pressed defending army once found itself with King Kamehameha's advancing army in the front and a steep precipice at its back. Every municipal treasurer would feel right at home there.

The analogy is not too far-fetched, since all governmental units have been caught these past two years between the grinding attack of inflation and the steep decline of recession. In my remarks, I would like to discuss how those two forces helped create the fiscal problems of state-and-local governments, as well as the near-crisis situation in the municipal-bond market. Certainly the problems of the state-local sector are crucial to the national economy, because of both its rapid growth and present size; this sector has grown twice as fast as the rest of the economy in the past decade and a half, and now employs 16 percent of the nonfarm workforce.

Surprisingly, hardly anyone foresaw the oncoming crisis several years ago. Just as the Vietnam peace dividend was supposed to ease the Federal government's financing problems, so the revenue-sharing dividend was supposed to solve the problems of state-local government finance during the 1970's. Budget surpluses were projected—and for a brief time actually realized—partly because of increased aid from Washington, and also because of such factors as a widespread increase in tax rates and a falling real demand for costly educational services.

Effects of Inflation and Recession

The financial situation has now changed considerably, with expenditures rising sharply and revenues lagging substantially. Consider first the expenditure side. Inflation has boosted the cost of governmental goods and services, and has helped account for the strong drive by public-employee unions for large wage increases. At the same time, recession has increased the demand for welfare and other services.

Now look at the revenue side. Inflation has reduced the real impact of the $30-billion revenue-sharing program, which incorporated an inflation factor far smaller than the actual rate of price increase. Inflation also has meant a loss in revenues, in real terms, from that half of the state-local tax structure which normally responds slowly or not at all to rising prices—meaning gasoline, liquor and property taxes. The recession slow-down in business activity meanwhile has meant a slower flow of revenues from income and sales taxes, in contrast to their usual tendency to expand at least proportionately with rising activity.

The result has been a rising tide of red ink across the land. State-and-local governments in the aggregate have moved into deficit, despite legal or traditional rules against deficit financing. Indeed, if we ignore the surpluses run up by their pension funds and consider operating budgets alone, we see that state-and-local governments as a group have been running deficits for the last several decades, except for the initial revenue-sharing period of several years ago. In the aggregate, state-local operating budgets shifted from a $10-billion *surplus* to an $11-billion annual *deficit* between late 1972 and early 1975.

Short-term Solutions
This situation, as you know, has forced governmental units everywhere to adopt hard-nosed cost-reduction programs during the past year or so. In earlier business downturns, most jurisdictions were able to cope by making minor adjustments; for example, by spending previously accumulated surpluses or manipulating budgets through shifts in timing of receipts and expenditures. Today, however, there are no more surpluses to spend, and no more room for fiscal sleight-of-hand. Rigid economy is the order of the day, as can be seen from the $8 billion worth of tax increases, service cutbacks, and capital-construction reductions scheduled for this year.

According to a recent survey by the Congressional Joint Economic Committee, state governments plan to make $4 billion in adjustments, either by raising taxes or reducing services, while local governments plan to make $3 billion in similar adjustments—and together, they will delay or cancel roughly $1 billion in capital-construction projects. The Congressional survey suggested that the problem centered in the larger metropolitan areas, but a follow-up survey by the National League of Cities found that the same problem existed among small and medium-sized cities. The League reported that one-third of the cities surveyed had cut payrolls already through layoffs or other means, almost one-half had scheduled tax increases, and over one-half had postponed essential capital expenditures.

A number of solutions have been proposed for state-local fiscal problems, most of them involving injections of Federal money. Some of the alternatives include an expanded public-service employment program, an accelerated public-works program, or expanded revenue-sharing or other grants programs. Some of these programs have merit, but the general approach tends to evade the issue by shifting the problem back to the general taxpayer. It's been suggested also, in New York City's case, that the Federal Reserve should come to the aid of beleaguered communities. But this proposal, aside from ignoring the fact that the System's special lending powers are narrowly circumscribed by law, could undermine the nation's financial strength by setting a precedent for the Fed to support all types of public and private credit demands, at the cost of future inflation. The only useful solution in the long run is to cure the underlying evils of inflation and recession—the evils which created the governmental financing problem in the first place.

