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BY THE COMPTROLLER GENERAL 110741

Report To The Congress

OF THE UNITED STATES

New York City's Fiscal Problems: A Long Road Still Lies Ahead

During the past 4 years New York City has made progress in dealing with its fiscal problems, but significant budget deficits are projected for the next few years, and there are major uncertainties ahead.

GAO says the City should face up to the need for budget cuts and it should take additional steps to improve its economy, an assessment City officials strongly disagree with. Other Federal and State agencies generally agree with GAO's concerns, but they differ on what should be done.

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UNITED STATES GENERAL ACCOUNTING OFFICE

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses New York City's efforts to deal with its fiscal problems. While recognizing the progress the City has made the report calls attention to the significant budget deficits projected for the next few years.

Beyond a discussion of these issues, the report also draws attention to the underlying issue of national urban policy. New York City like so many major, older industrial cities seems to require ever-growing infusions of Federal and State aid in order to avoid chronic and ultimately fatal budget deficits. This larger issue obviously requires a continuing focus at the Federal level. Nevertheless, there is much the City can do to alleviate its own problems, and the report focuses on those needed actions.

We made our review pursuant to the New York City Loan Guarantee Act of 1978 (Public Law 95-339).

Copies of this report are being sent to interested congressional committees, the Secretary of the Treasury, State and local officials, and other interested parties.

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

NEW YORK CITY'S FISCAL PROBLEMS: A LONG ROAD STILL LIES AHEAD

D I G E S T

In accordance with its financial recovery plans, New York City has steadily reduced its annual operating deficits since 1976. (See p. 6.) However, the City still has a long way to go. (See p. 19.)

Its current financial plan is designed to achieve a balanced budget under generally accepted accounting principles by 1982. However, the plan has uncertainties which could substantially increase the City's projected deficits. The City needs to change its budgetary strategy by:

--Facing up to the need for budget cuts. (See p. 14.)

--Revising the financial plan. (See p. 10.)

--Aggressively applying a milestone system for tracking the progress of its plan. (See p. 22.)

--Taking still more steps to improve its economy. (See p. 24.)

FACING UP TO THE NEED FOR BUDGET CUTS

The City made some specific programmatic budget cuts early in 1976. Since then it has been relying essentially on a strategy of containing costs and using Federal and State aid to close its budget gaps. (See p. 7.) The City's current financial plan continues the strategy of relying heavily on the latter. Outside help obviously is beneficial from a City perspective, but local officials may be relying too heavily on others. The City's chances of continuing such a policy are questionable in view of the fiscal "belt tightening" that is expected at the State and Federal levels. (See p. 16.)

GGD-80-5

Tear Sheet. Upon removal, the report cover date should be noted hereon.

The City has planned for alternative budget cuts if the anticipated level of State and Federal aid does not materialize. However, a disproportionate amount of these cuts have been delayed until the later years when they could be even more difficult to achieve, considering the potential impact of the 1980 wage settlement with the municipal unions and an economic downturn. (See p. 19.)

PREPARING A MORE REALISTIC PLAN

The City's latest financial plan, approved in June 1979, projects a balanced budget, on a State legislative basis,1/ for 1980 and budget gaps of \$464 million, \$830 million, and \$854 million for 1981, 1982, and 1983, respectively. (See p. 14.) However, these estimates are conservative since they do not take into account two factors.

First, most of the current labor contracts between the City and its employees expire in June 1980. Except for a provision of \$82 million for fiscal year 1981, the impact of probable increases in labor costs was not considered in calculating the projected budget gaps. The City's latest financial plan acknowledges that a wage increase similar to the last one negotiated would increase the projected budget gaps by \$43 million, \$295 million, and \$465 million in 1981, 1982, and 1983, respectively. (See p. 10.)

Second, the City's revenue projections are based on economic assumptions which may be overly optimistic. Depending on the severity and nature of the expected economic downturn, City revenues could be reduced. GAO estimated that reduc-

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1/State law permits certain deviations from generally accepted accounting principles. Under those principles the deficits would be greater until 1982, when the deviations from generally accepted accounting principles will no longer be permitted.

tions could be about $69 million in 1980, and $122 million in 1981. The City has also estimated the impact of a recession for 1980 and 1981. Its latest financial plan included a contingency program of budgetary actions to deal with these recession forecasts. The City has not yet included the impact of such estimates in its projected gaps, preferring to wait until the economic outlook becomes clearer. (See p. 14.)

IMPROVING ITS SYSTEM FOR MONITORING BUDGET CUTS

Considering the City's need for budget cuts, the extent to which those cuts are monitored will, in part, determine how successful the City will be in balancing its budget. In February 1979, the City agreed to reinstitute a system for measuring the progress of its budget balancing actions.

Reinstatement was urged by both State and Federal monitors who saw it as one more tool the City could use to achieve its goal.

This is a strong, positive action which should expedite the tracking of progress on the City's budget balancing actions. (See p. 23.)

TAKING STEPS TO IMPROVE ITS ECONOMY

Improving the City's economy is a precondition to solving its fiscal problems. Shortly after the fiscal crisis of 1975, City officials recognized the urgency of improving the City's economic base and have taken some actions to achieve that goal. Obviously, the City's budgetary situation limits its ability to mount a comprehensive economic recovery program. While GAO recognizes these limitations, it believes there is still a need for a more aggressive effort.

Although the long decline in employment finally ended in 1978, and there are other signs of improvement, the City has not entered a period of full economic recovery. Future performance of the City's economy is not expected to improve markedly, and a stagnant economy could limit tax revenue growth in the future to less than the rate of inflation. When this outlook is coupled with the fact that expenditures are more likely to grow at a greater rate than revenues, the result is a projection of chronic deficits unless there is a constant injection of Federal and State aid.

The City needs to take further actions to improve its business climate, induce more investment in the City, and lower the tax burdens on its corporate and individual residents. (See p. 24.)

RECOMMENDATIONS

The Secretary of the Treasury should:

--Encourage the City to revise its financial plan to reflect the need for additional budget cuts. (See p. 20.)

--Monitor closely the implementation and use of the milestone system. (See p. 23.)

--Urge early negotiations between the City and its unions to give the City a more precise picture of how the settlement will affect its financial plan. (See p. 21.)

--Encourage the City to take further actions to improve its economic base. (See p. 38.)

COMMENTS OF CONCERNED OFFICIALS

Officials of the Department of the Treasury, City of New York, Financial Control Board, Office of the New York State Special Deputy Comptroller for New York City, and Municipal Assistance Corporation commented on this report. These comments are summarized below. (For the full texts see apps. II through VII.)

City's comments

The City acknowledged that it still has a long way to go to attain its fiscal and operational goals, but it emphasized that it has met or exceeded every financial, budgetary, and operational requirement imposed on it since the beginning of the fiscal crisis.

City officials strongly disagreed with GAO's assessments and recommendations, saying their current strategy will close the projected budget gaps effectively.

Department of the Treasury comments

Treasury agreed that the City must continue its retrenchment strategy, and stated that GAO's basic budget analysis did not differ significantly from their own. But Treasury believes it would be premature to make cuts now.

Treasury believes the City's current approach is sound, and the City will be successful in meeting the goal of full market reentry by fiscal year 1982. Accordingly, Treasury disagreed with GAO's recommendations for specific actions by the Secretary. Although GAO did not recommend that the Secretary mandate City action, Treasury also felt that the recommendations would go too far in involving the Secretary in local matters. At the same time, Treasury recognized that the Secretary can and has suggested certain actions to the City to ensure continued compliance with the act.

Financial Control Board's comments

The Financial Control Board shares many of GAO's concerns regarding the City's fiscal outlook. However, the Board believes that the City's plan and related controls are more than adequate to assure that the City will meet its statutorily required goal of a balanced budget by 1982.

The Board pointed out that the City's dependence on ever-growing infusions of State and Federal aid is not a problem unique to New York City. Rather it is common to most major, older industrial cities, and is worthy of the focus of national policy and Federal attention. The Board indicated that the report was shortsighted in simply dismissing the possibility of an expanded Federal role in this regard.

Considering the City's short-term budgetary limitations, the Board noted that it may not be feasible for the City to pursue a more aggressive economic development policy as GAO recommended.

Special Deputy Comptroller's comments

The State's Special Deputy Comptroller's Office stated that they have voiced concerns similar to GAO's in many of their reports.

Municipal Assistance Corporation's comments

The Municipal Assistance Corporation stated that their response was one of general agreement with GAO.

They noted in a report attached to their comments that it was understandable that there might be differences of opinion on the likelihood of future events. However, they cautioned that:

> "If, on the other hand, our concerns turn out to be correct, and the budget reductions are not instituted promptly, the City may find itself, in two years, facing an impossible set of problems: a budget deficit of enormous dimensions, recessionary upward pressures on costs and a simultaneous decline in revenues, no direct access to the financial markets, MAC's borrowing capacity exhausted, and the loan guarantee legislation expired. The result, then, would be infinitely worse for the City.

We believe that, on balance, the risk of inaction at this time is too great. The penalty for guessing wrong, in terms of what can happen within two years, is too severe."

Contents

ABBREVIATIONS

GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office

CHAPTER 1

INTRODUCTION

New York City's fiscal crisis has been given national attention since early 1975. In the 4 years that have passed since then, the City's proponents and opponents have made sound arguments both for and against a wide variety of issues related to the problem. Some observers cited a downturn in the economy as the cause of the crisis; others have cited gross mismanagement. Some have advocated bankruptcy; others have argued that such a course of action is unthinkable. Some believe the crisis is over; others believe it has gotten worse.

Against this background of substantial controversy, the Congress must assess the City's situation and decide whether to extend further help in the form of loan guarantees under the New York City Loan Guarantee Act of 1978 (Public Law 95-339). Under this law, either the Senate or the House can act to disapprove the loan guarantees to be given in the City's fiscal years 1980 and 1981. This report has been prepared to help in that decisionmaking process and presents our assessment of the situation.

Some general background is essential to understand the New York City problem in its proper context.

In early 1975 New York City found itself no longer able to borrow to meet its cash needs, a normal and necessary practice for cities. This created an immediate financial crisis of major proportions. The City lacked funds to meet payrolls and everyday expenses and to repay creditors for previous borrowings coming due.

Through the spring and summer of 1975, City and State officials took a number of actions which enabled the City to remain fiscally afloat and temporarily eased the crisis. Together they arranged for advances of funds from the State, cuts in the City's budget, creation by the State of the Municipal Assistance Corporation, bonds to be marketed on behalf of the City, creation of an Emergency Financial Control Board as a fiscal overseer of the City's budget, reform of the City's accounting and budgeting practices, and development of a 3-year financial plan to balance the City's budget.

THE FINANCIAL PLAN

Although the crisis of early 1975 was triggered by the City's need for operating cash, the problem was more deeply rooted. A severe budget imbalance existed. When the plan was drawn in October 1975, the City's fiscal year 1976 revenue estimate was $11.5 billion; its expenditure forecast was $12.5 billion. This left a deficit of approximately $1 billion to be added to accumulated deficits, reported by the City to be about $5 billion. To make matters worse, the City, with State approval, had been borrowing to pay for normal operating expenses included in its capital budget. By 1975 these borrowings had grown to more than $700 million annually. Capital budget borrowings should be used to finance long-range, municipal improvement projects. In this case, the borrowings tended to disguise the fact that the 1975-76 operating deficit was about $1.7 billion, instead of $1 billion.

City and State officials prepared a plan to deal with the budget imbalance through a series of sharp budget cuts. The plan was approved by the Emergency Financial Control Board on October 20, 1975. As shown below, the plan anticipated deficits in the years ending June 30, 1976 and 1977, and a small surplus by June 30, 1978.

Summary of Financial Plan

	Year ending		
	6/30/76	6/30/77	6/30/78
	(millions)		
Revenues	$11,519	$11,981	$12,313
Expenses	12,600	12,913	13,006
Less:			
Planned budget cuts	92	462	724
Net expenses	$12,508	$12,451	$12,282
Projected (deficit)/ surplus in expense budget	$ (989)	$ (470)	$ 31

The plan did not reflect the impact of the borrowings included in the capital budget. In nonaccounting terms it did not count all the City's expenses. Had those expenses been included, the projected deficits would have been much larger as shown on the following page.

Summary of Financial Plan
Considering All Operating Expenses

	Year ending 6/30/76	Year ending 6/30/77	Year ending 6/30/78
	(millions)		
Projected (deficit)/ surplus per financial plan	$ (989)	$ (470)	$ 31
Operating expenses in capital budget	(697)	(647)	(597)
Total projected operating deficits	$(1,686)	$(1,117)	$ (566)

Late in 1975 an agreement was reached among the clearinghouse banks, municipal pension funds, sinking funds, and Municipal Assistance Corporation, which provided a source of funds to cover the capital needs and operating deficits over the 3-year financial plan. This agreement's principal element was the commitment of trustees of the City's retirement systems to invest about $2.5 billion from the pension funds in City or Municipal Assistance Corporation obligations.

Despite these actions, it was clear that additional assistance was needed. In the fall of 1975, City officials looked toward Washington for help. At the same time, the State legislature approved a package of local taxes aimed at further easing the situation.

In recognition of the actions taken to prevent the City's financial collapse and the commitment of State and City officials to correct the practices of overspending and over-borrowing, Federal legislation was enacted in December 1975. The New York City Seasonal Financing Act of 1975 (Public Law 94-143) gave the Secretary of the Treasury authority to lend the City up to $2.3 billion annually to meet seasonal financing needs resulting from the City's uneven revenue flow. The Secretary of the Treasury's authority to make loans to the City under that act terminated on June 30, 1978, which coincided with the period covered by the financial plan.

The objective of all parties associated with fashioning the complex financial recovery plan was to permit the City's return to the credit market subsequent to June 30, 1978. Unfortunately, that goal was not achieved. The City, as we had predicted in a report to the Congress in April 1977,1/ turned to Washington for further assistance in early 1978.

That additional assistance was furnished in the form of guarantees of City securities under the New York City Loan Guarantee Act of 1978. That act authorized the Secretary of the Treasury to guarantee up to $1.65 billion in City securities which would be sold only to City or State agency employee pension funds. Those guarantees were to form the cornerstone for a financing package of $4.5 billion in which banks and the public would participate.

The objective of this new 4-year (July 1, 1978 to June 30, 1982) financial plan was similar to that of the original 3-year plan; i.e., to permit the City to return to the credit market.

1/Assessment of New York City's Performance and Prospects Under Its 3-Year Emergency Financial Plan (GGD-77-40, Apr. 4, 1977).

CHAPTER 2

PROGRESS WAS MADE DURING THE FIRST 3 YEARS

At the end of the 3-year financial plan (June 30, 1978) it was clear that progress had been made toward putting the City's fiscal house in order. The actual operating deficit had been reduced from about $1.8 billion to about $700 million, and other positive fiscal signals were apparent. The City had a new accounting system in place and it had undergone its first audit by a firm of independent certified public accountants. The City had also met the budgetary goals set out in its financial plan. Although it fell short of its goal of market reentry by June 1978, a new plan had been designed and a financing package was in place to permit the City to achieve that goal by 1982.

The schedule on page 6 shows the progressive reductions in the City's deficit between 1976 and 1978.

In attempting to measure the City's progress it is difficult to make extensive comparisons between the fiscal data available for 1976 and the data available for 1978. City officials would be the first to point out that in 1976 their accounting system was very poor, and the data it produced was questionable. Further, in 1976, the City's budgets were much different from what they were in 1978. The costs of some operations--courts and higher education, for example--had been partially shifted to the State; the salaries of many employees were being paid for by the Federal Government under the Comprehensive Employment and Training Act program in both budgets, causing distortions; and other City operations had been reorganized and, in some cases, streamlined. In spite of these changes, however, it is possible to make some overall observations about what took place between 1976 and 1978.

Comparison of Operating Results
1976-1978

------------(millions)------------

Revenues (excl. intra-City)	1976 Actual	1977 Actual	1978 Actual
	---------(unaudited)---------		
Taxes			
General property taxes	$ 2,966	$ 3,236	$ 3,230
Other taxes	2,805	2,990	3,186
Miscellaneous revenues	884	906	856
Grants			
Federal	2,341	2,421	2,535
State	2,371	2,325	2,303
Disallowances	(125)	(125)	(125)
Unrestricted intergovernmental aid	767	886	994
Transfers from capital budget			
Capitalized expenses and interfund agreements	654	615	633
Total revenues	12,663	13,254	13,612
Expenditures (excl. intra-City)			
City and MAC debt service	$ 2,309	$ 2,344	$ 2,184
Pensions	1,137	1,194	1,172
Public assistance	1,383	1,402	1,369
Medical assistance	1,397	1,397	1,144
Health & Hospital Corporation	663	647	665
Transit subsidies in misc. budget	164	196	279
Housing Authority subsidies	76	69	62
General reserve	-	-	-
General operating expenditures	6,502	6,334	6,705
Total expenditures	13,631	13,583 a/	13,580
Surplus/(Deficit) - State legislative basis	(968)	(329)	32
Transfers from capital budget - capitalized expenses	(654)	(615)	(577)
Accrued pension liability	(200)	(75)	(162)
Miscellaneous adjustments	-0-	(20)	(5)
Surplus/(Deficit) - generally accepted accounting principles	$(1,822)	$(1,039)	$(712)

a/In an earlier report, we questioned the charging of $216 million of labor costs to 1978. Although the City and its independent CPAs disagreed with our opinion, we believe the 1978 expenditures are overstated by that amount, and the 1979-80 expenditures will be understated in a like amount.

1978 BUDGET SUCCESSFULLY BALANCED

The City is permitted under State law to fund certain operating expenses through its capital budget and to exclude from the budget some current obligations to employee pension funds. These two items account for the differences between the City's $32 million surplus as calculated under State law and its $712 million deficit as calculated under generally accepted accounting principles.

Exclusive of these items, the City balanced its 1978 budget. Further, the City was on target in phasing its operating expenses out of the capital budget, and it was planning to accelerate the phase-out and shorten the schedule permitted under State law.

City officials said that they were able to achieve the 1978 budget balance, in part, because of an increase in unrestricted Federal aid over the amount projected in the City's original plan. This increase, primarily consisting of countercyclical funds, netted the City about $240 million in budget balancing aid. Further, an inflationary economy positively affected tax revenues.

