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UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE SUBCOMMITTEE FOR URBAN AFFAIRS
OF THE JOINT ECONOMIC COMMITTEE OF THE CONGRESS
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Mr. Chairman and Members of this distinguished Subcommittee. The hearings you have called on "Financial Outlook for State and Local Governments" are important and timely. New York City's financial and fiscal problems have given rise to widespread fears that we now face either an epidemic of financial crises or draconian cuts in services in the state and local sector. But neither is inevitable. We can both avoid financial crises and maintain, and even increase, delivery of local public services, if we act responsibly. At the national level, above all this means we must stop inflation and keep it from rekindling. At the state and local level, governments must manage their fiscal and financial affairs efficiently and prudently. They must resist both pressures to spend annually more than their annual revenues and corollary pressures to hide deficit spending behind budgetary gimmicks. Good management is essential to maintain investor confidence in the state and local sector, and rebuild it in subsectors where recent events have eroded it. Also, I believe we need a mandatory Federally administered program of reporting by state and local governments. Information is the essential ingredient of discriminating credit markets. In turn, efficient, discriminating credit markets are essential both to prevent the allocation of financial and real resources to users who can't or won't pay the bill, and to assure access to financing for those who can and will.

BACKGROUND

Even with the best management in a non-inflationary economy selected central cities, especially in the east and midwest, would face difficult socio-economic problems today. Their problems have been growing since World War II. Throughout the post-war period, employment opportunities have been shifting away from the east and midwest to the south and west and from central cities to suburban areas.

There were many reasons for the shift of job opportunities to the south and west and from central cities to suburban areas. Among the more important were the following.

o The growth of tertiary economic functions, headquarters activities and service industries, and as a corollary, of white collar jobs which could be performed far from both raw materials input and markets.

o The growth of foreign imports of steel, autos, clothing and numerous other goods traditionally manufactured in the east and midwest. In turn, this trend was strengthened for many years by overvaluation of the dollar in foreign exchange markets.

o The growth of oil and natural gas as industrial fuels and the corollary decline of coal.

o The growth of the petrochemical industry.

o Relative labor costs.

o The highway construction program.

o Construction of water storage, pipeline and irrigation facilities which brought relatively cheap water to the southwest.

o The growth of Japan and trade with the Far East.

At the same time that job opportunities were shifting out of eastern and midwestern central cities, unskilled farm and rural populations have tended to concentrate in central cities, especially in these areas, replacing middle income residents who accompanied the movement of jobs out to the suburbs.

These enormous underlying changes and trends are manifestations of progress which benefits the nation as a whole. It would have been neither possible or desirable to have prevented them. We cannot expect all regions and cities to operate at uniform levels at all times. We live in a world of change. Necessarily, because of changing preferences, technology and population and other resources, there always will be some regions and cities which prosper relative to others. From the end of World War II until recently, coal producing regions and the cities located in them, for example, declined relative to other regions and cities. But now these same coal regions and cities appear to be growing relatively rapidly. Clearly, it would be a mistake to try to block the normal forces of change and progress from working their way through the economy. Nonetheless, we must recognize that the changes and trends which dominated the post-war period raised problems for some central cities, especially in the east and midwest. In specific, these cities have been faced with demands for government services that have been growing faster than their tax bases.

But this squeeze has been with us for some time. It is only recently that problems in the state and local sector have awakened fears of widespread crises. Why? The reason is that there are two new elements in the picture. One is inflation. The second is the New York City experience.

INFLATION

The major source of the present financial and fiscal problems which afflict elements of the state and local government sector is inflation. I recognize of course that recession also raises problems for state and local governments, particularly by increasing their welfare loads and decreasing cyclically sensitive sales and income tax revenues. But the evidence is persuasive, as I shall show, that inflation is the major root of state and local government financial and fiscal problems.

On the expenditure side, inflation raises demands for both more and increased services supplied by government. Inflation squeezes people financially in two ways. It erodes the purchasing power of our cash balances and fixed income bonds and other assets. Second, it increases the real taxes we pay by putting us in higher tax brackets without necessarily increasing real incomes. One consequence of the effects of inflation on purchasing power and after tax income is that the public demands more and increased government supplied services which, because they are publicly supplied, appear to be "free." During the past ten years -- marked by relatively rapid inflation -- we have seen relatively rapid growth in state and local expenditures on higher education, health, hospitals, and vendor payments for medical care.

