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In early 1975, budgetary crisis necessitated both State and Federal intervention to maintain New York City's financial operations. An Emergency Financial Control Board was created, giving the State an active role in city affairs, and Federal loans of \$2.3 billion were authorized. Findings/Conclusions: The fiscal and economic base of New York City continues to deteriorate, and this deterioration is at the root of the city's problems. It will continue to be difficult to cut expenditures. To achieve a balanced budget if fiscal year 1978 will probably require major administrative actions and policy shifts at the Federal and State levels. Barring such shifts, 1977-1985 will be an extremely difficult period for the city. Declaring municipal bankruptcy will not solve the city's problems. The Federal Government should explore ways to generate better municipal fiscal information for better decisionmaking at all levels of government. A number of city efforts to improve its economic base have already occurred, and alternative Federal policies toward urban areas are suggested. (DJM)

00300



REPORT TO THE CONGRESS

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

Summary:
The Long-Term Fiscal Outlook
For New York City



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

B-185522

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

This report is being released concurrently with our study, "The Long-Term Fiscal Outlook for New York City" (PAD-77-1). The report summarizes the contents of the study and presents its main conclusions.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), the Accounting and Auditing Act of 1950 (31 U.S.C. 67), and the New York City Seasonal Loan Act (P.L. 94-143).

We are sending copies of this report to the Secretary of the Treasury and the Director, Office of Management and Budget.

A handwritten signature in black ink, reading "James B. Steeds".

Comptroller General
of the United States

SUMMARY:

THE LONG-TERM FISCAL OUTLOOK

FOR NEW YORK CITY

THE CITY'S FINANCIAL PROBLEMS

Until early 1975, New York City was able to pay its bills by borrowing in the capital markets whenever tax receipts fell short of operating expenditures. This practice was financially unsound, but New York had a unique ability to convince the financial community that this approach was feasible. In April 1975, the financial community was no longer willing to accept the City's money market instruments. The ensuing budget crisis necessitated both State and Federal government intervention to maintain the City's financial operations.

An Emergency Financial Control Board was created, giving the State an active role in City affairs, and Federal Government loans to the City up to \$2.3 billion were authorized to alleviate part of its cash-flow problems and to give it time to set its financial house in order. A 3-Year Financial Plan was formulated by City officials and approved by the Control Board. The plan calls for the City to eliminate operating deficits, balance its budget in fiscal year 1978, and consequently be eligible to reenter the capital markets at that time. The City is now midway through that 3-year effort.

REASONS FOR THE STUDY

Under the terms of the New York City Seasonal Loan Act (Public Law 94-143), we are to monitor the City's financial activities over the period fiscal year 1976 to fiscal year 1978 and report to the Congress. A report entitled "Assessment of New York City's Performance and Prospects Under Its 3-Year Emergency Financial Plan," is being issued under separate cover.

In addition to the immediate problems, however, we think that the Congress should be informed about the City's long-run economic prospects and that it be made particularly aware of the interrelationships between short-run budgetary decisions and the City's long-run economic and social viability. Accordingly, the study, "The Long-Term Fiscal Outlook for New York City" (PAD-77-1), looks beyond the

3-Year Financial Plan to assess the City's prospects under several different national and City economic and financial scenarios.

To accomplish this task, we had to analyze the short-run economic and budgetary problems facing the City and assess the economic costs and benefits associated with alternative courses of action. The study analyzes the City's economic base, changes in that base, and the impact of those changes on City revenue sources over the period 1977-85. The report attempts to identify unique aspects of the City's economic problems and to distinguish those unique factors from the common characteristics of declining urban centers. The study indicates that over the long run, barring major State and Federal policy changes, the City's ability to deliver services to its citizens is constrained by trends in its tax revenue base. The actions taken during the current 3-Year Financial Plan can have both positive and negative effects on that longer term base. The study attempts to isolate that portion of the City's problems that can be attributed to the general demographic and economic movement to the South and Southwest. Finally, long-run assessments, based on past, present, and probable future City actions, form the basis for our conclusions.

CONCLUSIONS

Based on available information and an assessment of the City's recent budgetary and economic history, we conclude that:

1. The fiscal and economic base of New York City continues to deteriorate, and this deterioration is at the root of the City's problems. The City's economic base has been deteriorating because people, jobs, and businesses have been moving out of the City and into the South, Southwest, and West for a number of years. The reasons for that movement are complex; they include important changes in costs of living and doing business, the availability of land and labor, possible changes in tax burdens for firms and individuals, and the desire of many people for the outdoor lifestyle available in warmer climates.