Problems of Recession

This leads to the basic question—can we achieve a strong economic recovery without inflation? I can't say yes unequivocally, but the prospects are much brighter now than they were a few short months ago. First of all, the upturn definitely seems to be underway. The leading indicators of business activity have been giving off favorable signals for the past four months, and the indexes of current activity have now reinforced those earlier signals. Industrial production turned up in June, and an even broader measure—real GNP—practically stabilized in the second quarter after the most prolonged and most severe decline of the past 40 years. Some significant problems remain, of course. Although the number of jobs has increased in recent months, almost 8½ percent of the labor force is unemployed, and more than one million of the 8 million jobless have been looking unsuccessfully for work since the beginning of the year. Roughly one-third of the theoretical capacity of the nation's industrial plant remains unutilized, and this has caused corporate planners to reverse gears and slash away at their budgets for new plant and equipment.

Nonetheless, the script for recovery has already been written, especially in the form of the spring upturn in consumer expenditures. In real terms, consumer spending rose at more than a 6-percent annual rate during that period, reflecting an unparalleled 25-percent rate of gain in real disposable income, which offset practically all of the prolonged income decline since late 1973.

Take-home pay was boosted about $48 billion this spring by the provisions of the Tax Reduction Act, including actual tax cuts as well as increases in social-security and other transfer payments. That stimulus was reinforced by a slowing of the inflation rate, which also helped boost real income. Admittedly, little of this strength has shown up in the crucial auto and housing industries, but the upsurge in buying power creates the groundwork now for a strong rise in other household-budget categories, and later on for an upturn in those two depressed sectors as well.

A second major element in the recovery script is the prospective turnaround in business spending for inventories. This sector was the weakest link in the severe slump of last winter and spring, but because of its self-correcting nature, it should be one of the stronger elements of the outlook for the next year or so. Business inventories declined at more than a $26-billion rate in the first half of this year, so that stock-room shelves have now been cleared of most of their excess supplies. With final demand now rising, businessmen should begin ordering more inventory, cautiously at first and then more confidently. Also, as consumer buying continues to rise and as inventory restocking begins, businessmen will be forced to restart some of their idled production lines. Rising demands on capacity, plus the increased investment tax credit, should then lead businessmen to resuscitate some of their now-dormant capital-spending plans. On the basis of this unfolding scenario, real GNP could increase as much as 8 percent by a year from now.

Problems of Inflation
From all that I've said, it would seem that the recession danger to state-and-municipal finances will gradually be overcome during the next year. But what of the inflation danger? First the good news. The annual rate of inflation declined during the second quarter almost to the 5-percent level, far below the 14½-percent peak rate of late 1974. But the bad news is just as important. There's no guarantee that we can push the inflation rate below 5 percent, and judging from some early-summer developments, we may be hard-pressed to keep the rate from rising again, at least temporarily. Food prices recently have risen sharply, and they could continue to do so in the wake of heavy export sales to the Russians and other overseas buyers. Fuel prices could jump again in the event of another price increase by the OPEC oil cartel, or even in the event of sudden decontrol of the domestic market, necessary as that move would be for the sake of a rational energy policy. Industrial prices also are stirring again—witness the aluminum industry, the rubber industry, and the hints from Detroit of boosts in 1976 auto model prices.

However, it's not the increases in individual sectors of the economy that we have to worry about; these happen every day in response to specific market forces. The danger is an upsurge generated by the same basic forces that have been behind the powerful groundswell of prices throughout the past decade; that is, unparalleled Federal budget deficits and a necessarily accommodative monetary policy. The portents are not entirely favorable. The largest deficit in history ($59 billion) is in prospect for fiscal 1976 because of the tax cut, the recession-caused decline in revenues, and the substantial rise in new expenditures. Moreover, the Administration calculates that the deficit could actually go as high as $88 billion if Congress extends recent tax cuts, ignores Administration spending-cut requests, and passes new spending bills now pending in Congress.

Such a development would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. Some observers argue that the Federal Reserve should try to ensure that all borrowing demands (both Federal and private) are accommodated at stable or declining interest rates. Such an approach, by flooding the markets with liquidity, could prevent current credit-market strains but at the expense of fueling inflation anew as the recovery builds up steam. The end result of this renewed inflation would be a continued fiscal crisis for every governmental unit in the land.