In addition, inflation increases state and local government employees' demands for higher wages and fringe benefits. And because the state and local government sector provides services the nature of which make it difficult to substitute capital for labor in producing, matching productivity increases cannot be achieved. As a result, labor costs rise.

And while demands and costs are rising, inflation tends to reduce the real revenues of state and local governments that are generated with given tax rates, and increases taxpayers' resistance to higher state and local taxes. Let me emphasize that inflation is itself a tax. Thus, last year's state and local government revenues can never be sufficient to maintain their service levels in an inflationary period.

This would not be a problem if state and local government revenues were income-elastic. But for local governments which rely heavily on the property tax, they are not. It is administratively difficult to reassess property fast enough to keep pace with inflation. As a result, inflation reduces local governments' real revenues and they must make up the loss by increasing tax rates. But they find it difficult to do so. This is because taxpayers, who tend to lose in inflation, revolt. Those with incomes fixed by contract or otherwise must continually try to "catch-up" with living costs. Also, as indicated already, those whose taxable incomes rise at the same rate as living costs find that nonetheless they too must "catch-up" because their incomes are taxed at progressively higher rates. And everyone loses because inflation erodes the value of money and fixed income assets. Thus, inflation strengthens resistance to higher taxes, and hence local governments find it difficult to extract additional tax revenues from their tax bases during inflationary periods.

In short, inflation puts state and local governments in a vise between rising demands for more and increased services (which cost more to deliver) and diminished (relatively) revenue capacity.

The squeeze on the state and local government sector which results from inflation is evidenced by the data for the post-war period. As shown by Exhibit A, in years when the prices of goods and services purchased by state and local governments rose 4 percent or more, their expenditures, as measured in the national income accounts and defined in real terms, rose on average 4.7 percent and real revenue from their own-sources rose on average 3.4 percent. In contrast, in years when these prices rose less than 4 percent, real expenditures rose on average 6.2 percent and real own-sources revenue 5.4 percent.

In years when the state and local deflator rose 6 percent or more are compared to years when it rose 3 percent or less, we find that real state and local government expenditures rose on average 4.8 percent and real revenue from their own-sources 2.7 percent in the high inflation years, as compared to 6.0 percent for real expenditures and 5.8 percent for real own-sources revenue in low inflation years.

It should be apparent that inflation exacerbates the state and local government sector's revenue problem and reduces its ability to deliver services.

Moreover, in those recession years when the inflation rates for goods and services purchased by state and local governments was 3 percent or less, real state and local expenditures rose on average 6.1 percent and real own-sources revenue 5.4 percent. Only in the recessions of 1969-1970 and 1974-1975 when the inflation rate was 6 percent or more, did real state and local government expenditures and own-sources revenue grow less than average for the post-war period.

The data would appear to demonstrate conclusively that inflation, not recession, is the principal cause of the problems which now beset so many state and local governments. It follows that their outlook will improve if we stop inflation.

To do this, by far the most important thing Congress can do is to keep the lid on Federal spending. Only Congress can do this, and it must be done. And we need not fear that in slowing inflation we will slow the recovery and increase unemployment.

On the contrary, recent experience indicates that inflation places enormous financial strains on the business sector of the economy, strains which have always led to recession. During the early and intermediate stages of inflation, sales in current dollars rise and inventory speculation and credit demands mount. As a consequence, labor costs and interest rates rise and corporate profits are squeezed. Then the cycle reverses itself. Production and employment are cut and inflation tapers off as recession trends accelerate.

The way to avoid cutbacks in production and employment is to avoid the inflation in which they begin. Once again, this requires above all Federal fiscal restraint. The President has proposed such restraint for the next fiscal year. It is up to Congress to legislate it.

MANAGEMENT

Stopping inflation is essential to the financial and fiscal health of the state and local government sector. If it isn't checked, there is little that can be done to prevent deceleration of the growth of local government services; or even, ultimately, to maintain current service levels. But stopping inflation will not be enough. The outlook for state and local governments depends also on how well or badly they manage their fiscal and financial affairs.