The City was also able to alleviate significant budgetary pressure by reorganizing debt and stretching out maturities with the help of the Municipal Assistance Corporation. That action reduced debt service costs during the 3-year period by about $125 million. Viewed in the long run of course, stretching out debt is not favorable because the City will ultimately have to pay more interest before the debt is retired. Nevertheless, this action positively affected the City's budget.

The other major factor affecting the budget balance is less susceptible to specific measurement; however, its impact is obvious. The City essentially pursued a cost containment program during its first 3-year plan, and it took advantage of natural employee attrition. As a result of all these actions its budget surplus ran close to the amount planned.

BUDGET CUTTING POLICY CHANGED

It is important to note in discussing the first 3 years that the original plans which were put together during the height of the fiscal crisis in late 1975 called for budget cuts of $724 million as the primary means of reducing the gaps between revenues and expenditures. It appeared that all the parties concerned saw the problem as a spending problem. These budget cuts were intended to consist of swift and sharp expenditure slashes which would bring the budget into balance rapidly. Between January and June 1976, the City pursued this policy and took actions planned to reduce personnel costs by $48 million and cut City services by $152 million. These cuts of $200 million represented the City's target for the year ended June 30, 1976, and they included things like personnel reductions in various agencies, closing day care and elderly service centers, and reducing library hours.

Subsequent to that time, however, the City changed its policy from one of making sharp programmatic cuts to one of cost containment and seeking out new revenues. The net result of that policy shift had the same effect on the financial results as programmatic cuts in that the City met its 1978 plan. However, the City is projecting deficits in the early 1980s, and they may, in the future, have to revert to their policy of programmatic cuts. The City recognized this possibility in its later financial plans.

The City's policy shift from budget cutting to cost containment and raising new revenue is understandable. Budget cutting and the related reduction of municipal services places hardships on local City residents and may be politically and economically disadvantageous. However, the City's decision to avoid sharp cuts, which were clearly seen as necessary early in the fiscal crisis, may account in part for its failure to get back into the long-term credit markets. Additionally, the City's projected future deficits detract from its achievements to date and, in our opinion, cannot be perceived of as healthy from an investment standpoint.

A recent credit report of Moody's Investors Service indicated this. Moody's found weakness in the current plans of the City, especially in the need for long-term solutions. The report advised investors that "While the financial condition of the City has stabilized, the overall position has not changed dramatically and has perhaps worsened." It also stated that "* * * basic structural weakness in the overall credit outlook persist."

CONCLUSIONS

Although the City achieved a balanced budget in accordance with State requirements at the end of the 3-year plan and other positive fiscal signs were apparent, it had not regained entry to the long-term credit market. The City's failure to do so may have been, in part, because it opted for cost containment rather than cuts, and it relied heavily on assistance from the State and Federal Governments.

CHAPTER 3

UNCERTAIN PROSPECTS FOR THE 4-YEAR PLAN AND BEYOND

New York City is now into the second year of its 4-year financial plan, which is designed to produce a balanced budget under generally accepted accounting principles by 1982. Latest available data indicate that the City's record of progress through June 30, 1978, has continued under the 4-year plan, but uncertainties could pose major problems for the City during the later years of the plan. Because of these uncertainties, the City should begin now to make budget cuts.

By June 30, 1978, the City had made substantial progress towards correcting its budget imbalance, and it achieved a small planned budget surplus on a State legislated financial basis. However, these actions did not resolve the City's basic fiscal problem, and it was unable to regain access to the credit market. The failure to achieve market reentry necessitated further Federal assistance to help resolve the City's fiscal dilemma.

On January 20, 1978, the City submitted to the Secretary of Treasury its initial financial projections and budget gap estimates, together with actions to close the gaps for the 4-year period ending June 30, 1982. These projections pointed to steadily increasing annual budget gaps reaching almost $1 billion by 1982 and served as the basis for consideration of the need for additional Federal assistance, which was ultimately provided in the form of the New York City Loan Guarantee Act of 1978.

The objective of the new 4-year plan is similar to that of the original 3-year plan, i.e., to permit the City to return to the credit market. The plan is periodically updated and revised. The most recent revised plan was approved by the Financial Control Board on June 21, 1979.

The City is now into the second year of the 4-year plan; however, despite a favorable outlook for fiscal years 1979 and 1980, the long-term prospects for achieving and maintaining balanced budgets under generally accepted accounting principles for 1982 and beyond, as well as for successful reentry into the credit market, continue to be uncertain.

A combination of budget underspending together with inflation-driven revenues will permit the City to exceed its financial plan target for 1979 (the City anticipates a surplus of about $200 million on the State legislative basis), and the current outlook is for the same favorable factors to help produce a 1980 balanced budget under State law. Even with these positive factors, however, the City's latest approved plan projects budget deficits of $464 million for fiscal year 1981, $830 million for 1982, and $854 million for 1983.

The projected 1981-83 budget deficits do not represent the totality of the budget imbalance which the City will have to overcome to arrive at a balanced budget for 1982 and future years under generally accepted accounting principles, because the 4-year plan does not adequately recognize two significant uncertainties which can reasonably be expected to have a major impact upon it. The plan

--does not make adequate provision for future labor costs, and

--is based on economic assumptions which may be overly optimistic.

These uncertainties taken together with the budget gaps recognized by the City point to the need for prompt action in making major budget cuts.

LABOR CONTRACT COSTS NOT PROVIDED FOR

Although most of the current City employee labor contracts expire in June 1980, the City's financial plan has made limited provision to deal with these possible increased costs.

The City footnoted its June 1979 plan to indicate that projected labor costs were not included except for a provision of $82 million in 1981. The footnote acknowledged that a wage increase similar to the last one negotiated (1978) would increase the projected budget gaps by $43 million, $295 million, and $465 million in 1981, 1982, and 1983, respectively. However, these amounts were not included in the projected gaps. We estimated the cost of the last labor settlement at $868 million over a 2-year period. While the terms of the new contract may well differ from the old one, it appears the City's estimate of the impact of a wage settlement could be conservative.

Understandably, City officials are reluctant to include large reserves for wage increases in their budgets. They believe the reserved amounts could become the floor for wage negotiations, since the labor unions will assume the

City is willing to give up at least the amount that has been set aside. However, past experience indicates that when the news media focus on wage negotiations in New York City, the relative positions of the parties are rarely kept secret for very long. Considering that fact there may be more merit in maintaining the integrity of the financial plan by providing for more realistic estimates of potential costs in the budget gaps.

Most of the agencies charged with monitoring the City's fiscal progress disagree with our position and offer the same reasoning for disagreeing as does the City. Nevertheless, we believe it is important to include these amounts and accurately state the magnitude of the real budget deficits to be faced by the City. We see little difference between showing these potential costs in footnotes to the plan, as the City has done, or including them in the deficit projections. It is reasonable to assume that the labor unions would be just as likely to make the same assumptions, whether the figures are footnoted or included in the deficits. Further, the practice of footnoting potential costs seems disadvantageous since it tends to disguise the true deficits the City must contend with.

Obviously, no one can predict with certainty what the settlement will cost. Nevertheless, the development of an early strategy to deal with the settlement could help avoid placing the City into the difficult position of closing a substantially increased budget gap in a very compressed period of time.

At a minimum it would seem prudent for the City to include in its financial plan its best estimate of the 1981 settlement and to take budgetary actions to deal with those increased costs. Further, considering the seriousness of the situation, the City and its unions should accelerate the negotiating timetable so that an early settlement can be reached.

It is neither in the City's interest nor in the unions' interest to make their final offers known early in negotiations. However, the Secretary of the Treasury, using the leverage available under the 1978 Loan Guarantee Act, could perhaps help foster serious negotiations well before they might otherwise take place. This could possibly bring about an early settlement, or at least give the City a more precise picture of how the settlement might impact its financial plan. With this knowledge, the City could then begin to plan at an earlier stage for the actions needed to fund any wage increase.

Both Treasury and the City disagree on the merits of having the Secretary involve himself in what they believe is a local matter.

We are not suggesting a direct forced involvement by the Secretary. However, because of the Federal interest here and the seriousness of the issue we believe the Secretary should encourage the parties to negotiate at an early date.

PLAN'S UNDERLYING ECONOMIC ASSUMPTIONS MAY BE OVERLY OPTIMISTIC

In its financial plans, the City provides projections of the budget 4 years into the future. This can be useful in monitoring the City's budgetary and program planning, if there are reasonable assurances of the forecasts' accuracy. From a theoretical basis, the forecasts of the City's budget should be based on a model of the New York City economy. This would reflect the interrelation of the budget and the economy. However, data availability and resource limitations have hampered this development. 1/

Instead, the City uses separate forecasting techniques for each type of revenue and expenditure account. On the expenditure side, much of the forecasting relies on the qualitative judgement of analysts familiar with the account item. On the revenue side, certain general revenue fund accounts are forecasted using quantitative methods. Currently, only the economically sensitive taxes, e.g., sales taxes or income taxes, are forecasted quantitatively.

The City employs forecasts of national economic indicators to project both the City economic indicators and the City's economy to the national economy. The forecasts of national economic conditions were taken primarily from the Wharton Econometric Forecast Associates' projections of national economic activity.

In general, the estimating procedures are thorough. The City's recent forecasts of the economically sensitive tax revenues have been conservative. But this was during a period when the national economy was enjoying sustained growth. In the event of a moderate recession, the City's revenue projections could be overly optimistic.

1/There are currently two commercial large scale models of the New York City economy, but neither has yet been able to incorporate a complete public sector.

A recession scenario

The economy of New York City has been adversely affected by the two most recent national recessions, and there is reason to believe that the local economy is still vulnerable to cyclical downturns. Accurately predicting a national recession is a difficult undertaking, and estimating the impact of a national recession upon the local New York City economy is particularly speculative. However, with the assistance of the City, we estimated tax revenues of the City that are responsive to economic conditions. In doing so, we assumed a moderate recession scenario in the national economy. Using the Wharton model, new forecasts of the national economic indicators were created to reflect a national recession in the third quarter of 1979 through the first quarter of 1980 as shown below. We assumed that City revenues would be primarily affected in fiscal years 1980 and 1981.

According to the national recession scenario, there would be lower tax revenues of $69 million for fiscal year 1980 and $122 million for fiscal year 1981. City officials similarly estimated the impact of a recession at $100 million in 1980 and $150 million in 1981, although they have since lowered their estimates somewhat. The June 1979 financial plan included a contingency program of budget cuts and revenue increases to deal with these recession forecasts as well as other shortfalls in revenues. The contingency program called for budgetary actions of $81 million and $106 million in those years if revenues fall short of the estimates.

	City forecast--Feb. 1979		GAO forecast	
	FY 1980	FY 1981	FY 1980	FY 1981
	(millions)			
Personal income tax	$ 855	$ 891	$ 845	$ 881
Financial income tax	154	163	151	159
General corporation tax	532	566	520	538
Sales tax	1,039	1,104	994	1,025
Utility tax	117	127	118	126
Total	$2,697	$2,851	$2,628	$2,729

It is to the City's credit that its contingency plan was so quickly prepared. However, it should be noted that the potential impact of the recession and other revenue shortfalls have not yet been incorporated in the budget gaps shown in the financial plan.

The current forecasts of the major models of the national economy, while unanimous in predicting a slowdown in economic activity for 1979 and 1980, vary with regard to the composition and degree of that slow-down and also the accompanying rate of inflation. Because the City's tax revenues are positively sensitive to the rate of inflation, the impact on tax revenues resulting from a cyclical downturn could be offset by a high rate of inflation. This is not an unlikely event given the current price levels. While a high rate of inflation would increase tax revenues, the level of expenditures would rise correspondingly. Material, equipment, and labor costs, if past experience holds true, would also rise. While these expenditure increases may lag behind revenues, they would eventually be felt. These higher expenditure levels would hamper the City's attempts to balance its budgets in the following years.

The City's current contingency plan recognizes only the impact of a recession on tax revenues. In the event that an economic downturn was accompanied by high inflation rates, forecasted tax revenues may actually rise. However, a recession will adversely affect the City's total budget, inflation notwithstanding. The City is aware of the various potential revenue and expenditure effects of the recession on its financial plan and intends to consider needed adjustments to the plan as the effects of the recession become clearer.

NEED FOR MAJOR BUDGET CUTS

The City's June 1979 financial plan points to steadily increasing annual budget gaps reaching over $850 million by 1983. The following schedule summarizes the problem.

New York City's Financial Plan

	FY 1980	FY 1981	FY 1982	FY 1983
	(millions)			
Expenditures	$12,843	$13,035	$13,438	$13,804
Revenues	12,843	12,571	12,608	12,950
Gap to be closed	$ -	$ 464	$ 830	$ 854

To close these gaps the City has presented two alternate levels of budget balancing actions. City officials are committed to implementing a series of actions, which they term as "Level I" actions, in each of these 3 years. For the remainder of the balancing actions they are relying on the State and Federal Government. The City has also indicated that, to the extent it does not realize additional State and Federal aid, it will implement further "Level II" actions. These two scenarios are shown on the following schedules.

Level I
Incremental Budget Balancing Actions
Assuming Major Federal and State Assistance

	FY 1981	FY 1982	FY 1983
	(millions)		
New City actions	$294	$126	$123
New Federal and State actions	170	240	(99)
Prior years' City actions (cumulative)	-	294	420
Prior years' State and Federal actions (cumulative)	-	170	410
	$464	$830	$854

Level II
Incremental Budget Balancing Actions
Assuming Major Reliance on City Actions

	FY 1981	FY 1982	FY 1983
	(millions)		
New City actions	$350	$291	$ 94
New Federal and State actions	114	75	(70)
Prior years' City actions (cumulative)	-	350	641
Prior years' State and Federal actions (cumulative)	-	114	189
	$464	$830	$854

Reliance on other levels of government

Under its June 1979 plan for fiscal 1980-83, the City is asking for a substantial commitment of State and Federal resources to close its budget gaps (see p. 17). The City has indicated additional actions which will be implemented should State and Federal aid not materialize. If these cuts were required, the burden would shift back to the City, but that would create other problems since significant actions have already been delayed to the later years of the plan (1981-1983).

In our opinion, the plan represents an excessive reliance on State and Federal actions. These requests for increased aid will come at a time when both the State and Federal Governments are conscientiously avoiding new programs as part of a general response to taxpayer dissatisfaction with increased governmental expenditures.

With regard to State aid for 1980, the approved State budget provides about $200 million which had earlier been promised by the Governor. In order to provide this aid, however, the State may be causing itself budgetary problems. In its recent note prospectus, the State of New York pointed out that it intends to defer $350 million in personal income tax refunds from 1980 to 1981 and also use a tax refund reserve in fiscal 1980. Together these actions will produce about $550 million of nonrecurring receipts which may not be available in future years. Also, the recent collective bargaining agreement reached by the State with most of its employees permits it to defer some of the costs of the settlement until future years, a factor which will bring additional pressure on later budgets.

A recent report of the Nova Institute 1/ discussing some of these matters concludes that "Fiscal 1981 may well turn out to be the year of the 'crunch' in New York State's budget". This concern raises questions about the State's ability to provide increased aid to the City in the future.

Potentially adding to the State's problem in providing future assistance to the City is a proposed termination of Federal revenue-sharing payments to the States. If such a proposal were passed, according to a State budget official, it would cost the State over $200 million in 1981, making

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1/An Analysis of the New York State Executive Budget for Fiscal Year 1980 (February 1979).

it exceedingly difficult to provide any additional aid to the City beyond 1980.

Although more help from the State and Federal Governments is uncertain, the City's June 1979 revision to its 4-year plan evidences substantial reliance on State and Federal aid, as shown below.

Projected Federal and State Aid Required to Close Budget Gaps in the June 1979 Financial Plan

	FY 1981	FY 1982	FY 1983
	(millions)		
Level I	$170	$410	$311
Level II	$114	$189	$119

Especially significant is the City's continued reliance on State and Federal aid, even after implementing its Level II cuts, compared to the original (January 1978) plan which projected little additional intergovernmental aid beyond 1980.

Given the growing disenchantment with government expenditures at all levels, as well as some questions about the financial picture ahead for the State, it would be prudent for the City to rely more heavily on actions within its own control to balance the budget. Relying on other governmental levels, as the City has successfully done in the past, may obscure the need for City actions. As pointed out in chapter 2, the crisis was originally perceived as an excessive expenditure level in relation to the City's revenues, or a spending problem. Efforts to gain additional State and Federal aid tends to shift the focus away from cuts in City expenditures.

Delaying the cuts

The City's current plan recognizes the possibility that some or all of the anticipated State and Federal actions to help balance the budget might not materialize. This was done by laying out additional actions which would be used to offset shortfalls in State and Federal aid. If it implements these actions, in addition to the Level I actions, the City's plan shows relatively little need for State or Federal actions beyond 1982. However, accomplishing both sets of City actions between 1981 and 1983 would be a very substantial task, especially because heavy actions are scheduled for later years.

As shown below, the City has indicated that it has taken $174 million and will take $187 million in Level I budget actions in 1979 and 1980, respectively. The 4-year plan indicates that the additional actions the City must take before 1983 range from about $500 to $700 million depending on the level of Federal and State aid.

City Budget-balancing
Actions Taken and Planned

Fiscal year	Actions taken	Actions Planned: Assuming major Federal and State assistance (Level I)	Actions Planned: Assuming major reliance on City actions (Level II)
	(millions)		
1979	$174	-	-
1980	-	$187	-
1981	-	294	$350
1982	-	126	291
1983	-	123	94

The somewhat disproportionate level of cuts being reserved for the later years becomes more significant when one considers the additional gap-closing measures the City will likely have to take between 1981 and 1983 to offset the cost of the new labor settlements and the potential impact of the recession. While making no significant provision in its financial plan for these costs, the City has estimated that a settlement similar to the one negotiated in 1978 would add $43 million, $295 million, and $465 million to the budget gaps for 1981, 1982, and 1983, respectively. The City's projections of the impact of a recession and other revenue shortfalls would add $81 million and $107 million to the deficits in 1980 and 1981. Under these assumptions the City would have to add $991 million to its already projected gaps and plan on additional budgetary actions to cover that amount between 1980 and 1983.

Budget-balancing Actions Required
Considering Future Uncertainties

	FY 1980	FY 1981	FY 1982	FY 1983
	(millions)			
Gaps per City	-	$464	$ 830	$ 854
Estimate of labor settlement (note a)	-	43	295	465
Estimate of recession and other revenue shortfalls (note b)	$81	107	-	-
Gap to be closed considering future uncertainties	$81	$614	$1,125	$1,319

a/If the settlement approximated our estimate of the cost of the last settlement (about $400 million per year) this would significantly increase the cuts required.

b/These amounts reflect the impact of a recession only on the City's revenues. A combination of inflation with recession could have a much different impact. (See p. 14.)

