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MEMORANDUM

NYC
SUBJECT: Structure of the Municipal Market

The municipal bond market is unique. Not only must it supply credit to State and local government, but it must do so at rates sufficiently attractive (vis-a-vis the terms available to other borrowers) to provide a subsidy (in the form of lower borrowing costs) to municipal borrowers. Accordingly, when it is said that conditions in the municipal market are poor, or are deteriorating, what is meant is that borrowing costs are not sufficiently different from those in the taxable market.

Like all markets, rates in the municipal market are sensitive to laws of supply and demand. But in the municipal market, the supply of available credit (or, conversely, the demand for municipal bonds) is determined not only by the overall availability of credit, but also by the need for tax-exemption or tax shelter.

A tax-free entity -- a pension fund or foundation, for example -- will demand no less yield on a municipal tax-exempt bond than on a fully taxable bond of comparable quality. But at the other end of the spectrum, an investor subject to a 70 percent effective tax rate could receive 70 percent less yield from a tax-exempt security and still break even. Accordingly, there is a direct relationship between the level of Federal taxation



and the supply of credit to the municipal market.

The municipal market is populated primarily by investors who rely on return from financial assets as an important source of income.* To the extent those investors are subject to a lower rate of taxation (for whatever reason) the premium they are willing to pay for tax-exempt securities (and thus the subsidy provided the borrower) is commensurately reduced.

Supply of Tax-Exempt Credit

In recent years, the major institutional purchasers of tax-exempts -- commercial banks and fire and casualty insurance companies -- have moderated their involvement in the municipal market. With respect to insurance companies, the explanation is quite straightforward: underwriting losses have increased dramatically relative to premium income, thus "sheltering" a much larger portion of total income from Federal tax.

A more complex set of factors has been at work with respect to the need for tax-exempt income at commercial banks:

1. Offshore operations have accounted for an increasingly large share of income (more than 50% in the case of Citibank and Morgan Guaranty, for example.) Taxes paid to foreign governments on income derived from such operations may be credited against U.S. tax liability, thus reducing the effective U.S. rate and the consequent need for shelter.



* As such, investors can be distinguished from industrial corporations which look primarily to capital assets, rather than financial assets as the primary income source.

2. Most major U.S. banks have expanded into related financial areas such as leasing. Such activities provide substantial tax shelter.
3. As a consequence of general business conditions and aggressive lending policies, loan charge-offs have increased substantially, thus reducing taxable income. For example, aggregate net charge-offs by the New York Clearing House member banks grew from \$42.7 million in 1969 to \$419.1 million in 1974.
4. Concern with image and public relations has led many banks to adjust their holdings to insure a "respectable" level of taxable income and of tax payments. Historically, many banks -- especially smaller ones -- paid no Federal tax at all, primarily as a result of tax-exempt income. In recent years, more banks have decided that "a reasonable" level of tax payments is desirable.

After commercial banks, households (i.e., individual investors) have traditionally been the largest owners of tax exempts. Although precise data is not available, dealers report that the shocks of the past year (repeal of the Port Authority Covenant, UDC, New York City) have cut sharply into individual interest in tax-exempts.

Demand for Tax-Exempt Credit

At the same time factors have been at work to moderate the supply of credit available to the municipal market, demand



for such credit has grown dramatically. In the last decade, tax-exempt debt outstanding rose from \$100 billion to \$207 billion. In 1974 alone, \$22.8 billion in bonds and an additional \$29 billion of short term notes came to market.

Much of this debt was issued for traditional public purposes -- e.g. schools, water and sewer facilities, hospitals, etc. But \$2.2 billion, nearly ten percent of the total bond volume, was used to fund pollution control facilities of private corporations. The financial benefits of the tax-exempt subsidy accrued not to the taxpayers, but to corporate shareholders. And an additional \$340 million of publicly issued tax-exempt debt was in the form of industrial development bonds, used to finance everything from warehouses to fast food outlets.

In addition to this \$2.5+ billion annual volume of publicly marketed tax-exempt debt for private purposes, it has been estimated that at least another \$4 billion (and perhaps as much as \$7 billion) per year is placed privately, normally in the form of direct bank loans. In short, as much as 25% of the annual demand for tax-exempt credit may be for non-public purposes.

Impact of Inflation

To this point, we have identified the following sources of disturbance: stagnant supply of tax-exempt credit caused by (1) less institutional need for tax-exempt income, and (2) uncertainty as to the soundness of tax-exempt credits; sharply increased



demand for tax-exempt credit, in large part attributable to the use of such credit for non-public purposes. To complete the survey, we must look at the impact of inflation on both the supply and demand sides.