For years it was widely, if naively, believed that tradition and laws constraining cities to balance their operating expenses and revenues, precluded other than accidental transient operating budget deficits. But New York showed that it is possible for a city to spend more than its revenues as a routine and habitual matter. New York was able to hide large consecutive deficits behind budget gimmicks including especially by accruing revenues designated receivable from the Federal Government which were in fact not due.

The source of New York's deficits was the response of its elected officials to the problems of rising demands by residents for more and increased public services and by employees for higher wages and fringe benefits. The measures New York adopted were uncommon, uncalled for and operated to undermine its financial position and economic capacity. The evidence on this is presented in the Congressional Budget Office's widely read study entitled "New York City's Fiscal Problem." The relevant data have been duplicated here in Table 1. They show public sector spending, employment and debt levels in New York and eleven other central counties. For convenience, I have also indexed the data and rearranged the order of the central counties involved in Table 2.

The evidence is clear. New York City and the central counties it comprises spend substantially more money and issued substantially more debt per capita, and put substantially more people per 10,000 population on its payroll than comparable government units. Let me stress that I am not comparing New York data to data for the other cities listed in the tables, but to data aggregated for all of the local government units that provide services to the residents of the central counties where these cities are located. Unlike so many other studies, the data I am comparing are comparable.

Let me stress also that the data that I selected for comparison from the Congressional Budget Office's report are the only truly relevant and comparable data tabulated in that much quoted document. In addition to the data duplicated here, the report provides data on salary levels and expenditures on commonly supplied services. In these respects, New York is like other places. But such comparisons are misleading. They ignore New York's relatively high debt service charges, its extremely generous fringe benefits and its wide ranging spending activities. These uncommon charges, benefits and expenditures provided the fuel that propelled New York towards default.

Consider the City's 1975-1976 fiscal year budget as it was originally submitted. That budget provided $1.8 billion for debt service and $1.3 billion for pensions. In addition, of the remaining $10.1 billion expenditures, the 1975-1976 budget, as submitted, provided $477 million for higher education, $586 million for charitable institutions, $890 million for City hospitals, $137 million for various housing activities and $180 million in subsidies for the transit system. The grand total of these uncommon items is $2.3 billion, and of this amount $802 million represents tax levy funds.

If other local governments were to spend money as New York has been doing, they would soon be in the same kind of fix New York now is in. But as long as other governments refrain from the temptation to follow New York's lead, we will not have to worry about New York's financial and fiscal woes afflicting other cities.

SEATTLE

The experience of Seattle demonstrates that hard times and difficult problems need not lead to a financial crisis. Seattle's jobs and tax bases were seriously eroded by sharp cutbacks in the aerospace industry beginning in 1968. But Seattle is now neither heavy with debt or in need of help. Seattle responded to its problems by raising taxes to counter the drop in revenues produced by layoffs of aerospace workers, and judiciously reducing its level of services. It did not defer current expenses or borrow in anticipation of future revenues. Seattle balanced current expenses and revenues. This, in the final analysis, is the only policy that works.

It is not easy to pursue this policy. Last year, Seattle's voters turned down a special school tax assessment. As a result, course offerings were cut. The City's property tax base is described as "stagnant" in a recent newspaper article by its program budget manager, Mr. Robert Cowan. And if present trends continue, there will be a gap between revenue and expenses next year. But "if that is the case," Mr. Cowan said, "then we'll have to raise taxes again or reduce our services further. It has to be one or the other." Mr. Cowan is both realistic and responsible.

OTHER CITIES

Will other cities choose New York or Seattle as their model? None of us can predict the future with certainty. We can, however, cast light on the question by examining what other comparable local spending jurisdictions have been doing.

Examination of the data in Tables 1 and 2 indicates that only New York's spending, employment and debt levels are significantly out of line with the group averages. To clarify this question, I translated the data in Table 1 into "normalized" measures. This is done by computing how far away an observed number is from the average of its series in terms of what statisticians call the standard deviation of the series. The level of expenditures for New York is 2.34 standard deviations away from the average of the expenditures series. The level of employment for New York is 1.99 standard deviations away from the average of the employment series. New York's debt levels are 2.22 and 2.02 standard deviations away from the averages of the two debt series. For normally disturbed numbers these are significant differences.