The City has indicated that the $294 million in planned 1981 actions will "impair" services to City residents. The incremental cuts for 1982 and 1983 will obviously have a more adverse impact on City services. It seems reasonable to assume that that City officials will request the State and Federal Governments to help alleviate their budgetary dilemma. However, the State and Federal Governments may be unwilling or unable to respond.

As a result, the only prudent course of action we see open to the City is to face up to the need for more expenditure reductions now. We believe it would be wise to implement more cuts in 1981, instead of waiting until the latter years of the plan when the pressure of time would compound the difficulties in making cuts. It would be even wiser to accelerate some of the cuts to 1980 to ease the pressure. The Municipal Assistance Corporation recently reached a similar conclusion. In a June 11, 1979, letter to the City transmitting its annual budget review the Corporation expressed the view that "* * * the City should begin to exercise greater budgetary restraint now." It noted that:

"During the past two years there has been no net reduction in the City's labor force. The City has benefitted greatly from a lengthy inflationary economic surge which has resulted in greater-than-anticipated tax collections. The City has also benefitted from significantly stepped-up levels of Federal and State aid and from budgetary relief through a variety of MAC and Federal financings and stretch-outs. We do not believe these benefits can continue or recur at these levels."

Accelerating budget cuts might be interpreted by the investment community as a signal that the City recognizes the magnitude of the tasks it faces and is willing to begin. Evidence of determination by the City could create a more favorable impression with investors and ultimately stabilize the City fiscally. Investors after all determine whether the City will ultimately stand on its own and whether special Federal financial assistance can be ended. In fact, it may not be so much success in budget cutting, but a determined effort that is the key to restoring the confidence of investors.

The City's current plan offers little evidence that the City has faced up to the need for budgetary constraint. For example, in 1980 the City expected to realize $180 million in additional revenues. It has already budgeted $140 million of these funds mostly for increased hirings or other programs in that year.

CONCLUSIONS

Our analysis suggests that the City's 4-year financial plan does not adequately provide for two major future events which could have a significant impact on it. Further, the plan shows continued heavy reliance on uncertain Federal and State aid. In view of the apparent uncertainties of this aid, the City should reconsider its plan for postponing budget cuts until the latter years of the plan.

RECOMMENDATIONS

We recommend that the Secretary of the Treasury encourage the City to revise its plan to acknowledge the need for immediate additional budget cuts. A plan providing for greater budgetary restraint, together with vigorous implementation of that plan, will help to demonstrate to investors and the public the City's willingness to promptly confront the difficult financial tasks it faces.

We further recommend that the Secretary of the Treasury encourage early negotiations between the City and its unions to give the City a more precise picture of how the settlement will affect its financial plan.

CHAPTER 4

AN IMPROVED MONITORING SYSTEM MAY HELP

If the City's financial plan is to have a reasonable chance of success, City officials must know as early as possible whether the actions they are taking to close the budget gaps are achievable and on target. Any slippage from the goal projected for the City's budget cuts or revenue increases would indicate the need for alternate actions.

We have twice urged the Secretary of the Treasury (October 22, 1976 and January 18, 1979) to support the reinstitution of a milestone monitoring system which would provide early warnings of any slippage in programs to close the City's gap. Such a system operated during the first year of the City's first financial plan (fiscal year 1976) and provided early warnings when the City went off target.

That system was relatively simple to use. A series of milestone target dates was established. Whenever those dates were not met, it was obvious that other action would be required if the desired results were to be achieved on schedule. For example, in one of its early savings programs the City planned to increase revenue from its mid-town tow-away program by $1 million. Contracts had to be signed with private tow truck operators by the end of March 1976. To meet that date, the contracts had to be prepared by January 14th and ready for approval by the City's attorneys, the Comptroller's office, the Emergency Financial Control Board, and others at various dates during February and March. If any of those interim dates were missed, the savings projection would be jeopardized and another action might be required, such as compressing the remaining dates, or possibly substituting another savings program.

In the summer of 1976, City officials decided to abandon this system of monitoring by milestones. This decision was based, in part, on the City's belief that its new quarterly allocation system would provide sufficient information to permit effective monitoring of both expenses and revenues. While we agreed that the quarterly allocation system would help, we believed it would also be valuable to continue the milestone system which provided interim warnings of shortfalls more frequently than every 3 months. The City disagreed and eliminated the milestone system. As stated earlier, we objected to this action, but not until recently was the support for a milestone system sufficiently widespread to convince the City to reinstitute it. In a February 1979 meeting of the Financial Control Board, the City agreed to a resolution calling for implementation, on a trial basis, of a monitoring system tracking budget-cutting programs. We consider this a very positive development.

At the present time, negotiations are being conducted between the City and its monitors to determine the programs that will be monitored and the specific type of reporting the City will provide under this system. We believe it important that early implementation of this system take place, particularly considering the need for making budget cuts. The milestone system, complemented by monthly reports subject to public scrutiny, is vital in that it would not only provide an early warning of slippage in budget cuts, but it would also go a long way toward raising the confidence level of investors by publicly showing the intentions of City officials as well as their progress.

The other monitoring agencies generally agree that an effective milestone system would be helpful in tracking the City's progress on specific budget balancing actions. The City strongly disagrees and has stated that monitoring by a number of agencies, both Federal and State, is more than adequate.

CONCLUSIONS

The milestone monitoring system is needed by the City to provide early warnings of any slippage in programs to close the budget gap, but the City has encountered delays in implementing such a system. Aggressive implementation and use of the system would represent a very positive step toward an effective management device to aid in assuring that needed measures to close the budget gap are on schedule.

RECOMMENDATION

We recommend that the Secretary of the Treasury closely monitor the City's implementation and use of the milestone system.

CHAPTER 5

TAKING STEPS TO IMPROVE ITS ECONOMY

Improving the City's economy is a necessary precondition to solving its fiscal problems. The needed economic development, however, cannot take place without increased investment. Shortly after the fiscal crisis erupted in 1975, City officials recognized their role in changing policies that would promote private investment and have taken some actions to achieve that goal. Unfortunately, considering the extent of the problems ahead, it seems clear that more should be done.

The City is faced with limitations in this connection. Some positive economic actions may have negative budgetary impacts in the short run. Similarly, some positive short run budgetary tactics may be economically negative. As a result the City must carefully weigh its actions. Although we recognize that limitation, we still believe the City needs a more aggressive economic plan.

While the long economic decline, as measured by employment, finally ended in 1978, the City has not entered a period of full economic recovery. In fact, a stagnant New York City economy is forecast through the 1980s. This will probably limit the growth of tax revenue in the future to less than the rate of inflation. Coupled with expenditures more likely to grow at a greater rate than the revenues, that scenario leaves questions about the City's ability to pay its own way. Without a comprehensive economic plan and with the given level of State and Federal involvement, the City's financial deficits will likely remain chronic.

ECONOMIC OVERVIEW

The beginning of the severe contraction in the City's economy coincided with the 1969-70 recession. However, unlike the national economy, the City's economy never fully recovered. Nearly every available economic indicator reflected the seriousness of the plight. Total employment fell by an annual average of over 77,000 between 1969 and 1977. A corresponding rise in the unemployment rate reached double digits in 1975. A parallel decline in population has still not ended almost 10 years later.

In 1978 total employment stopped falling for the first time in 9 years. Almost all of this can be attributed to the services and local government sectors. The gains in the retail trade sector and the finance, insurance, and real estate sectors were almost insignificant, while the manufacturing sector continued to decline. Though there are some signs of improvement, such as encouraging growth in the borough of Manhattan, it is evident that the City's economy has still not stabilized.

A number of explanations have been offered for the City's economic problems in the 1970s. The adverse impact of the two national recessions since 1969 are considered by some analysts to be partially responsible for the local downturn. However, that theory is questionable because the City's economy appeared to be only marginally affected by the recovery phase of recession. In addition, the economy had already been losing ground to the rest of the nation throughout the 1950s and 1960s. Another explanation is that the decline merely reflects the shift of jobs and industry from the Northeast region to the South, Southwest, and West. But in contrast to that viewpoint, the New York-New Jersey area (excluding the City) has experienced moderate employment gains since 1969. Other reasons offered have ranged from high energy costs to a disproportionate regional distribution of Federal spending.

To an extent, a number of factors played a part in the City's economic decline and stagnation, but no one factor offers a wholly satisfactory explanation. Perhaps the most important observation that can be made here is that the underlying contention of all these explanations suggests that forces beyond the City's control were responsible for the economic decline and the City was, as the popular theory suggests, a "captive of events."

Certainly there are forces, both political and economic, which have adversely affected the economy and are beyond the City's control. However, the City is not completely captive to these outside forces. It has powers, primarily in taxation, that if used properly can have substantial direct and indirect effects upon its economic base.

PREVIOUS STUDIES OF THE CITY'S ECONOMY

Before the fiscal crisis erupted, available information about the City's economy was not substantial. However, since 1975, many studies have analyzed the City's economy and its relationship with the budget as well as its links to the regional and national economies.

These studies were commissioned on either the Federal, State, or City levels. The following is a list of major studies.

City level:	Temporary Commission on City Finances, Series of Interim Reports, 1975 to 1977.
	Economic Recovery: New York City's Program for 1977 - 1978. City's commitment to economic recovery December 1976.
	Task Force on Business Taxes Office of Economic Development. (currently underway)
State level:	Report of the Special Task Force on Taxation, Need to Revise Taxation, May 1976.
Federal level:	The Long-term Fiscal Outlook for New York City, Report to the Congress by the Comptroller General of the United States, April 1977.

These studies reported findings and recommendations specific to their individual mandates. However, the reports concurred on the point that the City's economic policies, primarily in taxation, had contributed to its declining economic base. Furthermore, the reports agreed that if those policies were properly revised, it would induce substantial improvements in the performance of the local economy with concomitant fiscal improvements. Some of those suggested revisions and the actions taken are outlined in appendix I, tables 6, 7, and 8.

<u>TAXATION</u>

It has become evident that a government's budgetary decisions both in regard to revenues and expenditures affect its economic base. On the revenue side, tax policy can have a debilitating effect on the economic base if the mutual interdependence of the private and public sectors is not recognized. The past policy which yielded the City's current tax structure did not reflect this relationship.

In the mid 1960s, the City imposed a commercial rent occupancy tax and switched from a gross receipts tax on corporate business to a gross profits tax. An income tax on residents was also imposed. In general, this signaled an era of substantially higher business and individual taxation. More specifically, it increased the burden of taxation for certain groups, such as manufacturing firms and high income residents.

Manufacturing has historically been the weakest sector of the City's economy. That sector has experienced an employment decline of over 500,000 jobs since 1950, and the decline has still not stopped. The Temporary Commission on City Finances did an econometric analysis of the problem and found that for manufacturing firms the advantages of being located in the City had dwindled over time. As a result, an individual firm's decision to move became more sensitive to local tax rates.

The Temporary Commission reported that manufacturing firms were indeed responding to higher taxation in the City by relocating elsewhere. In essence then the City's business tax policies were encouraging the decline in manufacturing. The Commission recommended that a series of business tax reliefs be enacted simultaneously, such as reducing corporate income taxes from 10.05 percent to 5 percent and lowering commercial rent tax to a flat 2.5 percent. The study found that this would halt the decline in manufacturing, and the cost of implementation would be offset within 3 years by increased revenues. These recommendations were echoed by the Special Task Force on Taxation. (See app. I, table 7.)

Relatively higher personal taxes in the City also add costs to local businesses. For example, private firms compete on a national level for their managerial and technical employees. As a result of the higher personal taxes the firms must provide higher wages and salaries for these employees to adjust for real earnings. This further aggravates the competitive position of firms located in the City and provides additional incentive to leave.

Locational decisions based on taxation are made by individuals as well as businesses. The combined State and local taxes for New York City residents are significantly higher than the two surrounding states, New Jersey and Connecticut. For higher income individuals, who are more mobile, the relative difference is even greater because of the progressive nature of the personal income tax. Inflation has compounded the burden by pushing most workers into higher tax brackets.

As these tax burdens increase, the more mobile individuals are increasingly pressured to move, and this has the effect of further dampening business activity. The need to reduce personal taxes to stem this out-migration has been proposed by the studies above.

Early in the crisis, City officials appeared to embrace the concept that a conscious undertaking to improve the City's economy was needed. As a result, a number of tax changes were implemented. However, upon closer scrutiny only changes in the relatively minor taxes were fully implemented. The rate reductions on the major taxes tended merely to offset the rate increases enacted after 1975. For example, the corporate tax rate was lowered to 9 percent, but it had previously been raised from 6.7 percent to 10.05 percent in 1975. State revisions of personal exemptions and standard deductions in 1979 have lowered taxable income, but the City tax rates are still higher than they were in 1975. The tax burden, as measured by the tax rates, which were created earlier and which were considered to have been instrumental in the economic decline of the 1970s, was not lowered. (See app. I, tables 4 and 5 for a survey of changes in the rates on business and personal taxes since 1974.) It is doubtful that the marginal effect of these reductions was significant enough to induce increased business activity.

Currently, the prevailing policy centers on a number of business assistance programs. The City's Office of Economic Development is primarily responsible for policy implementation. Its major weapon is a tax abatement program operated by the Industrial and Commercial Incentive Board. Business firms on an individual basis can be granted tax exemptions for the expansion of existing facilities and the building of new ones. This program has been criticized by the City Comptroller for operating haphazardly and without any discernible policy or criteria for granting exemptions. The City is attempting to correct this problem. However, questions regarding the program's concept remain. While the selected firms may benefit from substantial tax savings, it is doubtful that the piecemeal basis of this program can make significant improvements to the overall business climate.

We recognize that the City will have difficulty financing any major tax cuts in the short run. Expenditure cuts are one method of financing which should be explored. However, if service levels were to be reduced, some of the benefits could be negated.

OTHER POLICIES AFFECTING THE ECONOMY

New York City's capital expenditures

The City is the source of the capital infrastructure vital to its private economy. This capital, invested in mass transit, streets and highways, water and sewer lines, bridges and buildings, etc., plays a substantial role in determining the quality of life and cost of doing business in the City. The City, however, faces problems with respect to its capital assets because, in simple terms, they are deteriorating. The deterioration was accelerated by the curtailment of capital spending from 1975 to 1978. Further, significant amounts of capital funds were used to support the operating budget, thus limiting the amount of available capital funds.

Current expenses which were funded from the capital budget amounted to over $650 million in 1976. They have been lowered to $445 million in 1979, and the City plans to remove them from the capital budget by 1982. From 1976 through 1978, capital transfers represented nearly half the capital budget.

True capital expenditures (see fig. 1) were rising substantially through 1975 increasing almost three-fold since 1968. During this time the emphasis was on new capital projects rather than rehabilitation or replacement of the existing capital assets. New subways, streets, sewer and water lines, etc., can function well, however, only if the entire infrastructure, new and old, is properly maintained.

During this time, the existing capital assets deteriorated. For example, the replacement cycles for streets, sewers, and water lines were 150, 300, and 200 years respectively.1/ It is estimated that 40 percent of the City's streets currently need to be reconstructed. To maintain and upgrade the transit system would now require about $500 million annually. And the two main water tunnels which bring water to the City from the Catskill Mountains have never been shut down for inspection and repair. If they were shut down now, there is concern that they could not be reopened.

The City Comptroller advised us that his office recently completed a study which estimated that some $40 billion needs to be spent on capital construction projects over the next 10 years if the City is to bring its physical plant to a reasonable state of performance.

1/The Mayor's 1980 budget message recommmends replacement cycles of 35, 100, and 100 years respectively.

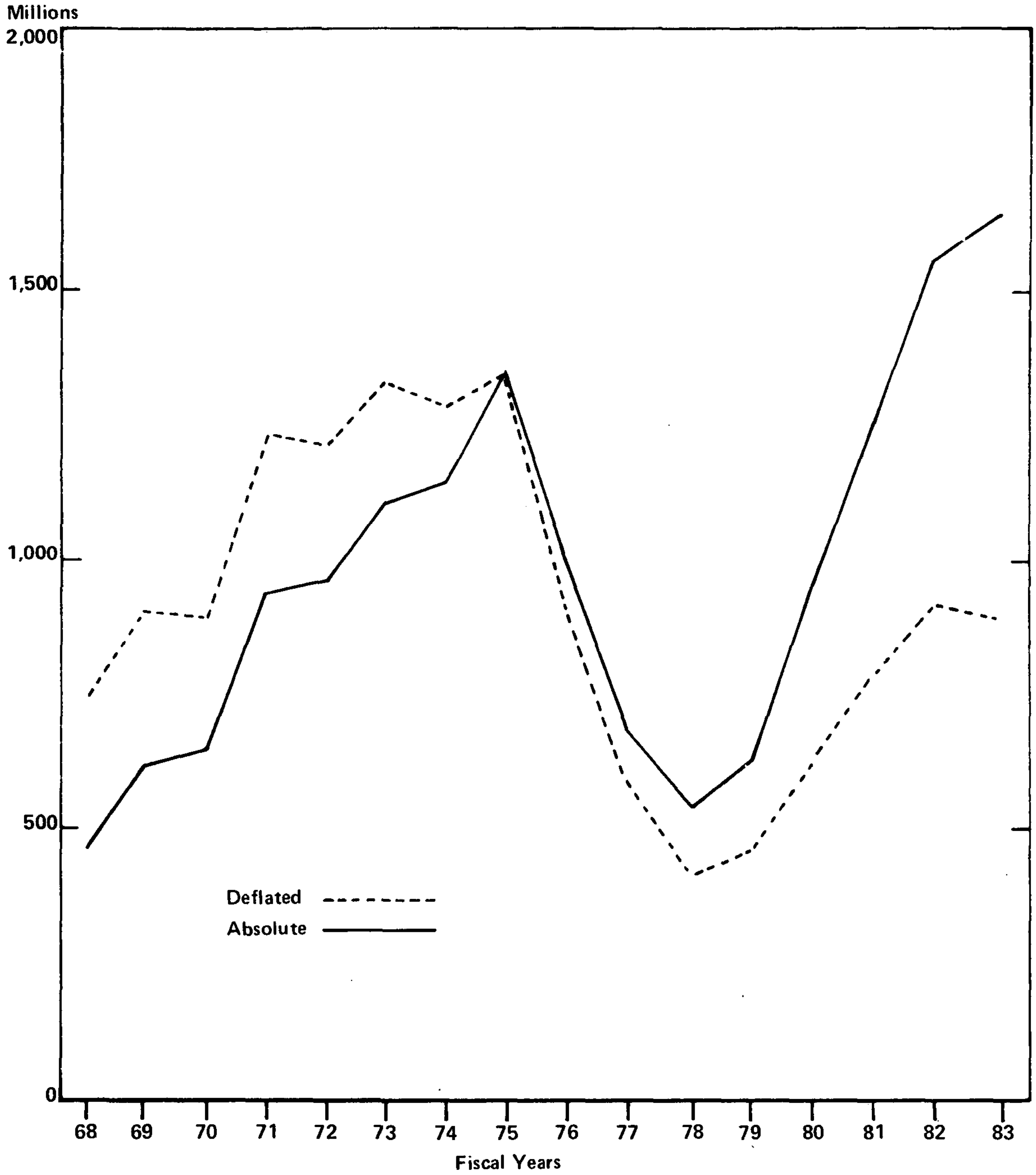
The neglect of capital maintenance, both before and after the fiscal crisis, has not unduly affected the City in the short run. Minimal maintenance seems to have kept services from the capital assets at a fairly high, though declining, level. The major effects of this policy, if continued, would be felt in the next decade or so as the City faces major repair and replacement of many of its capital assets at the same time. The cost of not maintaining its capital assets in the past will then be very high in terms of greatly reduced services or higher taxes for increased debt service to rebuild them.

