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THE FUTURE OF STATE AND LOCAL GOVERNMENT FINANCES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON URBAN AFFAIRS

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

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THURSDAY, JANUARY 22, 1976

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON URBAN AFFAIRS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 5302, Dirksen Senate Office Building, Hon. William S. Moorhead (chairman of the subcommittee) presiding.

Present: Representatives Moorhead and Long; and Senators Javits and Taft.

Also present: Ralph L. Schlosstein, professional staff member; Michael J. Runde, administrative assistant; and M. Catherine Miller, minority professional staff member.

OPENING STATEMENT OF CHAIRMAN MOORHEAD

Chairman MOORHEAD. The Subcommittee on Urban Affairs of the Joint Economic Committee will please come to order.

Today, the Urban Affairs subcommittee holds the first in a series of hearings on the future of State and local government finances. The hearings are designed to separate fact from fiction about State and local governments in the next 5 to 10 years. We will examine the aggregate State and local sector of the economy, as well as individual governments that may experience difficulties.

State and local governments have been buffeted by a series of devastating economic developments in the last 2 years. First, inflation caused State and city expenditures to swell much faster than revenues grew. Then recession significantly eroded revenue growth and increased the demand for State and local government services.

This fiscal double whammy of inflation and recession has caused the most severe State and local government budget crunch since the Great Depression. According to a survey undertaken by this subcommittee last May, State and local governments will be forced to institute massive budget adjustments this year to keep their budgets in balance. Taxes will go up $3.6 billion, expenditures will decline $3.3 billion, and capital construction projects worth $1 billion will be delayed or cancelled.

While these budget adjustments are quite widespread, they are not occurring in every government in the country. Some State and local governments, particularly those with economies dependent on energy or agriculture, are still in relatively good shape. Others, that have been victimized by the depth of the recession, have been devastated. In fact, there seems to be a direct relationship between the severity of the State and local unemployment rate and the magnitude of the budget crisis.

Unfortunately, these budget adustments will not be confined to this fiscal year alone. Next year will probably be worse. Many State and local governments have been reluctant to make adjustments, hoping that a vigorous economic recovery and a reduction in the inflation rate will bring budgets back in balance next year. But these hopes are somewhat unrealistic. Even the most optimistic forecasts suggest that unemployment will exceed 7 percent through 1976 and that the inflation rate will not fall much below current levels. So the outlook for State and local budgets in the next year is really quite bleak.

But beyond the immediate future, it seems inevitable that many States and cities will experience permanent fiscal problems. Population shifts, job movements, and increases in poverty will befall many governments. Cities and even States in the declining or stable regions of our country have already been affected. Some, like Newark, have cut back servely and have become hollow cities. Others, like New York, have tried to maintain business as usual and have abruptly been disciplined. But these two choices seem to be all that is available to these cities and States in the future. They can roll down the hill like Newark or jump off the cliff like New York. With either alternative they wind up at the same place, the bottom of the hill.

The subcommittee intends to examine many key questions about the future of State and local government budgets. First, we will attempt to determine whether the current budget crisis is a cyclical phenomenon related to recession and inflation or a permanent development that will eventually affect all State and local governments.

Second, we want to identify specific governments or types of governments that will be particularly vulnerable to serious budget crises in the next 5 to 10 years.

Third, we will examine the adequacy of existing Federal Government policies to deal with State and local fiscal imbalances.

Finally, we hope to explore policy options that can arrest future budget crises before they occur.

Today, the subcommittee will receive testimony from three experts in State and local government finance. Our first witness will be Mr. Brenton Harries, the president of Standard and Poor's, a service that rates municipal bonds. He will be followed by Mr. Roy Bahl, who is the director of the Metropolitan Studies Program at the Maxwell School at Syracuse University. Mr. Bahl is accompanied by Messrs. Bernard Jump and David Puryear. Our last witness will be Mr. Thomas Muller, who is director of evaluation studies with the Urban Institute.

Before proceeding with the witnesses, do any of the Members present wish to make a statement?

Senator Javits. Yes. I would like to just speak briefly. First I would like to join in congratulating the Chair on these hearings which are critically important because I rate, after the problems of peace, unemployment, and inflation, the crisis of the cities as the next priority for our country. Who can say that better than I?

Also I am extremely pleased that the largest number of witnesses this morning are from my State, one, the services which Mr. Harries has which is, of course, international in its scope, and the others, the distinguished academicians from Syracuse University, in the Maxwell School.

Mr. Chairman, due to the problem I have of many committee meetings at the same moment, I may not be here as much as I should like, but I would greatly appreciate it if the witnesses would know that I will give the greatest thought and study to what they say as I am deeply involved and will be involved in legislation of all kinds respecting the urban crisis.

And second, I would be grateful to the Chair, if at the request of the minority staff, the Chair will be kind enough to put any questions forth which I am unable to do, within reasonable time, of course.

Chairman MOORHEAD. The Chair will be very happy to cooperate with the distinguished Senator from New York. We are pleased to have so many witnesses from your State.

Senator JAVITS. Thank you very much, Mr. Chairman.

Chairman MOORHEAD. Gentlemen, without objection, I will place Senator Taft's opening statement in the hearing record at this point. Senator Taft is a member of the full committee, and will be participating in the hearing today.

OPENING STATEMENT OF SENATOR TAFT

STATE AND LOCAL GOVERNMENT FINANCES

Local governments have an enormous planning problem because of changes in Federal policies. The Federal Reserve blows hot and cold, affecting interest rates and generating business cycles. The Federal Government buffets the Federal Reserve with its swings from small deficits to large deficits (never a surplus), pushing it into erratic policies. Municipal bond rates gyrate, turning state and local projects on and off, or wreaking havoc with State budgets. We all know what unemployment does to State budgets. And now we have a new fiscal year, which may help us to bring Federal spending under control, and put it on a more stable path. But local government does not enjoy the luxury of another three months in which to make decisions. Most of them must have their budgets approved this spring. They must plan spending for July 1 to June 30, or even for April 1 to March 30. How can they make such plans, involving parts of the next Federal fiscal year, when the largest single source of Federal funds impacting on county and city budgets lies neglected in committee? Revenue sharing is up for renewal. It has been known for years that it would have to be considered by this Congress. Yet we have done little advance work, and made no plans, which would allow us to move quickly on this matter. So here we are, already into the state and local government planning period, with not a peep out of the Congress on revenue sharing. This program should be extended in a stable, predictable, and long-range fashion.

We also have pending before the Banking Committee a measure introduced by Senator Eagleton, which I strongly support, and which would require the registration with the SEC of all State and municipal bonds. I hope that hearings on this bill, S. 2574, can be held shortly. It will help restore confidence in the market, will help prevent disreputable accounting practices, forcing problems into the open in time to correct them, and protect investors.

Chairman MOORHEAD. Mr. Harries, please proceed with your testimony, sir.

STATEMENT OF BRENTON W. HARRIES, PRESIDENT, STANDARD & POOR'S CORP.

Mr. HARRIES. Thank you, Mr. Chairman.

I have submitted a prepared statement to the subcommittee. I would like to make my remarks this morning very brief and then welcome your questions.

Chairman MOORHEAD. Without objection your prepared statement will be made part of the hearing record.

Mr. HARRIES. Thank you.

I would like to invite the committee's attention to some immediate problems which you will be hearing about which may throw out of focus the longer term view you are attempting to take of the problem. In New York particularly we have had a problem of cash flow. The problem is now spilling over into the school districts in the State who normally could expect to receive school aid payments in the spring of the year. As you know, New York State is still foreclosed from the capatal markets, so the normal modus operandi of the State of borrowing $3 billion to $4 billion in the spring may be severely interrupted. This is causing a bit of chaos with some of these school districts who have borrowed in anticipation of receipt of this money.

This spillover effect has gone to Massachusetts, which is also foreclosed from the markets because it incurred a very heavy budget deficit very quickly earlier this year, and I would like to invite your attention to a third place where it has spilled over in a rather conservative city called St. Paul, Minn., which last week had a problem of coming to the market and now is faced with an imminent $25 million default on school district notes.

The problem of short term borrowing is something that I feel the committee should address themselves to and I would point out as you did, Chairman Moorhead, Newark, N. J. The amount of short-term debt of Newark, N. J., is zero. The State doesn't permit it, therefore, Newark operates consistently with surplus budgets without having to meet short-term borrowing.

Now, I grant you that the center of Newark looks somewhat like a city after the war, but on the other hand, they have taken the strong steps necessary to maintain fiscal solvency.

I would like to address myself to another question which has been prompted by the Congress and you will hear more of and it is in the matter of disclosure on municipal bond issues. With the passage of the Securities Amendments Acts of 1975, there has been removed from the municipalities, the issuing governments, any requirement of disclosure. This is the so-called Tower amendment which went into the act.

I think the Tower amendment is fine because it in effect keeps the Federal Government still out of any overview, if you will, of local government financing, but this committee in recommending legislation will run up against this, I am sure, as you proceed through your hearings.

I believe that disclosure is a State problem and can be handled at the State level. I would point out it is far more serious than people fully realize. For example, 2 weeks ago the State of New Jersey sold

$50 million of general obligation bonds. Because of the cautiousness of the attorneys for many of the leading underwriters who would normally bid for New Jersey's bonds, two large New York banks did not submit bids. One very large New York dealer did not submit a bid. The field was left to one dealer and one bank.

The Chase Bank was the bank that stayed in the account. Their attorneys insisted that they receive from the State attorney general, the State treasurer and the Governor signed certifications that all material facts were divulged, that no material facts were omitted.

The normal spread that underwriters could expect to receive on New Jersey bonds would be $7 or $8 per $1,000, and this particular issue, because of the problems raised by disclosure, and perhaps the elimination of some competition because certain banks dropped from the account, the bids came in with a spread of $15 a bond. This means that New Jersey in effect paid $7 per bond more than they might have had to do. $7 a bond on a $50 million issue is $350,000 in excess costs.

I submit that this is an urgent problem. It will have to be solved by mid-year, I would think, and hopefully at the State level and I wanted to mention the other problem of cash flow because you will be hearing more about it increasingly. It does not necessarily mean lack of basic credit worthiness. I submit that in the problems of New York City that although the cash flow problem brought them down, the basic credit worthiness of $6 billion of long-term debt in New York City is still within limits. The city can manage that amount of debt. It was the short-term debt, the borrowing for operating expenses, that cause the difficulties.

I wanted to get these two relatively short-term issues on the record and I would like now to pause and proceed to your questions because I have submitted my comments in answer to your longer term questions.

Thank you.

Chairman MOORHEAD. Thank you, Mr. Harries. Your prepared statement will be placed in the hearing record at this point.

[The prepared statement of Mr. Harries follows:]

PREPARED STATEMENT OF BRENTON W. HARRIES

I am pleased to present this statement in response to the Chairman's letter of January 9 and address myself to the specific questions contained in the letter:

(1) *What is a realistic outlook for the aggregate state and local government sector, given realistic unemployment and inflation assumptions?*

The municipal market despite the problems caused by New York City's fiscal crisis set a record for financings in 1975. Total issues of both long and short term securities were approximately $60 billion. This is about 16 percent higher than the previous year. The split between long and short term was about equal.

Despite the rapid drop in interest rates in the past two months, however, best indications are that the market will probably be somewhat less for 1976.

There are several reasons:

1. Voters appear to be rebelling against the incurrence of additional general obligation debt. The results of the bond elections in November were that over 70 percent of the referendums were defeated. In 1974 only 38 percent were defeated and 1975's rejections were the highest on record.

2. Two of the largest short term borrowers in the market, New York City and New York State, are currently excluded from the capital market. Because of the problems of these two entities in 1975, there is much greater awareness

of the difficulties inherent in short term borrowing. I think it fair to say that there will be much less use of short term borrowing in future municipal markets.

3. In 1975 the Municipal Assistance Corporation for the City of New York sold about $4 billion of long term debt replacing an equivalent amount of short term New York City debt. It is highly doubtful that this issuer will be in the market at all in 1976.

4. Over the long outlook, I think we can expect a slowdown in the rate of growth of bond issuance assuming that the rate of unemployment and inflation moderate. Between 1950 and 1974 municipal bond volume grew at about a 10 percent annual rate. Over the same period state and local government expenditures on goods and services grew at the same rate. It would be logical, therefore, to assume that over the balance of the decade we could reasonably expect volume and spending to move together. Most business analysts are forecasting a slowdown in the rate of growth of expenditures of state and local governments. This then will ease the pressure on the bond market, the voter rejection of proposed bond issues will slow construction expenditures and a slowing of the birth rate will mean lesser populations in elementary and secondary schools and ultimately at the university level. This last item alone is estimated to mean a $30 billion "saving" by 1980. In addition, I believe there is a much greater awareness on the part of our population that we cannot keep spending our way by borrowing. This is obviously resulting in a more careful reordering of priorities.

If we can assume that the relationship between state and local government purchases of goods and services will track long term bond volume, it should be safe to assume that a 7 percent growth rate would be realistic. This assumes 5 percent inflation and 2 percent real growth. This means that long term bond volume will be virtually unchanged in 1976. With short term volume likely to drop substantially, total municipal financing will be down in 1976.

In spending categories welfare is now the second highest state and local function in terms of dollar cost next to education. In the first half of the 1960's welfare spending grew at 7½% annually; in the ensuing five years at 18 percent a year.

The provision and maintenance of some 3.8 million miles of highways and streets represents the third ranking state-local service in terms of dollar costs. The highway share in state-local budgets declined markedly during the sixties and is expected to fall further during the seventies. The projections indicate an expenditure rise of 82 percent from 1970 to 1980, from $16 to $30 billion.

Spending for health and hospitals, the fourth largest category, is projected to rise from less than $10 billion in 1970 to $30 billion in 1980, approximately tripling. The rate—12 percent annually—is higher than that of the sixties as a whole, and above that indicated for most other services.

The four most costly functions discussed above make up about 70% of all state-local general spending. Outlays for the mixed category—"all other," including such services as police and fire, interest on debt, sanitation and sewerage and others—are projected to rise from $38 billion in 1970 to $104 billion by 1980, or 175%, at a rate somewhat higher than in the sixties generally.

The projection results do not foretell broad general problems of fiscal crisis for state and local governments. Nor do they suggest a rosy financial future for each of the 71,000 or so taxing jurisdictions. There are needs not being met, and acute fiscal problems in some areas, particularly in some large and old cities. How to solve these "pocket" problems within our present inter-governmental revenue system, despite years of discussion, still remains something of an enigma.

(2) *Are there states and cities that are likely to have insufficient revenues to meet basic needs in the future? Is the New York Ctiy situation likely to be repeated?*

If one defines "basic needs" as; fire, police, sanitation, water, electricity, etc., then it certainly should be possible to raise sufficient funds on the local level. However, if one insists that welfare, education, health care, etc., are "local" needs and responsibilities, then there will never be sufficient revenues on the local level.

The New York City situation need not necessarily be repeated if prudent fiscal management is followed. It is highly unlikely that any other city's problems combines all the elements that contributed to New York City's difficulties—

the tremendous range of services the city attempted to provide, the high cost and low productivity of municipal employees, the vulnerable economic base, the unorthodox financial and borrowing procedures, the huge amount of short term borrowing that accelerated so rapidly in 1974, etc. While some municipalities have made use of some "gimmicks," in general, most units of government were jolted by the New York City situation to such an extent that it is doubtful that they would ever allow their own situations to continue to deteriorate.