Nevertheless, the impact on the City's economy has been notable and severe. During the 1960s, private sector employment in the City grew only 2 percent, compared to almost 27 percent in the entire country. During that decade, U.S. employment in manufacturing grew about 7

percent, but it declined in New York City by 19 percent (representing a loss of 180,000 jobs). Since 1970 the City has experienced a drastic decline in employment with a loss of 468,000 jobs; since 1969 manufacturing employment has fallen at an average annual rate of 48,000 jobs. The prospects for halting this trend are not bright. City policies that directly or indirectly influence its economic base are limited in number and scope. Governmental policies (at any level) have generally not been effective in revitalizing the fiscal base of a city or a region. Deterioration of large cities is a new experience in this country, and appropriate remedies have not been developed to refurbish a city like New York.

2. New York City will continue to find it difficult to cut expenditures. Accordingly, if the City is to achieve a balanced budget in fiscal year 1978, it will probably require major administrative actions and policy shifts at the Federal and State levels. The City, under its 3-Year Financial Plan, has made many cuts in its programs. Nevertheless, its budget has continued to grow. Further cuts are planned, but they will probably be difficult to identify and execute. Nonetheless, many more expenditure reductions will be necessary to balance the budget by 1978. Expense-cutting is made especially difficult for the City because it is unable to control large segments of its budget, such as welfare and Medicaid. Expenditures in these program areas represent a large fraction of the City's budget, yet the City has little budget control over them. Thus, new arrangements between the City and higher levels of Government may be necessary to alter the magnitude of uncontrollable expenses in the City's budget. The City's deteriorating economic base is not likely to allow the City to raise enough revenues to cover its expenditures by 1978.

In the City of New York's Financial Plan published January 6, 1977, entitled "Program to Eliminate the Budget Gap: Fiscal Year 1978," the City presented a program to restore a balanced budget by the summer of 1978. Much of that program involves action requiring State support and a great deal of Federal assistance that would provide budget relief.

3. Barring major policy shifts at the State and Federal levels, 1977-85 will be an extremely difficult period for the City. The City's budget is sensitive to economic factors. Our assessment of the influence of these factors on the budget indicates that, under the best of circumstances, the City will face extraordinary financial pressures in the late 1970s and the 1980s. Expenditure levels for the City are difficult to

cut, and revenue growth is limited by the City's deteriorating economic base and the insensitivity of certain sources of revenue to inflation.

4. Declaring municipal bankruptcy will not solve the City's problems. Although the municipal bankruptcy option is available to the City, none of the City's basic problems would be dealt with expeditiously under this option. Municipal bankruptcy would not solve the budgetary and financial problems or bolster the deteriorating economic base.

5. Better budgetary and fiscal information on cities is needed, and the Federal Government should explore ways to generate such information for better decisionmaking at all levels of government. In recent years, cities have made considerable progress in improving their accounting systems and budgetary information. Better fiscal, budgetary, and accounting information is needed by decisionmakers at all levels of government. Our studies in New York City and elsewhere have indicated that sufficient management and budgetary information does not exist for most cities. More and better data would allow cities to address their present and potential financial problems more comprehensively.

NEW YORK CITY EFFORTS TO IMPROVE ITS ECONOMIC BASE

The City has recognized that its economic base is an important element of its future financial viability. The City's newly founded Department of Economic Development has recently completed a detailed study aimed at securing a fundamental change in the City's policies as they affect its economic base. The proposed 5-year economic recovery plan includes capping the real estate tax, reducing the commercial occupancy tax, eliminating the sales tax on machinery and equipment through a tax credit process, and generally reducing business taxes when possible. Many other steps designed to improve the local business climate are also set forth. The program has been launched by the City administration. Various implementing steps will require the approval of the Emergency Financial Control Board and State or local legislation. We believe that these and future City efforts to firm up its economic base are steps in the right direction. However, it is not known whether these actions, by themselves, are sufficient to counteract the dramatic declines the City has experienced in its economic base.

ALTERNATIVE FEDERAL POLICIES TOWARD URBAN AREAS

Our analysis indicates that New York City's long-term problems reflect a long-term decline in economic activity

exacerbated by cyclical swings in national economic activity. During periods of recession, New York City, like many other older urban centers, experiences higher unemployment rates than the Nation as a whole. During periods of inflation, the City must finance rapid increases in the cost of public services with a revenue base that is relatively less sensitive to price changes. Thus, recession and inflation have added to the City's financial problems. In the absence of effective countermeasures, a recurrence of recession and inflation similar to the 1974-75 situation would make the City's budget problems even more severe.