Inflation's impact on the supply side is quite complex. On the one hand, since inflation causes an increase in taxable income while real income remains constant, it can be said to increase the need for tax shelter. More importantly, however, inflation reduces the amount of funds available for investment and increases the price of what is available:

- Under our progressive tax system, inflation drives taxpayers into higher brackets without increasing real wealth; a greater proportion of after tax income must be spent rather than saved to maintain a level standard of living.
- Inflation and its now inevitable handmaiden -- the expectation of future inflation -- makes savers less willing to invest funds for extended periods and causes them to demand higher returns for what is invested.

On the demand side, inflation drives up the component and overall costs of the projects which must be financed. The result is a greater demand for tax-exempt credit without an increase in the benefits provided.

Overall Market Impact

All of these phenomena have contributed in varying degrees to the current condition of the market. As of September 1,



the Bond Buyer 20-bond index stood at 7.18%, within a few basis points of its historical high. Although it is difficult to calculate with precision the level of subsidy such rates provide, it is clear that the subsidy is well below the 35 - 40% traditionally thought to be provided by the tax-exemption.

Potential Additional Complications

Two additional difficulties exist on the horizon. First is tax reform. Should corporate tax reform result in an overall lowering of the tax burden for financial corporations, the contribution of this sector will be further eroded. In addition, modifications of the minimum tax rules could lessen individual investor commitments to the market.

Of more immediate concern is securities regulation. The 1975 Securities Act Amendments brought municipal dealers under Federal regulation for the first time. While such a move was long overdue and sound as a matter of policy, it will impose new costs on the market, costs which must ultimately be borne by the issuers.

Moreover, the New York City situation has focused attention on the need for better information about individual municipal credits. While the new 1975 law expressly forbids the United States Government from requiring issuers to disclose anything, it equally expressly authorizes imposing such a disclosure burden on underwriters and dealers. In addition, a recent lawsuit raises the question whether an underwriter or dealer can be held



liable under the anti-fraud provisions of the securities law (e.g. Rule 10b-5) for failure to inquire behind the Official Statement into the issuers true financial condition.

Clearly, more (and more accurate) disclosure is a desirable -- indeed necessary -- objective. But if corporate disclosure rules are superimposed overnight on the municipal market (as could occur as a consequence of the above-mentioned lawsuit) no prudent firm would be willing to deal in either the new issue or secondary market. It would take at least 6 months to a year for most tax-exempt issuers to bring their financial information up to corporate market standards.

Potential Financial Policy Options for the U.S. Government

A. Reduction in Demand for Tax-Exempt Credits

1. Eliminate tax-exemption for pollution control, industrial development financing.
2. Finance Urban Renewal Projects (guaranteed by HUD) through the Federal Financing Bank.

B. Increase in Supply of Credit

1. Establish Federal Municipal Bond Bank to purchase state and local debt.
2. Direct Federal financing of state and local capital projects.
3. Measures to increase effective tax rate of financial institutions.
4. Exempt municipal bond income from minimum tax provisions.



C. Provide Direct Subsidy

1. Provide 33 1/3% interest subsidy on taxable debt issued by state and local government.



I. What bankruptcy bill in present form will achieve.

1. Prevent all city funds from being tied up by set-offs and lawsuits.
2. Enable orderly plan to be developed for partial payment of creditors over long term.
3. Enable some new borrowing, secured on priority basis by future tax revenues.

II. What bankruptcy bill in present form will not achieve.

1. Enable non-disruption of all city services.

New borrowing will not be sufficient to cover all current expenses, since future tax revenues at current level of spending will not do so. If non-disruption of all city services is desired, financial assistance will be necessary.

2. Assure sound management of city's finances.

Under the proposed bankruptcy law, city management will not (and cannot constitutionally) be placed in a Federal trustee, but will remain with elected officials. Bankruptcy court can exercise minimal control over city management by jawboning and by refusing to permit priority borrowing except for certain purposes. But basic management of city finances will remain in same old crowd. There will be no additional incentive to establish sound



fiscal basis so long as bankruptcy proceeding continues and enough financial assistance to meet current needs is received.

If assured reform of city finances is desired, one of the following methods must be considered:

A. As condition of commencement of bankruptcy proceeding, require filing of a good faith plan which will not only provide for partial payment of creditors but will also establish fiscal affairs of the city on a fiscally sound basis within a reasonable period of time--implementation of the latter to be commenced as soon as petition is filed, and petition to be dismissed if compliance is not continued.