San Francisco, which has the second highest standardized expenditures and employment levels, is only 1.38 standard deviations away from the expenditures average and 1.25 standard deviations away from the employment average. Boston, which has the second highest debt per capita, is 1.38 standard deviations away from the average of the total debt series and 1.87 standard deviations away from the average of the short term debt series. Only the last number approaches being statistically significant.

The third highest expenditures, employment and debt levels in Table 1 are all less than one standard deviation away from the group averages.

In summary, the evidence while not proving that none of the eleven covered central county jurisdictions other than New York are without problems, shows that none exhibits the levels of expenditures, employment and debt which New York did in the 1972-1974 period.

DEBT

Data on debt are not definitive. But when a city or state exhibits high debt relative to its revenue and relies increasingly on short term borrowing, it may be a sign of serious underlying fiscal problems.

Borrowing cannot permanently resolve the problem of reconciling the conflicting pressures on the expenditure and revenue sides of state and local governments. In time, credit and capital markets close to those governments which has relied heavily on borrowing to bridge year-to-year gaps between revenues and expenditures. Short term notes issued for purposes other than anticipation of conservatively estimated tax receipts reflect especially grave problems. They indicate that the issuer is unwilling to pay for the services it is purchasing and delivering, and that accounting tricks (e.g., accruing revenues) are being used to balance the budget.

Short term borrowing to finance deficits even if by one large issuer, can also cause major problems in financial markets. The process of short term local government financing and the shocks to it last year broadly parallel the commercial paper crisis early in the decade. There the cause was a major credit problem that quickly focussed attention on the liquidity positions of other issuers of commercial paper. Investors examined other issuers, not in terms of whether they had the earning power over time to pay back their thirty day notes or if someone else would buy them, in other words, if the market was open. They looked to see only if they could pay when due, and under circumstances where the market wasn't open. In a number of instances, they concluded the answer was no; and a run started on the commercial paper issuing entities.

This resulted in the creation of bak up bank lines or commitments. These arrangements effectively short-circuited the possibility of a chain reaction; it insured that commercial paper runs would not develop by guaranteeing that money would be there to pay notes when due, whether or not the market was open. Perhaps more importantly, it also meant that the credit of the issuer of commercial paper was under continuous review by its line banks. In this way, a structural weakness in our financial system was strengthened.

Short term notes issued by local governments for purposes other than anticipation of conservatively estimated tax receipts present some of the same risks that were exposed by the commercial paper crisis of 1970. And perhaps a similar solution is appropriate: use of back up lines from banks to insure that when the system is under pressure as a result of credit problems, perfectly sound credits do not become enmeshed in the cumulative and reinforcing unraveling process. It is all too apparent that the short term tax exempt market is not immune to the "run" mentality which became prominent in 1975. What is not so easy to recognize is that this dangerous process does have some positive side effects. It has removed from the acceptable list of municipal practices heavy short term borrowing programs designed to bridge the gap between what people want and what they are willing to pay for.

Another serious problem involves moral obligation bonds. The UDC technical default a year ago was only a first step in exposing the tenuous nature of this obligation. The moral backing approach is only a sophisticated means of relieving budgetary pressure: like short term debt, it is used to pay for things that parts of the electorate may want, but which taxpayers will not buy. As such, it is not a surprise that some legislatures have not moved promptly to use tax money to carry the moral pledge. A moral obligation bond must be viewed primarily as a revenue bond.

DISCLOSURE

All in all, the politics and economics of municipal finance have changed significantly in the past 12 months. The changes reflect new information. Both the public at large and investors and securities dealers in particular have been affected, and I believe the changes are "for the better."

The electorate is becoming acutely aware of their community's credit standing -- and preserving it has become a political imperative. Because of what happened to New York City, the electorate now knows that budget gimmicks, such as charging expense items to the capital budget, and budgeting expenditures on a cash basis and revenues on an accrual basis, are not a substitute for the tough budget cutting or revenue raising decisions that have to be made when estimated revenues fall short of proposed expenditures. Voters will be alert to future use of such gimmickry by any jurisdiction.

Second, if somewhere voters should try to follow the New York model, they will meet stiff investor resistance. New York City noteholders did not get bailed-out. Their notes were either rolled-over or put in moratorium. In either case, they suffered a loss of capital value. Now the entire investment community knows that it is possible that a city will be unable to pay the principal on its securities as it comes due, and that the Federal Government will not pick up the tab. As a result investors will be more careful in the future.