The impact of recession and inflation on city finances is not unique to New York City: it is common to many, perhaps most, State and local governments. The effect on cities of fluctuations in the national economy is one of many reasons for the Federal Government to pursue effective economic stabilization policies. Reducing the national rate of inflation and unemployment would greatly benefit the Nation's cities.

One policy would be to introduce standby measures to offset the effects of economic downturns and periods of rapid inflation. One such approach might be antirecessionary aid to State and local governments which could be targeted to their needs. The difficulties of this approach include developing valid indicators of need, distinguishing problems resulting from national economic fluctuations from those resulting from long-term declines in particular regions or localities, and assuring that such aid does not undermine fiscal discipline at the State and local levels.

In addition to the problems created by recession and inflation, New York City is burdened by long-term economic decline. The City's economic base has eroded severely in the last decade, partly reflecting the relative decline of the Northeast region. Long-run fiscal prospects for the City are critically related to the direction of future changes in the local and regional economy. The Federal Government could move in several directions in trying to deal with urban and regional economic decline.

If the Federal Government chose to soften the blow of the economic movement from the Northeast, revenue sharing formulas could be altered to give additional weight to factors that are indicators of the declining economic base of cities. The Federal Government could also provide assistance aimed at alleviating the social costs imposed upon new and rapidly growing centers of economic activity. For this course of action, it would be difficult to draw a line between easing the adjustment process and becoming

committed to supporting a permanent level of services that cities would otherwise be unable to finance from local revenues. This approach risks undermining fiscal discipline at the State and local levels.

The Federal Government might try to retard the adjustment process by encouraging new or expanded economic development in the regions suffering from economic decline.

Efforts could also be made to design a set of incentives to encourage investment in declining localities and regions. Areas might also be revitalized through multi-state or regional organizational arrangements to coordinate plans and agree on development priorities. It should be noted, however, that the record of regional development efforts is spotty, both here and abroad. There have been few real successes and many instances where accomplishments have been limited. If this approach were to be chosen, emphasis should be placed on those economic activities for which the region is specially suited rather than on a broad effort to rebuild the region's traditional economic base.

We emphasize that this discussion is intended to illustrate the available options and the difficulties involved in any approach. Much more analysis will be required to provide a basis for choosing among those options or for devising an appropriate combination of them.

COMMENTS OF CONCERNED OFFICIALS

We received comments on this report from officials of the City and the Emergency Financial Control Board. The Office of the State of New York Special Deputy Comptroller for New York City was requested to provide comments, which it provided at the staff level. We requested, but did not receive, written comments from the Federal Office of Management and Budget and the Department of the Treasury.

The written comments which were received are summarized below.

City comments

City officials said our report was a comprehensive and thoughtful examination of the broader aspects of the City's current and long-term fiscal difficulties. The City reaffirmed its intent to balance its budget for fiscal year 1978, but indicated that its economic recovery will be possible only if the coalition of interests in the unions,

the financial community, the State and Federal governments, and the public continues to work together.

In its comments, the City indicated that several approaches that the Federal Government could adopt within the general framework of fiscal Federalism would aid the City. The City agreed with the major thrust of our conclusions.

Emergency Financial Control Board comments

The Board's executive director observed that, if the City cannot meet all of its credit needs privately after fiscal year 1978, it has no choice but to turn to the Federal Government for assistance. He was pleased that this issue was being raised in a new forum.

Federal assistance to the City could take various forms. There is a long history of Federal assistance to stimulate and support State and local programs, but direct Federal aid to a city, which the Federal Government has provided in the form of seasonal loans, presents a different policy question. Direct Federal Government aid to a local government with the explicit objective of enabling the local government to meet its overall fiscal needs may require certain safeguards to insure that the government has adequate incentives to efficiently manage its own financial affairs.

SUMMARY OF THE CONTENTS OF THE REPORT

The report reviews the City budgets for the past 15 years and describes important changes in the composition of its expenditures and revenues. It also reviews in detail the mayor's fiscal 1976 budget proposal and the budgetary implications of the 3-Year Financial Plan and its modifications.

The report also contains projections of City revenues and expenditures to fiscal year 1985 under various sets of assumptions about the performance of the national economy, State and Federal contributions to the City, and the City's ability to execute its 3-Year Financial Plan and attain budgetary balance in 1978. These alternative projections, which cover a range of possible outcomes, are intended to illustrate the types of fiscal problems the City might be confronted with after the completion of the 3-Year Financial Plan. Even under the best circumstances, the extraordinary current financial pressures on the City are likely to persist into the 1980s.