A related and even more immediate problem is the danger of Federal "crowding out" of other borrowers in the nation's credit markets. It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But if the Federal deficit substantially exceeds the Administration's proposed figure, total credit demands could rapidly outrun the available supply of funds, forcing interest rates higher and crowding many non-Federal borrowers out of the market. I don't need to remind you that the most likely losers in this game of musical chairs would be state-and-and local governments, along with mortgage borrowers.

We've received a hint recently of what could happen along this line. The anti-recession program, with its outpouring of Treasury funds into private deposits, helped bring about a 14½-percent annual rate of growth in the money supply during May and June. Since this rate of expansion was far outside of the Federal Reserve's 5-to-7½ percent target range, the Fed moved to offset the money-supply bulge in the course of its regular open-market activities. But in the wake of this action to avert future inflationary pressures, short-term interest rates suddenly rose by a full percentage point, and fears of renewed credit stringency (however unwarranted) began to surface again.

Problems of Municipal Financing

All these intense fiscal pressures and renewed inflation fears have surfaced recently in the muni-bond market. Faced with massive operating deficits and forced to allocate more and more of their revenue-sharing funds simply to cover current expenses, state-and-local governments have had to raise record amounts of funds in the capital market at record interest rates. But their marketing task has been complicated by the disappearance of many traditional purchasers, either because of more attractive investing opportunities elsewhere or because of fears regarding the safety of investments in certain municipal issues.

New tax-exempt issues this year could easily exceed the 1971 peak of $25 billion. How much could be marketed today at lower interest costs is anybody's guess, since state-and-local governments—unlike the Federal government—are quite sensitive to the yields they must pay on their debts. Although interest-ceiling laws have been liberalized, other considerations (such as voter referenda) make many governmental units reluctant to issue debt at very high interest costs.

Yields generally have remained quite high in the capital market this year. This reflects in part the investment community's demand for a significant inflation premium, and in part the heavy borrowing requirements of corporations and (especially) the Federal government. Still, the pressures undoubtedly are greater in the tax-exempt sector of the market than elsewhere. One symptom of course is today's extremely high level of tax-exempt yields. Another symptom is the development of a definite two-tier market, 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 the earlier years of this decade, the spread this spring was more than 100 basis points.

The most obvious example of course is New York City, which is playing the same destabilizing role in the tax-exempt market that Con Ed played in the corporate market last year. This spring, New York had to pay 8.69 percent on an issue of bond-anticipation notes, or about 200 basis points more than the average tax-exempt yield at that time, and soon thereafter the city found it all but impossible to get money at any price. When the city approached the brink of bankruptcy, the state legislature created the Municipal Assistance Corporation, and authorized Big Mac to issue as much as $3 billion in long-term debt in order to repay a like amount of the city's short-term debt. The idea was to give the city enough breathing space so that it could balance its books, regain the confidence of investors, and resume borrowing on its own next fall. But as you've noticed, the new agency has had considerable trouble marketing its own issues, even though the city's sales-tax and stock-transfer tax revenues are earmarked for its debt-service payments. It used to be that Big Mac brought to mind the image of a deluxe hamburger with all the trimmings; today all the trimmings are gone.

With problems such as these, investors are not exactly rushing forward to buy tax-exempt issues, except at very high yields. Besides, the usual participants in this market have other reasons for staying on the sidelines this year. Fire-and-casualty insurance firms have been limiting their commitments because of recent unprofitable operations. Commercial banks, who had taken down more than two-thirds of all new issues at the beginning of the decade, reduced their share to only one-fourth of the total last year—and more recently they have become net liquidators of municipals. Apparently this is more than the usual cyclical phenomenon; although they are traditionally the dominant factor in the tax-exempt market, commercial banks may become much smaller purchasers as time goes on.

Banks now have greater offsets to taxable income than in earlier periods, and hence they don't need as much tax-exempt income from municipals. These offsets include some of the increase in loan-loss reserves which many banks have arranged as a result of the recession. Also, bank holding companies engaged in leasing activities are able to generate 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. Besides, in this period of uncertainty where default becomes an ever-present threat in the municipal market, banks logically prefer to rebuild their portfolios mainly with the safest possible investment, U.S. Treasuries. And with the Federal deficit at its present size, they obviously have no difficulty in finding enough Treasuries to buy.