Advantages

1. Eliminates need of Federal Government drawing up or approving plans for fiscal retrenchment beforehand--decisions will have to be made by city and approved by district judge.

2. Provides automatic sanction for failure to live up to plan, without substantial possibility of political interference.

Disadvantages

1. Cannot be certain what the judge will consider a sound fiscal plan.



2. Sanction for failure to comply with plan is massive--namely, dismissal of bankruptcy suit enabling all creditors to set off their claims or seek other judicial remedies at once.

B. Condition the granting of any Federal aid upon immediate establishment and implementation of sound fiscal plan.

Advantages

1. If properly structured, could enable continuous Federal surveillance of implementation of reforms.

2. Enables measured response--withholding of greater or lesser amounts of funds.

Disadvantages

1. Does not remove the matter from the political arena--President is blamed for cutting off funds and causing 5,000 policemen and brain surgeons to be fired.

2. May not be a credible sanction, since political resistance to cut-off would be substantial.

C. Do not condition Federal assistance at all, but make it very clear that it is a one-shot subsidy not to be repeated. City would then presumably be forced to set its house in order.

Advantages

1. Removes Federal Government from political decisions concerning what city services must be cut back.



2. Is the solution least destructive of the principles of federalism.

Disadvantages

1. The Federal warning that "this is the last time" may not be credible and the city may simply place itself in the position of having to be rescued again.

2. May be difficult to obtain legislation from the Congress without strings.



Tab B

It is proposed that the New York State legislature pass any of the following tax packages and direct that the revenues are to be applied to finance special new MAC notes to be issued on December 1, and thereafter as required.



Net Cash Requirements
million dollars

	N.Y. City ¹	N.Y. State (incl. HFA)	Total
Dec. 75 - June 76	\$ 699	\$1,811	\$2,510
July 76 - June 77	390	50	440
July 77 - June 78	-434	-	-434
Total	\$ 655	\$1,860	\$2,515

¹ Includes deferral of all payments on principal of notes and bonds and cancelling half of all scheduled interest payments.



Option 1

Cash Need \$2,960 million

Option A:	10% Income Tax Surcharge (2 years)	\$ 764
	4 cent gas tax (3 years)	696
	1 cent sales tax (3 years)	1,515
		<hr/>
		\$ 2,975
Option B:	5% Surcharge (2 years)	\$ 382
	6 cent Gas Tax (3 years)	1,044
	1 cent Sales Tax (3 years)	1,515
		<hr/>
		\$ 2,941
Option C:	5% Surcharge (2 years)	382
	4 cent Gas Tax (3 years)	696
	2 cent Sales Tax first year,	
	1 cent 2nd and 3rd year	2,020
		<hr/>
		\$ 3,098

Surplus of \$597 million available for refunds year 3.



Option 2
\$250 Million Mitchell-Lama Purchase
Cash Need \$2710 million

Option A:	7% Surcharge 2 years	532
	4 cent gas tax 3 years	696
	1 cent sales tax 3 years	1515
		<hr/>
		2743
Option B:	4% Surcharge 2 years	304
	5 cent gas tax 3 years	870
	1 cent sales tax 3 years	1515
		<hr/>
		2689
Option C:	9% Surcharge 2 years	684
	6 cent gas tax 3 years	1044
	1 cent sales tax 2 years	1010
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		2738



Option 3

\$250 million M-L Purchase
\$200 million GNMA Purchase HFA Mortgages
\$250 million Guarantee HFA Bonds

Cash Need 2490

Option A:	8% Surcharge (2 yrs)	\$608
	5 cent gas (3yrs)	70
	1 cent sales (2 yrs)	1010
		<u>\$2488</u>
Option B:	4% Surcharge (2 yrs.)	\$304
	4 cent gas (3 yrs.)	696
	1 cent sales (3 yrs.)	1515
		<u>\$2515</u>
Option C:	9% Surcharge (3 yrs.)	\$1026
	4 cents gas (2 yrs.)	464
	1 cent sales (2 yrs.)	1010
		<u>\$2500</u>
Option D:	9% Surcharge (3 yrs.)	\$1026
	1 cent sales (3 yrs.)	1515
		<u>\$2531</u>



Option 4

No default

Cash Needs \$5,813 million

11% Surcharge (3 years)	\$ 1,254
6 cent Gas (3 years)	1,044
3% Sales (1st year)	1,515
2% Sales (2nd and 3rd years)	2,020
	<hr/>
	\$ 5,833



MEETING ON NEW YORK CITY AND NEW YORK STATE
FINANCIAL SITUATIONS

Unless some form of outside financial assistance is forthcoming, it is the consensus of your advisers that New York City will go into default, most likely during the first two weeks of December. The only possible way New York City could avoid default would require Federal assistance or substantially increased taxation by the State of New York or the use of the City and State pension funds.