Budgets past and present

New York City budget data indicates that the City has not had a surplus in its operating budget since 1960 and that the operating deficit has in recent years risen to \$500 million or more. Major factors contributing to this deficit have been the rapid growth in expenditures on social services, education, and health services--which make up about 60 percent of expenditures in the mayor's proposed 1976 budget. The 5-year period 1971-75 has seen debt increase from 11 to 15 percent of total expenditures.

The mayor's proposed 1976 budget was modified by the 3-Year Financial Plan, which in turn was revised several times. Major modifications occurred in debt service, social services, higher education, and in the various smaller agencies included under the "other" category. The result of these modifications was a projected 1976 deficit of \$1.05 billion. The City and the Control Board are apparently trying to constrain the fiscal 1977 budget expense totals to the fiscal 1976 levels. This suggests that the City may have substantial difficulty in attaining the balanced 1978 budget proposed in the most recent plan revision.

Future budgets

Attempts to achieve a balanced budget will be affected by economic factors, such as persistent inflation and high rates of unemployment, as well as administrative factors, such as the City's ability to plan, initiate, and execute budgetary cuts.

The expenditure and revenue projections are based on two different inflation and national economy growth rates, combined with an assumption about whether the City will meet its 1978 Financial Plan balanced budget goal. Under the most optimistic set of assumptions (sustained economic growth, City attains goal), a very small deficit of \$15 million is estimated for 1985. Under the most pessimistic set of assumptions (cyclical economic growth, City falls short of goal), the deficit is estimated to be much larger.

The concept of budget controllability

The report identifies four major sources of difficulty in the City's controlling its expenditures. These controllability problems, subject to solution over time or with changes in law, arise from the following sources:

1. Expenditures that reflect the City's long-term contractual obligations.
2. Programs legally mandated by other levels of government.
3. Independent boards within the City government structure itself.
4. General obligations to the public to maintain an orderly environment.

The first source of uncontrollable expenditures reflects the City's present and future obligations and includes such items as debt service and pensions. Public welfare and medical assistance are examples of the second category of uncontrollable expenditures. These are mandated at the State level, and the City, acting alone, cannot cut the benefit levels to participants. The third source of uncontrollable expenditure, independent boards and related nonprofit corporations within the City, is an area for which budget cuts have been proposed under the 3-Year Financial Plan. The report discusses some of the reasons for this success. The fourth source of uncontrollability is best illustrated by reference to the Police and Fire Departments--areas in which cutbacks are difficult because of the necessity of maintaining public order. The various ways in which all these constraints combine to limit City budgetary initiatives are analyzed as preparation for a more detailed discussion of budgetary issues and options within the various expenditures/program areas.

The report also reviews each major area of program expenditure and details the various budgetary options available to the City, acting on its own. Health and welfare are discussed together, and a close link is shown between levels of expenditures in these areas. Medicaid forms the basis for that link. The areas of welfare, health, education, debt, pensions, transportation, police, fire, sanitation and public housing are discussed in detail. In addition, the various options and alternatives open to the City are summarized. The picture that emerges is that the City acting alone is severely constrained. It has made many of the "easier" cuts and is close to the point at which it cannot cut or even hold the line without help from other levels of government. If the City severely cuts certain segments of its budget, there is a real danger that the quality of City life will deteriorate.

The municipal bankruptcy option

There is considerable disagreement about whether immediate default and bankruptcy would solve the City's financial and economic crises. Some argue that formally declaring bankruptcy would drastically disrupt the City's functioning; have severe spillover effects at the local, national, and perhaps international levels; and merely postpone the financial crises. Others suggest that the potential local, national, and international effects have been overstated; that bankruptcy would have a permanently favorable effect on the maturity composition of the City's debt; and that it would also help revitalize the City's economic base.

Our assessment indicates that chapter IX of the Federal Bankruptcy Act, as applied to the New York City situation, would not be the best way to solve the City's financial and economic difficulties. First, it does not address the City's economic problems and may, in fact, have harmful effects on the City's long-run economic viability if court-imposed solutions limit policy options aimed at revitalizing the economic base. Second, as a means of lengthening the maturity of the City's debt, bankruptcy should be viewed only as a last resort after normal market processes and other types of intervention have failed. For, although municipal bankruptcy might accomplish some of the same objectives, it:

1. May postpone the time at which the City can reenter the capital market both because of legal constraints and because of its potential for limiting rather than creating policy options aimed at solving the City's economic problems.
2. Is more likely to reduce investment values in New York City and the ability of other State and local governments to externally finance expenditures.