We know of no city or state that has relied so heavily on short term borrowing. On a much smaller scale, Massachusetts is suffering the same problem of market access. Inability to borrow to meet maturing debt can trigger immediate default. Normally borrowing is for capital needs which can usually be postponed if market access is denied. In the case of New York and Massachusetts, much of the present borrowing requirement is to meet short term debt. For example, New York State has $1.6 billion notes maturing next March 31. Tax revenues will provide probably $800 million. The amount of tax revenues which are not available to meet these notes will, in effect, be the State's operating deficit for the year. If the State does not have access to the borrowing market, this deficit could, probably, be met by state pension funds. Massachusetts does not have this safety valve. There are no pension funds at the state level.

Going further, New York State historically borrows in the capital market in the spring between $3 to $4 billion revenue anticipation notes. This cash is then disbursed to the various political subdivisions of the State to fund their needs of education, social services, etc. If the State is unable to borrow these funds there will be the possibility of defaults on obligations of these local authorities which were anticipated to be met from the State borrowings. Again the problem is inability to borrow to meet maturing debt. In the corporate market this has been the cause of every major default in recent years. Penn Central and W. T. Grant initially defaulted because of inability to meet short term debt.

(3) *Are certain types of governments, revenue bases, or regions more susceptible to fiscal problems than others and why?*

Yes, most municipal problems are concentrated in cities, with the majority of those in the northeast and mid-west sections of the United States. Fiscal and economic problems often go hand in hand. Old, established cities with no room for expansion and faced with competition from the surrounding suburbs usually do not have the growing economic base to generate new revenues. In addition, the people moving into the community to replace those leaving may very well cost the community more in services than they generate in income. Increased taxes to cover the difference only succeeds in further accelerating the flight of the taxpayers out of the community. Therefore, this type of community, often found in the northeast region of our country, but by no means limited to such, is most susceptible to fiscal problems. Unquestionably, cities are bearing a disproportionate share of the nation's social and economic burdens and are fast running out of funds to support them. To become economically competitive with suburban and semi-rural areas, a complete takeover of welfare by the federal government would do much to eliminate this unjust disparity.

Other units of government are usually limited in scope to well defined responsibilities with their taxing power in most instances sufficient to meet their needs.

Where countries are concerned, they are also feeling budget pressures. However, since in most cases they have access to the higher income groups in the suburbs, part of the higher income group can be called upon to pay for the inner city burden. As examples; Essex County, New Jersey, in which the City of Newark is located; Erie County, New York in which the City of Buffalo is located.

(4) *What policy recommendations would you suggest to deal with State and Local fiscal problems that are likely to develop in the next five to ten years?*

I am not certain that I could classify these as policy recommendations but certainly the shattering of confidence of the investors in the meaning of full faith and credit caused by the federal bankruptcy legislation and the New York State Moratorium Act will cause borrowing problems at higher interest rates nationwide.

The Bankruptcy Act of 1893 currently has 15 chapters in it. To—quote—help—unquote—New York, President Ford introduced a bill to provide Chapter 16—a proceeding to permit a municipality to seek the shelter of bankruptcy. There has never been a way for municipalities to obtain the shelter from creditors that Federal bankruptcy provides. The bill is currently in conference, different versions having been passed by the Senate and House.

We have outstanding in the United States today some $220 billion of municipal debt. About $140 billion of this is tax supported—so called general obligation debt wherein the full faith and credit of the issuer is pledged. How is this full faith and credit pledged? Historically, and in most states, the fundamental security for this debt is either a constitutional or statutory requirement that the debt is secured by ad valorem taxing power.

Ad valorem—to the value of. This means that the municipality is required, in order to pay off its general obligation bondholders, to levy and raise taxes on the taxable property in its city or county to the value of the land and the buildings. This has been and is the fundamental security of most tax supported municipal bonds.

This requirement of ad valorem taxation will be abridged by this bill because the municipality will have a refuge it can seek called bankruptcy court, and bondholders can be shut off from this direct requirement of the issuer. A fence can be erected, protecting the municipality from the bondholders, a fence called bankruptcy.

Every bondholder of a general obligation bond will have something taken away from him. He will suffer a diminution of his basic security pledge.

The bill also provides for a new class of securities *senior* to the general obligation bonds in order to provide cash for maintenance of essential services. Again, the bondholders' security pledge will be short circuited.

There are other ways to see that essential services are provided in the event of default on debt repayment. Our fathers and mothers came through 7,000 municipal defaults in the 1930's without a bankruptcy court. Permitting the issuer to hide behind the protection of a bankruptcy court is *not* the answer. This bill will alter drastically the very structure of municipal debt.

The moratorium legislation passed in New York State providing for a delay of repayment of principal and smaller interest payments on $1.6 billion New York City notes is another problem area.

Without question this has to be the worst legislation passed by any state in this century. A clearer case for abrogation of contract could not be made.

Bad enough for the New York City noteholders; how about the effect of this legislation, if held to be constitutional, on other debt issuers? In New York State, catastrophic. The amount of interest payments that taxpayers in New York will have to pay in future years in order to compensate buyers for the risk that the issues they buy might also experience a moratorium if things go sour boggles the mind.

And how about other cities and states away from New York? New York case law has historically been powerful precedent for other jurisdictions. Investors can ask, if New York can get away with it, why not Colorado, Minnesota?

Court actions challenging the law have been instituted in both the state and federal courts. The state court has found the act constitutional. In my humble opinion the act is blatantly unconstitutional and will be so found to be. The noteholders were offered a substitute—a MAC 8% bond due in 11 years which we found unratable. And some 28 percent of the noteholders exchanged *irrevocably and forever* their City notes for the MAC bonds. 72 percent of the notes—$1.1 billion are, or shortly will be, in default.

So what has been accomplished by this moratorium act? It has accomplished two things. One, it has bought time, time for the City and State to get their affairs in order, budget balanced, priorities realigned. Court appeals alone can easily run a year past the due dates of the notes. And two, the passage of the act was, in my mind, a political expedient. It said to President Ford, Treasurer Secretary Simon, the Congress and the nation—look to what we will do to prevent a complete breakdown, look how far we will go!

But what of the $1.1 billion noteholders who are out there hanging in the wind? There is no provision in the three-year moratorium plan for their notes to be repaid. The MAC exchange was supported to handle that.

Hopefully this legislation will be found unconstitutional and the court may give the State and City time to enforce the ruling. This will most certainly mean a return of the City and State to Washington sometime soon. But, I submit to this Committee that this legislation must not continue on the books. It will create fiscal problem throughout the country.

Turning to other policy recommendations we should identify those municipal services that are truly local responsibilities (police, fire, sanitation, etc., etc.)

and which should, for the most part, be funded on the local level and shift the funding of services which are really the responsibility of higher levels of government (education, welfare, transportation, etc.) to the appropriate higher level with its broader revenue-raising capacity.

Other suggestions:

Direct revenue sharing to where the needs are and not on a something-for-everyone basis.

Strong efforts should be made to mandate an appropriate program of adequate funding of pension programs. I mentioned previously that Massachusetts has no funded pension program at the state level. By their estimate the amount of funding required would be somewhere between $8 and $11 billion. To attempt to fund this in the foreseeable future would cause an additional strain on the expenditure budget. There are many other jurisdictions in the country that are severely underfunded for pension liabilities. This can be a serious problem for municipalities in the next decade.

Greater federal participation in urban renewal programs.

Eliminate, as much as can be, the issuance of short-term securities to fund needs which should be financed by long term obligations.

My final suggestion would have been heresy on my part a few years ago but it is that we must search out new ways to sell municipal bonds. In business, if you have trouble selling your product, and there is no way for you to change the buyer, you change the product. The major buyers of municipal bonds have historically been commercial banks, casualty companies, and individuals. But there have been changes in the reasons why these three groups have historically been the main buyers of tax-exempt securities.

The Bank Holding Company Act of 1969 opened up a whole new set of tax shelters for banks through holding company subsidiaries qualifying for such tax breaks as accelerated depreciation and investment tax credits. Municipal bonds are no longer the only way for banks to shelter income. Indeed, bank demand for municipals has been decreasing for the last 4 years.

Fire and casualty insurance companies are taxed at regular corporate rates and therefore buy municipals to shield profits. But their purchase of state and local bonds falls sharply in years of heavy claims when they have little or no profit to shield. These sporadic investors can't be counted on to provide the investment capital which will be needed in the future.

As for individuals, the loss of investor confidence caused by the events in New York has been shattering. Some of the prices on municipals today are ludicrous—totally out of proportion with actual risk. But investor psychology has been badly hurt and will take a long time to mend.

What about the big pools of funds that municipals don't appeal to because they are not benefited by the tax exempt interest which municipals offer? Foundations, pension funds, mutual savings banks, and other low tax institutions. To appeal to them means paying more interest.

There are bills in Congress again this year providing for what is called the taxable bond option, wherein the issuer may elect to sell tax exempt or taxable. If taxable the bills provide that the Federal government reimburse the municipality anywhere from a third to 40% of the interest cost, and the IRS theoretically gets the subsidy back in taxes on the total interest.

I submit that maybe this is an idea whose time has come. The market for municipals must be broadened to make up for the loss of investor confidence and the changing benefits of tax exemption. In addition I have long believed that an issuer should have all avenues of choice open to him to select that which will result in the lowest possible cost of money to his taxpayers.

Pollution financing through industrial companies probably accounted for close to 3.5 billion of the total long term debt sold in 1975. In big industrial states like Pennsylvania there were complaints from municipal issuers that these issues sopped up a sizeable amount of the tax exempt money available. It may be time to review if this is a proper continuing use of tax exempt borrowing.

In conclusion, it should be pointed out that there are still a great many states, cities, counties, towns and agencies that have kept themselves on sound financial footings through this period of unprecedented recession and inflation. They have been able to obtain funds as needed at reasonable rates. They are continuing to control their own destinies. I would strongly oppose any Federal legislation that had as its goal a Federal takeover of state and local government financing.

Chairman MOORHEAD. Without objection, I think we had better hear from all members of the panel and then members can direct their questions to individual witnesses or to the panel generally.

Senator JAVITS. Mr. Chairman, could I ask Mr. Harries one question in view of the fact that I won't be here?

Chairman MOORHEAD. Certainly.

Senator JAVITS. Mr. Harries, one thing interests me. I notice your emphasis on the New York City, New York State, and others being out of the securities markets. Could you give us any guidance as to what kind of debt is involved here? You could answer this question by any criterion you wish to set—for example, years to maturity—so one can get an idea about the matter.

Mr. HARRIES. Senator, may I first say to you, sir, I compliment you on the testimony you gave last fall in the various committees on the New York problem.

You know I shared your views because I thought New York City could not suffer the social consequences of default. It was not until this year that the capital market was closed down to the Urban Development Corp. in February 1975 when the corporation suffered a $105 million note default. I submit to you, sir, the markets will never open to Urban Development Corp. again. They will never sell another security.

In the case of New York State, the markets must open if at all possible by April or May of this year and if my understanding is correct the banks in New York in effect have told the State that there are two requirements for them to underwrite. First, the State must provide a more permanent program to handle the financing of the State agencies, the so-called moral obligation bonds of the State, and, second, the budget must be in balance to show the rest of the 49 States so that the bonds can be distributed into the hinterlands as they usually are.

I am told that the market has a very good chance to reopen for New York State particularly on the basis of what Mr. Levitt announced yesterday, that he had had a change of mind as to the investments of pension fund moneys into so-called moral obligation bonds. As to the market for New York City securities, the market will remain closed as long as this horrible moratorium legislation that we have in New York remains on the books, as long as 75 percent of the noteholders are in default which they are now, and there is no other word for moratorium but default.

I would point out to you and remind you of some of my testimony before the Senate and House committees on the New York loan bill. If New York City permits bonds to default, or if they should default, New York City will be precluded from the market for a minimum of 20 years because there are a great many investors across the country bound by wills, terms of trust agreements, which say "thou shalt not invest in a security of any issuer that has defaulted in the past 20 years". Bond default would be crucial and devastating. The note default is bad enough.

May I add for the record we never rated New York City's notes for precisely these reasons.

I hope I have given you some timetable. New York City can do nothing in the market until the note default is cured. New York State hopefully can come back into the market in the spring.

May I stress for the record New York State's bond requirements are quite low. New York State only has $3.2 billion of general obligation bonds outstanding. Add to that another $6 billion in moral obligation which brings it up to $9 billion. Add to that the MAC requirements or moral obligation MAC bonds and we can build the number up to $12 billion or $13 billion level. The actual general obligation debt of the State is only $3.2 billion.

Senator JAVITS. Thank you very much.

Chairman MOORHEAD. Do you have any other questions?

Senator JAVITS. No. Thank you very much.

Chairman MOORHEAD. Thank you very much, Senator. Thank you, Mr. Harries.

Chairman MOORHEAD. The subcommittee would now like to hear from Mr. Roy Bahl. Mr. Bahl, anytime you want to yield to your associates we will be glad to hear from them, too, of course.

STATEMENT OF ROY BAHL, DIRECTOR, METROPOLITAN STUDIES PROGRAM, MAXWELL SCHOOL OF CITIZENSHIP AND PUBLIC AFFAIRS, SYRACUSE UNIVERSITY, ACCOMPANIED BY BERNARD JUMP AND DAVID PURYEAR, ASSISTANTS

Mr. BAHL. We have agreed that I will make a brief statement, perhaps emphasizing a few points in the prepared statement which we have already submitted to you, and I should say that——

Chairman MOORHEAD. Without objection the entire statement will be made a part of the record.

Mr. BAHL. I should say that what we have submitted is a statement of a summary of research which we have carried on under various auspices for about the past 5 years and we would be happy to supply any further detail of that that the committee would like to see.

Being fairly brief, what we would like to do today is talk a little bit about lessons from the New York City experiences. We recognize that New York City is an exaggeration and there are not other cities in this country like it, but we also think there are some valuable lessons that have resulted from the New York City, financial problem and things that might be very helpful for us to examine in considering what the next 5 to 10 years might hold for the State and local sector in terms of its fiscal behavior.

I think one has to start with the notion that there is a lot of confusion about problems in the State and local sector. For example, there is the question of whether or not there is an aggregate problem of State and local sector. Will they or won't they pile up deficits in the coming years?

There is a question as to whether or not whatever problems exist are simply extensions of the problems of the economy and with recovery these problems disappear.

There is confusion over whether the problem, if it exists at all, is widespread or limited to pockets. For example, northeastern cities.

And finally there is this question of whether or not the New York City thing was a management problem anyway and therefore not a transferrable problem to other cities.

In a nutshell our position is that the State and local sector does face serious fiscal problems in the coming year, that while recovery of the economy certainly would help the situation, by no means is it going to solve it, and that the New York City problem, while indeed complicated by financial management, was not primarily a management problem. It was no more a management problem than it was a problem of a deteriorating economic base.

With those points, what we would like to do is talk about some lessons from New York City and I think we should start by saying that we have attempted to examine whatever projections do exist on the State and local sector and we have looked at the two systematic analyses done by the American Enterprise Institute and by the Tax Foundation who are reputable groups who do very competent work, and they indeed project surpluses in the State and local sector during the coming years.

We have come at the problem another way. We have been primarily working on the problems of the local governments and in particular State governments and we would submit the following, that if we learned one valuable lesson from the New York City affair it was that you can't separate the problems of the city from the problems of the State and that a State indeed must worry about fiscal crisis faced by New York City. So following the leads of Mr. Muller's very good work for the Urban Institute, we looked at declining cities in the country, cities that are losing population as a rough approximation for cities that might be experiencing problems.