The fall in capital expenditures reached a low in 1978, declining by 62 percent from their 1975 high of $1,356 million. However, beginning in 1979 the City recognized the need to halt and reverse the deterioration of its capital assets. The 1979-82 capital expenditures plan emphasizes rehabilitation and replacement of the City's infrastructure; in 1979, almost two-thirds of the City's capital spending is for this purpose. However, in real terms, (deflated dollars) total capital expenditures fall far short of the precrisis level (see fig. 1). For the 8 years preceding the crisis, the City spent an average of $1.125 billion a year. For the 8 years succeeding the crisis, expenditures are projected to average $714 million a year. This is a reduction of about 37 percent a year.

Whether or not the emphasis on rehabilitation and replacement in light of reduced real capital expenditures will be enough to bring the existing capital assets up to par and keep it there will be an academic question if the City cannot reenter the long-term bond market. Through 1982, the capital budgets will be financed with Municipal Assistance Corporation and federally guaranteed bonds. In 1981 and 1982, the City will attempt to sell its own bonds to fund part of the capital budget; if it cannot sell them, a backup sale of Municipal Assistance Corporation and federally guaranteed bonds will be held. After 1982 capital expenditures are expected to be financed solely with the sale of City bonds. If the City cannot sell its bonds then it would have three basic options (1) plan for drastic cuts in current services in order to make the needed investments, (2) seek out intergovernmental funds, (3) do not make the investments and allow its capital infrastructure to continue decaying--with eventual repercussions on the City's economy.

Figure 1

NEW YORK CITY CAPITAL EXPENDITURES
FISCAL YEARS 1968-1983 1/



1/ DATA FOR THE YEARS 1979-1983 ARE ESTIMATES.

In brief, the City has been living beyond its income by consuming its capital, i.e., by allowing its capital assets to decay. The City must halt and reverse this decay as a part of solving its fiscal and economic problems.

Reversing the deterioration of the City's infrastructure will be a serious challenge even if it regains access to the credit markets to finance its capital plan beyond 1982. Financing the needed capital investments, even at reasonable rates of interest, will add to the City's already heavy level of debt service and result in added pressures on its operating budget. Without any new State or Federal assistance in the capital infrastructure area, the City may face the dilemma of simultaneously needing additional capital investment and having to balance its operating budget.

Rent control and rent stabilization

Rent stabilization was recently extended for another 3 years. This action reflects the strong political support for the continuance of City regulation in the rental housing market. The current regulation is administered through rent control and rent stabilization. Each system has its own unique history and impact on the City. In present form, their effects are similar--subsidization of renters, primarily by owners.

Rents under both systems are now allowed to increase, but at a rate that has turned out to be less than the rise in operating costs. This keeps rents from reflecting the cost of operating rental housing in the City. The resulting decline in rental income discourages owners from properly maintaining their properties. In some cases it can lead to property abandonment if owners cannot cover operating costs.

There is evidence that rent control and rent stabilization have caused deterioration and abandonment of rental housing in the City. To the extent that this lowers property assessments and promotes real estate tax delinquencies, property tax revenues decline. Recent estimates of lost real estate revenues have been as high as $200 million for a single year.

Though the real estate market has suffered seriously, it is incorrect to assess the potential gains from that perspective alone. Some form of rent regulation has been in existence for over 37 years. Because of the pervasiveness of the policy, any major changes will have political and social, as well as economic, ramifications throughout the City.

For example, proponents of rent control and rent stabilization claim its elimination would have a deleterious impact on low income families. Therefore, any benefits in real estate revenues resulting from the elimination should be offset by increases in welfare payments to the low income families who were correspondingly affected.

This question can only be answered by accurate data, particularly the income distribution of those living in regulated housing, and sound analysis of such data. There have been recent studies, including that of the Temporary Commission on City Finances, on this issue, but the City should determine for itself the relevancy of the various arguments.

In any event, if the City wishes as a matter of policy to subsidize low income families, some form of income supplement would be a more direct and effective method than rent control and rent stabilization. As it stands now the City is certain only that tenants in the two systems are being subsidized. If the issue can be resolved properly revenue gains could result.

LONG-TERM ECONOMIC FORECAST

Wharton Econometric Forecast Associates have developed a regional model of New York with the New York City economy as an integrated part of the region. It is a new model and is still undergoing an evaluation period. However, in the aggregate its forecast of the New York City economy is consistent with the City's own implied forecasts.

An analysis is provided of the forecast for the New York City economy in conjunction with the economy of the surrounding area. While forecasted measures have been included, the levels are not meant to be firm predictions. Long-term forecasts do not have that capacity. Rather, the forecast is used to provide a measure of what the long-term economic condition of the City could be.

Gains in such economic measures as total employment and output during 1978 provided some evidence that the City's economy is beginning to stabilize. However, our analysis of the Wharton Regional Model Forecast indicates that the City has not turned the corner toward full economic recovery.

The City's general competitive position for business location will continue to be poor. The City's economy, as measured by employment growth, is forecasted to be stagnant through 1980. This stagnation is reflected in the employment growth for all the major sectors, even services. The projected rates of growth for employment lag significantly behind the national averages.

Real personal income in the City will grow through the 1980s but at a slow pace. We do not see any national developments on the horizon that would alter this outlook for the City.

Employment and output growth rates in the area surrounding New York City are projected to exceed those of the City, but continue to lag slightly behind the national average. In direct contrast to the City, employment growth in the manufacturing sector in the surrounding area is projected to outstrip the national average.

The long-term outlook shows that the New York City economy will continue to lose ground to the surrounding area. The City recognized a recent private survey which indicated that some of the gains made in the surrounding area are at the expense of the City. Over half of the firms in the survey stated they would relocate to the surrounding area in the event that a move had to be made.

LONG-TERM FORECAST OF THE CITY BUDGET

We prepared a long-term forecast of expenditures and revenues which reflects the forecast for the City economy. This forecast illustrates the need for budget reductions and a comprehensive economic strategy which could improve the City's long-term outlook. The normal uncertainties of long-term forecasting are compounded by the changes in the accounting structure of the budget that have taken place over time.

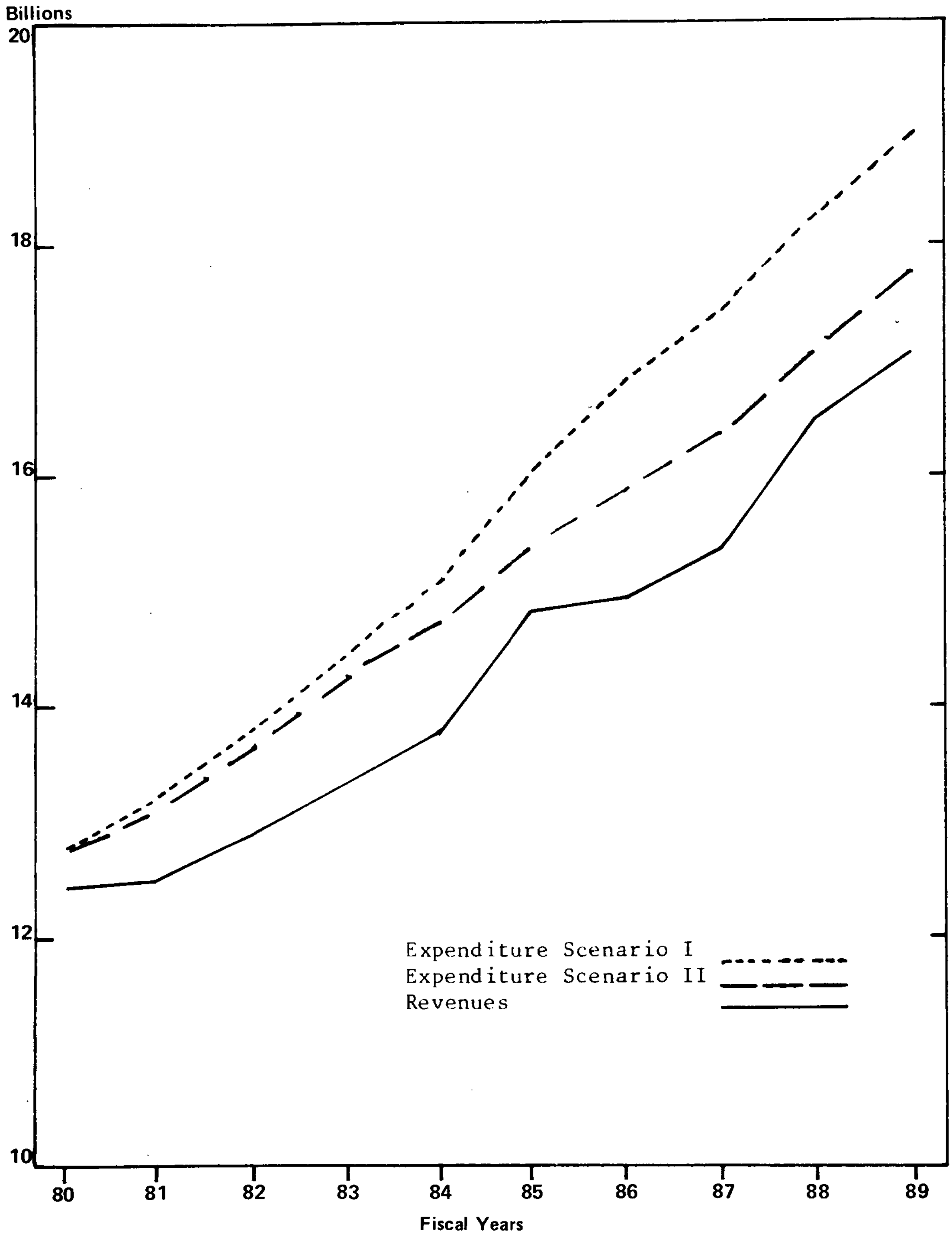
The City strongly objected to these forecasts stating "We see little substantive benefit to be derived from your engaging in this kind of guessing game." As stated above, we recognize the limitations of these long-term forecasts, but we believe they are more than just guesses. The forecasts suggest long-term trends in expenditures and revenues so as to illustrate the future budget situation. They indicate the formidable nature of the problem that the City faces over the long run.

City revenues

To facilitate the forecast, City revenues are separated into four categories (1) general fund revenues, (2) Federal and State intergovernmental aid, (3) real estate taxes, and (4) other miscellaneous revenues. Not all of these categories

Figure 2

PROJECTIONS OF NEW YORK CITY BUDGET (GAAP)
FISCAL YEAR 1980-1989



lend themselves to statistical forecasts. Long-term forecasts of Federal and State intergovernmental aid are particularly difficult since the levels are established by aid programs, some of which expire during the forecast period, and may be replaced by others not yet conceived. On the other hand, general fund tax revenues are more easily quantified.

The general fund revenues depend on the overall performance of both the national and City economies. The tax models developed by the City's Office of Management and Budget have been used to forecast some of the general fund tax revenues. It should be noted that the longer the forecast is extended, the less certain are the projections. Independently derived national data were used as inputs to the model. The derived projections of the City parameters were verified for consistency with the Wharton regional forecasts. The revenue projections are presented in figure 2.

City expenditures

The City's expense budget is made up of a large number of programs. The size of that budget after 1979 depends upon future budget decisions with respect to those programs. Other factors are inflation, productivity, and changing levels of program responsibilities.

Since 1975, the City has had success in constraining the growth of its expense budget. This was accomplished through such actions as cost containment, the reduction of debt service, and shifting program responsibilities to other levels of government.

Because of the nonrecurring nature of some of these methods, such as reducing debt service, there is some doubt that this trend can be maintained in City expenditures. A reasonable alternative projection would have the cost of current service levels growing at about the expected rate of inflation.

Two separate expenditure projections were made. Each assumes that current service levels will remain unchanged.

Scenario I

The expenditure projections are based on the City's own estimates through fiscal year 1983 adjusted for possible wage increases in 1981-83. For fiscal year 1984 and beyond we assumed that fiscal year 1983 per capita expenditures (other than debt service) would remain constant in real terms, i.e., would increase only by the amount of expected inflation. The impact of inflation on areas such as other than personal service costs were incorporated along with the effect of future wage settlements.

Scenario II

The alternative forecast of City expenditures is based on its performance from 1975 through 1979. After adjustments for stretching out debt service and shifting of program responsibilities, the rate of growth of expenditures averaged an estimated 4.25 percent annually. This rate was then applied to an adjusted 1980 expenditure level to derive the more conservative estimate for the years 1980 through 1989.

Neither of these scenarios is intended to predict what the City's expenditures will actually be in the 1980s. At best, they point out trends and magnitudes that could prevail if there are no major changes in the underlying forces and data impinging on the City's expenditures.

CONCLUSIONS

The City's economic problems have been a major factor behind its fiscal problems. To some extent, these economic problems were caused by factors beyond the City's control. It is apparent though that the City's policies over the last decade, primarily in taxation, have caused a further exodus of firms, jobs, and individuals. Studies commissioned on the Federal, State, and local levels concur that counterproductive taxation has led to a deterioration of the City's tax base, and unless significant changes are made City revenues will continue to fall short of their potential.

This finding indicates that the City is in a position to help itself out of its current fiscal problem. So far, the City's efforts have been limited due primarily to fiscal constraints. New York City remains in a poor competitive position for business location when compared to the surrounding area. Lower taxes elsewhere in the metropolitan area and in other sections of the country continue to be a major factor in business relocation from the City in 1978.

The future economic outlook leaves little hope for real growth unless the City implements a comprehensive plan to improve its stagnating economic base. The plan should be centered around the development of a tax structure that is competitive with jurisdictions in the surrounding areas. Financing tax cuts will be a challenge, but every avenue should be explored.

RECOMMENDATION

We recommend that the Secretary of the Treasury encourage the City to continue to take action to improve its economic base. The findings contained in the various economic analyses which have been prepared for the City should provide a solid basis for this action.

CHAPTER 6

SCOPE OF REVIEW

We prepared this report during the course of our monitoring work under the provisions of the New York City Seasonal Financing Act of 1975 and the New York City Loan Guarantee Act of 1978. That work, conducted primarily in New York City, included reviews of City records, discussions with City officials and others concerned with the City's financial problems, regular attendance as observers at Financial Control Board meetings, and coordination with the Special Deputy State Comptroller for New York City and officials of the Department of the Treasury.

This report was prepared on the basis of information available to us as of July 31, 1979.

Table 1

Payroll Employment by Location of Job for
New York City and Standard
Metropolitan Statistical Area (1960-1978)

Year	New York City	Rest of Metropolitan Area	Total	Percent in City
	(000 omitted)			
1960	3,538.4	2,176.1	5,714.5	61.9
1965	3,577.3	2,502.2	6,079.5	58.8
1969	3,797.7	2,903.2	6,700.9	56.7
1970	3,744.8	2,941.0	6,685.8	56.0
1971	3,609.4	2,927.3	6,536.7	55.2
1972	3,563.1	2,995.1	6,558.2	54.3
1973	3,538.4	3,084.9	6,623.3	53.4
1974	3,444.6	3,098.1	6,542.7	52.6
1975	3,275.9	3,004.5	6,280.4	52.2
1976	3,204.7	3,060.1	6,264.8	51.1
1977	3,180.0	3,148.8	6,328.8	50.2
1978	3,223.9	3,229.1	6,453.0	50.0

Source: Bureau of Labor Statistics

Table 2

Composition of New York City Employment Changes

1969-1978 for Selected Industries and Sectors

	Employment change (000 omitted)	Percent change
Private sector	-573.8	-15.1
Manufacturing	-291.0	-35.2
Services	36.9	4.7
Retail	- 68.2	-15.5
Finance, insurance, and real estate	- 49.0	-10.5
Other	-202.5	-15.7
Government	- 35.5	- 6.5
Federal	- 20.8	-19.7
State	14.0	36.6
City	- 28.7	- 7.1

Source: Bureau of Labor Statistics

Table 3

New York City Population (1960-1977)

Year	Population	Percent change
1960	7,782,000	-
1970	7,895,600	1.5
1971	7,886,500	-0.1
1972	7,823,800	-0.8
1973	7,665,000	-2.0
1974	7,577,600	-1.3
1975	7,472,500	-1.3
1976	7,453,600	-0.8
1977	7,312,200	-1.4

Source: Department of Commerce, Bureau of Census (Does not include illegal aliens.)

Table 4

Changes in

Major New York City Taxes On Business

Since 1974

A. General corporation tax on net income

(1) 1974 - 6.7 percent.
(2) 1975 - Raised to 10.05 percent.
(3) 1977 - Reduced to 9.5 percent.
(4) 1978 - Reduced to 9.0 percent.

B. Financial corporation tax on net income

(1) 1974 - 6.756 percent.
(2) 1975 - Raised to 13.823 percent.

C. Real estate tax

(1) 1974 - 8.795 percent.
(2) 1978 - Capped at 8.75 percent.