Prospects for the City's long-term economic base

The City has experienced a migration of people and jobs to the suburbs and a movement of households and employment to the Southern and Western States. Between 1969 and 1974, employment declined in New York City while expanding by 35 to 44 percent in Arizona, Colorado, and Florida. Factors

contributing to this movement of jobs and business activity include technological developments (which have reduced the benefits of centralized facilities), energy cost differentials, and lower wages for industrial workers in other regions. Personal taste is also a major factor, since many people find the warmer, sunnier climates as well as lower living costs attractive.

Net migration from U.S. central cities totaled 7 million persons between 1970 and 1975, representing a fourfold annual increase over the 1960s. For a 5-year period of the 1970s, New York City's population decreased by 327,200 persons. In contrast, New York City suburbs, for the same period, showed a net population increase of 14,500 persons, only a small fraction of the City's population loss. Since those who migrate are younger, better educated, and more highly paid than those who remain behind, the City has been left with an increasing proportion of households which require public assistance.

To a large extent, the interregional movements of jobs and people reflect a set of nationwide social and economic adjustments. New York City is an aging, highly dense city which is losing population. It has twice as many municipal workers per capita as its surrounding suburbs and has traditionally paid them better. The resulting high payrolls, combined with increasing debt levels and the need for social services, has placed the City at a tax disadvantage relative to the suburbs since the City has to tax at higher rates to afford such expenses. High City taxes have contributed to the exodus of persons and business activity.

There is little direct evidence that intraregional or interregional shifts are largely attributable to fiscal or economic policies of any level of government. What does emerge from the available statistics, however, is that high taxes (particularly at the local level) have probably accelerated the rate of movement to the South and Southwest.

State and Federal policy options

By what means could the State and Federal governments aid the City and how costly and effective would some of these policy options be? These questions must be viewed in a broader context than just aid to New York City, because other cities in financial trouble are likely to press for similar assistance. What, then, is to be the policy toward local governments which have or will have financial problems,

either because of local problems or because of the long-term decline of certain sections of the country?

The Federal Government is, of course, already heavily involved in State and local government finances, with general revenue sharing, matching grants, and other forms of programmatic aid and regulations. The questions of State and Federal policy options should be discussed in terms of goals, alternatives, and criteria by which policies are to be evaluated. The types of policy options are:

1. Improve the City's economic base.
2. Cut spending and increase revenues.
3. Improve management and control.
4. Redefine the region responsible for the function.
5. Federal or State takeover of certain functions.
6. State and Federal aid.

These options are appropriate to different degrees for the City, the State, or the Federal Government.

This report presents several examples of policy options, such as welfare reform, State takeover of the City university, and regionalization of the transportation system. These examples are presented not as recommendations, but as estimates of how such changes might or might not help solve the City's problems. In general, there is little chance of substantial relief from State aid, since the City is so large compared to the rest of the State. Certain types of welfare reform could reduce the City's financial burden, but they cannot solve its long-run problems. Moreover, in some illustrations City residents would have to pay higher State and Federal taxes.

The complex questions surrounding the option of massive Federal aid to cities--a so-called new "Marshall Plan"--are posed in this report. But our purpose is merely to provide an agenda for further analysis, not to answer questions that are fundamentally political as well as economic.

MANAGEMENT AND BUDGETARY ASPECTS OF MAJOR NEW YORK CITY AGENCIES

The report also reviews the functions and some management problems of the seven major City agencies: the Human Resources Administration; the Board of Education; the Health and Hospitals Corporation; the Transit Authority; and the Police, Fire, and Sanitation Departments.

The Human Resources Administration and its subsidiary agencies control, coordinate, and dispense most of the family, social, and community welfare services. Federal and State aid is an important source of the agency's revenues, but it is accompanied by a host of State and Federal rules and regulations. The key issue is whether substantive improvements in the efficiency and economy of welfare programs can be achieved by the City without State and Federal action.

The task of providing public school education is shared by a citywide Board of Education and 32 community school boards. Since the City is attempting to reduce expenditures to meet its 3-Year Financial Plan, the issues appear to be (1) determining the appropriate balance between State and City support for public education and (2) deciding on the quality and total level of support to be provided. Similar issues are at the heart of the City university's problems.

The New York City Transit Authority operates subway and certain bus lines under the guidance of the Metropolitan Transportation Authority, a public benefit corporation. The primary issue is determining a fair allocation of costs among transit patrons, which includes City and regional taxpayers and other beneficiaries.

Efficiency and economy in operations can help solve financial problems facing all City agencies. Efficiency and productivity improvement play a dominant role in the operations of the uniformed services (police, fire, and sanitation). These departments are financed mainly from local taxes. The services provided are labor intensive and the quantity of services is proportional to staffing use. Defining and measuring productivity and determining the appropriate level of service are major tasks of management in these departments.