If you look at the State and local government expenditures in States where those cities are located you account for half of the total State and local governments in 1974. So at least intuitively it would seem that if major cities are going to face financial problems then the States in which they are located are going to face financial problems, and since this is half the sector, the sector as a whole must be facing some kind of a problem in the coming years.

Now, why might cities face problems? We think there are three important lessons about coming city problems from the New York City experience, that there are three factors that would underline the problems. One is the economic base decline. One is the question of inflation. And the third is——

Chairman MOORHEAD. The second one is what, sir?

Mr. BAHL. Inflation. And the third is public employment issues.

Let me take each of those in turn and briefly make the point. The economic base decline in New York City has been dramatic. Between 1969 and 1975 they lost nearly a half million jobs. We are not talking about resident jobs. We are talking about jobs in New York City.

To underline the severity of the thing, if you look at large manufacturing establishments, defined as those with more than 20 employees, for the 5-year period, 1967–72, those firms left the city at an average net rate of one each day for a 5-year period. So that is a substantial decline.

If you look at New York City's job potential, compare New York City's growth in the last 5 years to the national growth in employment, what you would find is that New York City fell short of that potential by one million jobs.

Just to give you an example of what that might mean in terms of how it translates to the public sector, in some earlier work on the city we estimated, albeit roughly, but we estimated that a job in the city lost would cost the city government approximately $800 in tax revenues. Now, $800 in tax revenues times a job potential shortfall of one million jobs is $800 million, which is roughly the size of the New York City deficit.

While these numbers are crude and we wouldn't want to live and die on those kinds of numbers, what it does suggest is that the economic base deterioration in no small way contributed to the New York City problem and one should underline that that was a deterioration very much beyond the control of the city government.

We should then worry about whether or not this kind of deterioration is likely to happen in other cities. We have examined the data of job trends in city areas and we find at least in St. Louis and Philadelphia there has been a decline. At least available data would show that. The difficulty is you can't say with any certainty for all cities because we have no data on that. The only data we have is for cities which are co-terminus with their counties. We have no other basis for making an inference. So one really doesn't know what is happening in other cities but I think one could make a reasonable point that much of the problem of New York City in terms of its inability to hold jobs is present in the core of lots of other urban areas.

My colleague, David Puryear, will talk to that later when we get to the questions.

So we think economic base decline is something that is likely to happen to other cities.

Next, and briefly on the question of inflation, and I know you talked about this a great deal, in a piece of work we recently finished for the National Science Foundation we made the following estimate, that for all State and local governments between 1972 and 1974, the effect of inflation was to drive expenditures up by about 25 percent, but the maximum it could have driven revenues up, a maximum, assuming States could have captured inflationary increase in revenue base was about 15 percent. So over that 2-year period State and local governments in the United States had about a 10-year decline in purchasing power which we would submit is a substantial decline for a government trying to buy an increasingly larger package of services.

The second point we would like to make on the inflations issue is that is in northern cities fully one fourth of the increase in expenditures over the past 5 or 6 years has been due directly to inflation. Now, inflation certainly isn't isolated in New York City and certainly inflation is a factor that is beyond the control of the city government, so there really isn't much of a policy response one can make to inflation.

The third point is the public employment issues and there are important public employment issues. New York City as late as 1972 in terms of comparable function employment per thousand population and, in terms of average wages adjusted or unadjusted for cost of living was not out of line. New York City didn't look that much different from other large cities up until 1972. To the extent it did, it did so with respect to pensions and fringe benefits and my colleague, Bernard Jump, who is an expert in that area, would be willing to talk to that.

But in general New York City did not appear to be that far out of line as late as 1972.

There are other public employment issues and we could talk about more but one interesting one is the extent to which increases in social security costs have impinged upon the city's ability to meet its expenditure obligations. This is another factor that is beyond the control of the city and another factor that may affect a number of cities.

Now, in the face of this kind of argument about what happened in New York City, that the economic base was declining, that inflation was eroding the purchasing power of revenues, that there were certain employment issues that may or may not have been under the control of the city, we raise the question of whether or not the New York City problem was essentially a financial management problem and then we raised the second question whether or not we could extend these problems to other cities.

I think the answer to the question is clearly these factors are beyond the control of the city governments and they will affect other cities and for this reason we would argue that the New York City situation is not an isolated thing that we can forget about. Inflation, social security, economic base deterioration are factors that are going to increase budget problems for other cities across the country.

We don't want to stand here today and tell you that New York City is managed as well as it could be or that there were no management problems. That certainly is not true and certainly I know we would be called on that were we to say it in any case. But you are aware of a lot of evidence on the management problems of the city.

All we would like to do is make the argument that there were other lessons to be learned. In fact, we think one could effectively argue that the management problems of New York City simply put off the day of bankruptcy, that financial gimmickry and the sort of short term borrowing that was used to keep the city afloat for a period of time really forestalled another kind of default that was coming, a default in terms of absolute deterioration of public services and a lowering of the services provided particularly to low income people in the city.

Well, having said that, let me just say very briefly what we think in terms of reform and nothing we have to say is new. It is clear that local governments particularly are going to have to tighten their belts. Federal assumption of welfare has been recommended by so many people and so many public interest groups and we certainly would second that kind of recommendation with enthusiasm, but the real key to resolving the problem at the local level probably lies with State government. The fortunes of the State are so closely tied to the fortune of the city that State government involvement particularly in the case of State assumption of social service financing is almost necessary to have a viable local government sector.

I guess in closing what we would like to say is that we don't really foresee other cities across the country becoming New York City in the sense of possible default on their debt obligations but there is more than one way to default and we think a lot of other cities across the country are apt to default that other way, that is to say, by not providing an adequate level of public service.

Chairman MOORHEAD. Thank you very much, Mr. Bahl.

I violate my own rules just to get one clarification. What do you mean by the problem of social security? Particularly in regard to New York City?

Mr. BAHL. You don't mind if we pass this around according to who works on what?

Chairman MOORHEAD. I don't want to get into long questions before we hear——

Mr. JUMP. Simply the costs involved and that fact that once a city and State have agreed to let their employees participate in social security as they do in New York, that these costs are pretty much out of the control of the city and State. Whatever the Congress decides in the way of social security costs will have to be paid by the city. The city must pay.

Chairman MOORHEAD. You are talking about the payroll tax, not the benefits received.

Mr. JUMP. That is right. Yes. That also is a problem that we can get into.

Chairman MOORHEAD. Thank you, Mr. Bahl, for your testimony and that of your colleague as well; your prepared statement will be inserted in the hearing record.

[The prepared statement of Mr. Bahl follows:]

PREPARED STATEMENT OF ROY BAHL

The Outlook for State and Local Government Fiscal Performance

I. INTRODUCTION

Even in the midst of the most serious state and local government fiscal crisis since the depression, there is disagreement and confusion about the outlook for this sector of the economy. Among the important points of disagreement are:

Will the state-local sector in aggregate face a large deficit and require a massive federal bailout?

Is this fiscal problem mostly a result of the poor performance of the economy and, therefore, one which will tend to disappear during recovery?

Is there a healthy fiscal position for the state-local sector in general but financially troubled packets within the sector, e.g., large northeastern cities?

Was the New York City debacle mostly a result of years of bad management and, therefore, not a transferable experience or forewarning to other cities?

The resolution of the disagreement surrounding these important issues holds the answer to the question of what is the proper federal government policy response.

In this brief paper, we will argue that the evidence suggests that while the fiscal troubles of only a few urban governments have been publicized so far, the list of potential candidates for trouble in the near future is sufficiently large to imply that the aggregate state-local sector may be approaching a grim if not crisis situation; that economic recovery in the next five years is not likely to resolve the problem—although such a generally welcome event would certainly mitigate the stress; and that the fundamental New York City crisis was no more the result of financial mismanagement than it was the inevitable outcome of a deep-seated economic base deterioration which is also taking hold in many other large American cities.

Throughout this paper, we draw primarily on work carried out in the Metropolitan Studies Program of the Maxwell School of Citizenship and Public Affairs at Syracuse University. (See also reference [1]).

II. THE OUTLOOK

There are not a great many systematic projection exercises carried out for the state-local sector. Two such studies with which we are familiar are those carried out by the Tax Foundation [12] and the American Enterprise Institute [11]. These projections agree in two important respects: that the state-local sector will be in surplus by 1980, and that fiscal problems will relate more to specific urban areas with 'special' difficulties. The clear implications of these findings (actually stated in the AEI Volume) is that state-local tax rate cuts are in the offing.

Though we do not have an alternative model to offer, we would like to raise several objections to the optimism of these studies. Both of these studies are competently done, but make some assumptions with which we take issue, particularly in the areas of service legal improvements and projected employee compensation rates. We also are in disagreement with the AEI model assertion that inflation will stimulate revenues more than expenditures—that finding is in direct contrast to results of our own research [5, 6]. These questions are explored in greater detail in the next section.

It seems virtually certain that states cannot long remain aloof and insulated from the problems of their local governments. Sooner or later, the result of local stress must be adverse fiscal consequences for the relevant states. And one form that such fiscal consequences would be likely to take would be state assumption of some of the costly financial responsibilities formerly borne by the cities. In table 1, we show that ever a mere sample of states containing large cities with declining populations[1] accounts for 49.7 percent of aggregate state and local government expenditures. Even without taking account of the other states containing economically troubled cities, it is difficult to be entirely sanguine about the prospects for an aggregate budget surplus in the immediate offing in the state-local sector.

TABLE 1.—TOTAL EXPENDITURES OF STATE AND LOCAL GOVERNMENTS IN STATES WITH DECLINING MAJOR CITIES (1973-74)

State	Cities	Total general expenditure (millions)
California	Oakland, San Francisco	$23,392.2
Maryland	Baltimore	4,319.2
Massachusetts	Boston	6,137.0
Michigan	Detroit, Flint	9,375.0
Missouri	St. Louis	3,447.1
New Jersey	Jersey City, Newark	7,172.0
New York	Buffalo, Rochester, Syracuse	26,228.4
Ohio	Akron, Cincinnati, Cleveland, Dayton	8,090.5
Pennsylvania	Philadelphia, Pittsburgh	10,474.3
Total		98,635.7
Total for 50 States		198,618.2
Percentage		49.7

Source: 1970 Census of Population. General Population Characteristics. Governmental Finances in 1973-74.

With the point made that one cannot properly separate urban from state fiscal problems, we would propose to turn to the very serious and important issue of the factors which underlie the city fiscal problems. The current New York City debacle has renewed attention to the serious financial problems of American cities, particularly metropolitan central cities. And as bad as the consequences of the New York City collapse are for its residents, the whole experience holds an important lesson for financial planners in other cities and for federal government policy makers. Unfortunately, the tone of present federal policy gives

[1] In the absence of employment or other more directly economic indicators of cities' conditions, declining population will serve adequately as a proxy.

every indication that this lesson will be lost, at least so far as federal help to the cities is concerned. For this reason, we use the section below to emphasize the possible parallels between the problems facing New York City and those which may be ahead for other large cities.

III. REASONS FOR BIG CITY FISCAL PROBLEMS

Four important dimensions of the urban fiscal problem must be considered in arriving at a realistic program to strengthen the financial viability of large central cities. These four interrelated elements of the problem are the declining economic base of metropolitan central cities, the effects of inflation on public expenditures and revenues, the rising cost of public service delivery, and the more purely financial management problems of cities. While all of these considerations are important in understanding what has happened to cities in general and to New York City in particular, federal government reaction to the New York City problem seems to have been focused relatively most on the more pure financial management issue and least on the problem of a declining economic base. We would like to argue that this is an incorrect emphasis and, further, that the problems facing large central cities are in large not controllable by the city governments. Hence the posture taken by this administration toward the New York City problem is not only incorrect but leads to inappropriate and shortsighted public policy.

Declining Economic Base

The New York City problem underlines the importance of relating the fiscal health of the city to the basic health of its economy [2]. Often overlooked in the current frenzy caused by the struggle to avoid default by New York City is the long-term deterioration in the city's economic base. Whether the city has been hopelessly extravagant in its spending, as some argue, or whether New York has had special problems which caused it to provide a broader range of services than is typical of cities generally, as others contend, the question remains: Why is New York less able to afford these things now than it was a decade ago? And despite the damage done recently by the combination of inflation and recession, the fundamental answer is traceable to a steady decline in the economic base which ultimately supports jobs, income, and city revenues.

From a peak of 3.8 million in 1969, employment in New York City declined by more than 11 percent to 3.4 million by June of 1975, while employment in the nation as a whole was growing by 8.3 percent. This job loss in New York City resulted from both employment reductions by firms remaining in the city and reductions in the number of firms. In fact, over the 1967–1972 period, an average of 231 nonservice sector firms closed their doors in the city each month. The decline in employees was spread across all sectors of activity; large manufacturing establishments (those with 20 or more employees) went out of business in the city at a rate of nearly one a day.

The magnitude of this employment loss may be translated into some dramatic statistics [3]. If employment in New York City had grown at the national rate between 1965 and 1974, New York City would have 1.03 million more jobs than it now has—nearly 25 percent more. The city government revenue loss implied by this job loss is substantial and goes a long way toward explaining the current fiscal gap faced by the city. An earlier study prepared by the Metropolitan Studies Program at Syracuse University estimated city government tax revenues per job to be about $820 in 1970 [4]. Assuming that an additional job in 1974 would have generated $820 in city tax revenues, New York City's unretalized job potential of nearly 1 million workers implies an unrealized revenue potential of more than $800 million. In other words, the failure of the city's economic base to grow at the national rate has contributed materially to the current revenue shortfall. And though simple extrapolations are often misleading, the decline which has occurred since 1969 would imply a loss of an additional 350,000 jobs by 1980. In turn, this implies a further tax revenue loss in excess of a quarter of a billion dollars. Although these projections are designed only to illustrate the approximate magnitude of job and tax losses, they do suggest a major decline in the ability of the city government to balance its budget. What this means is that emergency financial administration and management reforms and 'temporary' aid from state and federal governments can do little more than deal with the perennial short term crisis. Long term financial help requires a revitalization of the economic base.

While it may be appropriately noted that many of New York City's problems are unique and that New York City's situation is always somewhat of an exaggeration of what is occurring in other cities, the problem of a declining economic base is present in large metropolitan core cities across the country. Older central cities, particularly those in the Northeast, have fared worse than the newer Southern and Western central cities, but all central cities have experienced employment suburbanization as industries have moved to newer, more spread out facilities closer to their suburban employees. It is difficult to document these central city employment trends with available data because no public or private agency collects employment data for cities. The only appropriate comparison which can be made is of employment in central cities which are coterminous with counties and there are but ten in the United States.[2] As may be seen from the comparisons in table 2, New York, Philadelphia and St. Louis all experienced employment declines over the 1965–1972 period and only Denver, Jacksonville, and Nashville showed employment growth rates which exceeded the national average. If data were available for the most recent three year period, perhaps the picture would be even worse.

The lesson here is that the economic base of central cities, even those which are coterminous with county boundaries, are not growing fast by comparison with the nation. This implies that the private economy in cities will not offer a rate of growth sufficient to sustain continued rapid city government budgetary expansion.