One of the distinguishing characteristics of the municipal bond market in the future will be a continuing interest in credits. Not the broad shift to only the very highest rated credits that characterized the closing months of last year. In time, this will be seen to have been a temporary response, followed by a continuing selection process in which those municipalities that are judged to be doing an inferior job in handling their affairs will have their status reflected in higher borrowing costs and, in extreme cases, limited access to markets -- both of which will also be visible to the voters of these entities. In the future, because of the new sensitivity to changing conditions, the process with respect to particular credits is likely to be gradual: the warning signals will go up earlier.

Dealers and investors now will want to look very carefully at the liquidity position of municipalities. They will want to evaluate their short term indebtedness. They are going to demand much more information than in the past. For tax anticipation financing, their disclosure standards will be considerably higher than in the past so that the efficacy of the concept can be preserved. Other forms of short term financing will be weighed even more carefully.

To improve the flow of information about the financial and fiscal conditions of state and local governments, I believe we need a mandatory Federally administered program of reporting by these jurisdictions. Elected officials at all levels of government need such reports to track and monitor state and local fiscal activities, and pinpoint incipient problems in state and local finance. The rating services need them to rate state and local governments. Underwriters and investors need them to evaluate risks. Finally, voters need them to ensure confidence in the credit-worthiness of their government.

This will mean complete disclosure and a uniformity of reporting standards. It will require the rating services, underwriters and investors to do more credit analysis and to pay more attention to the legal underpinnings of individual issues.

A mandatory reporting program need not be burdensome or expensive. An audited annual report, updated by quarterly reports and reports of significant events, is all that would seem to be required. I do not believe that registration of new issues or any form of Federal pre-sale clearance is necessary or appropriate. Current, accurate and comparable data, on file and readily available, will provide the input for the market -- dealers, investors and the rating services -- to perfect an early warning system. Reliable up-to-date information will operate to prevent profligate state and local governments from using budget gimmicks to finance habitual deficits. Such governments won't be able to market their debt. At the same time, disclosure will make it easier for financially sound fiscally responsible jurisdictions to obtain financing for both capital improvements and seasonal needs.

CLOSING COMMENTS

I want to make several summary comments in closing. First, let me say a word about New York's future. The City has been through a terrible crisis. But as a result, there seem to have been a constructive change in attitudes about its accounting and financing practices. The City is beginning to take the steps it must take to regain access to the credit and capital markets and to regain control of its own affairs. It ahs a strong economic base on which to build. I wish the change in attitudes could have come about differently -- it was a terrible process. But the important thing is that positive financial and fiscal change is beginning to happen. For our part, we shall closely monitor what is happening not only to protect the Federal loans but to make constructive suggestions whenever we can.

Second, and above all else, we must stop inflation. This means we must hold the line on Federal spending.

Third, our financial markets have proven to be tough, resilient and discriminating. Despite the UDC and New York City episodes, markets absorbed record amounts of state and municipal securities last year, totalling nearly $60 billion.

Furthermore, interest rates on municipals were not out of line relative to corporate yields considering that 1975 was a recession-recovery year. For example, as reported by the Joint Economic Committee in its study of "New York City's Financial Crisis," in 1970 the ratio of yields on all long term tax-exempt securities to yields on long term taxable corporate securities was .754. In the July-October period last year, it averaged .764. Moreover, in the case of Aaa municipals, the ratio was .761 in 1970 and average .738 in the July-October period last year. Even in the first three weeks of October last year when the New York crisis peaked, the ratios were only .784 for all municipals and .762 for Aaa rated securities.

Fourth, I believe we need a mandatory Federally administered program of reporting by state and local governments. Information is the essential ingredient of discriminating credit and capital markets. With reliable, complete and up-to-date information, dealers and investors can accurately and confidently rate state and municipal issuers of securities.

Long term, the alternatives are clear: either we stop inflation, improve the flow of information and encourage markets to discriminate among issuers on objective grounds or we abandon the existing system of state and local finance for a system of Federal control of all public sector financing. I'm sure I need not tell the Committee where I stand on this point.

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