D. City sales tax, including machinery and equipment

(1) 1974 - 4 percent.
(2) 1977 - Tax credit for sales tax for manufacturers on machinery and equipment purchases.
(3) 1978 - Tax credit for sales tax for aircraft industries on parts and supplies.

E. Commercial rent tax

(1) 1974 - 2.5 percent on $2,499 annual rent or less up to 7.5 percent on rent of $11,000 or more.
(2) 1977 - The 1974 tax rates reduced 10 percent with additional 10-percent reduction effective by 1982.

F. Unincorporated business tax

(1) 1974 - 4 percent.

G. Stock transfer tax

(1) 1974 - Maximum rate of 5 cents per share with value of $20 or more.
(2) 1979 - 30 percent rebate of tax and elimination of 25-percent surcharge. 100-percent tax rebate by 1982.

H. Bond transfer tax

(1) 1975 - 50 cents per $1,000 face value imposed.
(2) 1976 - Tax expired.

Table 5

Changes in

Major New York City Personal Taxes

Since 1974

A. Income tax

(1) 1974 - Low range 0.7 percent on first $1,000. High range $673 plus 3.5 percent on income over $30,000.
(2) 1976 - Raised to 0.9 percent on first $1,000 up to $675 plus 4.3 percent on income over $25,000.
(3) 1978-1979 - Revisions of personal exemptions and standard deductions to reduce tax.

B. Sales tax

(1) 1974 - City tax of 4 percent plus State tax of 3 percent.
(2) 1975 - Total tax raised to 8 percent--4 percent each City and State tax.

C. Real estate tax

(1) 1974 - 8.795 percent.
(2) 1978 - Capped at 8.75 percent.

D. Auto use tax

(1) 1974 - $15 per year.

E. Cigarette tax

(1) 1974 - 4 cents per pack plus 3 to 4 cents tar and nicotine tax when certain limits exceeded.
(2) 1975 - Raised to 8 cents per pack; tar and nicotine tax dropped.

F. Commuter tax

(1) 1974 - 0.45 percent of wages and salaries and 0.65 percent on self-employed earnings, after exclusions of up to $3,000.

G. Estate tax

(1) 1975 - Estate tax enacted.
(2) 1976 - Estate tax repealed.

Table 6

Significant Findings by the

Temporary Commission on City Finances

Purpose:	Tax action	Status
To lessen tax burden on individuals and to stem out-migration.	Double commuter tax.	(a)
	Increase capital gains deduction from 40 to 50 percent.	(b)
	Provide for Subchapter S status in State and City tax law to conform with Federal law.	(a)
	City cigarette tax not be reduced or eliminated.	(b)
	Repeal Emergency Tenant Protection Act to phase out rent control and rent stabilization.	(a)
Purpose:		
To make NYC more competitive economically and to stimulate economic development and growth.	General corporation tax be reduced from 10.05 to 5 percent.	(c)
	4-percent sales tax on machinery, equipment, fuel and utilities be eliminated.	(b)
	5-percent investment credit for purchases of new machinery and equipment, and structures.	(b)(d)
	Reduce commercial rent tax from a maximum of 7.5 percent to a flat 2.5-percent rate.	(c)
	Increase and extend exemptions from property tax for newly constructed manufacturing facilities.	(c)

a/No action.

b/Implemented.

c/Partly implemented.

d/Implemented by New York State.

Table 7

Suggested Tax Changes

Special Task Force on Taxation (1976)

Purpose:	Tax action	Status
To stem out-migration, by reducing personal income taxes, to make NYC economy more competitive, and to stimulate economic growth.	Eliminate 2.5-percent State surcharge on personal income tax.	(b)
	Reduce State income tax 1 percentage point a year for 5 years from 15 to 10 percent and reduce base for maximum tax from $25,000 to $15,000.	(c)
	Exempt manufacturing and processing facilities from City occupancy tax.	(b)
	Allow tax credit of City sales tax on machinery, equipment, fuel, and utilities against State business taxes.	(b)
	Reduce by 50 percent both State and City tax imposed on first $50,000 of corporate income and unincorporated business income of manufacturing concerns.	(b)(d)
	Extension of 25-percent surcharge on stock transfer tax.	(e)
	Allow tax credit against State taxes on stock transfer tax.	(c)
	Repeal City estate tax.	(b)

a/No action.

b/Implemented.

c/Partly implemented.

d/By New York State.

e/Tax being phased out.

Table 8

Suggested Tax Changes

Economic Recovery Programs (1976)

Purpose:	Tax action	Status
To stem out-migration, by reducing personal income taxes, to make NYC economy more competitive, and to stimulate economic growth.	Cap real estate tax.	(b)
	Eliminate City 4-percent sales tax on machinery and equipment.	(b)
	Phased reduction in commercial rent tax by 20 percent.	(b)
	Increase State investment tax credit on expansion of manufacturing facilities from 2 to 5 percent.	(c)
	Tax abatement	
	(1) New construction--50-percent exemption decreasing 5 percent annually.	(b)(d)
	(2) Major modernization or expansion--95-percent exemption decreasing 5 percent annually.	(b)(d)
	(3) Job incentive tax credits.	(a)

a/No action.

b/Implemented.

c/Partly implemented.

d/By New York State.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

SEP 24 1979

Dear Mr. Voss:

Secretary Miller has asked me to respond to your letter of August 4, 1979 requesting comments by Treasury on your draft report to Congress entitled "New York City's Efforts to Deal with its Fiscal Problems." We have reviewed the draft and find that it provides a thoughtful perspective on the immediate fiscal issues confronting the City and the prospects for the long-term health of New York. In general, the report agrees with our view that the City has made progress in dealing with its fiscal problems but must continue its retrenchment strategy to achieve access to the public credit markets for its full financing needs.

The draft report recommends that the Secretary of the Treasury initiate four specific courses of action in his role as overseer of the New York City Loan Guarantee Act ("Guarantee Act") of 1978. Before commenting on these recommendations, several observations are appropriate with respect to Treasury's role in the Federal Loan Guarantee program.

Congress enacted the Guarantee Act to provide four years of relative financing calm that would enable the City to truly balance its budget and to reenter the public credit markets for its full capital needs no later than its 1982 fiscal year. At the time the Guarantee Act was approved in August 1978, the City had made significant budgetary progress. However, the public credit markets remained closed to the City. The legislation contemplated that the City's satisfaction of a number of stringent and specific conditions would result in the restoration of investor confidence in City securities. Those conditions include, but are not limited to, the City's:

-- achieving budget balance under generally accepted accounting principles (GAAP) by its fiscal year 1982, with substantial progress toward that goal in each of the three preceding years;

-- making its best effort to find unguaranteed sources of financing and "phasing-in" access to the note and bond markets throughout the four-year period; and

-- implementing new management initiatives, including the establishment of an Audit Committee and a Productivity Council.

To date, prior to each issuance of Federally guaranteed City bonds--in November of 1978 and February, June and August of 1979--the Secretary of the Treasury determined that the City, the State, and other appropriate parties satisfied the conditions set forth in the Act.

The Guarantee Act was not intended to mandate, or even to authorize, Treasury's management of the affairs of New York City. The integrity of local governments is an important part of our Federal system.

In making his periodic assessments of the City's compliance with these conditions, the Secretary of the Treasury has suggested certain actions to the City to ensure continued compliance with the Act. In June, for example, due to the projected magnitude of the budget gaps in the City's 1981 and 1982 fiscal years, Treasury required the City to develop a $100-million contingency plan to be implemented in January, 1980, should these estimated gaps remain as large.

We agree with your draft report that the City has made progress in recent years. We also agree that the City must continue its retrenchment policy in order to achieve the goals of the Guarantee Act--true budget balance and full market access by its 1982 fiscal year. Treasury will continue carefully to monitor and comment on the City's progress in satisfying the standards set by the Act.

With respect to the specific recommendations outlined in your draft report, our comments are as follows:

1. <u>The City should be required to revise its plan to reflect the need for additional budget cuts</u>

The basic budget analysis contained in this section does not differ significantly from Treasury's own. The City's budget for FY 1980 gives every indication of being balanced according to State law. The FY 1981 budget gap appears manageable. However, the potential magnitude of the FY 1982 gap could cause problems for the City. It may be necessary for the City to adopt programmatic cuts during these years, though the implementation of these cuts is not assured at this time. Mayor Koch is committed to taking all appropriate actions to comply with the requirements of New York State and Federal law. He has met all prior statutory goals. Our present analysis leads us to conclude that it would be premature, and would not be in the best interests of the City and its citizens, to require the City to adopt programmatic budget cuts of any specific amounts.

While your report cites certain "downside" uncertainties in the City's budget through 1982, there is insufficient emphasis on the "upside" potential in those years. The City's recent announcement of an unaudited State-law surplus of $200 million in its 1979 fiscal year indicates the City's increasing ability to control its budget. The City's continuing demonstrated ability to control its expenditures, the positive effect of non-budgeted "one shot" revenues and agency underspending, and the increasing revenue collections beyond Plan estimates resulting from the high rate of inflation, mitigate the case for specific budget cuts at this time.

We share your concern with respect to two major uncertainties--the impact on the City's economy of a major national recession and the forthcoming wage settlements. However, we cannot conclude that these uncertainties make it necessary for the City to initiate an immediate expenditure-reduction program.

During the past few years, actual revenue collections have exceeded City estimates. For the most part, this has resulted from higher-than-expected rates of inflation, causing unexpectedly favorable operating results. There is no basis to conclude that future actual collections will be less than the estimates. In discussions with various City officials, our staff has concluded that the estimates of revenues, as provided in the financial plan, allow realistically for an economic downturn and the concomitant reduction of revenues. As shown in your draft report, the City has a set of contingency estimates in the event of a more serious economic setback. Further, Treasury's independent analysis of the near-term prospects for the City's economy concludes that any likely recession-induced revenue shortfalls will be compensated for by the revenue increases likely to result from the continued rapid rise in prices.

With respect to the upcoming wage negotiations, your report suggests that the City increase its projections of labor costs. We believe it would be unwise for the City to concede prematurely that the settlement will be in excess of its current projections. Furthermore, the balanced-budget mandates of both the Guarantee Act and State law offer sufficient assurances that the labor settlements will not jeopardize the City's prospects for achieving budget balance in accordance with the objectives of the Guarantee Act.

Finally, the draft report concludes that the City's reentry into the long-term credit market will best be accomplished by: (1) implementing sharp budget cutbacks and (2) reducing the City's reliance upon State and Federal funding.

After a lengthy and detailed analysis of the City's fiscal progress, the staff of Treasury's Office of New York Finance has concluded that, while GAO's recommendations are generally sound, the City's access to the long-term credit markets will be better facilitated by the successful implementation of a gradual fiscal plan. Abrupt and potentially disruptive budget cuts may prove counterproductive from the longer-term "economic development" perspective.

With respect to the City's "excessive" reliance on State and Federal funding, two comments are in order:

-- First, Governor Carey remains committed to New York City's solvency. The State has continually supported New York City during its fiscal crisis and there is no reason to conclude that this support will diminish. In your April 1977 report, "The Long Term Fiscal Outlook for New York City", you indicate that, "In general, there is little chance of substantial [budgetary] relief from State aid." As you now must acknowledge, State assistance to New York City has grown substantially since April 1977. While the total dollar amount may not appear to be growing significantly, the State has taken certain substantial actions in the area of "load shedding" (e.g., courts takeover, CUNY, SSI) which have a major recurring (and growing) impact on the City's budget. Your current report indicates, for example, that the City is likely to receive more than $200 million of new State aid in its 1980 fiscal year.

-- Second, the most recently available data suggest that New York City relies less on Federal and State aid than 11 other major cities and that the proportion of its budget financed by Federal aid is within 5 percent of 22 other major cities. Hence, the City's reliance on intergovernmental fiscal assistance is not significantly out of line with that of numerous other major cities.

(See GAO note 1, p. 55.)

Your conclusion that, without immediate additional budget cuts, the City may have difficulty achieving access to the public credit markets is somewhat muted by recent significant events indicating progress toward returning to the public long-term bond market. In FY 1979, the City sold $275 million of short-term notes in the public market and it plans to issue as much as $600 million in notes to the public during FY 1980. The City pension funds were able to privately place $52 million of MAC bonds in the secondary market at extremely favorable rates, and MAC bond issues have been selling on progressively more favorable terms. These positive developments do not necessarily indicate the present existence of a public market of the magnitude required to allow the City full access, in amounts and on terms sufficient to meet the financial plan. However, we are confident that the City will be successful in meeting the goal of full market reentry by FY 1982. (See GAO note 2, p. 55.)

2. Monitor closely the implementation and use of a milestone system for tracking progress against the City's Plan.

The City has negotiated and implemented a new milestone system in cooperation with various monitoring agencies. Treasury has received regular reports produced by this system and, although further refinement of these reports may well be required, we are satisfied that a good beginning has been made.

In addition to these milestone reports, further credit should be given to the City for its work in generating the many financial and management reports required by its numerous monitors. These reports, such as the Monthly Financial Plan Statements, are especially valuable in our assessment of the City's fiscal progress. The recordkeeping capacity needed to produce these very useful tools was not available prior to the fiscal crisis. The milestone reports are a valuable tool of limited applicability in a much larger kit of useful monitoring tools. We do not feel that additional or more comprehensive reports are called for at this time.

3. Encourage the City to take further action to improve its economic base.

Since the onset of its fiscal crisis, the City has recognized the need for tax reform and a strong economic incentive program. The 1974-75 recession seriously aggravated the long-term decline in the City's economy. Although the City's population is still declining, employment, the Consumer Price Index, and other economic indicators suggest that a movement towards economic stability is underway.

It is difficult, at best, to distinguish the various factors that disrupt from those that encourage the City's economy. For example, the draft report's finding that "a stagnant NYC economy is forecast through the 1980's" is correct only if the health of the economy is measured by total employment. What your draft report fails to recognize, and it is not alone in this regard, is that employment alone, without regard to its composition, may be a misleading measure of economic health. The economic base of the City has shifted from manufacturing to service-related fields and these service industries are likely both to grow and to be less sensitive to national economic cycles. (See GAO note 3, p. 55.)

These comments are not meant to imply that the City no longer faces serious, longer-term fiscal and economic problems. While we agree that the Secretary should continue to offer the City encouragement and advice, it does not necessarily follow, nor was it the intention of the Guarantee Act, that the Secretary should involve himself directly in decisions relating to local economic policy. This is especially true today in light of the City's moderate success in its effort to create a hospitable business climate.

Finally, many of the suggestions for tax cuts and economic programs indicated in the draft report have, to an extent, already been implemented. Of course, the City must continue to evaluate its economic development policies in the context of its serious fiscal problems. It is to the City's credit that the economic policies currently being fostered have been so well received.

4. Encourage early negotiations between the City and its unions to give the City a more precise picture of how the settlement will impact its Financial Plan.

Your report states that the Secretary, "using the leverage available under the Loan Guarantee Act, could help foster serious negotiations well before they might otherwise take place, and possibly bring about an early settlement."

We believe that such a course would involve an unwarranted intrusion into local political matters. In practical terms, Treasury could only exert this leverage by threatening to decline to issue guarantees until a labor agreement had been reached. This leverage could only be effective with management, if at all. It has been said by some that the pressure from Congress to have completed labor settlements in place in the Spring of 1978 had just such an effect on the last round of labor negotiations.

- 7 -

Needless to say, beyond the possibility of costing the City more and thus increasing the budget gaps to be closed in subsequent fiscal years, such Federal intrusion could have profound local repercussions unless firmly mandated by statute. Of course, Treasury is most interested in the City and its unions concluding an agreement, amenable to all parties, as soon as practicable. Direct Federal intervention, however, could prove counterproductive.

Again, we appreciate the opportunity to comment on this draft report. We hope that your report and the related comments will assist in clarifying public understanding of the issues involved and further the City's efforts to regain its economic viability and financial independence.

Sincerely,

R. C. Altman

Roger C. Altman
Assistant Secretary

Mr. Allen R. Voss
Director
General Government Division
U. S. General Accounting Office
Washington, D.C. 20548

GAO notes:

1/ GAO's concern is whether the City can continually rely on other levels of Government for significant budget balancing aid. The extent of the City's reliance on this type of aid, in relation to the extent to which other cities rely on similiar aid, is only marginally related to this issue.

2/ Short term note sales are indicators of the City's progress to date. However, the Municipal Assistance Corporation has advised the City that long-term bond sales will be successful only after the City demonstrates that its future budgets will be balanced in the face of pressure for increased expenditures and fluctuations in revenues.

3/ Total employment is the most widely used measure of the City's overall economic health because it is the best available aggregate economic indicator. While there have been changes in the composition of employment there is little evidence that this would offset other long-term economic problems facing the City and long-term employment declines cannot be ignored.

The City of New York Office of the Mayor Office of Management and Budget

Municipal Building
New York, N.Y. 10007
James R. Brigham, Jr.
Director

August 29, 1979

Mr. Allen R. Voss, Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Voss:

I am responding on behalf of Mayor Koch to your report entitled "Report on New York City's Efforts to Deal With Its Fiscal Problems". We thank you for the opportunity to comment on the findings and conclusions contained in the report.

We note that your report recognizes some of the positive action taken by the City in resolving many of the management and control problems which brought it to the brink of fiscal disaster in 1975. We would emphasize that the City has met or exceeded every one of the financial, budgetary and operational requirements provided by Federal, State or City legislation since the inception of the fiscal crisis. Yet, while it is important to document our progress toward fiscal solvency, it is no less important to realize that the City still has a long way to go to attain its fiscal and operational goals. As a demonstration of this resolve, Mayor Koch on August 14, when reporting on the anticipated budget surplus stated ... "[The surplus] means that the City through tighter controls over expenditures and the receipt of higher than anticipated revenue ended the past fiscal year some $200 million closer to a true budgetary balance ... This is very encouraging, but we must be aware of the need for continuing restraint and fiscal retrenchment."

As you are aware, however, the City has made progress in resolving its management and control problems, and I think it would be useful to review some of the significant accomplishments attained during the past four years.