TABLE 2.—EMPLOYMENT GROWTH IN 10 METROPOLITAN CENTRAL CITIES, 1965–72

	1965	1972	Percent growth	1972 central city/SMSA employment ratio (percent)
Baltimore	345,364	357,928	3.6	61
Denver	199,299	271,695	36.3	63
Indianapolis	267,170	308,782	15.6	89
Jacksonville	126,505	173,613	37.2	100
Nashville	139,092	183,320	31.8	90
New Orleans	212,875	235,856	10.8	75
New York City	3,120,766	3,116,479	−.1	63
Philadelphia	731,993	712,235	−2.7	49
St. Louis	357,586	350,852	−1.9	47
San Francisco	350,671	385,379	9.9	40
United States	60,815,000	72,764,000	19.7	

Source: County Business Patterns.

There is evidence that national economic recovery, while it will help both central cities and suburbs, will widen the growth gap between them. During the recession years 1969–1971, employment in the central counties of large metropolitan areas fell at an annual rate of —0.9 percent while suburban counties experienced a growth in employment of 0.1 percent. During the recovery of 1971–1972, central county employment grew 2.3 percent while suburban county employment grew at 4.3 percent. Thus, the differential in growth rates was 1 percent during the recession and 2 percent during the recovery. This disparity can only hasten the day of fiscal reckoning and if data on central city employment were available, the gap would almost certainly be even greater.

The Impact of Inflation

The generalization that inflation has been pushing up the cost of government is easily documented, but the exact impact of inflation on the central city fiscal situation is difficult to calculate. Not one of the generally available price indexes is an accurate measure of changes in the cost of providing government services. Not only are these indexes inadequate on the expenditure side of the fiscal equation, but they completely ignore the impact of inflation on revenues. Inflation increases not only the cost of goods and services purchased by local governments, it also increases the *nominal* value of many of the tax bases which support these expenditures. Inflation affects property values, the value of retail sales, the nominal level of personal and corporate income and other components of the tax base of state and local governments.

[2] This comparison also forces exclusion of government and proprietorship employment.

The Metropolitan Studies Program of the Maxwell School, under the sponsorship of the National Science Foundation has developed a set of inflation indexes which measure the impact of inflation on both expenditures and revenues of state and local governments [5, 6]. An analysis employing these indexes reveals a variety of interesting information about the impact of inflation on state and local governments.

TABLE 3.—SOURCES OF LOCAL GOVERNMENT GROWTH IN EXPENDITURES AND REVENUES, 1967–72

	Expenditures		Locally raised revenues [1]	
	States	Local governments	States	Local governments
Total growth (millions)	[2] $23,259	[2] 42,258$	$32,868	$27,507
Growth index	197.7	184.3	189.4	172.00
Inflation index	[2] 122.6	[2] 123.1	115.2	127.1
Percentage of growth due to inflation	22.2	27.3	17.5	37.4
Percentage of expenditure growth due to real compensation	13.9	17.3	(3)	(3)
Percentage of expenditure growth due to changes in input quantity	63.8	5.4	(3)	(3)
Percentage of revenue growth due to change in tax rates	(3)	(3)	37.2	39.2
Percentage of revenue growth due to other factors	(3)	(3)	45.3	23.4

[1] For local governments includes the property tax rate only. For State governments includes property, general sales, motor fuels, individual income and corporate income tax rates.
[2] Excludes intergovernmental expenditures.
[3] Not applicable.

Source: David Greytak and Bernard Jump, "The Effects of Inflation on State and Local Government Finances, 1967–74" (Syracuse, N.Y.: Metropolitan Studies Program, Suracuse University, 1975).

As the summary data in table 3 indicate, over the period 1967–1972 the prices paid by both state and local governments increased by about 23 percent. This implies that approximately one-fourth of the growth in state and local expenditures can be attributed to inflationary increases in prices and costs. Wage and salary increments which allowed public employees to improve their real standard of living (i.e., employee compensation increases in excess of cost of living increases) accounted for an additional 15 to 18 percent of expenditure growth. Finally, it is noteworthy that two-thirds of state expenditure growth and about 55 percent of local government expenditure growth can be associated with the factors we generally consider to be closely related to levels of service—the number of employees and the amount of materials and supplies with which they work.

But more important is the impact of inflation in the past few years when price increases have been more dramatic. Our analysis of the post-1972 period is restricted by the time lag inherent in the collection and reporting of data, but from the data which are available, we have calculated inflation indexes covering the 1972–1974 period for both expenditure and revenues for states and all levels of local government. (See table 4.) The two most significant results from this period are: (1) As measured by these indexes, the impact of inflation on expenditures during the two-year period, 1972–1974, was approximately equal to that which occurred during the whole of the previous five years, 1967–1972. (2) Expenditure levels were much more responsive to inflation than were revenues at both the state and local levels.

Perhaps a convenient way to convey the magnitude of stress that inflation has placed on state and local governments is to consider the implications of these findings in terms of state and local governments' purchasing power of state and local governments demonstrate vividly the severe impact of recent inflation levels. For example, if the increase in the nominal values of municipal tax bases which occurred between 1972 and 1974 had been taxed at 1972 effective rates, the revenues raised by municipalities would have increased by about 15 percent (revenue inflation index=114.6, see table 3). On the other hand, if municipalities had simply maintained 1972 levels of services and compensated employees and transfer recipients for increases in the cost of living, expenditures would have increased by about 25 percent (expenditure inflation index=125.4).

TABLE 4.—EXPENDITURE, REVENUE, AND PURCHASING POWER INDEXES AND REVENUE BASE PURCHASING POWER LOSS, STATE AND LOCAL GOVERNMENTS, 1972–74

Type of government	1974 inflation indexes (1972=100) Expenditures (1)	Revenues (2)	Index of 1974 purchasing power of 1972 revenue base[1,2] (1972=100) (3)	Purchasing power loss (millions)[3] (4)
States	125.4	113.6	90.59	$6,648
Counties	125.4	115.9	92.43	1,038
Municipalities	125.4	114.6	91.39	2,021
Townships	125.5	116.1	92.51	233
School districts	125.0	117.9	94.32	1,227
Special districts	125.7	112.9	89.82	372

[1] 1972 revenue excludes intergovernmental aid.
[2] Equal to: 100 (col. 2/col. 1).
[3] Equal to: (1972 revenues exclusive of intergovernmental aid)—[(col. 3) (1972 revenues exclusive of intergovernmental aid)/100].

Source: David Greytak and Bernard Jump, "The Effects of Inflation on State and Local Government Finances, 1967–74" (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1975).

In effect then, the result of inflation was that by 1974 the net purchasing power of municipalities' 1972 revenue bases had declined to about 91 percent of their 1972 level. Similar purchasing power losses were experienced by states and by other levels of local government.

The dollar impact of this decline in purchasing power is enormous. Between 1972 and 1974, states alone lost over $6,648 million of purchasing power. This is an amount greater than the 1974 revenue sharing entitlement. Counties, municipalities, and townships together lost about $3.3 billion of purchasing power, an amount equivalent to roughly 80 percent of their total general revenue sharing entitlement in 1974.

What this trend suggests is that few governments can long continue adding employees and raising salaries without a corresponding increase in revenues. That the inflation-induced growth in revenue potential has been falling well short of the inflation-induced growth in expenditures does not augur well for the state and local government revenue outlook if inflation continues much longer at recent rates.

However unsatisfactory the implicit responsiveness of revenue bases to inflation, the picture becomes even more grim in terms of governments' capacity to capture inflation-induced incremental revenues. To a large degree, this capacity is a function of the kind of revenue system used. Generally, property taxes are the predominant source of locally raised revenues. Despite taxable property *values'* considerable responsiveness to general inflation, most property tax *systems* are slow to capture inflation-induced increments to property tax bases and the regulations and administrative procedures under which property tax systems operate may be such that the systems will never quite keep up with rapid inflation.

This deficiency is especially likely to occur with respect to property assessment if, as is the case in most communities, reassessments are customarily made only once every few years. Moreover, though it is technically feasible to raise nominal rates enough to hold effective property tax rates at least constant even without shortening the time between full reassessments, there are institutional and political barriers that lead to lengthy lags in the adjustment process.

Rising Costs of Public Services

While the economic decline of central cities has been undermining their ability to provide public services and increasing the need for these services, the cost of providing them has been rising. Costs have risen because of the increase in the number of public employees, the increasing levels of employee compensation, and the increasing cost of fringe benefits. Unlike federal civilian employment which has been declining as a proportion of the country's total employment, state and local government employment has been growing comparatively rapidly for many years. Indeed, state and local government employment has probably been the fastest growing component of total employment in recent decades, having increased as a proportion of total employment from 7.6 percent in 1950 to nearly 13 percent in 1973. Though the state and local government sector might continue for some time to be the sector of the economy where employment grows most rapidly, recent trends suggest that the rate of growth in state and local government employment is now beginning to slow. Though such employment has grown at an annual rate of 4.2 percent since 1950, the annual growth for 1973 was 3.7 percent and for 1974 it was down to 3.2 percent [7].

Employment by large cities (that is, those with 50,000 or more population in 1970) has until recently grown at rates approximating those of the entire state-local sector. Now, however, large cities as a group have had a sharp decline in the rate at which they are increasing employment, and some large cities are now reducing employment. After growing by an average of 3.4 percent yearly between 1967 and 1972, and by 4 percent between 1972 and 1973, large city employment grew by only 0.8 percent in 1974. As a matter of fact, seven out of the 20 largest cities—New York City, Chicago, Dallas, Boston, St. Louis, New Orleans, and Phoenix—had actual employment declines in 1974 and nine—including three of the seven just noted—had declines in 1973. (See table 5.)

TABLE 5.—EMPLOYEES (FULL TIME EQUIVALENT) OF LARGE CITIES, 1967–74

	1974	1973	1972	1967	Average annual rate of increase 1967–74 (percent)
New York	395, 430	395, 640	373, 292	320, 885	3.0
Chicago	44, 416	45, 811	45, 236	39, 857	1.6
Los Angeles	44, 560	44, 038	42, 689	37, 115	2.7
Philadelphia	37, 124	36, 509	36, 890	33, 140	1.7
Detroit	27, 017	25, 371	26, 583	26, 012	.5
Houston	11, 937	11, 839	11, 520	8, 423	5.1
Baltimore	38, 103	37, 538	37, 481	34, 559	1.4
Dallas	13, 078	13, 356	12, 894	9, 657	4.4
Washington, D.C	50, 082	49, 273	49, 324	37, 474	4.2
Cleveland	13, 260	13, 084	12, 596	14, 640	−1.3
Indianapolis	9, 988	9, 589	7, 014	3, 751	15.0
Milwaukee	9, 699	9, 140	9, 388	9, 308	.6
San Francisco	21, 482	21, 046	20, 943	17, 942	2.6
San Diego	6, 801	6, 511	6, 856	4, 596	5.8
San Antonio	10, 356	9, 948	9, 359	7, 475	4.8
Boston	23, 373	23, 673	24, 765	23, 604	−.1
Memphis	22, 114	21, 227	22, 318	20, 192	1.3
St. Louis	13, 497	14, 066	14, 094	13, 138	.4
New Orleans	10, 168	10, 398	10, 958	9, 742	.6
Phoenix	6, 932	6, 940	6, 159	4, 881	5.2

Source: U.S. Bureau of the Census, "City Employment" (selected annual issues), Washington, D.C.: U.S. Government Printing Office).

The differences in the behavior of public employment for large cities compared to state and local government in general may be an indication that inflation and recession hit the public sectors of large cities harder than they hit other types of governments. The slowdown in public employment growth, with actual declines in some cities, suggests that service levels in large cities are at best holding their own. As already pointed out, it is likely that the kind of impact which such employment changes will have on the provision of public services will accentuate the decline of economic activity in these cities.

At the same time that public employment has, on the whole, been growing in the state and local government sector of the economy, so has the compensation of the average state and local government employee. Average wages and salaries paid by state and local governments exceed those paid by employers in the private sector, as they have during much of the past two decades. Moreover, average salaries in the state-local sector have been growing faster than private sector salaries. (See table 6.) Interestingly, average salaries of federal employees continue to be a great deal larger than state-local salaries, though the latter increased faster in 1973.

TABLE 6.—AVERAGE ANNUAL WAGES AND SALARIES PER FULL-TIME EQUIVALENT EMPLOYEE, 1950–73

	1973	1970	1965	1960	1950
All industries	$9,106	$7,571	$5,705	$4,743	$2,992
Private industry	8,900	7,471	5,706	3,890	2,536
State and local government	9,425	7,818	5,952	4,550	2,786
Public education	9,624	8,140	5,846	4,752	2,794
Federal General Government (civilian employees only)	12,984	10,519	7,605	5,895	3,494

Source: "Survey of Current Business" (selected July issues); U.S. Department of Commerce, "The National Income and Product Accounts of the United States, 1929–65, "statistical tables, a supplement to the survey of current business (Washington, D.C.: U.S. Government Printing Office, 1966).

Of course, labor costs are not fully accounted for by wages and salaries alone. Such supplements as retirement benefits, social security coverage, health and hospital insurance, and life insurance add substantially to employment costs. On the whole, the costs of such supplements have increased more rapidly than salaries in private industry, in state and local governments, and in the federal government [8]. Although the average cost of supplements to salaries for state and local government employees is now approaching $1,100 annually (an amount equivalent to 12 percent of the average salary), this cost is still well below that incurred by both private industry and the federal government. (See table 7.)

TABLE 7.—AVERAGE ANNUAL SUPPLEMENTS TO WAGES AND SALARIES AS A PERCENTAGE OF AVERAGE ANNUAL WAGES AND SALARIES, 1950–73

	1973	1970	1965	1960	1950
All industries	13.6	11.4	9.6	8.6	5.3
Private industry	14.1	11.7	9.9	10.6	6.2
State and local government	11.5	10.5	8.6	8.8	5.2
Federal General Government employees	10.9	7.8	6.8	6.7	5.6

Source: Same as table 6.

Although the fringe benefits identified above as supplements are often considered to constitute the full package of fringe benefits, it is important to recognize that a substantial portion of wages and salaries is actually made up of other costly fringe benefits including paid vacations, holiday pay, sick leave pay, workmen's compensation coverage, and the like. When the costs of these benefits are added to those that supplement wages and salaries, the total cost of all fringe benefits may be equivalent to more than 30 percent of pay for time actually worked in both municipalities and private industry. (See table 8.)

TABLE 8.—ANNUAL PAY FOR HOURS WORKED AND EMPLOYER COST FOR FRINGE BENEFITS, EMPLOYEES OF SELECTED MUNICIPALITIES AND ALL PRIVATE INDUSTRY, 1970 AND 1973

	Annual pay for hours worked			Employer cost of fringe benefits			Fringe benefit cost as a percentage of pay for hours worked	
	Amount		Percentage change, 1970–73	Amount		Percentage change, 1973–73		
	1970	1973		1970	1973		1970	1973
Police	$8,238	$9,574	16.2	$2,783	$3,290	18.2	33.8	34.4
Fire	7,833	9,412	20.2	2,686	3,522	31.1	34.3	37.4
Sanitation	6,300	7,064	12.1	1,844	2,419	31.2	29.3	34.2
Other general municipal employees	6,451	7,772	20.5	1,782	2,331	30.8	27.6	30.0
All private industry	6,705	8,167	21.8	1,839	2,520	27.0	27.4	20.9
All manufacturing industry	6,648	8,092	21.7	1,764	2,432	37.9	26.5	30.1
All nonmanufacturing industry	6,778	8,238	21.5	1,951	2,644	35.5	28.8	32.1

Source: Computed from data in Edward H. Friend, "1973 National Survey of Employee Benefits for Full-Time Personnel of U.S. Municipalities" (Washington, D.C.: Labor Management Relations Service of the National League of Cities, 1974), pp. 48 and 49.