1. Should the Administration propose actions to prevent a New York City default?

A number of bills which would provide Federal financial assistance in the form of direct loans or guarantees are currently under consideration in both the House and Senate.

Option A: Recommend measures to prevent default without the use of Federal funds. Such measures would include an increase in the State sales tax, an income surtax, or the obligation of New York State and/or New York City pension funds.

Option B: Support congressional proposals to provide Federal loans and/or guarantees, with stringent control provisions imposed by the Federal Government.

Option C: Propose no measures which would prevent a New York City default.

2. What actions are required in the event of a New York City default?

A. Legal - Department of Justice proposed amendment to the Federal Bankruptcy Act.

Ask Congress to enact an amendment to the Federal Bankruptcy Act which would add a new chapter providing for the adjustment of the debts of major municipalities. (Tab A)

The proposed amendment would prevent, in the event of a New York City default, all City funds from being tied up through litigation and require that an orderly plan be developed for partial payment of creditors and an operational plan for the City. However, under Constitutional limitations, the operation of the City and its operating expenditures must remain under the



QUESTION: Under your proposal, how would New York City get the funds to meet essential services?

ANSWER: According to New York City's figures, the City's cash needs for operations and capital projects (not including any payments of principal and interest on outstanding debt) will exceed revenues by approximately \$700 million during the period December 1, 1975 - June 30, 1976. There are at least three ways this gap could be made up.

First, New York State could impose a temporary and emergency tax -- perhaps a package involving the income, gasoline and sales taxes -- to generate the necessary cash.


Second, the assets of the pension funds could be used to collateralize borrowing by MAC or the City. State and City pensions hold well in excess of \$10 billion of unencumbered assets which would be used for this purpose.

Third, in the context of an orderly debt restructuring proceeding, the court could authorize the City to issue certificates of indebtedness, to be payable, on a prior claim basis, out of revenues in years after the budget balancing process is complete.

BACK-
GROUND:

There are really two problems: the net cash flow shortfall referred to in the answer and the so-called seasonal problem. The remaining seven months of the fiscal year can be broken down into two periods: December-March in which the City runs a \$1.3 billion cash deficit (net of debt service) and April-June in which it runs a \$600 million surplus. On a direct revenue anticipation basis, the City should be able to borrow \$600 million during December-March, but it needs one of the mechanisms described in the answer to borrow the remainder.



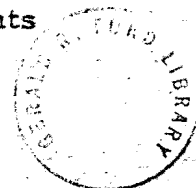

Gerald L. Parsky
Assistant Secretary of
Treasury

NEW YORK CITY CASH FLOW NEEDS
(dollars in millions)

	<u>Fiscal Year 1976-1977</u>	<u>Fiscal Year 1977-1978</u>
July	1218	1079
August	480	410
September	(148)	(138)
October	505	94
November	146	70
December	566	392
January	116	56
February	72	(14)
March	270	387
April	(475)	(587)
May	(308)	(335)
June	<u>(823)</u>	<u>(907)</u>
Total	1619 ^{1/}	507 ^{2/}

1/ Excludes \$164 million financed from debt service payments to pension funds.

2/ Excludes \$274 million financed from debt service payments to pension funds.



Insert before existing language of section 311 "(a) and add at the end thereof the following subsection (b):

(b)(1) Upon application of petitioner the Secretary of the Treasury may guarantee, in whole or in part, payments of principal, of interest, or both, on certificates of indebtedness issued pursuant to this section for the purpose of providing funds for the maintenance of essential services.

(2) The provision of such guarantees shall be on such terms and conditions as may be established by the Secretary of the Treasury in his sole discretion.

(3) Any decision, rule or other determination by the Secretary of the Treasury pursuant to the authority conferred under this section shall not be subject to judicial review by any means.

(4) The aggregate amount of guarantees outstanding at any time under this section shall not exceed /\$3,000,000,000/; the aggregate amount of guarantees outstanding with respect to any petitioner and any affiliate of such petitioner shall not exceed /\$1,500,000,000/."