With regard to budgetary reform, the City

- limited growth in budgetary outlays to only 7% between 1975 and 1980, far less than the growth experienced by New York State (31%) or by the Federal Government (63%) for the same period

- issued audited financial statements in FY 1978 which showed that the City operated within a statutory balanced budget for the year ended June 30, 1978, the year in which a budgetary gap of approximately $1 billion had been forecast in the original City three year financial plan

- accelerated in January 1978 the completion of phaseout of capitalized expenses and committed to a budget balanced in accordance with generally accepted accounting principles by FY 1982

- anticipates a statutory surplus of approximately $200 million for FY 1979 and a fiscal year-end cash balance of approximately $800 million, over $100 million of which will be used to reduce the amount of prospective bond sales for capitalized expenses and so save the City future long term debt service cost

- adopted a balanced budget for FY 1980, half way through the four year plan, including a further acceleration of the phaseout of capitalized expenses.

With regard to its finances and improved credit conditions for its own and MAC securities, the City

- reduced seasonal borrowing requirements by almost 70% from $2,100 million during FY 1977 to $650 million in FY 1979

- reentered the public short-term credit markets for $275 million of the FY 1979 seasonal borrowing requirement with succeeding reduction in the interest rate paid

- witnessed a dramatic improvement in the credit market evaluation of MAC securities, with a significant decrease in the interest rate to 7.57% for a recent MAC debt offering and the successful and profitable resale by the City pension funds of a portion of their MAC security holdings in the secondary market

- anticipates meeting reduced seasonal financing needs of $600 million or less for FY 1980 through the public credit markets with a supporting credit facility, if needed, provided by City banking institutions and with greatly expanded participation by out-of-state and foreign banks.

With respect to improvements in management and operational controls, the City

- implemented a major new integrated financial reporting system (IFMS) which together with other City control subsystems provides monthly City operating statements within 30 days after month end for review and analysis by the City's five principal fiscal monitors and all City observers

- reduced the City's workforce by 61,000 from FY 1975 to FY 1979

- concluded labor negotiations with a settlement well within current Federal guidelines and accomplished this without any labor disruptions, proving that the City and its union workforce could bargain realistically during this period of fiscal constraint

- reacted promptly and decisively, taking the necessary actions in September 1978 to offset the loss of over $100 million of Federal countercyclical aid, thereby successfully maintaining its balanced budget for FY 1979.

With respect to the City's efforts to improve its basic economy and business conditions, the City

- stabilized its real estate tax rate for four years through FY 1980

- eliminated the effect of $200 million in tax increases originally prescribed as part of the Federal loan agreements in FY 1976

- enacted the complete phaseout of the effect of the stock transfer tax by FY 1982, a tax which had provided over $260 million in revenues for FY 1976

- broke an extended period of decline in overall employment levels since 1969 during which 600,000 jobs were lost, gaining 68,000 jobs since early 1977 primarily in the private sector.

- experienced dramatic improvement in its real estate market with the construction of several new major hotels and four new major corporate headquarters - IBM, AT&T, Phillip Morris and Continental Insurance - all demonstrating renewed confidence in the City's long term viability.

- witnessed a boom in tourism with over 17.5 million tourists expected this year and in major conventions, including the Democratic Party National Convention, all contributing to near capacity hotel occupancy and significant increases in restaurant and other tourist-related businesses.

Having recognized some of the achievements of the City during the 1976-1979 fiscal period, you must agree that, although the City still faces difficult obstacles ahead, we are on the right road to fiscal solvency. Hence, we cannot concur with the basic premise of your report - that the City should abandon a viable and proven budgetary strategy in order to initiate larger budget cuts. We continue to believe that a balanced approach to closing the City's budget gaps is the most reasonable and the most practical - an approach which involves Federal and State participation but with the main emphasis on a comprehensive City program of cost reductions, revenue enhancements and improved operating efficiencies. This overall approach to all aspects of the budget rather than an emphasis on budget cuts, best serves the interest of the City and its citizens.

In your April 1977 report on "The Long Term Fiscal Outlook for New York City" you stated:

> "We believe that the solution [to the City's fiscal problems] involves a complex combination of actions that to be fully effective need to be developed in concert with each other."

We concurred with that statement in 1977, and still agree today, that a balanced approach is the most prudent and responsible means to achieving the City's fiscal and budgetary goals.

Your report suggests four elements as the basis of a revised budget strategy, and we would submit the following comments regarding them.

<u>Facing up to the need for budget cuts</u>

Your conclusion that the City continues to rely heavily on other levels of government for aid in narrowing its future budget gaps, is incorrect. The City is projecting a smaller proportion of State and Federal aid than it has in previous gap closing plans. There are certain levels of Federal and State aid that are assumed, yet these levels were agreed to in large part as reasonable by Federal officials as part of the City's original January 1978 Four Year Financial Plan. It is, thus, inappropriate under these circumstances to state that the City is relying heavily on the Federal or the State government for additional revenues. (See GAO notes 1 and 2, p. 63.)

As you state in the report, the City has planned for alternative budget cuts in the event the anticipated State and Federal aid does not materialize. We are prepared to implement these cuts if needed in the same manner as we have demonstrated during FY 1979. We do believe, however, that the balanced approach which the City is currently pursuing can negate the need for sharp budgetary cuts - cuts which could impair esssential City services - and still provide for additional costs such as those to be incurred in the forthcoming labor negotiations. The City entered into a reasonable labor agreement in FY 1978 with the City unions, and is committed to reaching a fair settlement that is within our resources again in FY 1980.

Preparing a More Realistic Plan

We take strong exception to your statement that the City needs to prepare a "more realistic" plan. We consider your conclusion to be incorrect and essentially to be a matter of form rather than of substance. Our fiscal monitors have evaluated the City's financial plan within the context of the additional disclosure provided by the City regarding the costs associated with the upcoming labor settlements, as well as the contingency program developed to offset the potential impact of a recession. These are disclosures which you readily acknowledge in your report and they are part of the City's overall financial plan.

We would point out that the City developed a separate statement regarding labor costs and a separate contingency program for very practical reasons. With respect to labor costs, it has been the City's policy not to include estimated costs of pending labor settlements in its published financial plans because such amounts could become the floor for wage negotiations. This month, in a television interview, Barry Feinstein, President of Teamsters Local 237, confirmed the wisdom of our judgment when he stated:

> "Obviously, if the City says we now have a billion dollars in the budget for collective bargaining, the unions would say that's the billion, we've got that. Now let's find some more."

With respect to the City's revenue estimates we do not believe the revenue estimates used in the Plan are based on overly optimistic economic assumptions, as your report indicates. On the contrary, these "economically sensitive" revenue forecasts are based upon national economic indicators, available from widely accepted economic forecasting evaluations. As an additional measure to provide for the prospect of a severe economic downturn, the City prepared and submitted to FCB a contingency program of budgetary actions.

Your report incorrectly states that the City has estimated the impact of a recession at $81 million in 1980 and $106 million in 1981. These figures refer to the amount in the contingency program developed by the City, and are not City estimates of the impact of a recession. The contingency program will be implemented fully or partially as circumstances warrant during the fiscal year. (See GAO note 3, p. 63.)

Sharpening Up Its System for Monitoring Budget Cuts

We believe your proposal that the City sharpen its monitoring systems ignores several salient facts. The City's operations are reviewed, not only internally by this office and the audit staff of the City Comptroller, but also by five independent fiscal monitors, as well as being subject to the broad overview of the U.S. Congress. These monitors include:

- U.S. Department of the Treasury
- Financial Control Board
- Municipal Assistance Corporation
- U.S. General Accounting Office
- Office of Special Deputy State Comptroller

For reporting and monitoring purposes, the City prepares monthly financial operating statements and variance reports and issues them within thirty days after month's end - a major accomplishment for any entity approximating the size of New York City.

On a quarterly basis, the Financial Plan is modified and submitted for the review and approval of the Financial Control Board. The plan must include revised estimates for revenues and expenditures based on the latest information covering the current year as well as the succeeding three years. In addition, contingency programs and programs to eliminate future gaps are provided as required.

On an annual basis, the City's books and records are audited by independent certified public accountants and full financial statements are issued publicly within 120 days of the fiscal year end.

Thus it can be seen that the City must answer to a number of fiscal monitors, at Federal, State and local levels, a fact which contributes substantially to the City's own internal control.

(See GAO note 4, p. 63.)

Taking Steps to Improve the Economy

Contrary to your report, the City has taken an aggressive role towards improving its economy as indicated by the actions listed earlier in this letter. Although we are constrained by our fiscal condition from doing as much as we would like in this area, your own report (Appendix I, Tables 6, 7 and 8) shows that the City has fully or partially implemented 20 of 25 economic recommendations, including all the major recommendations of various City-related commissions.

We do not accept a premise of your report that, once the City achieves true budget balance under generally accepted accounting principles, it will lapse into a pattern of recurring budget deficits. Your report does not present any explanation of the basis for such a conclusion other than simple extrapolations of recent rates of expenditure growth and economic stagnation, neither of which is supported by anything other than a "scenario."

We see little substantive benefit to be derived from your engaging in this kind of guessing game. Furthermore, it is inappropriate for GAO to characterize any additional Federal or State aid as simply "infusions" required to offset chronic deficits. The City has not and does not now seek any special budgetary aid for New York. Rather, our programs and proposals for budgetary assistance generally have been national or state-wide in scope and targeted at fundamental urban problems or equitable redistribution of costs.

Recommendations

Based on our discussion above, we do not concur with the four recommendations provided in the report. Further, while the advice and consultation of the Secretary of the Treasury is always appreciated and has been helpful to the City in the past, we believe it is wrong for the GAO to suggest that the Secretary should involve himself further in local matters, especially those matters which are properly within the jurisdiction of the City administration and which are being responsibly addressed by City officials. (See GAO note 5, p. 63.)

In closing, I want to emphasize that although we have come a long way, the City still faces difficult fiscal prospects. However, we are convinced that the course we are now pursuing, coupled with the continued support of interested and concerned parties, will enable us to meet our future challenges.

Very truly yours,

Louis A. Friedrich

for James R. Brigham, Jr.
Director

GAO Notes:

1/ The City's plan projects substantial amounts of new budget balancing Federal and State aid as shown on page 17 of this report.

2/ We do not believe that approval of the City's plan by Federal officials represents a commitment of Federal funding. That commitment can only result from Congressional action.

3/ See page 13 of this report.

4/ We believe, together with the other monitoring agencies, that milestone monitoring will add significantly to the City's capacity to track budget cuts.

5/ GAO is not recommending that the Secretary mandate action, but rather that he encourage the City to take certain actions to ensure continued compliance with the act.

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
MUNICIPAL BUILDING
NEW YORK, N. Y. 10007

HARRISON J. GOLDIN
COMPTROLLER

TELEPHONE: 566-1945

MARTIN IVES
FIRST DEPUTY COMPTROLLER

August 20, 1979

Mr. Allen R. Voss
Director, General Government Div.
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Voss:

Comptroller Goldin asked me to respond to the revised draft of your "Report on New York City's Efforts to Deal With Its Fiscal Problems."

I'm pleased to note that you have fully considered the comments that I made on July 18 to your earlier draft. Hence, except for the following recent developments, we have no further comments:

a. Page 12 of draft. The City currently estimates, pending review of all data leading to the issuance of our financial statements on October 31, that it completed the fiscal year ended June 30, 1979 some $200 million better than budgeted.

b. Page 35 of draft. The City Comptroller recently completed a study which estimated that some $40 billion needs to be spent on capital construction projects over the next 10 years if the City is to bring its physical plant to a reasonable state of performance. (A copy of that study is enclosed.)

Sincerely,

Martin Ives

yb

Enclosure

cc: Comptroller Goldin
Budget Director Brigham

State of New York
Financial Control Board

270 Broadway
New York, New York 10007
(212) 488-4294

Comer S. Coppie
Executive Director

August 23, 1979

Mr. Allen R. Voss, Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Voss:

I and my staff have reviewed the revised draft of the proposed "Report on New York City's Efforts to Deal with its Fiscal Problems" prepared by the staff of the United States General Accounting Office. In general, we share many of the concerns regarding New York City's fiscal outlook identified in the draft report and are happy to have this opportunity to outline how these concerns are being dealt with through our monitoring and control process.

We concur with a number of the draft report's main observations, including the following: (1) that funding for future labor settlements and the state of the national economy comprise the two largest areas of uncertainty confronting the City's fiscal future (although we would suggest adding the fiscal outlook of the Health and Hospitals Corporation to that list); (2) that the reinstitution of the milestone monitoring system pursuant to the Financial Control Board's February 1979 resolution can provide a useful tool for maintaining effective controls on the City's budgetary progress; (3) that economic development must play an important role in the City's fiscal recovery, in the absence of which the City will need ever-increasing levels of outside aid (or will be obliged to impose chronic reductions in the level of services it provides); and (4) that the City's recent pattern of capital underspending will have to be remedied if the City's capital plant is to be restored to a level which can help improve the City's economic development in the future.

Mr. Allen R. Voss, Director August 23, 1979

In reviewing the draft report's specific recommendations, however, we would offer the following observations for your consideration:

(1) While we fully concur that future labor settlements and the current national economic downturn (as well as the outlook for the HHC) are serious potential hazards in the City's road to fiscal recovery, we believe that the four-year Financial Plan now in place, together with the quarterly Financial Plan modification process and the steps already undertaken or committed to by the City, provide us with the tools and the opportunity to enable the City to achieve its statutorially-required goal of a budget balanced in conformance with generally accepted accounting principles (GAAP) by fiscal year 1982. In addition, the Financial Emergency Act authorizes the Control Board to modify the Financial Plan at <u>any</u> time if it is necessary to carry out the purposes of the Act. We will not hesitate to recommend such action to the Board if adverse budgetary developments threaten the City's ability to balance its budget in a way that cannot be accommodated within the quarterly modification process.

In evaluating the viability of the City's current four-year Financial Plan, we have considered the City's pattern in recent years of consistently conservative revenue estimates, the Mayor's explicit commitment to continue the underspending of the expense budget which has characterized recent years, the additional $32 million incorporated in the City's general reserve for FY1980 (bringing that up to a level of $132 million), the contingency program amounting to $81 million in FY1980 and $106 million annualized thereafter (which was not formally incorporated into the Plan's aggregate expenditure and revenue limitations, but which will be available on an "as needed" basis for the future), the reinstitution of the milestone monitoring system, and an accelerated process for developing the "PEG" program, all of which augment the Control Board's quarterly review process to determine the extent to which the Financial Plan must be modified on a regular and ongoing basis.

We also agree that early negotiations between the City and its unions would give the City a more accurate assessment of how the settlement will impact its Financial Plan. We have serious doubts, however, as to whether it would be constructive too far in advance of the collective bargaining process to require the City to make its "best estimate" of the costs of a possible settlement in the Financial Plan and to demonstrate precisely how these costs would be funded. Such a requirement could adversely affect the collective bargaining process, particularly if imposed by third parties not directly involved in the negotiations. The Control Board, of course, has the ultimate responsibility of approving such collective bargaining agreements only if they are adequately provided for in the Financial Plan before us at that time.

(2) We share your concern that the "Level I" estimates projected for State and Federal aid in the Financial Plan may be too optimistic, although the State's track record during the past two budget cycles does provide a somewhat greater degree of confidence that the State is willing to provide the needed resources than do recent trends at the Federal level. Nevertheless, our concern in this area is precisely what has led the Control Board to require the City to identify in "Level II" the kinds of actions it could take in the event that the more optimistic projections of Federal and State aid are not forthcoming. It is our judgment that the amounts of additional State and Federal aid projected as needed after Level II is incorporated in the Financial Plan remain quite modest and should be attainable, particularly since the "baseline" estimates of projected State and Federal aid are generally conservative.

(3) As noted above, we also concur with the importance of economic development to provide the resources necessary for the City's long-range fiscal recovery. As the draft report correctly points out, absent real economic growth, the City will need ever-growing infusions of State and Federal aid in order to avoid chronic -- and potentially fatal -- reductions in the level of services delivered. This, of course, is a phenomenon which is not unique to New York City and is, in fact, common to most major, older industrial cities. As such, we would expect this problem to be deemed a worthy focus of national policy and Federal attention. By simply dismissing the possibility of a constructive Federal role in the face of the current "taxpayer dissatisfaction with increased governmental expenditures," the draft report reaches conclusions which do not fully consider the regional and national implications of a Federal refusal to provide assistance to areas where economic growth is insufficient to produce adequate resources for essential services.

Nevertheless, regardless of the role ultimately played by the Federal Government, we fully recognize that the City's efforts to promote real economic growth will play an important part in its long-range fiscal recovery, and that these efforts should include taxation policies which make the City more economically competitive. This is particularly important since State and City taxes were driven to a dangerously high level in the effort to avoid a City bankruptcy in 1975.

In that regard, we believe that both the City and the State deserve substantial credit for the tax reductions which have already been enacted since that time, and during a period of continued fiscal stress. At the City level, this includes reductions in general business taxes and the commercial rent tax, a modest reduction in and cap on the real property tax, a four-year phase-out of the effects of the stock transfer tax, and selective tax incentives for certain kinds of economic development. The State has embarked on a policy of substantial reductions in the personal income tax, cuts in the corporate franchise tax, a four-year phase-out of the unincorporated business tax, increased sales tax exemptions, and a variety of investment tax credits.

While the overall level of City taxation still remains higher than that of the pre-1975 period, one important goal may already have been achieved: namely, a reversal of the perception that New York's tax levels are locked into an ever-increasing spiral and a recognition that the operative trend is toward a lower tax burden in the future.

The draft report's recommendation that the City undertake an even "more aggressive effort" to reduce taxes highlights a fundamental conflict in the near term: in the face of budget gaps such as those now reflected in the Financial Plan (to be compounded, as noted, by the cost of future collective bargaining agreements), it would be extremely difficult for the City to implement substantial additional tax reductions in the short run without drastically curtailing services in a way that could affect economic development just as adversely as high tax levels. Therefore, while acknowledging that substantial tax reductions could encourage economic development in the long run, we would note that it may not be feasible for the City to pursue such a course "more aggressively" until the period after it has achieved its GAAP-balanced budget as required by law.

I thank you again for the opportunity to comment on your draft report and hope that you will find our observations helpful.

Sincerely yours,

Comer S. Coppie

Comer S. Coppie
Executive Director

APPENDIX VI

STATE OF NEW YORK
DEPARTMENT OF AUDIT AND CONTROL
OFFICE OF SPECIAL DEPUTY COMPTROLLER
FOR THE CITY OF NEW YORK
270 BROADWAY
NEW YORK, N.Y. 10007

SIDNEY SCHWARTZ
SPECIAL DEPUTY COMPTROLLER

August 17, 1979

Mr. Allen R. Voss, Director
General Government Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Voss:

I appreciate the opportunity that you have given me to comment on your August 4, 1979 draft report on "New York City's Efforts to Deal with its Fiscal Problem." As you know, my office has been closely monitoring the City's financial picture over the last four years and has issued numerous reports regarding the City's fiscal situation. These reports in many instances have made observations and voiced concerns similar to the ones that you have raised in your draft report.