Of all the fringe benefits received by employees, the most costly by far are pensions and social security coverage. Together these two account for the largest proportion of fringe benefit costs, by a margin of as much as three to one. In the large sample of municipalities for which information is available, pensions and social security take 40 cents out of every $1 spent on fringe benefits, while paid vacations, holidays, and health benefits each take between 10 cents and 15 cents.

Not only are pension benefits costly relative to other fringe benefits, they are also becoming more costly relative to wages and salaries paid to state and local government employees. Whereas state and local government retirement contributions per employee grew by 9 percent yearly between 1967 and 1972, they have increased at annual rates of above 10 percent in the last two years. (See table 9.)

TABLE 9.—STATE AND LOCAL GOVERNMENT PAYROLL EXPENDITURES AND EMPLOYEE RETIREMENT CONTRIBUTION PER FULL-TIME EMPLOYEE EQUIVALENT, 1967–74

	Payroll expenditure per employee	Retirement contributions per employee	Retirement contributions on a percentage of payroll expenditure
1967	$6,040	$415	6.9
1972	$8,750	$639	7.3
1973	$9,146	$707	7.7
1974	(1)	$804	(1)
Average annual growth rate (percent):			
1967 to 1972	7.7	9.0	
1972 to 1973	4.5	10.6	
1973 to 1974	(1)	11.4	

1 Not available.

Source: Computed from data in U.S. Bureau of the Census "Government Finance" (selected years) (Washington, D.C.: U.S. Government Printing Office); U.S. Bureau of the Census, "Finances of Employee-Retirement Systems of State and Local Governments" (selected years) (Washington, D.C.: U.S. Government Printing Office); and U.S. Bureau of the Census, "Public Employment" (selected years) (Washington, D.C.: U.S. Government Printing Office).

Although these rates of increase are substantial, it is very probable that many state and local governments are not currently setting funds aside in amounts that reflect the true rate at which pension benefits are being accrued by employees now on their payrolls. If this speculation is correct, city pension obligations could become a great deal larger. This would seem to us a matter which should be of concern to the federal government because of cities' claims that the federal government should accept a greater role in assisting them through their time of fiscal difficulty.

In a sense, retirement obligations constitute a more serious burden than wage costs and other fringe benefit costs because, to the extent that a city does not repudiate its promise to pay pension benefits to employees already on the payroll —and it is to be hoped that no employer would contemplate otherwise—a city can do very little to reduce pension costs quickly even if it begins reducing employment and puts a total freeze on wages. For example, in a 1975 study we concluded that were New York City to immediately impose salary freezes and reduce employment by two percent yearly for the remainder of the decade, its retirement costs in fiscal 1980 would still be more than $1.2 billion, an amount almost 40 percent greater than its retirement outlays for the year just ended.

Lest anyone conclude erroneously that the pension situation in New York City is merely one more reason to view that city's problems as atypical of large cities, we hasten to add that there are many other cities and some states whose unfunded accrued pension obligations are probably soon going to be proportionately more burdensome than those faced by New York City. Indeed, we call to your attention the recent publicity given to Washington,, D.C.'s $1 billion plus unfunded pension liability.

Financial Mismanagement

While these three factors—the declining economic base, inflation, and rising public employee costs—have combined to push some central cities into a financial corner, there is a tone on the part of federal policy which suggests that the problem is in large part seen as a financial management problem; that is, cities simply are not run well. This feeling that the delivery of public services could be more efficient has shown itself in a number of ways. First, the creation of Government Commissions to study and improve the productivity of public services and the effort devoted by such prestigious research sponsors as the National Science Foundation to improving the efficiency of service delivery are indications of this concern. Even the New York City government has spent considerable effort and resources in using management consultants in hopes that the complex system of service delivery could be made more efficient. In fact, we have not progressed very far in our understanding of how we might substitute capital for labor to improve the productivity of service delivery in a local public sector. In fact, we are not even close to agreement on how one measures such increments in productivity. One might reasonably hypothesize that the net effect of this interest in improving service delivery efficiency has been to divert attention away from the issue of service delivery equity.

A second kind of evidence which suggests federal government preoccupation with management issues is the administration response to the New York City situation, where recent federal government intervention was contingent on the city first putting its own house in order by means of both tax increases and expenditure reductions. The fact that New York City taxes are apparently already measurably higher than those in the rest of the country [9], and that the problems of the city may not even be primarily of its own making, are forgotten or at least underemphasized issues.

In fact, the potential for limiting the growth in government expenditures in New York City as well as in most of the major cities in this country is extremely limited. Most city government expenditures are 'uncontrollables' in that they are not easily cut back—at least in the very short run. The loss by New York City of access to the money and capital markets demonstrates in vivid fashion that commitments to spend for debt retirement and interest payments are irreversible. So, too, are commitments to pay retirement benefits to public employees. With the exception of debt service outlays, nonlabor current operating expenditures—items such as power costs, gasoline, and most equipment and supplies—neither loom large as a proportion of most cities' budgets nor do cities have a great deal of control over increases in the costs of such items. Hence we are left with the personnel component of cities' budgets as the most logical area where cost savings can be made. But if more than nominal reductions are made here then there may be severe repercussions both for local economy and for the level of services delivered to the inner-city residents. In short, the flexibility to manage the growth of expenditures in the very short run is limited and the pressures for cost increments are generally outside the control of the local government. What this suggests is three avenues or strategies for long term reform: a no-growth budget policy for many cities, an increased role of financial assumption by state governments, and a realistic federalism.

IV. THE POLICY OPTIONS

The magnitude of the state-local fiscal problem suggests that remedial policy must involve all three levels of government. What we see as needed for the near term future are austerity budgets at the local level, increased state government financing involvement, and hopefully, yet another new federalism.

No-Growth City Budgets

To the extent central city fiscal problems stem from the process of economic decline, cities are suffering from problems that afflict all 'mature' economies and the best solution may be simply to concentrate on the problems of adjusting to the new reality of a slower growth. Recent trends in population growth in the United States suggest that employment growth will be slowing throughout the country and that the national economy will have to adjust to this slower rate of growth. In that core cities are growing slower even than the national economy, they are doubly damned in that their budgets will have to reflect an even more stringent measure of control than those of governments in other parts of the country.

The primary form which this adjustment will take is likely to involve changes in the level and mix of public expenditures. Planning for future growth will be replaced by planning for the conversion to a stable or very slow growing economy. The first place this retrenchment will be felt is in the area of capital spending where cities will have to postpone those kinds of capital expenditures which are effectively luxuries—e.g., municipal recreation or auditorium facilities, street system improvements, municipal public buildings. The curtailing of other kinds of capital projects, improvements to sewer systems, delaying the construction of new school buildings, etc., will no doubt also be called for. Together, these kinds of actions will reduce the debt service costs of city governments which, with the real possibility of rising interest rates, will be a substantial saving.

The other element of no-growth planning has to do with the negotiation by the city government with public employee unions. In the long run, central city governments simply cannot afford to continue granting the kind of wage rate and fringe benefit increments which they have in the past—no matter how fair or unfair such increments may be. However, the overall slowdown in the national economy may suggest that even with slower rates of increment in public employee compensation, parity with the private sector may be maintained. At any rate, it would appear that there is need to centralize the collective bargaining process at the state level, and to create some form of wage and benefit guidelines for public sector employees.

This economic and fiscal retrenchment has potential dangers because too severe a curtailment of public sector activities may well exacerbate the growth problem. However, there are some potential advantages to the slowdown if the state is able to mobilize its resources to take advantage of the opportunities. The problems of traffic congestion, environmental decay, and housing shortages are three examples of areas in which a period of slow growth, once the state and local economy has adjusted to it, can provide a necessary breathing space.

State Government Subsidy

A second element of answering the longer term needs of central cities is the increasing of state financial assistance to city governments. If one takes the lesson of the New York City experience and looks ahead to potential solutions to the city financial problems in general, the most apparent reform will be increased participation by the State Government in the delivery of urban government services. In the case of New York City, perhaps the most viable solution to its problems is to turn the city into a Cleveland, that is to say, a city which has minimal responsibility for the delivery of social service functions. However, state assumption of primarily the welfare, education, and health-hospitals function brings to the forefront a new set of financing and equity issues. First of all, it means that state governments will have to search for new resources since state assumption inevitably involves cost increments. As some of our recent work has shown, unless the proper choice of tax instruments is made, such state assumption may be accompanied by unfavorable income distribution consequences, i.e., if sales taxes are chosen as the financing mechanism over the income tax alternative, tax burdens on the urban poor may rise as a result of state assumption [10].

A second problem is the possibility that state governments may not adequately recognize the particular social service needs of the urban poor who tend to be clustered in the central city. In state legislatures where the suburban-rural dominance is important, this problem may loom very important.

Over and above these issues is the financial difficulty in which state governments are increasingly finding themselves. For inflation, rising public employee costs, and increased service demands are all factors which have affected state as well as city governments. Again, in the highly urbanized Northeastern states where the economic base has grown slow relative to the rest of the nation, and where tax effort is already high in most cases, it is not clear that such expansions in government resources are feasible or possible. In these cases, the no-growth budget policy again becomes a real consideration. Certainly state government capital expenditures will have to be curtailed and it is likely that stringent controls over public employment costs will have to be maintained. With such financial pressure on state government budgets, the assumption of social service financial responsibilities from cities will not be made with great enthusiasm and the maintenance of social services at adequate levels in central cities is doubtful.

The Need for a New Federalism

What the above suggests is that with a slowdown of the growth in the national economy, there also will be a slowdown in the growth of the state-local sector. An important implication of this pattern is the possible curtailment of social services in the central cities, a restriction on public employment compensation growth, and likely increased tax burdens on the urban poor. Even so, state and local governments will be strained to remain financially viable. These factors together suggest the need for a realistic new federalism, not one that focuses on improving the efficiency of federal aids by consolidation or amalgamation but one which recognizes the serious income distribution consequences of what lies ahead for the nation's cities. Full federal assumption of welfare costs would be a first step in this direction. An increased and realistic allotment of revenue sharing monies but under a formula which recognizes the particular problems of central cities would be a second element of such a federalism.

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Chairman MOORHEAD. We would now like to hear from Mr. Muller.

STATEMENT OF THOMAS MULLER, DIRECTOR, EVALUATION STUDIES, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. MULLER. Thank you, Mr. Chairman.

It is my view that to project or estimate the fiscal outlook for State and local government in the coming years, one needs to initially note the regional shifts in populaton, employment, and income which have been taking place in recent years. These shifts have hurt some States and cities and helped others. It is not generally realized that between 1973 and 1975, every State in the Northeast and Northcentral States—these two regions comprise one-half our Nation's population—with two exceptions, the States of Maine and New Hamphsire, had either no net migration or out-migration.

Net out-migration from these two regions included over 2½ million people in the last 5 years. At the same time, the States in the South and West, with only three exceptions, gained population through in-migration from the North, Central and Northeastern States. This is a unprecedented North to South movement.

The tabular information provided in my written testimony shows that in the 1960's, Illinois, New Jersey, and Connecticut attracted people from other parts of the country. This trend has been totally reversed in the 1970's. In the case of Connecticut and New Jersey, it appears that New York City's economic problems have affected the two States on its immediate periphery.

As Mr. Bahl indicated, employment growth has been extremely low in the Northeast and Northcentral States. In fact, between 1969 and 1974, in the Middle Atlantic region the States of New Jersey, New York, and Pennsylvania collectively had an absolute drop in private employment. There were fewer people working in these States in the private sector during 1973 than there were in the prior 4 years.

Illinois also shows a slight absolute decline in private employment despite the fact that there are additional young persons entering the labor market.

Between 1969 and 1974 the South Atlantic States have increased private employment by 26 percent, the South Central region by 19 percent, and the Mountain States by 33 percent.

So we have substantial shifts in the location of jobs as well as people which can be considered a chicken-and-egg problem. People move where there are jobs and jobs move where there are people. This is not a new phenomenon in our Nation, but one should appreciate that this movement is more intense than at any other time in recent decades.

The combination of out-migration of families, particularly from cities in the Northern States and the change in the birth rate will mean that during the 1980's there will be fewer people between the age of 17 and 25 entering the job market. This will mean that a disproportionate number of the aged and the very young, who require social services, will be concentrated in those States and cities which have an economic decline, a demographic phenomenon which is beyond our control.

Turning specifically to fiscal matters, there is little doubt that the Western and Southern States, because of a continuous gain in personal income and employment, are less susceptible to the type of fiscal problems that are faced by cities in the Northeast and Midwest. The problem seems to be concentrated in the so-called "manufacturing belt", in part because manufacturing employment has become a less important element in our economy than in previous decades.

However, one should not attribute the more stable fiscal situation in the South and West simply to gains in private employment. There are a number of other factors which are causing the fiscal disparity between these regions and the Northern parts of our Nation.

One factor is that most large cities in the South and West, such as San Diego, San Antonio and Houston, annex substantial areas contiguous to their political boundaries and thus are able to capture within their borders middle income households and business firms who typically locate outside the political boundaries of our high density cities in the Northeast and Northcentral States, where most large cities are fiscally fenced in by incorporated suburbs.

A second important factor is that wages and benefits of municipal workers in almost all Southern States and many Western areas are substantially below the level of the northern regions, which essentially means their municipal payrolls tend to be lower. There are also fewer public employees per capita in many areas of these regions, resulting in lower State and local taxes.

In part, the wage differences between regions in the public sector reflect regional differences in the cost of living. A typical intermediate family in 1974 living in the Boston or New York regions needed 30 percent more income than the same household living in Houston, Nashville or Orlando to maintain a similar living standard. This difference in the cost of living itself is attributable to a substantial degree to differences in the cost of local and State government. For example, personal income taxes for a typical family, which includes Federal State, and local income taxes, averaged approximately $2,800 in Boston and New York, and about $1,380 in Houston, Nashville and Orlando. Income taxes alone account for $1,500 difference for a family earning $13,000 to $16,000.

In housing there is a cost difference of over a $1,000 for this prototype four-person intermediate family. The housing cost differential is due in part to differences in property taxes, as much as $1,000 between Boston and Houston, and differences in the cost of heating and maintaining a housing unit. This of course, is again linked to differences in both climate and the local cost of energy.

We find is that one can explain a good bit of the difference in the cost of living between the regions of country simply by estimating differences in the cost of providing State and local public services.

This situation will in the future lead to even more migration because the cost of living differentials are greater than wage differentials. What this means is that a family living in a northern State, if it moves to much of the South, can accept a decrease in wages of, let's say, 15 percent and still be better off than living in one of the large cities of the North, particularly in Massachusetts or New York.

Thus we see the public service costs as one element in the current migration pattern.

Within our metropolitan areas the movement from the central city to the suburbs, not limited to any particular region of the country, has accelerated since 1970. During last 5 years the net movement of households from central cities include 7 million persons. In other words, 7 million more people left our central cities than moved back into the cities. This is the largest annual rate of migration that we know of since the census has been tabulating these type of data, and it is not limited to middle income whites. The middle income blacks, are perhaps leaving cities as rapidly as middle income whites.

The second question that the committee asked in its correspondence is: What type of government is more susceptible to fiscal problems now faced by many cities?

