Statement of

Robert D. Reischauer

Special Assistant to the Director

Congressional Budget Office

before the

Subcommittee on Economic Stabilization

of the

House Committee on Banking, Currency and Housing

October 23, 1975

Mr. Chairman, I appreciate the opportunity to appear before this subcommittee. The Congressional Budget Office prepared at your request a background paper entitled _New York City's Fiscal Problem_ which was released on October 10, 1975. My remarks today will center on a few of the issues raised in that paper but, in keeping with the CBO's mandate to provide the Congress with nonpartisan analysis of policy options and budget matters, I will not make any recommendations concerning whether or not some form of federal assistance should be provided to New York.

The first thing that strikes one about the drama that is being played out is that there is no single villian. Rather, responsibility for New York's dilemma must be shared, to a varying degree, by the whole cast of characters. Clearly New York City officials are guilty of irresponsible budget behavior, of spending more than they were receiving, and of hiding these practices with budget gimickry that would relegate the most ingenious of OMB directors to the minor leagues. The citizens of New York are also to blame for allowing themselves to be deluded into believing that they could forever consume more public services than they paid for and for providing little support to those officials who warned that the city was heading down the road towards fiscal disaster.

New York State, for its part, did not exercise its legal responsibility to ensure that the city was behaving in a fiscally sound manner. In a less direct sense, the state contributed to the city's woes by requiring that local governments in New York bear an unusually high fraction of the costs of the state's welfare programs, programs whose payment levels and eligibility requirements are specified by state law. The financial institutions also are not without blame, for as Felix Rohatyn has testified, "Money was made available to the city in ridiculous amounts and on ridiculously easy terms." And some responsibility must rest with the bond rating agencies who chose to upgrade the ratings on city securities while the city was running a large current account deficit and accumulating a huge amount of short-term debt.

To the extent that the federal government is responsible for the state of the economy, its part can not be ignored either. The immediate crisis was precipitated now rather than at some later date largely because of the recession and the inflationary pressures of the past few years. Finally, like any good tragedy, the fates -- or the forces over which men seem to have little control -- have played their role. Through the accidents of history

and geography, New York has been the nation's port of entry, its mecca for drug addicts and the home of the United Nations. Therefore the city has had to bear costs that are imposed on no other local government in the nation. Furthermore, the suburban and regional shifts in economic activity that are affecting the tax base and service requirements of many of the older large cities in the northeast and northcentral regions have also hurt New York's fiscal position.

Without some form of federal assistance, or at least a good prospect for such assistance, New York City will probably default on its obligations in December. Unfortunately, no one can provide you with a definitive judgment concerning the repercussions of such a default since the nation has not experienced a comparable event. Honest men will disagree over the likely impacts -- some believing that they will be small and manageable, others convinced that they will be of catastrophic proportions. Much will depend upon the nature of the default, the speed with which the city is able to put a reorganization and repayment plan into effect and the responses of investors and persons doing business with the city.

The impact of a default would be felt most heavily by city residents, since a default would involve a sharp and

immediate reduction in service levels. For, even without payments for debt service, city receipts will fall some $600 million below expenditure requirements during the December through June period. Cuts beyond the $600 million level might even be necessary, since cash flow during this period is uneven, and funds therefore would not be available to meet payrolls on the designated days. City services would likely be further disrupted if vendors and employees withheld the goods and services normally provided because of the uncertainty over whether or when they would be reimbursed.

The announced policies of the Fed and the FDIC should considerably lessen the impact of a default on the nation's financial institutions, but how the stock market, international money markets and other markets might respond to a default is by no means clear. If a default by the city results in a closing of the municipal bond market to all but the highest rated jurisdictions, other state and local governments that depend upon rolling over short-term notes could be forced into temporary default -- even those that are in a basically sound financial position. Unfortunately, no one knows how many governments must have continuous access to the bond market, and cannot avoid borrowing while

the after-shocks of a city default die down. It is possible that, even if the bond market does not shut down, governments will be forced to pay higher interest rates -- or a risk premium. While the evidence to date does not suggest that this has been as significant a factor as has been alleged by some, it would be foolish to dismiss the possibility that escalating interest rates will result from a default.

Just as the focus of responsibility for New York's current problems is diffuse, so too are the possible sources of actions that could help stave off a default. At this late stage,the city acting on its own can do little to avoid defaulting on its obligations. From December 1 until the end of the fiscal year, the city's cash requirements for services and debt service exceed its receipts by some $3.5 billion. It is unrealistic to think that the city could either raise taxes or cut services to the extent needed to avoid borrowing to make up much of this shortfall. The state's ability to provide the resources required by the city may also be inadequate,especially if, as seems to be the case, the state cannot borrow in the city's behalf without being itself forced out of the bond

market. A surcharge on state revenues of roughly one-half, a complete cessation of direct state services, or some combination of these approaches would be required to generate $3.5 billion over a seven-month period.

As is evidenced by the financial plan approved by the Emergency Financial Control Board on October 20, the city and the state have already made great strides towards putting the city back on a sound financial footing. However, because much has been done already and because default probably cannot be avoided solely by city and state policies, it does not necessarily follow that the city and state have done all that is conceivable to help the situation. State and city officials have concluded, after weighing the pressures they are facing, that the city should move gradually over the next three years towards a truly balanced budget. A more rapid shift is possible but also would be likely to cause significant hardships for the residents of the city. City taxes could be increased or service cutbacks instituted more rapidly. More employees could be terminated.