Consequently, 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 or 1974-75. With such a narrow base, the market apparently needs restructuring to attract a broader group of investors. The market in its infinite wisdom has already come up with one possible solution—tax-exempt bond funds. These funds have been tailored for the large number of individuals with relatively high incomes but not much wealth, permitting them to avoid the usual drawbacks to muni-bond purchases, such as high minimum-purchase requirements and lack of portfolio diversity. Rates of return on muni-bond funds have now reached a level that is attractive to middle-income families, with income around $18,000 a year. As a result, sales of these funds were almost as great in the first half of this year as they were in all of 1974.

A more basic means of widening the market would be to grant state-and-local governments the option of issuing taxable bonds, with a direct Treasury subsidy making up for the higher interest cost of such securities. (This option of course would not replace their present right to issue tax-exempt bonds.) Pension funds, life-insurance companies and other investors who are uninterested in the tax-exemption feature would probably enter the market once this step was taken. But the argument for reform has broader aspects. Critics of the present system claim that if Federal assistance for state-and-local governments is a legitimate goal—as seems likely in view of the $54 billion in grants budgeted for this fiscal year—then it should be accomplished through direct rather than indirect means. At present, the Federal government loses more than $4 billion in revenues annually from the unpaid taxes investors normally would pay on bond-interest income, while states and municipalities gain perhaps no more than $3 billion from the lower level of interest rates they pay on tax-exempt securities. Reformers thus claim that the Federal government loses much more than state-and-local governments gain in the form of lower interest costs. On the other hand, many observers argue that the tax-exemption privilege is a basic constitutional right, going back to the Supreme Court's decision in 1819 in *McCulloch vs. Maryland.* In this view, if the Federal government begins to pay some substantial share of the interest on municipal debt, it might next move to exercise control over the issuance of that debt. These observers thus fear a definite threat to the sovereignty and independence of state-and-local governments.

Any attempt to reconcile these conflicting viewpoints should include several basic safeguards. State-and-local governments must preserve their freedom to act, independent of Federal control, on matters of purely state-and-local concern. Moreover, any Federal interest subsidy must be automatic and irrevocable, and at least as generous as the present financial advantage which the states and municipalities enjoy by virtue of tax exemption. In practice, a governmental agency—at its own option—might ask underwriters for bids on both a taxable and nontaxable basis, accepting the bid with the lowest net interest cost. The issuing agency thus would have the ability to utilize whichever segment of the market that provides it with the broadest access to funds.

Concluding Remarks

Measures for broadening the market represent only one aspect of the desperately needed cure for state-local financing problems. I suggested at the outset that there is no long-run solution to these problems without a cure for the basic ills—recession and inflation—that are now wracking the entire national economy. But there's more involved than that. A glance at those communities that manage to operate within their budgets, despite all sorts of economic difficulties, suggests that good management is an essential element in the overall solution. A basic requirement for every governmental jurisdiction is to give constant attention to appropriate levels of taxes, wages, pensions and services.

Still, the most crucial requirement is an unremitting attack on inflation. It is inflation that has caused the worst budget distortions for state-and-local governments, forcing them into increased reliance on capital markets—which with their inflationary high yields, then consign these borrowers to the end of the queue. Other borrowers are also affected by this type of predicament, but perhaps none so much as state-and-local governments. To break out of that vicious circle, we must severely limit the size of Federal deficits, first in order to reduce the inflationary pressures generated by on-the-cuff spending, and second in order to reduce the capital-market pressures which limit so severely the scope of municipal borrowing.

I don't wish to end on a gloomy note, and I certainly don't intend to give any support to those investors who would simply dump their muni-bond portfolios. State-and-local governments generally were in good shape in the early years of this decade; thus, for most of them, the basic problem tends to be cyclical rather than structural in nature. The market is trying to put across one simple message—namely, that a return to fiscal health requires strong management policies at the local level, as well as strong anti-recessionary and (above all) anti-inflationary policies at the Federal level.