In my view, size itself is a factor. We generally find that smaller cities, regardless of where they are located, be it the West, the North or the Midwest, seem to be in a better fiscal shape. This is because outlays for public services on a per capita basis tend to be lower, while income doesn't vary much between large and small cities. This means that the tax burden for a typical houshold is lower in our smaller cities or townships compared to large cities outside the South.

At the same time, smaller communities appear to respond more quickly to economic changes affecting the fiscal status. They seem to have more mobility to respond. In a large city, bureacratic and other reasons cause a lag in the response of local government result in a drop in revenue and reduced outlays.

The third variable seems to be the degree to which local government can increase long-term borrowing or add new taxes without the approval of the State legislature or its own electorate. It appears that where local governments have to obtain approval to borrow or to increase taxes, they tend to be, not suprisingly, more fiscally conservative. I believe this is one factor why many cities which can borrow without having to go to the electorate have excessive debt.

We also find that where we have had city-county consolidation, as in Indianapolis, Jacksonville and Nashville, there are fiscal advantages which are similar to those of cities as in Texas which undertake large-scale annexation of semi-rural areas as a part of the city, thus insuring its future tax base.

Finally there is a question regarding the revenue base. Is there any relationship between the revenue base of a community and its fiscal posture?

The main difference which I find is that smaller cities depend much more on the property tax than large cities. Cities which have less than 50,000 residents obtain approximately three-quarters of their tax revenue from the property tax. As a city's size increases the number of taxes imposed on residents and business appears to multiply. Having a broad tax base by itself, although it has distribution implications, does not appear to be particularly helpful to assure the economic wellbeing of a city. Broadening the tax base by itself doesn't appear to be a particularly good option to maintain fiscal stability.

Finally, and let me turn to the outlook for local and State government, It is well recognized that from the mid-sixties on to the early seventies, municipal wages and fringe benefits—and we have a gentleman to my left who I am sure can speak more about this issue than I—surpassed wages in the private sector in most places in the country with the possible exception of the South. It is my view that the gap between private and public sector wages will not increase and will probably narrow in the next 5 or 10 years. The number of municipal workers, with few exceptions, increased in the early sixties and seventies, even in cities and inner suburbs which had absolute declines in population, I believe this trend will be reversed. Cities will have to adjust their payroll and their level of public employment to reflect the reduction in private jobs and population declines.

The ambition of State and local governments in the coming years, even after the economy recovers, will be to control the expansion of State and local payrolls at a rate consistent with the expansion of State and local revenue, that is, without the imposition of major new taxes. I believe this will become an overriding objective. Given the current mood of the electorate, pressure to maintain such a policy, essentially to avoid tax increases, will be with us for a long time.

However, even constraining municipal payrolls is an insufficient fiscal remedy, for some central cities where the increasing demand for social services from households below the poverty level makes budget balancing without severe effects on these programs an unrealistic near-term goal. However, the suggestion made by Mr. Bahl of total State takeover social function perhaps may not be as effective a solution as it appear. For example, about half of New York State revenue is derived from New York City. Thus, even if the non-Federal share of welfare is shifted totally to the State, for every dollar which the State pays out, about fifty cents has to come from New York City residents. A similar situation exists in any State where central cities form a large share of the total population. When one shifts expenses for services to the State level, this results in taking part of the same dollar out of one pocket in and putting it into another pocket of the same jacket.

While it is true the suburbs tend to be more affluent and tend to contribute substantially to the State tax base, simply shifting the burden to the State is only a partial solution, since many inner suburbs and smaller cities have fiscal problems.

I will not discuss the various municipal danger signals that we have examined but let me note two or three, and then conclude my remarks.

Substantial long-term out-migration, the movement of people out of a community over, a 10 or 15 year period. An absolute loss in private employment is a second danger sign. High local tax burden and an increasing proportion of population comprised of low income households are other adverse factors.

These municipal danger signals are interrelated. One follows the other; high per capita debt, high unemployment, and inability to annex can be added as other factors.

We have a situation in many cities where it takes, for example, in New York City 62 municipal and State workers, for every 1,000 in population to provide services. In the District of Columbia, adding State functions as in New York City, it takes 76 people to provide services for every 1,000 District residents. Having a municipal payroll this large means that a substantial share of total personal income, as much as 13 percent to 14 percent has to be allocated to meet public sector payrolls other than Federal employment. It is my view that the rate of increase in the local and State payrolls will have to stabilize to maintain fiscal solvency. This could be one factor in stabilizing migration.

In terms of any specific recommendations let me add one general statement. The regional changes which I briefly described are attributable to a number of forces such as preference of people to live in more temperate, less congested, aesthetically attractive areas. These causes, combined with lower costs of living, lower taxes, and increased employment opportunities, are the major factors which are causing inter-regional movement. While certain Federal policies do encourage this migration, it would be unreasonable to argue that public policies are the underlying cause for regional changes taking place.

For this reason, public actions to reverse the current regional movement are unlikely to achieve such an objective. If one accepts the premise that we will continue to have a shift of people, jobs, income, and wealth among our States, then we need policies which will facilitate this transition and improve the economic well-being of those remaining behind; particularly the less educated, very young, or very old.

The only specific comment in terms of policies which I would suggest is to reexamine the distribution of Federal employment, both in terms of defense contract employment and civilian and military employment. If one looks at these Federal payrolls as a percentage of total income, one finds that in New York State these payrolls comprised only 3 percent of all personal income in 1974; Arizona 10.3 percent; Texas 10.6 percent; North Carolina 12 percent; and in the State of Washington 10 percent of personal income is derived from Federal employment. We find that the States with substantial outmigration such as Michigan, Illinois, and Connecticut, have a very small federally sponsored employment and very low direct Federal employment. This disparity works to the disadvantage of the States which are losing jobs in the private sector.

We could also modify our revenue sharing formulas in a manner which would not work to the disadvantage of communities losing population by using the 1970 population as the base for calculating revenue sharing for those cities or States which had absolute loss of population since that year. Thus, a city would not be penalized for losing the very people who contribute most to its own tax base.

Thank you, sir.

Chairman MOORHEAD. Thank you, Mr. Muller. We appreciate your highlighting your testimony and without objection your prepared statement will be made part of the hearing record.

[The prepared statement of Mr. Muller follows:]

PREPARED STATEMENT OF THOMAS MULLER

REGIONAL SHIFTS AFFECTING THE FISCAL POSTURE OF CITIES AND STATES

Regional shifts in the early 1970s have had, and are likely to continue to have, a considerable impact on the fiscal posture of the Nation's cities and states, helping some and hurting others. Among these shifts are regional redistributions of population, employment, income, and wealth.

Between 1973 and 1975, all states in the Northeast and North Central regions, with the exception of Maine and New Hampshire, had either no net migration movement or outmigration.[1] Net outmigration from these regions included over 2.5 million persons during the last five years. Concurrently, all states in the South and West, with the exception of Delaware, Louisiana, and Maryland, gained population from immigration as well as from natural increase.

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[1] In the states of Vermont, Wisconsin, and Minnesota immigration offset outmigration.

TABLE 1.—NET MIGRATION 1960–70 AND 1970–75 SELECTED NORTHERN STATES

[In thousands]

State	Population (1970)	Migration 1960–70	Migration 1970–75	Migration 1970–75 as percent of 1970 population
New York	18,242	−212	−554	−3.0
Pennsylvania	11,794	−398	−238	−2.0
Rhode Island	915	6	−45	−4.7
Connecticut	3,032	204	−25	−.8
New Jersey	7,168	454	−44	−.6
Massachusetts	5,689	56	−24	−.4
Ohio	10,657	−136	−291	−2.7
Illinois	11,114	88	−369	−3.3
Michigan	8,882	0	−141	−1.6
Total		62	−1,731	

Source: Migration for years 1970–75 Bureau of the Census, population estimates and projections. 1974–75 estimates by author based on 1975 population estimates by State from Bureau of the Census.

As shown in Table 1, the direction of migration since the 1960s has been reversed in a number of Northern states including Illinois, Massachusetts, and New Jersey.

Employment growth, shown in Table 2 has been low in the Northeast and North Central states between 1969 and 1973. A few major industrial states show no employment change and, in the case of New York, an absolute decline.

The combination of outmigration, concentrated among persons in the 18 to 34 age category, and reduced private employment growth caused personal income to rise only slowly in these areas, in contrast to most areas of the South and West, where it has been substantial. Outmigration, combined with a slowdown in the natural increase of the population 14 to 20 years of age due to reduced birth rates, will result in a disproportionate number of aged and the very young requiring social services in states with population declines.

TABLE 2.—*Change in employment, 1969–73*

Regions:	
Middle Atlantic States	1.7
South Atlantic States	17.4
East-South Central States	16.2
East-North Central States	4.5
Mountain States	24.7
States:	
Illinois	0
New York	−.8
Pennsylvania	2.5

The gains in population, employment and income at the state level is reflected in most urban centers in the South and West. There is little doubt that these regions, due to increases in personal income and employment above the national average, are less susceptible to fiscal problems faced by many cities and some states in the Northern manufacturing tier. However, the stable fiscal situation in the South and West is attributable to more than location and expanded employment. Larger cities in these regions, including San Diego, San Antonio, and Houston tend to annex substantial areas contiguous to their political boundaries and thus are able to "capture" within their municipal limits middle income households and business firms typically locating outside the political limits of most high density Northeastern and East North Central cities which are fiscally fenced in by incorporated suburbs. Since wages and benefits for municipal workers in almost all Southern and many Western states are substantially below the level of other regions, municipal payrolls tend to be lower.[2] Outlays for mass transit are minimal, except in the San Francisco region, and the infrastructure is relatively new, thus requiring low maintenance.

[2] California is among the major exceptions to this pattern.

TABLE 3.—COST OF LIVING—INTERMEDIATE BUDGET—4-PERSON FAMILY (AUTUMN 1974)

	Total budget	Food	Housing	Personal income tax [1]
Boston	$16,725	$3,829	$3,707	$2,839
New York	16,648	4,099	4,072	2,757
Chicago	14,797	3,563	3,492	2,041
Kansas City	13,939	3,531	2,894	1,876
Houston	12,872	3,403	2,605	1,373
Nashville	12,996	3,241	2,883	1,391
Orlando	12,804	3,240	2,809	1,357
Denver	13,606	3,374	2,804	1,854
Urban United States	14,333	3,548	3,236	2,010

[1] Including Federal, State, local income tax payments.

Source: U.S. Department of Labor.

There are substantial regional differences in the cost of living as illustrated in Table 3. The cost of providing for a typical household in Boston and New York areas is almost 30 percent higher than in Houston, Nashville, or Orlando metropolitan areas. The cost of housing and personal income taxes (not levied in Florida or Texas) accounts for most of the differential. To a considerable degree, housing costs reflect property taxes and energy costs both substantially lower in the South. Since the cost of living differentials are greater than wage differentials, an expansion in employment opportunities may increase the rate of migration from Northern states. Such an influx itself can be expected to raise the cost of living in growing states.

Within metropolitan areas, the movement from central cities to suburbs and ex-urban areas appears to have accelerated in recent years. Between 1970 and 1975, the net movement from central cities included more than 7 million persons. This outflow was concentrated among the 20 largest central cities, including New York, Chicago, Los Angeles, Detroit, and Cleveland. While these are signs that a reverse movement of young, middle class households to some central cities is taking place, this movement is usually more than offset by middle income white and black families with children leaving the urban center. Outmigration to the suburbs appears to be increasing the intra-metropolitan income gap, particularly in the Northeast. This will add to the fiscal woes of these cities.

EFFECTS OF POPULATION SIZE, GOVERNMENT STRUCTURE AND THE REVENUE BASE ON FISCAL STABILITY

Smaller political jurisdictions tend to be more stable fiscally compared to more populous cities, regardless of their form of government, for several reasons. Since outlays for public service, on a per capita basis, tend to be lower, while average per capita income shows little change, tax burdens are below the large city average. Smaller communities also appear to respond more quickly to economic changes affecting their fiscal status. Large cities tend to have a strong executive form of government. However, it is not apparent that the formal organization of local government has a significant effect on the type of response to fiscal problems. The degree to which local government can increase its long term indebtedness, add new taxes, or increase tax rates without approval of the state legislature or its own electorate is likely to be a more important factor in maintaining fiscal solvency than the type of government.

In states where counties provide most municipal services, such as in Maryland and Virginia, their fiscal status appears generally more sound than in states dominated by multiple political jurisdictions. This is not attributable to scale economies, but the absence of concentrations of low income households in small municipal enclaves. City-county consolidations, including those in Indianapolis, Jacksonville and Nashville have fiscal advantages similar to those found in cities which have undertaken large-scale annexations, which essentially incorporate most of the contiguous urbanized and semi-rural areas.

There is a relationship between the revenue base of a city and its population size. Smaller municipalities depend primarily on property taxes. Thus, 76 percent of all local tax revenue for communities with 50,000 or less residents are from levies on property. As city size increases, the number of taxes on residents and business appear to multiply. However, a broad tax base, although it has distributional implications, is usually unrelated to a city's economic well being. The property tax has proven to be a stable source of income in recent years, since residential property, particularly owner occupied housing, has risen in value more rapidly than income. However, various exemptions may be eroding this major source of local revenue.

State governments are increasingly reluctant to permit municipalities to levy additional sales and income taxes which would compete with their major revenue source. Even if the absence of statutory barriers, increasing the existing tax rates or adding of new revenue sources which increase the overall tax burden is likely to be strongly opposed by residents. In many states, such as Massachusetts and New York, tax increases may be necessary, in the short run, to maintain fiscal solvency. However, their imposition is likely to have adverse long-term economic effects.

AGGREGATE OUTLOOK FOR LOCAL GOVERNMENT

The overall fiscal outlook for local government will depend on their ability to (1) balance increases in municipal payrolls with growth in revenue without the imposition of new taxes, and (2) limit increases in debt to the expansion of the tax base.

Many local as well as state governments initiated a number of fiscal measures during the current economic downturn. Municipal wages and fringe benefits, which surpassed the private sector during the 1960s and early 1970s, were curtailed in many instances during 1975. One can anticipate that the gap between private and public sector wages will not increase, and probably decrease in the next 5 to 10 years. The number of municipal workers, with few exceptions, increased in the 1960s and early 1973 even in cities and inner suburbs which had absolute declines in population. This trend is likely to be reversed. However, cities and metropolitan areas experiencing growth are likely to expand their public sector more rapidly than their population.

Education personnel are most vulnerable to reductions in staff size because demographic shifts are causing enrollment in all but rapidly growing communities to decline, while dissatisfaction with many public school systems is on the rise. The few larger cities, such as Cincinnati and New York, which are presently providing higher education at their own expense are negotiating or already in the process of turning over this responsibility to the state. Demographic changes may, however, reduce juvenile crime incidence and thus limit the recent growth in the rate of public safety employment.

Controlling the expansion of state and local payrolls at a rate consistent with the expansion of revenue without the imposition of major new taxes will be an overriding objective of most local and state governments even after the economy fully recovers. Given the current mood of the electorate, pressure to maintain such a policy will be strong, even if this has an adverse effect on social programs partially financed from local revenue. However, the constraining municipal payrolls will be an insufficient fiscal remedy for some central cities, where an increase in demand for services from households below the poverty level makes budget balancing an unrealistic near-term goal. A number of such cities, including those controlled, to some extent, politically by minority groups, will have difficult choices, caught between budgetary constraints and increases in social needs of their residents. In many instances, even a total state take-over of functions such as welfare provides little relief. For example, almost half of New York State revenue comes from New York City. Thus, for every additional dollar collected by the state to shift present program responsibility, 50 cents will be paid by city residents.