While New York City has made significant personnel cuts already,these sacrifices should be placed in a national perspective. The Joint Economic Committee's survey of the effect of the recession on state and local governments indicated

that many large cities that are not faced with fiscal difficulties as severe as New York's are making significant cutbacks in personnel in order to balance their fiscal year 1976 budgets. Also it is worth pointing out that over the past five years,with much less fanfare, a number of other cities have made very dramatic reductions in personnel. For example, Pittsburg reduced its full-time equivalent employment by 24 percent between 1969 and 1974 and Cleveland cut its workforce by 38 percent over the 1971 to 1975 period. Further wage cuts offer an alternative to service reductions. While New York has instituted a three-year wage "freeze," this does not mean that workers are receiving the same pay check today as they received before the freeze was instituted. Rather the freeze for the first year allowed for longevity pay increases -- those similar to moving up the steps in the civil service pay scale, continuation of the limited cost of living increments city workers receive and,for the lower-paid workers, some increase in base pay scales.

At the state level, taxes could be raised or state services reduced to provide New York City with additional revenues if the state legislature could be convinced to approve such assistance. Alternatively the state could

begin to assume a larger fraction of the welfare costs now borne by its local governments, a course of action that would necessitate higher state taxes but could result in some local level tax relief. While it is true that New York's state and local government taxes and charges per $1,000 of personal income are already nearly the highest in the nation, this does not necessarily mean that taxes can go no higher. Presumably those high taxes support superior levels of public services which the state's residents value highly and are justly proud of.

At the federal level, there are a number of possible approaches that could be used to provide assistance to the city either directly or indirectly through New York State and its agencies. I will confine my observations to programs currently under discussion -- that is, to direct federal loans or some form of federally guaranteed or insured taxable issue. While from a budget perspective these two alternatives may be treated very differently, their economic impact would be equivalent. In the first place substituting taxable federal or federally guaranteed issues for tax-exempt municipal notes would result in a gain to the Treasury in the form of increased tax receipts.

If, as was assumed by the Emergency Financial Control Board's plan of October 20, $6 billion worth of taxable securities were issued at an interest rate of 8½ percent, the tax gain would be in the neighborhood of $150 to $200 million dollars per year. If an insurance premium and service charge of 1 percent were imposed on these issues, the federal government would collect another $60 million per year. Against these certain gains must be weighed the possible cost to the federal government if the city were to default on these issues and leave the federal government with the responsibility of paying the creditors.

Some analysts have been concerned that federal loans or federally backed loans will put added pressure on the capital markets. It is important to recognize that this is not correct; these loans do not represent borrowing that is above and beyond what the city of New York would have engaged in had the crisis of investor confidence not occurred. In fact, New York's borrowing requirements this year should be considerably below what was planned before the market closed last March.

It should be realized that any form of federal assistance is likely to result in substantial capital gains or reduced capital losses for those holding New York City paper.

This is because any "solution" to the current crisis should reduce the risk premium now associated with city securities. As the interest rates facing the city fall, the price of outstanding city bonds and notes should rise, since they are close substitutes for new issues. Some may consider that such gains are well deserved by those who were willing to risk their capital in a very uncertain situation. Others may feel that federal action should not lead to large gains by private investors. If the latter view prevails, it is difficult to suggest a policy that could avoid such gains. While it may be possible to renegotiate interest rates with large holders of these securities such as the pension funds, commercial banks and insurance companies, it would be an extremely complex, if not impossible undertaking, for the great number of other holders. Moreover, the gains would not be limited to those holding the high-interest securities issued by MAC over the past few months. Those who had purchased older city securities on the secondary market at significantly discounted prices could also reap large gains. So too would purchasers of New York State securities or the bond and notes of other jurisdictions if the yields of those securities had been affected by the New York City situation. For

example, it is probable that the risk premium charged Philadelphia or Detroit would be measurably reduced by any federal plan to assist New York if that plan was generally available to other cities. This is because investors would realize that there existed a "savior" of last resort to which a city could appeal to avoid default. While small capital gains could be fairly widespread, the benefits of reduced interest costs would be equally widespread. For example, the citizens of Philadelphia and Detroit would gain in reduced debt service if the interest cost to these communities declined.

It is possible to place too much emphasis on this issue. It should be noted that a great many federal actions result in substantial capital gains to the holders of certain assets. The federal assistance provided to Lockheed affected the price of that company's stock; new public facilities can vastly increase the value of the real estate located in the vicinity of the facility; and many other similar examples could be cited.

In conclusion, I would like to point out that the situation in New York is going to affect the federal budget whether or not the city defaults on its obligations and whether or not the federal government provides explicit

assistance. Over the next few years New York will be reducing the size of its operating deficit and begin cutting back on its outstanding short-term debt. This will mean that there will be a decline in the total fiscal stimulus provided by the public sector. The effect of New York's austerity will be not unlike what would occur if the federal deficit were reduced. City cutbacks will reduce federal tax receipts and increase expenditures for such programs as welfare, foodstamps, medicaid and unemployment insurance.

The first-round effects on the federal budget of eliminating New York's current deficit cannot be estimated with any great degree of precision for they depend upon such matters as whether the city cuts services by laying off workers or by reducing the wages of those working for the city. However, our crude calculations suggested that the elimination of the city's deficit could add as much as $400 million to the federal deficit. This, it should be made clear, does not constitute a legitimate justification for permitting New York to continuing running a deficit. Fiscal policy has been and should be the responsibility of the federal -- not the state or local -- government sector of the economy.

New York's immediate problem will be resolved one way or the other in the next few months. While many of the attributes of this crisis are unique to New York City, some more general issues have been raised by this crisis. These include the fiscal pressures facing our large older central cities, the division of responsibilities for providing services between the various levels of government, the adequacy of existing institutions for marketing and rating the securities of state and local governments and the treatment of these securities under our tax laws. I hope that the process of examining these issues will begin before they are forced upon us by new crises.

Thank you.