With regard to the specific findings and recommendations contained in your most recent draft, I have the following comments.

The Four-Year Financial Plan

You note that the plan adopted by the Financial Control Board (FCB) on June 22, 1979 (a) delays fiscal cuts until the latter years of the plan and (b) places an excessive reliance on State and Federal aid. Similar findings were also contained in our reports on the Four-Year Plan (Report on the FY 1980 Executive Budget issued on June 6, 1979 and Report on Review of the Financial Plan FYs 1981 through 1983 issued on June 18, 1979). Our reports noted that only 11 percent of the gap-closing measures anticipated for the four-year period were being planned for FY 1980 and that many of the gap-closing expenditure reductions were offset by new expenditure commitments. We also noted that the City has been increasing its reliance on the State and Federal governments in spite of indications that such intergovernmental assistance may be declining. Our reports recommended that the City reconsider its decision not to go forward with any significant cost reduction measures in FY 1980.

Your report, in commenting on the increased reliance on State and Federal aid, focuses on "below the line" expectations. We believe it is also important to note that increases in such aid are also in the baseline revenue estimates. A notable example is the anticipated increase in State aid for the City University which has now been incorporated into the baseline forecasts as a result of recent legislation. The "below the line" increases discussed in your draft report are in addition to the already committed increases in such aid.

Your report also points out that the plan for FY 1980-FY 1983 does not recognize two significant uncertainties, the impact of future labor settlements and a possible recession. With respect to the former, while I agree that the labor settlements may have a material impact on the plan, I do not believe it prudent for the plan to provide an estimate of the potential impact. For one, it is virtually impossible to make an accurate estimate of such costs. In addition, as noted in your report, such an estimate would inevitably become the base for any negotiations with the labor unions. In my opinion, a better approach is the one we have used in our reports. We show the estimated cost of each one percent increase in salaries and wages and the effect of possible increases given these percentage costs within a broad range estimate.

An accelerated negotiating timetable, which you recommend, would, of course, help remove the uncertainties which currently exist regarding labor costs. However, here too, we believe it to be a judgment call as to the most effective strategy, and the possible additional cost to the City in meeting such pressures for accelerated negotiations.

I would also point out that your comparison of the cost of the FY 1978 labor settlement ($868 million) with the amounts footnoted in the Plan for a comparable future settlement ($43 million in FY 1981 with an additional $295 million in FY 1982) may be somewhat misleading. The FY 1978 contracts included costs associated with the $750 per annum non-pensionable cash payment, whereas the projected costs footnoted for FYs 1981 and 1982 reflect only the 4 percent wage increase. The costs of the non-pensionable cash payments through FY 1983 are already included in the baseline expenditure projections. (See GAO note 1, p. 73.)

With respect to the impact of a recession, your report states several times that the City has estimated that a recession would reduce City tax revenues by $81 million in FY 1980 and $106 million in FY 1981. This, however, may not be entirely accurate. The amounts you cite are not the City's estimate of the impact of a recession, but rather are the aggregate amounts of a contingency program which was submitted by the City along with its June 1979 Financial Plan. The City, in forwarding this program, noted that it could be implemented to absorb either the potential impact of a recession or other revenue shortfalls. In point of fact, in June, the City had unofficially estimated the potential impact of a recession to be somewhat higher (approximately $100 million and $150 million in FY 1980 and FY 1981, respectively); however, more recent City forecasts point to a smaller revenue loss due principally to the high rates of inflation which are anticipated. (See GAO note 2, p. 73.)

You also point out that GAO estimates that a recession would reduce revenues by about $69 million in FY 1980 and $122 million in FY 1981. These estimated reductions, however, relate to the revenue levels contained in the February financial plan. In the June plan, the revenue estimates were increased by $94 million in FY 1980 and $120 million in FY 1981. Thus, the GAO recession revenue estimates are $163 million and $242 million lower in FY 1980 and FY 1981, respectively, than the estimates contained in the most recent financial plan, unless these estimates have been revised by you in the interim. I would suggest that you reevaluate these estimates in the light of recent economic forecasts and events. (See GAO note 3, p. 73.)

As to New York City's need to borrow to meet cash needs, earlier analyses made by this office have shown that New York City does not appear to have had a true seasonal cash problem - that is an imbalance in the timing of receipts so that it came after expenses had to be paid - but that the so-called seasonal need resulted from the deferral of long-term borrowing and deficit build-ups that were never funded.

Milestone Monitoring System

Your report notes that "GAO views the reinstitution of the milestone monitoring system as a very positive action which should expedite the tracking of progress on the City's budget balancing actions." We too believe that the milestone monitoring system is essential in tracking the progress of the financial plan and were the first to advocate its reinstitution in a report on the City's Financial Plan issued in September, 1978. Subsequent to that time, we met with the Mayor and other top officials of the City administration, and in January of 1979 the Mayor agreed to the reinstitution of the milestone system on a trial basis. This agreement was recognized formally in a resolution adopted by the FCB on February 14, 1979.

We remain concerned, however, about the time delays which have occurred in the City's implementation of the system. We note that the reporting procedures are still in the developmental stage and there is a need to extend its application to other phases of the City's Expense and Capital Plans. In particular, the failure to provide a milestone monitoring program for the capital program hinders the ability of the City to develop and implement its long-term financing strategy, and limits its ability to rehabilitate its capital plant. We are pursuing this matter vigorously.

The City's Economy

You point out that the future performance of the City's economy is not expected to improve markedly and that future tax revenue growth will be at a rate which is less than the inflation rate. Our analysis had indicated that this is due to the fact that less than 50 percent of the City's revenues are responsive to inflation.

At present, about 20 percent of all revenues available for budget balancing purposes (all revenues exclusive of categorical State and Federal aid) are received from the State and Federal governments. While the expenditures funded by such revenues are subject to inflationary pressures, there are no assurances that these revenues will rise to meet the increased expenditure needs. Also, about 33 percent of all budget balancing revenues have in recent years been generated by the real estate tax which has not been responsive to inflation. This is primarily due to the City's conclusion that it should not increase its tax rates, including its real estate tax rates, based on the premise that a rate increase in what is already one of the most highly taxed communities in the nation would be counterproductive.

We view the fact that over 50 percent of all City revenues available for budget balancing purposes are not responsive to inflation as the City's most fundamental long-range problem. We believe that any economic development policy must address this problem and that until it is solved, the City will continue to face recurring budget gaps whose closing will probably require augmented State and Federal aid, a more economic operation, or a combination thereof.

The lack of growth in the City's real estate tax is also due, in part, to the City's policy of not reassessing residential property to reflect inflationary increases in value as well as the deterioration of the housing stock that has occurred in many City neighborhoods. The mandatory reassessment of all City property at full value scheduled to occur by FY 1982 could provide an opportunity for the City to reexamine its assessment procedures, and possibly result in an assessment policy which is more responsive to inflation. One of the problems in such a development, however, is the impact of such reassessments on home owners with fixed incomes.

The City has also set up various tax incentives to spur the development of real property. However, as you point out, it has been alleged that the incentives do not always have the desired effect. The State Comptroller's audit group is currently evaluating the procedures and methods used to stimulate real property growth in the City.

# # # #

In my view, your report reflects a very careful analysis and constructive evaluation of the City's current financial situation and future needs. Please let me know if I can be of any further assistance.

Sincerely,

Sidney Schwartz

SS/ib

cc: Edward Hefferon

GAO notes:

1/ GAO believes this comparison is valid since the 1979-1980 labor settlement cost the City $868 million. Regardless of the components of the new settlement, it is reasonable to assume it will cost approximately the same amount.

2/ See page 13 of this report.

3/ GAO's estimates of the effect of a recession on City revenues reflect the economic data contained in the February plan. They are a representative estimate of the effect which a moderate recession would have on tax revenues. While a national recession is now more certain, information pertaining to its severity is not much different than in our original forecast. Therefore, we do not believe that updated estimates would lend any greater accuracy to these estimates.

Robert F. Vagt

One World Trade Center, Suite 8901
New York, New York 10048
Telephone: (212) 775-0010

27 August 1979

Fred Schweiger
General Accounting Office
26 Federal Plaza
41st Floor, Room 4112
New York, New York

Dear Mr. Schweiger:

The response of the Corporation to the report by the Government Accounting Office was one of general agreement. I enclose a copy of our report which deals with these issues specifically.

Sincerely,

Robert F. Vagt
Robert F. Vagt
Executive Director

ENCLOSURE

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK

One World Trade Center, Suite 8901
New York, New York 10048
Telephone: (212) 775-0010

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK

11 June 1979

Honorable Edward I. Koch,
Mayor
CITY OF NEW YORK
City Hall
New York, New York 10007

Dear Mayor Koch:

As required by Section 3040 of the Municipal Assistance Corporation For The City of New York Act, we have reviewed the City's budget submission for the 1980 fiscal year. In accordance with the Act, we present our initial findings and determinations.

Our report reviews the Mayor's Executive Budget. It is based on our own studies and the staff analyses of the Financial Control Board (FCB) and the Office of the Special Deputy Comptroller (OSDC). We have met with both offices on the issues raised by these reports and have had discussions with the City on these matters as well.

The revenue and expenditure projections in the Executive Budget assume a modest economic downturn in the first half of FY 1980, and a gradual recovery in the second half of the fiscal year. If a more serious economic slump were to occur, the City's ability to achieve its FY 1980 targets could be significantly affected. Several of the City's major revenue sources -- the sales tax, personal income tax and stock transfer tax -- are economically sensitive, and revenues from the real property tax may decline, as well, if delinquency rates increase as a result of an economic decline coupled with increases in fuel and utility costs. The City's expenditures can be expected to increase if there is an economic downturn more serious than projected, as a result of increases in the public assistance caseload and related human services costs and potential increases in the number of housing units held by the City as a result of in rem housing proceedings.

Municipal Assistance Corporation
For The City of New York

11 June 1979
Honorable Edward I. Koch
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Nonetheless, we have determined that, as of now, the budget for FY 1980 is balanced within acceptable margins for error and conforms with the requirements of Section 3038 of the MAC Act, as amended, as it applies to FY 1980. Among the reasons for this conclusion are the following:

-- the general agreement among all parties on the core revenue and expenditure estimates after staff reviews by the OSDC and the FCB. In fact, the revenue estimates of both these agencies suggest that City projections for certain economically sensitive taxes -- stock transfer and personal income -- remain potentially conservative, if the City's economic assumptions regarding FY 1980 prove correct.

-- the size of the remaining uncertainties for FY 1980 in light of the City's successful performance in responding to larger uncertainties in previous years. The City has taken all the steps necessary to achieve the budgetary requirements of each year since FY 1976. The present City administration has committed itself to take whatever actions are necessary to continue its compliance with those requirements.

There are a number of areas of uncertainty, however, with respect to FY 1980 which warrant concern and which MAC will continue to review:

I. UTILIZATION OF NEW REVENUES

According to the OSDC, the Executive Budget reflects approximately $340 million in additional available revenue and State and Federal aid for FY 1980, compared to the Financial Plan approved in February. The City proposes to allocate $15 million of this amount to improve its basic long-term fiscal position (increased phase-out of capitalized expenses) and to use the rest either to increase spending levels or to reduce the level of budget reduction programs originally proposed.

One significant manifestation of this policy decision is the increase in the number of full-time City-funded employees as of June 30, 1980 by 2,900 positions above the February 1979 Financial Plan level. This will constitute a small net increase in the number of City-funded positions during FY 1980, rather than the 3.6 percent attrition program adopted in February 1979 or the original 4 percent attrition program adopted in November 1978.

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For The City of New York

11 June 1979
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This decision was made possible by increases in local revenues, the movement of anticipated revenues (proceeds from a bond sale by the Education Construction Fund) from FY 1979 to FY 1980, increases in State aid, and reductions instituted by the City through its Level I reduction program. These increases will enable the City to "buy-out" a portion of the CETA positions for which Federal funds will not be available as of October 1, 1979, to increase personnel in several agencies, and increase support for programs the City deems essential.

While these goals are not without merit, the result of this action is to once again postpone until later years -- when budget gaps are greater -- the implementation of an attrition (reduction of payroll) program. The OSDC, in its draft report, points out that, as a result of this decision, a substantially smaller percentage of the actions to reduce budget deficits for FY 1982 will be implemented in FY 1980 than was originally contemplated. Based on the January 15, 1979 Financial Plan, 25 percent of the actions necessary to close the FY 1982 budget gap were to have been taken in FY 1980. This has now been reduced to 11 percent. This decision implies that the City is not only reluctant to re-establish a program of retrenchment -- absent since 1977 -- but also that given a short-term increase in revenues the City will spend the bulk of those revenues rather than use them to improve its debt position or to ease longer-term expenditure problems.

II. HEALTH AND HOSPITALS CORPORATION

The staffs of the FCB and the OSDC report continued concern with the finances of the Health and Hospitals Corporation (HHC). The Budget proposes (a) the elimination of a $10 million City reserve for Medicaid which was used to meet HHC revenue shortfalls in FY 1979 and (b) a program to close a projected baseline deficit of $37.7 million.

The OSDC and FCB question both the baseline deficit and the program to close the gap.

The OSDC report of a proposed budget gap for HHC between $46 and $116 million is based on an analysis of revenue shortfalls, administrative problems in billing for Medicaid, the absence of programs to insure increased collections from self-pay patients,

Municipal Assistance Corporation
For The City of New York

11 June 1979
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potential costs relating to Social Security changes, and an evaluation of the proposed attrition program for HHC, which appears to require a 9 percent reduction in the HHC workforce between April 1, 1979 and June 30, 1980, with no corresponding decrease in revenue levels.

While the City is not legally mandated to eliminate gaps in the budget of HHC, past practice has been for the City to use its revenues to do so. In FY 1979, more than $45 million of City funds are being used to balance the HHC budget; if similar action is required in FY 1980, it would markedly reduce the City's reserves and could jeopardize its ability to respond to unforeseen events.

The City administration is scheduled to outline a program to control HHC costs on June 15.

III. SOCIAL SERVICES PROGRAM COSTS

The City's FY 1980 Budget projects a decline of $66 million for Public Assistance from the FY 1979 level. A portion of this program depends on welfare caseload reductions (a 3 percent decline projected for FY 1980), continued removal of ineligibles from the welfare rolls and a general stabilization of income redistribution programs.

Certain questions remain regarding these assumptions:

Caseload Projections

OSDC reports that the baseline caseload projections for the end of FY 1979 appear to be low. If the OSDC estimates are accurate, baseline costs will increase.

Economic Downturn

If the region were to suffer a serious economic downturn, the ability to maintain a shrinking caseload would be jeopardized. Depending on the depth and length of an economic slowdown, increases in applications for both Aid to Families of Dependent Children (where the City is responsible for 25 percent of the cost of each recipient) and Home Relief (where the City and State each pay 50 percent of the program) could be expected. Proportional increases in costs would also occur in the Medicaid program.

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Increases in the Basic Welfare Grant

New York State has not increased its basic welfare grant since 1974, with its standard of need computed on a 1972 base. Both the Speaker of the New York State Assembly and the Majority Leader of the New York State Senate have indicated their support for a grant increase. City officials support the concept of a grant increase, but take the position that the State should assume the full cost of the added amount, including any incremental Medicaid costs that might be incurred. Under present statutes, the City would be required to pay 25 percent of an increase in AFDC costs and 50 percent of an increase in Home Relief costs.

IV. PROGRAM TO ELIMINATE THE GAP

A substantial factor in the Executive Budget is the assumption of successful implementation of $153 million of cost reduction actions. The OSDC reports that "...many of these [cost reduction] programs, however, have as yet not been well defined," and that "...shortfalls in any of these areas will impact negatively on the City's plan." Among those areas of expenditure cited for particular concern by the OSDC are the Board of Education, the Board of Higher Education, and the uniformed services (Police, Fire and Sanitation). This lack of definition is of particular concern to MAC, as the City has already offset $119 million of new expenditures against these projected savings, leaving a net expenditure saving of $34 million.

V. FIRE DEPARTMENT PENSION FUND

The continued underfunding of the Fire Pension Fund threatens the solvency of that system. The OSDC report points out that if the City begins to fund the system based on up-dated actuarial assumptions -- a plan reported to be under consideration -- the City's costs for such funding could increase by between $65 and $85 million in FY 1980.

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Given the uncertainties discussed above, we believe it is imperative that the City implement a system of periodic reporting to the FCB, OSDC and MAC of information necessary to assess the developments affecting the City's revenues and expenditures during the coming year. Accordingly, we support the FCB's February 1979 resolution calling for the City to furnish monthly reports which would enable those agencies charged with oversight responsibilities to monitor the City's progress toward its budgetary goals.

We understand that the City has agreed to provide a series of reports in several critical areas which MAC will review in accordance with its statutory oversight responsibilities.

* * * * *

FINANCIAL PLAN -- FISCAL YEARS 1981-1983

The Financial Plan projects substantial budget gaps for each of the 1981 through 1983 fiscal years. The City projects a budget gap of $406 million for FY 1981, $793 million for FY 1982 and $814 million for FY 1983. These projections assume the Level I reductions contemplated for FY 1980 and take into account the reduction in the City subsidy for the HHC which is discussed below. The City has proposed a variety of programs to close those gaps. Some of the programs are within the control of the City administration while others are dependent on actions by other levels of government.

In analyzing the proposals for subsequent years, we remain cognizant of the fact that the City met or exceeded its goals with regard to balancing its budget and achieving the targets established in its financial plans from FY 1976 through FY 1979. This achievement is the product of several factors:

-- City actions to reduce expenditures, beginning in FY 1976, continue to have an effect on spending levels. Despite the fact that neither the FY 1978 nor FY 1979 budget was truly a "retrenchment" budget (see MAC Reports for FY 1978 and 1979) the actions taken in FY 1976 and 1977 have held City spending (in the FY 1980 budget) at a level approximately 7 percent above that of FY 1975.

-- The new City financial information and management systems have given City administrators better control over spending.

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-- Labor settlements between the City and the municipal labor unions have remained moderate during the period since 1975.