A number of municipal fiscal danger signals, identified in a previous Urban Institute publication, are listed in the subsequent section.

MUNICIPAL DANGER SIGNALS

Substantial long-term outmigration (in excess of natural population increase).

Absolute loss in private employment, or only minor gains even in periods of national economic growth.

High local tax burden (7 percent or more of personal income) and an increasing tax burden gap between the central city and its suburbs.

Increasing proportion of population comprised of low income households.

Substantially lower gains in per capita income than the metropolitan area or state.

Other factors, which usually correlate with the above list, include the following:

Inability to annex, consolidate or otherwise share in the regional tax base.

Debt service above, or close to, $1,000 per capita.

High unemployment.

Large concentration of employment in manufacturing.

Large cities with declining populations which have most of these adverse characteristics include Buffalo, Boston, Cleveland, Detroit, New York, Philadelphia, and St. Louis. Cities with a decline in population and several of the above factors include Cincinnati, Chicago, Baltimore, Pittsburgh, New Orleans, San Francisco, Milwaukee, and Seattle. However for numerous reasons, their fiscal outlook appears more favorable than those in the initial list. A number of smaller cities, such as Newark, New Jersey, are also in the danger category.

POLICY RECOMMENDATIONS

Regional changes, briefly described in my earlier comments, are attributable to a number of forces, such as preference of households to reside in less congested, aesthetically more attractive areas, many located in temperate climates. Lower living costs, lower taxes, increased employment opportunities, and higher levels of education are among factors which transform stated preferences for residing in areas with perceived higher quality of life to actual household relocations. While certain federal and to a lesser degree state policies encourage this movement, it would be unreasonable to argue that public policies are the underlying cause for regional change. By the same token, public actions to reverse current regional and intra-metropolitan flows are unlikely to achieve such an objective. Equally important, an effort to reverse the present trend would be extremely costly and could well have an adverse effect on the national economy. If one accepts this premise, then policies need to be shaped which will facilitate the transition, and improve the economic wellbeing of those remaining behind. Even our most economically depressed cities are likely to survive, although their traditional role as centers of urban activity will diminish. Their population, following several years, or perhaps another decade of outmigration, will stabilize, although it is difficult to predict at what point in time a balance between those leaving and entering will take place. Among policies to improve the fiscal status of some declining urban areas, briefly noted, are an increase in federally-controlled employment and modification of present revenue-sharing formulas. Whether creating public jobs at the municipal level is more advantageous than creating private sector employment, even if subsidizes, is questionable. In fact, there is some question whether an expansion of the public sector beyond its present size to the level of such nations as Great Britain or Sweden is either economically sound or politically acceptable.

TABLE 4.—EMPLOYMENT DIRECTLY ATTRIBUTABLE TO SELECTED FEDERAL ACTIVITIES, 1974

[In millions]

State	Defense contract payrolls	Federal, civilian, and military payrolls	Total federally generated payrolls	Personal nonfarm income	Payroll as percent of income
Connecticut	78	454	532	19,980	2.6
Massachusetts	299	1,036	1,335	33,354	4.0
New York	472	2,842	3,314	111,220	3.0
Pennsylvania	787	2,081	2,868	64,100	4.5
Michigan	266	990	1,256	52,850	2.4
Illinois	592	1,887		67,700	3.7
Arizona	361	736	1,094	10,649	10.3
Texas	2,213	3,925	6,138	58,151	10.6
North Carolina	928	1,928	2,856	23,726	12.1
Washington	676	1,354	2,030	18,760	10.8
New Mexico		543		4,484	
Hawaii	624	977	1,601	4,995	32.1
United States total	24,859	58,134	82,993	1,118,585	

Redirecting Federal Outlays

As shown in Table 4, defense contract payrolls, as well as federal civilian and military payrolls, are concentrated in growing states, while in states with substantial outmigration, such as Michigan, New York and Illinois, personal income from this source is substantially below the national average. For example, payrolls from only 2.4 percent of all personal income in Michigan, 10.6 percent in Texas. The present distribution of federal employment is attributable to many factors—economic, geographic and political—which results in the current concentration of federally-aided or sponsored facilities in certain states. Redirecting some federal employment and contracts, urban areas to more closely reflect their share of the national population could improve the economic posture of declining areas. However, such a policy would require careful examination, since it has potential adverse effects. In many cases, the cost of producing goods and services is likely to increase. An area would have to be economically competitive for such a system to work. Previous federal attempts to concentrate employment in depressed area appear, in retrospect, to have been less than successful.

Adjusting Revenue Sharing Formula

Two adjustments could redirect a share of general revenue sharing to cities or states with particularly serious problems—increasing or eliminating the 145 percent ceiling on aid to any local jurisdictions, which reduced the amount of aid received by a number of large cities with population decline, including Baltimore, Richmond, and St. Louis.

A second proposal is to use the 1970 population as the population base to allocate state and intrastate revenue sharing aid for states and those jurisdictions with a population of 10,000 or more which had an absolute *decline* in residents during the previous five years. For other states and jurisdictions, the most current population statistics, as is presently the case, would be utilized as one of the basis for computing revenue sharing funds. The second proposal would increase the level of revenue to declining cities even if the current ceiling were to remain in effect.

Chairman MOORHEAD. Let me first congratulate the panel for not focusing exclusively on the problems of New York. The problem there is now really in the hands of the legislative and appropriating committees and this committee is looking further ahead. We are more of a study committee, trying to anticipate problems that legislative and appropriating committees may face in the future.

However, having said that, I did want to see if I could clarify one point that you made, Mr. Harries, about the New York situation. You seem to—if I heard you correctly—lay great stress on the problem of short term financing in New York City. Am I correct on that?

Mr. HARRIES. Yes; that is correct.

Chairman MOORHEAD. Which may or may not apply to other cities across the Nation.

Mr. HARRIES. Oh, I certainly hope it does not apply. We know of no city or State in the country that was permitted to accumulate the amount of short-term debt that New York City did. But I must say that that is the modus operandi in New York. The State itself will come to the market in April or May and borrow $3 billion to $4 billion of revenue anticipation notes. This money will then be given to the various school districts in the State, on a per capita formula, for education, welfare, et cetera, and permit them to operate during the year. The State pays those notes off with money coming due each year through the State income tax and sales tax. That is not the normal practice in other States.

Chairman MOORHEAD. And it doesn't moderate your list of danger signals, Mr. Muller. I don't particularly know, other than you mention of debt services, the problem of short term financing.

Mr. MULLER. That is correct, and it is for the same reason that Mr. Harries noted and that is that typically local governments do not depend on short-term debt except when there is a shift in the economy and we will know that, for example, in fiscal 1972 and 1973 most cities accumulated a surplus which in many cases was used in fiscal 1975 to offset deficits.

Let me cite the city of Richmond, for example, which accumulated a substantial surplus in 1973 and 1974. It fell short by $7 million or $8 million in this last fiscal year but was able to use its excess accrued surplus to offset this deficit. In other cases, cities which have not accrued a surplus may borrow funds for 1 year or 6 months. However, I don't believe that nationally short-term borrowing is a critical problem because in many cases the local governments cannot borrow to meet an operating deficit, so that the situation isn't as common in most localities.

Chairman MOORHEAD. All of the witnesses in the panel have suggested that a declining economic base is the problem, and on the other side of the coin, the revitalization of depressed urban and even regional economies may be the cure. But attracting jobs to these areas is no easy matter. You mentioned climate and other variables. Some people have argued, however, that it is not economical to try to interfere with the market processes which tend to attract jobs and employment opportunities to the areas that seem more attractive instead of to those areas which at the present time seem to have chronic unemployment.

Do any of you have any thoughts on that matter, Mr. Muller?

Mr. MULLER. I would just like to note, and I believe I state here, that our experiences in the sixties in trying to aid depressed areas, particularly in the Appalachian region, though a number of programs do not appear to have been particularly successful. While these were relatively small-scale programs, and were geared to provide preferential contract treatment, or loans to business in these States, the experience was not as positive as one would have wished. This certainly raises a question as to what the cost of shifting private employment into more depressed areas is, and is the cost worth the benefit which is derived. What inefficiencies develop by this process is an open question and requires some thought.

In terms of Federal employment the situation is somewhat different because Federal wages are standard. A GS-13 is paid the same salary under the current legislation in Washington as he is, let's say, in Louisiana, and therefore, if we assume that workers operate at the same level of efficiency, it is not more expensive for a Federal installation, in terms of its payroll to be located in area A, for instance, than in area B. In the private sector the comments you attributed to others appear to be much more relevant because it is surely not economically efficient to pay someone more in one locality simply because it happens to be a depressed area. Such a practice could have an adverse effect on the national economy by shifting activity into these depressed areas at wages which are higher than they are in growing regions.

Chairman MOORHEAD. The President has recently made a proposal to give perferential tax treatment to businesses that locate in areas with high unemployment rates. Do any of you on the panel have any opinions pro or con on that proposal?

Mr. Jump. Mr. Chairman, I think there are two sorts of problems in terms of relating both of your last two questions. One is a question of suburbanization, the population trends. Another is a question of regional movement. I don't think it is economically efficient to try to stem either of those tides. I think appropriate public policy is to make sure that neither of those trends leads to such a serious fiscal crisis in central cities or in the northeastern and north central regions of the country that they are not only losing population because other areas are more attractive but they are actually pushing people or providing incentives for them to leave because of deterioration of public services.

I think that is the problem that justifies public policy so that we don't get into the vicious cycle that accelerates the process of population migration to other areas beyond what would happen if public services in those areas were maintained.

Mr. Harries. Mr. Chairman, I would concur with that and it goes to the point of one of the topics that Mr. Muller mentioned, that is of annexation. One of the great safety valves to prevent the deterioration of a center city in certain areas of the country has been the constitutional ability of the city to annex. Denver, Colo., just lost it through a passage of laws in Denver at the State level that said Denver could no longer annex. So Denver, a AAA-rated city, now has the problem of dealing with the central core problem and decay on its own level.

Houston, Tex., still has annexation privileges and continues to thrive and reach out and pick up nice residential areas to broaden the tax base. As we run out of nice residential areas and as we lose the power of annexation there is a new bit of legislation on the horizon passed in Minnesota called the "Fiscal Disparities Act" and I urge the staff to look into that if they can—they probably have—and examine and watch it work.

It was just found to be constitutional a matter of months ago, so it hasn't been in action very long, but what it did was to take about a six-county area surrounding Minneapolis and St. Paul and in effect all of the taxing authorities in the area swapped increases in tax bases to equalize any benefit of shift in movement. It was an effort to stop the problem that the learned gentleman over here talked about, people trying to attract business in by lower taxes, et cetera, and you get a vicious cycle.

In that area, if the city of Minneapolis picks up half a million dollars of new taxable evaluation during the year, the new base must be put into a pot and then everybody shares back out of that pot over time. It is to try and stabilize an area so you don't have this raiding. It is a new concept.

As a rating agency we are very interested in this because it appears to attack the problem of people stealing tax bases from each other.

Chairman Moorhead. I am vaguely familiar with that problem. I don't know if the political situation can be repeated in other parts of the country.

Mr. Harries, one technical question about the municipal bonds market. Do you think that the time has come for Congress to seriously consider taxable bonds option with interest subsidy as an option for

States and localities? You mentioned particularly New York and Massachusetts. Do you think that these areas and others would be aided by the enactment of the taxable bond option?

Mr. HARRIES. Mr. Chairman, having been intimately associated with the municipal bond market for 21 years, had I said this 3 years ago I would have been run out of New York on a rail. However, my attitude has changed toward taxable bond options. I am submitting a paper to the Ways and Means Committee to recommend that it be given serious consideration.

In my paper to you I comment that in business when your product doesn't sell to your public and you can't change your public, you change your product, and the people who have been buying municipal bonds historically are changing. Commercial banks have long been the major buyers of municipal bonds because it was about the only good tax shelter they could find. But with the passage of the 1969 Bank Holding Company Act, with the creation of some 2,000 bank holding companies in the last 6 years, and with these bank holding companies coming on the scene and finding all different kinds of places to shelter tax income, in tanker leasing, overseas investment credits and depreciation allowances—the things corporations can get. Now that banks can get tax shelters, they have backed away from being the major buyer of municipal bonds. Fire and tax insurance companies are number two. The amount of tax exemption they will need will vary with their given losses in any given year. Many individuals have left the municipal market and do not want to consider municipal bonds because of many reasons. They feel the industry is undergoing such dramatic basic changes as brought about by the Federal Bankruptcy Act, for example, which, when the President signs it, will say that a general obligation is not really a first lien on revenues, and we will permit a Federal bankruptcy court for a municipality. These basic changes are chasing some individuals out of the market. The big growth in money accumulation coming in an area that already has a tax shelter and that is pension funds. As ERISA has become the law of the land, if you will, requiring the corporations to fund their pensions, the amount of this money is the largest single reservoir of money building in the country. The only way that municipals can be attracted to it is to offer these funds a higher coupon bond, and higher coupon bonds will come about with a taxable bond where in the Federal Government will subsidize one-third to 40 percent of the interest.

I now believe perhaps this is an idea whose time has come. I am not convinced that it is a wash of cost as the Treasury projections indicate, that the Federal Government will get back that subsidy by taxing the taxable income. I do believe strongly that any municipal issuer, be he a treasurer, mayor, controller, should have every option available to him to get the lowest possible cost for social improvements, and if that is the way to do it, that is the way it should be.

Chairman MOORHEAD. Thank you. My time has expired. Mr. Long.

Representative LONG. Thank you, Mr. Chairman.

Mr. Harries, in light of the circumstances that exist today and everything that has led us up to where we are in this whole field, do you think New York is going to be able to borrow the $3 billion or $4 billion they need this spring?

Mr. HARRIES. I believe New York State will get to the market, Mr. Long. I mentioned to Mr. Javits before—he asked me a similar question. I think you had gone out. The banks in New York are the underwriting giants for New York securities and they cannot sell New York securities outside the State at this point in time. They feel and have evidently told Mr. Levitt, because I read it in the papers, that if the State will do two things, take care of these constant short-term borrowings that must be done by the Housing Finance Agency which total about $1 billion for the next year, if the State will see those are funded and not have a "Perils of Pauline" crisis each month and hit the headlines and everybody get a misimpression that these agencies are going to default on bonds, which is not the case—the default will occur in notes—if the State will take care of that, and two, if the State will get a balanced budget to show that the State is operating satisfactorily, the bankers believe they can find a market for short-term notes for the State.

I am afraid the interest rate will be high. May I bring to your attention and the attention of the subcommittee that New York State has, for example, $1.6 billion worth of notes coming due next March 31. That is a little over 2 months away. They were sold last May at an interest cost of 5.37 percent. Those notes are currently selling today at a dollar price of 98 and in the arithmetic of municipal bonds, Congressman, that means that the yield to maturity with only 10 weeks to go is probably up in the 14- to 15-percent range.

I would hope that the problem will be settled down to a point that when New York does come to market, if it does in April or May, to borrow on a tax exempt interest basis, the rate would be more realistic and in line with true risk.

Representative LONG. Thank you, Mr. Harries. I agree with you. I hope that does develop.