-- A general increase in the level of economic activity in the State and City and high inflation rates have produced steadily increasing revenues in economically sensitive taxes such as the personal income tax, sales tax and stock transfer tax.

-- Increases in levels of State and Federal aid during this period have been substantial, although this pattern -- at least with regard to Federal aid -- is now changing.

While the accomplishments of the City in meeting its budgetary targets must be considered when analyzing the programs to close the budget shortfalls for FY 1981 through 1983, it must be noted that the future gaps remain significant. Any major change in the precarious balance that has been established between revenue and expenditure patterns could easily jeopardize the impressive achievements of previous years. Projections for future years will be affected by national economic conditions which differentially affect the City's revenue and expenditure patterns. For example, while certain revenues (e.g., the real property tax) do not grow with inflation, high inflation rates put substantial upward pressure on all of the City's expenditures. Additionally, any prolonged recession tends to slow revenue growth without similarly reducing the need for increased expenditures.

In this context we feel it important to point out that the City's program to close projected budget gaps for FY 1981 through 1983 leaves numerous unanswered questions.

I. WAGE SETTLEMENTS

The Financial Plan states that, aside from a reserve of $82 million of potential new revenues to be derived from sale of property for Westway, no funds have been earmarked for a labor settlement. However, the Plan also states that a "no-cost" labor settlement during the present inflationary period is not likely.

The rates of inflation which resulted in steadily increasing local revenues during the past few years are likely to result in pressure for a wage rate increase in the contract to be negotiated for FY 1981 and 1982 larger than the one negotiated in 1978. The City must also negotiate a second labor settlement during the Financial Plan period, to take effect in FY 1983.

For each 1 percent increase in wages and fringe benefits, the cost to the City is approximately $44 million per year. In addition, beginning with FY 1982, the City must accrue an additional $8 million per year for pension costs for each 1 percent wage increase. No provisions for these costs have been made.

The Financial Plan reports that a wage rate increase comparable to that negotiated in 1978 (approximately 4 percent annually) could add approximately $43 million, $295 million and $465 million to the projected FY 1981, 1982 and 1983 budget gaps, respectively. For FY 1981, this amount assumes receipt of the $82 million mentioned above. Thus, based on the City's own estimates, the projected budget gaps for FY 1981, 1982 and 1983 are $449 million, $1,088 million and $1,279 million, respectively. For FY 1982 and 1983, these estimates do not include amounts which the City will be required to accrue under GAAP, resulting from pension costs attributable to future labor settlements. The OSDC has estimated these costs at $59 million and $89 million, respectively, for a wage rate increase comparable to that negotiated in 1978. Moreover, other uncertainties, some of which are discussed in this report, could further increase these gaps.

As we pointed out above, the City has committed itself to maintain a 1980 City-funded workforce level higher than that projected in February 1979, thereby retaining a base cost for personal services at a higher level than was projected in February 1979.

II. EXPENDITURE INCREASES IN THE COVERED ORGANIZATIONS

Health and Hospitals Corporation

While the City is not mandated to close the budget gap of the HHC, during each year of the financial emergency the City provided funding from its own revenues to insure a balanced budget for the HHC.

The Financial Plan calls for the City to reduce its subsidies to the HHC by $10 million in FY 1980, $40 million in FY 1981 and an additional $20 million in FY 1982. Analysis of the budget of the HHC by the staffs of the

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OSDC and the FCB indicates that the deficit for the HHC for FY 1980 appears to be well above the amount projected in the Executive Budget. The OSDC estimates a gap ranging from $46 million to $116 million for FY 1980. There are no programs currently proposed to reduce this deficit for FY 1980, nor is there evidence that the problems for subsequent years will not be greater. Presently, there is no basis for the assumption that the subsidy reduction program for HHC is possible. In fact, it remains to be demonstrated that the City will not be forced to increase subsidies in subsequent years. However, the City is scheduled to outline a program to deal with future HHC deficits on June 15.

Transit Authority

The Transit Authority (TA) has projected an operating deficit for FY 1981 of approximately $75 million. This projection does not include the cost of a labor settlement for the TA. The cost of such a settlement is approximately $9.5 million for each 1 percent increase in wages and fringe benefits. While the City is not obligated to increase its subsidy to the TA -- which has the statutory authority to meet deficits by raising the fare -- both the City and State administrations have pledged to maintain the 50-cent fare through 1982. Moreover, as part of the 1978 labor settlement with the TA, the City agreed to increase its operating subsidy to the TA to fund a portion of the wage settlement. The City's position is that any future increases in the level of operating subsidy for the TA should be funded by the State.

Board of Education

The single largest proposed reduction among the City's Level I actions to close the budget gap for FY 1981 through 1983 is a proposed reduction in personal service costs for the Board of Education. These reductions are based on the City's projections of declining pupil enrollment. However, the historical precedent has been that it remains difficult to implement major reductions in the budget of the Board of Education. For the remaining years, reductions are scheduled at the following levels:

Fiscal Year	Amount
1981	$ 52 million
1982	101 million
1983	148 million

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III. INTERGOVERNMENTAL AID

The Financial Plan for FY 1981 through 1983 looks to both the State and Federal governments for additional aid to close succeeding years' budget gaps. While the amounts of aid being sought appear reasonable in light of Federal and State patterns in recent years, they may prove to be unattainable, given the political and economic climate which currently prevails.

Federal Actions

Unlike the 1974-75 period when the Federal government was expanding its support for localities with programs such as CETA and counter-cyclical revenue sharing, there are few new Federal initiatives on the horizon. With the exception of the President's modified welfare program, which would provide limited assistance to New York City, the Federal government appears determined to reduce programs rather than expand them. The counter-cyclical revenue sharing program has expired, CETA has been reduced, mass transit aid is being funded at well below the authorized level, and the Federal revenue sharing program is under attack. While it is difficult to speculate on the outcome of the legislative process in Washington, the most vulnerable portion of the revenue sharing program appears to be the grants to states. Any reduction in that program, which currently provides the State with approximately $250 million annually, would severely limit the State's ability to provide additional assistance to the City.

State Aid

During the period of the fiscal crisis the State has continued to increase its commitment to assist the City. For FY 1980, for example, the City estimates that the State will provide increased budget balancing assistance of approximately $180 million. However, continued growth in State assistance will be shaped by several factors, in addition to the Federal activities mentioned above. In particular, the City makes no provision for certain new expenditure needs, such as increased public assistance grant levels or an increase in the mass transit subsidy, and maintains that any such increases should be funded by the State. To the extent that the State provides additional funding in these or other areas, it may be unable to increase substantially its unrestricted aid to help the City close its budget gaps.

The City's Contingency Programs (Level II Cuts)

The City's proposals for additional reductions in the event of failures to obtain Federal and/or State assistance fall into two categories:

Program Dependent on State Legislative Action

The single largest specified program in Level II is the elimination of the remaining portion of the Increased Take-Home Pay program, which requires the City to pay a portion of its employees' pension contributions. The State legislature has thus far steadfastly refused to consider this item.

Unspecified Actions

The Level II program proposes additional attrition in FY 1981 through 1983 with the amount of projected savings growing from $16 million in FY 1981 to $72 million in FY 1983. This is primarily an unscheduled and unallocated attrition program.

Additionally, the Level II program calls for "other actions" of $38 million in FY 1981, $140 million in FY 1982, and $35 million in FY 1983, which the City will institute to close the gap. Since these amounts are not listed in the "Revenue Changes" portion of the program, they would appear to be expenditure reductions and could entail deeper personnel cuts.

IV. POTENTIAL REAL ESTATE TAX LIABILITY

Pending litigation challenges the City's practice of assessing different categories of property at different proportions of full value. Several judicial decisions in other jurisdictions have held this practice to be a violation of existing State law. State legislation which makes resolution of these cases in the City's favor more likely has been enacted but is being challenged in court. The Financial Plan provides approximately $80 million annually to pay settlements based on pending real property tax claims. The City's most recent estimate of its potential liability for real property tax claims, in the event that plaintiffs ultimately prevail on the proportional assessment issue, is approximately $2 billion.

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V. CAPITAL FINANCING

Capital Budget

Essential maintenance of the City's physical infrastructure has been deferred for several years due to the lack of funds to support an on-going capital spending program. Significant portions of the existing physical plant are in dire need of major repair, and there are some additional new projects which should be commenced. The City has not been able to restore its capacity to implement needed construction; as a result, the level of capital spending in 1980, as in 1979, will be well below that which is projected.

Since the physical condition of the City is a key element of its attractiveness in the future to both families and businesses, the success of this program is critical to the City's long-term economic vitality.

Market Re-Entry

The City's ability to meet the statutory requirements for balanced budgets and to achieve other financial reforms resulted in public credit market acceptance of its short-term securities in 1979. The balancing of the FY 1980 budget should allow the City to finance its short-term needs in the public markets during the coming year.

This achievement demonstrates the distance the City has come since the crisis of 1974-75 and is evidence of the City's growing capacity to manage its fiscal cycles and near-term problems.

However, the event which will signal the fact that the City has restored a sound fiscal base for the long term will be the marketing of its bonds on a regular basis (currently scheduled to begin in FY 1981). We believe that the City will only be able to achieve this goal after it demonstrates not only the ability to manage its day-to-day operations but also that it has permanently in place a program which insures that the City's future budgets will be balanced in the face of pressure for increased expenditures and fluctuations in revenues. The City will be be required to show that it possesses the will to use short-term gains to improve its long-term position, and has responsibly anticipated and provided for those events which predictably jeopardize the Financial Plan.

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The success of the City's Financial Plan depends on a pattern of events which cannot be assured, particularly since the City has decided to put off that portion of planned reductions that is under its sole control -- reductions in the workforce. The City program requires:

-- moderate wage settlements, comparable to the 1978 settlement;

-- increasing levels of Federal and State aid for both City programs and the covered organizations;

-- avoidance of a prolonged and serious recession;

-- costs and revenues consistent with Financial Plan levels.

In the event that the City's assumptions are incorrect on more than one of these points, the levels of service cut-backs and personnel reductions required within a short period of time could be severe. Early actions to reduce the City's expenditures would increase the City's flexibility to respond to adverse changes in assumptions, should they occur.

* * * * * * * * * *

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MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK

11 June 1979

Honorable Edward I. Koch,
Mayor
CITY OF NEW YORK
City Hall
New York, New York 10007

Dear Mayor Koch:

Enclosed is the Municipal Assistance Corporation's annual budget review as required by our statute. Our review finds that the Executive Budget for FY 1980 conforms with the requirements of the MAC Act as more fully set forth in our report. There are aspects of this review, however, that raise questions about the future and to which we wish to address ourselves.

MAC's formal responsibilities with respect to the budget are limited to a one-year review, with the Financial Control Board responsible for reviewing a four-year span. However, MAC has a vital interest in the so-called "out-years" in view of the financing structure which we have put in place to support the City. Our comments, therefore, stem from our concern with financing which is impacted by the budget.

Enormous progress has been made since the beginning of the fiscal crisis in 1975-76, progress for which the City administration deserves great credit. Year after year, difficult budget gaps have been closed; expenses are being phased out of the capital budget on schedule; the City re-entered the short-term market this year after successfully carrying out difficult labor negotiations in 1978; a new accounting system provides both timely and accurate data; revenue estimates have been on the conservative side; cash is accumulating at a rapid rate and is expected to reach $600 million by June 30, 1979. You and your administration are justly entitled to feelings of accomplishment when comparing where we are today with where we were four years ago.

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It remains a sad, but nonetheless unavoidable, fact of life that the City still has a long and rocky road to travel. The City's own projections indicate potential budget gaps of $406 million in FY 1981, $793 million in FY 1982 and $814 million in FY 1983, with no provision for the cost of labor settlements to be negotiated in both 1980 and 1982. Based on the City's own projections, moderate settlements comparable to last year's (i.e., 4 percent annual wage increases) would bring the 1982 gap to more than $1.0 billion and the 1983 gap to more than $1.2 billion. Whether such settlements can be achieved is, of course, a matter of conjecture. Moreover, other uncertainties, some of which are discussed in our report, could increase the gaps still further.

Of course, there are known offsets to these potential gaps. As each year's gap is eliminated, there is a corresponding reduction in the gap for future years. The recent pattern of conservative projections and underspending may continue. Nonetheless, our review indicates that, for the City's future financial plans to succeed, the following must occur:

- there must continue to be moderate wage settlements;
- there must continue to be increasing levels of Federal and State aid for both City programs and the covered organizations;
- the City's economy must avoid a prolonged and serious recession;
- costs and revenues must be consistent with Financial Plan levels.

If events develop less favorably, cutbacks -- possibly severe -- in services and personnel will be required, and quickly. Given present economic conditions, we do not believe these assumptions have a high probability of materializing.

The City's current long-term financing is based on a $4.5 billion package which runs out in 1982 when the Federal guarantee legislation expires. An integral part of the package calls for the City to re-enter the long-term market on its own in FY 1981 and to be fully self-sufficient by FY 1983. The City would, by then, have sold an aggregate of $900 million of its bonds and be expected to raise roughly $1 billion annually on its own thereafter.

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Market access will occur as a result of credibly balanced budgets on a recurring basis, without resorting to expedients such as including expense items in the capital budget, and as a result of a sustained level of economic activity.

To this end, commitments for the four-year financing package were obtained from financial institutions, union pension funds, the public markets, the State, and ultimately the Federal government, based on the following fundamental premises:

-- The City, by FY 1982, would have a balanced budget. All expense items would have been phased-out of the capital budget. Budgetary restraint would be continued, under an extended FCB. Personnel reductions would be effected through attrition, if possible, rather than layoffs. Productivity gains would fund wage increases. Union-management cooperation would permit such productivity gains to occur.

-- The City's physical plant would be restored by allocating $2.3 billion to true capital projects. Benefits to the City would occur as a result of lower maintenance costs, quality-of-life improvements, and job-creating impact.

-- Substantially increased levels of State and Federal aid, beyond the increases which helped close earlier budget gaps, were considered unrealistic.

-- The possibility that MAC could continue to substitute itself for the City in the long-term market by issuing Third Resolution MAC Bonds after 1982 was sharply circumscribed. Third Resolution MAC Bonds could only be issued if the New York State Legislature granted approval and lifted MAC's borrowing capacity beyond $8.8 billion <u>and</u> if the underlying City bonds carried investment-grade ratings from both Moody's and Standard & Poors.

How do these premises compare with actuality in our view?

-- During the past two years there has been no net reduction in the City's labor force. The City has benefitted greatly from a lengthy inflationary economic surge which has resulted in greater-than-anticipated tax collections. The City has also benefitted from significantly stepped-up levels of Federal

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and State aid and from budgetary relief through a variety of MAC and Federal financings and stretch-outs. We do not believe these benefits can continue or recur at these levels.

-- Further improvement in productivity (i.e., to provide the same services with fewer people) are essential. Productivity is a two-way street; it requires management sophistication and labor cooperation. It requires sharing the benefits on an equitable basis. The City and the unions must develop a working productivity program.

-- The City's capital construction program is lagging behind the level anticipated in the Four Year Financial Plan. The shortfall is harmful to the City's economy and results in continued heavy expenses to maintain an antiquated physical plant.

-- Moody's recently refused to improve the City bond rating, maintaining a below-investment-grade "B" rating. Although there were some factual errors in the Moody's report, we believe that greater confidence in the City's budgetary resolve and its ability to control its budget may be needed for the City to obtain investment-grade ratings on its long-term bonds and subsequent full market access (i.e., regular access, for substantial amounts of bonds, on acceptable terms).

The most favorable development for the market for MAC bonds would be an investment-grade rating on City bonds. Although MAC's credit is separate and apart from the City's, an improvement in the City's bond rating would, in our judgment, result in significant reductions in MAC's future interest rates. This would obviously benefit the City's budget.

On the basis of these factors we conclude as follows:

-- Fiscal year 1982 is just around the corner. Given the City's potential budget gap and its lack of access to the long-term credit market, the City should begin to exercise greater budgetary restraint now.

-- The original FY 1980 City financial plan, adopted in November 1978, was premised on a net attrition rate of 4 percent in the City-funded labor force, rather than the increase in the City-funded labor force now provided for in the budget. A 4 percent attrition

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rate would result in a reduction of personnel costs of approximately $65 million in the first year as a result of phased implementation and $130 million per year thereafter. The City and the FCB would be well advised to maintain this initial resolve. It is difficult to believe that a 4 percent annual personnel reduction cannot be made up with productivity improvements and management efficiency, without loss of services.

-- The City projects a large cash balance at June 30, 1979, currently estimated at about $600 million. A portion of this cash should be applied either to debt reduction or to reduce seasonal borrowing needs.

We realize that the above recommended actions are beyond MAC's authority to require. As the City's long-term financing agent, however, MAC is obliged to recommend policies that, in our judgement, will help insure the City's re-entry into the credit market.

A $65 million budget reduction in FY 1980, as a result of a 4 percent net attrition rate, would save a total of $300 million by 1982. A similar option is available to the City in each succeeding year.

The implementation of such an attrition program would be painful and require a concerted, day-to-day management effort to provide the same level of service. However, if it turns out that our pessimism is unwarranted, upward budgetary adjustments can always be made at a later date.

If, on the other hand, our concerns turn out to be correct, and the budget reductions are not instituted promptly, the City may find itself, in two years, facing an impossible set of problems: a budget deficit of enormous dimensions, recessionary upward pressures on costs and a simultaneous decline in revenues, no direct access to the financial markets, MAC's borrowing capacity exhausted, and the loan guarantee legislation expired. The result, then, would be infinitely worse for the City.

We believe that, on balance, the risk of inaction at this time is too great. The penalty for guessing wrong, in terms of what can happen within two years, is too severe.

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What we have here, obviously, is a basic difference in judgment as to the likelihood of future events and comparative risks with respect to budgetary actions. We are more pessimistic than you are. It is not unusual for men of goodwill and integrity to differ sharply on matters such as these. We have, as we indicated, the greatest admiration for the considerable achievements of your administration and the integrity and spirit of your leadership. Nothing in this review is in any way meant to denigrate these considerable accomplishments.

Respectfully submitted,

/s/
Felix G. Rohatyn
Chairman

/s/
George D. Gould
Chairman

/s/
Edward M. Kresky
Vice Chairman

/s/
Eugene J. Keilin
Chairman, Finance Committee

/s/
Robert F. Vagt
Executive Director

/s/
Stephen Berger
Budget Consultant

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