Mr. HARRIES. Mr. Long, if it does not develop there will be wholesale defaults triggered across New York with various school districts already in debt to their local banks for municipal notes for operating and funding their needs. They are currently spending money in anticipation of receiving the money in April, May, June, et cetera, from the State.

Representative LONG. The relationship of this to the ability of municipalities, and particularly small municipalities, and I represent a number of them, the ability to pass bonds issues and finance them, even a continuation of taxes, had an effect in its worst example that happened in my own district a month and a half ago in which the library tax, in which the entire library system in this particular parish in Louisiana was defeated. So as of the end of this fiscal year, they have absolutely no way to finance the library system at all.

It is combined with the cynicism that everyone feels and a lot of other subjects are involved in it, but it is a reflection of the instability that exists here and I guess the thing that causes more trouble than anything else is the instability rather than things moving badly and settling down or moving a little better and settling down.

Mr. HARRIES. As you know, the voters in November turned down some 71 percent of all bond issues proposed to them, the biggest defeats coming in Ohio, for some major issues. That is exactly the reverse of the philosophy of a year ago. About a year ago, possibly 70 percent were approved.

Representative LONG. I read your figures on that and they were really amazing. I knew it was bad but I didn't know it was that bad and that widespread over the country.

In that regard a lot of experts in State and local government believe that once we have worked our way out of this current recession, assuming we do, and the inflation that somehow is a part of it, at least gets that on a more acceptable level, that the State and local sector at that time ought to again achieve surpluses. Do you as members of this panel think that their optimism in this regard is justified?

Mr. HARRIES. I do. I think there is a much greater realization on the part of legislatures that unbalanced budgets can come about quickly in periods of a double whammy recession-inflation. A classic example is Massachusetts. Mr. Long, you are from Louisiana. I am from New England and to know that Massachusetts all of a sudden had a $450 million deficit where their total budget is only $3 billion for the year, it came upon them as a shock.

I appeared before the Massachusetts Legislature about a month ago and to show you that, although it was a shock, they still hadn't realized a very basic fact of life; that fact being that credit is a very fragile thing, and the question was put to me this way. Mr. Harries, we have just passed a $350 million general obligation bond issue in our State. Do you think we should bring it in light of what we are experiencing?

I said, well, it is none of my business whether you want to sell $350 million in bonds but you people must realize something. You don't have any credit and you can't even borrow to meet maturing short term notes, and when you can't sell any bonds outside of Massachusetts, you have got to forget it. You have got to tighten the old string and get your budget in balance, which I think the State has now done because Governor Dukakis came on television and said, look, I campaigned on a platform that I won't raise taxes but I have got to change my mind.

The same thing has happened to Mayor Rizzo in Philadelphia. This realization is gradually getting through that credit indeed is fragile and can be lost.

Representative LONG. I won't raise the logical question that would follow at this stage because we are now really concerned with this specific responsibility today and that is how fast is the Federal Government approaching the same sort of situation, but I would appreciate the views of the other gentlemen on the panel with respect to this possibility in municipal governments in the event we can work our way out of this recession.

Mr. MULLER. I do agree with Mr. Harries here because if there is a benefit from the New York fiscal dilemma, it is that other governments, both at the State, county, municipal level, have begun——

Representative LONG. That sounds like a good news, bad news joke.

Mr. MULLER. That is right. They have really begun to appreciate the importance of credit and the importance of not overspending.

I think we have to recognize that since 1946 at the local level we have had a 4½ percent annual increase in local employment. Over a period of 30 years, 4½ percent more local workers each year.

Representative LONG. A $4\frac{1}{2}$ percent increase in what?

Mr. MULLER. Per annum increase in local employment. There are only 2 years since 1946 that municipal employment did not increase—in 1950 and 1962.

Representative LONG. How does it compare in general terms, without being specific. I wouldn't expect you to have these terms, figures, immediately at your fingertips. How does that compare in general with the activity at the Federal Government during that same period?

Mr. MULLER. The Federal Government stabilized after 1967–68 and essentially transferred some of the functions to States. It is providing the money but some of the increase at the local and State level in employment is attributable to Federal programs which require, as in most schools, a school district title I coordinator, and a title II coordinator. The coordination of various Federal programs have really shifted some Federal employment to the State and local level but there is no question that over the last decade employment at the local and State level has risen much more than at the Federal level.

Representative LONG. I got you off your main track. Go back to it if you wish.

Mr. MULLER. Essentially it is related because it is my view that the increase in the level of employment and wage increases, which have been more rapid at the local and State level than at the private sector have been one of the underlying factors in the current fiscal crises. I believe this trend will shift, for two reasons. Even after the current recession will hopefully pass and we will revert to a more stable economy, one detects a certain amount of resentment among private sector workers. If you have a job in the Government at any level, it was pretty well guaranteed for life. This is no longer the case, but the popular belief remains. One has, presumably, job stability and in many cases, the municipal worker receives a higher salary than the person performing a similar job in the private sector.

During an economic boom period this is generally not a consideration, but when high unemployment is present, there is a certain amount of resentment which builds up that will remain with us. The private worker who still comprises the great majority of the work force will be much more concerned by wage and benefit increases which are beyond the level of what he receives since he feels he is paying for the increase personally. Be it right or wrong, he views the public worker as being paid out of his taxes; out of his pocket.

I believe that payroll constraints is one reason why in the coming decade the likelihood of a surplus in any given year will be greater than it has been in the past.

Mr. JUMP. May I respond also to that question about what the States and local outlook will be once the recession is over.

I think it is clear when the recession does end this will help but we are convinced that there are several cities that are in long term trouble because of the decline in their economic base. I don't think there is anything that is going to happen in the way of general economic expansion to reverse the kind of deterioration that is taking place and indeed it may be a good thing in terms of the functioning of the economy that some cities grow and some essentially lose some of their former strengths and specialties. So that is important.

Now, it is true that cities are probably going to behave better, having observed what can happen to cities that don't manage themselves as well as they should, but one of the problems is that some cities have now committed themselves to obligations—and I am thinking here not only of debt but of this nasty one that is starting to cause a great deal of concern, namely, pensions—that are unfunded. I mean the city of Washington, D.C., now has liabilities well over a billion dollars that it has not put money aside for. Those are liabilities on behalf of the people already on the payroll who have earned it or who are already retired. New York has been well publicized. The entire State of Massachusetts is unfunded, not simply underfunded, and has literally awesome prospects for cost of pensions in the near future.

So these kinds of problems I think are not going to be evaded by the cities, and so we are to a large degree pessimistic about the outlook for some cities. When you look at all the cities and all the States together it may be kind of true that there is a surplus and that is extremely important for the capital markets. That doesn't necessarily help those individual cities and perhaps those States that are already in serious trouble.

Representative LONG. The general health is good, but you still die, you still die. You are just as dead.

Mr. JUMP. Precisely.

Representative LONG. Thank you, Mr. Chairman.

Mr. BAHL. If I could add a postscript, Mr. Long, we did see some evidence as to what happened to large central counties in the United States during the last recession and the last recovery and if that is any indication of what will happen when we begin to have a sustained recovery it showed that large central counties, the primary part of which is central cities, did not recover during the last recovery, that while the rest of the country was coming out of it with employment increases, in many of these cases there were actually employment declines during the recovery.

Representative LONG. That is what prompted my question, is that it just appeared to me that the optimism that they had, at least as it relates to this particular problem, was not justified optimism. Thank you.

Chairman MOORHEAD. Senator Taft.

Senator TAFT. Thank you very much, Mr. Chairman.

There has been some mention by the panel of revenue sharing but particularly with regard to the formula. Having labored on this question of the formula when it was up here before I must say I am not very optimistic about the lack of change.

Let's take a look at the realities of revenue sharing, the problems you gentlemen are dealing with.

Local governments have an enormous planning problem because of changes in Federal policies. The Federal Reserve blows hot and cold, affecting interest rates and generating business cycles. The Federal Government buffets the Federal Reserve with its swings from small deficits to large deficits—never a surplus—pushing it into erratic policies. Municipal bond rates gyrate, turning State and local projects on and off, or wreaking havoc with State budgets.

We all know what unemployment does to State budgets. And now we have a new fiscal year, which may help us to bring Federal spending under control, and put it on a more stable path. But local government does not enjoy the luxury of another 3 months in which to make decisions. Most of them must have their budgets approved this spring. They must plan spending for July 1 to June 30, or even for April 1 to March 30. How can they make such plans, involving parts of the next Federal fiscal year, when the largest single source of Federal funds impacting on county and city budgets lies neglected in committee? Revenue sharing is up for renewal. It has been known for years that it would have to be considered by this Congress. Yet we have done little advance work, and made no plans, which would allow us to move quickly on this matter. So here we are, already into the State and local governments planning period with not a peep out of the Congress on revenue sharing that we can see today. This program should be extended in a stable, predictable, and long-range fashion.

I wonder if any members of the panel would comment on this situation with regard to revenue sharing and what its effect is upon the overall municipal and county financial picture?

Mr. HARRIES. May I take a first shot at that question and suggest I agree with you completely, Senator, that it is time to act. We lowered the rating on the city of Philadelphia last month because they had in their anticipated revenues for next year revenue sharing and I don't know how many other entities are including it in their revenue budgets next year and it is, as you point out, not an accomplished fact. So I agree with you, let's get it resolved.

Senator TAFT. Any other panel members.

Mr. PURYEAR. I think we would concur that revenue sharing should be reennacted and made far more permanent than it is now. This uncertainty is clearly causing great difficulties for cities. We would like, however, to see some changes in the formula such that we identify, pinpoint and better allocate the money to those areas that are deteriorating and need more money. I think people can disagree about the formula and how the moneys are distributed but I think the program is important.

Senator TAFT. I agree. The table in Mr. Muller's prepared statement, I believe, shows the loss of population and many of the major States; States which in my opinion—only one of them has suffered in the formula that was adopted by the Congress insofar as revenue sharing distributions are concerned.

Mr. MULLER. Just one comment. One of the items in the revenue sharing formula which hit cities which have declined the most is the 45 percent ceiling. For example, cities such as Baltimore or St. Louis receive substantially less than they really would receive using the three basic criteria, population, income, and degree of tax effort. However, the ceiling is that no community can receive more than 45 percent above the per capita average of the entire State, thus hurting declining cities. The situation varies from State to State, but this is one aspect of revenue sharing which does seem to be, in a sense, discriminatory.

I well understand why Congress included this provision. The idea obviously was that no one community should get the lion's share of the total State appropriation. One basic concept of revenue sharing is the principle of ability to pay, partially negated by the ceiling provision.

Senator TAFT. Thank you very much. Let me move to another subject, there is pending before the Banking Committee a measure introduced by Senator Eagleton, and I cosponsored it and strongly support it, which would require the registration with the SEC of all State and municipal bonds. We are hopeful hearings on this bill, S–2574, can be held shortly. I believe it would help restore confidence in the market, would help prevent disreputable accounting practices and force problems into the open in time to correct them and protect the investors.

Would you comment, Mr. Harries.

Mr. HARRIES. I have great personal regard for you as a Senator, Senator, but I think this bill is very bad. I am very familiar with filing with the SEC. As you well know, a major portion of our business deals with corporate bond and stock registrations.

The reason the SEC can accept corporate bonds and stock registrations is because we have in the United States at the corporate level uniform accounting principles. I know and see the problems that the SEC has in understanding the differences between various industries, but at least we do have uniform accounting principles to guide us.

First, there are no uniform accounting principles in the municipal business. The closest you come to it is a State by State handling of the problem and I submit to you that this is indeed a State problem and should remain there for two reasons. One, I think the State should be directly responsible for the accounting principles that are used within that State.

Second, I strongly believe that if the SEC is given overview for municipal filings that there will be an inevitable infringement upon the local control of how the money is spent.

I think this is wrong. I think it is an area that the Federal Government should stay out of. I agree completely with the Tower amendment in the Securities Act which prohibits the SEC from requiring such things from issuers because the amendment does give local rule a safeguard.

I suggested in the national press last week that the States take upon themselves the responsibilities for policing this. I call your attention to North Carolina where they have only 12 people, that is all it requires, at the State level. They examine every bond issue that comes from any community in the State and from the State itself. They don't examine it as to concept, only as to form. So they are absolutely certain and certify to the underwriting world that all material facts have been divulged, the figures are accurate, there have been uniform accounting principles applied throughout the State and then I would point to the fact that we have more counties in North Carolina rated AAA than any other State.

Their borrowing costs are reasonable and I think the system works well.

Senator TAFT. Did you think we might well move to require States on some basis to adopt such an approval?

Mr. HARRIES. I would applaud that, yes, sir, absolutely. In Ohio, in your own State, you have the Municipal Advisory Council which is an informal group, not at the State level, and I would suggest if that were part, for example, of the State treasurer's office like North Carolina's is, that when the bond issues come and there is a certification of the attorney general that everything is here, everything has been included that is material, there have been no material facts omitted, that is what the investor needs. That is what will help the market, not an SEC filing. I don't think there is enough space in Washington to handle an SEC office building that would handle the kinds of issues that would come in from municipals. You are talking about a huge market here. We have about 4,000 new issues a year in municipals. In the corporate markets I would put that number at 1,200; perhaps less.

I disagree strongly with the bill and would be happy to attend your hearings.

Senator TAFT. You are obviously a potential witness for any such hearings. You do agree, I take it, that the fact that there has been a lack of uniform policing of applicable regulations regarding municipal accounting and county accounting is in part responsible for the problem we have now, particularly in the case of New York?

Mr. HARRIES. The lack of uniform accounting principles throughout municipalities in the United States is the largest single problem we have in rating. However, we can handle it I think if we have individual State policing.

May I point out to you at the moment there is a set of guidelines being circulated to the industry and we have made our comments to it, that have been put together by the Municipal Finance Officers Association. This is a group of about 3,500 municipal finance officers, comptrollers, et cetera, throughout the United States.

Now, if we can get them to agree on what should be disclosed and we can then say, look, these are the guidelines of what you should disclose, then the various States pick them up and enforce them at the State level, and locally insure conformity with the guidelines, insuring disclosure, we have gone a long way.

Senator TAFT. What sanctions do we have to be sure that is done?

Mr. HARRIES. To be sure the disclosure is correct?

Senator TAFT. If we do go through the SEC?

Mr. HARRIES. At the moment you can't go through SEC except under the fraud provisions against the municipalities and there is a current investigation of New York on that very level.

Senator TAFT. But we would need to develop some kind of Federal sanction to make sure this was a State regulation.

Mr. HARRIES. I don't know.

Senator TAFT. The States haven't stepped up and done it.

Mr. HARRIES. New York just announced that they have introduced a bill patterned after the North Carolina system. So the States are waking up to the fact that this would be the way to handle it. This would take care of a very, very serious problem that is happening every day right now. Before you came in I commented that New Jersey sold $50 million 2 weeks ago and they had to go through the trauma, that is really what it was, of unnecessary work. of getting the State attorney general, State treasurer and Governor to certify the financial statements. This was unnecessary.

Senator TAFT. Thank you very much. Is my time up, Mr. Chairman.

Let me ask just a couple more questions if I may.

Mr. Bahl, your discussion of policy options doesn't mention the things that could be done to make the market more receptive to municipal bond issues. Specifically I am thinking of proposals to eliminate overcrowding in the bond markets by doing away with pollution control and industrial development bonds, et cetera. Would you comment.

Mr. BAHL. The fact is we really don't have a lot to say about that. It probably is a question better addressed to Mr. Harries because he has studied it.

Mr. HARRIES. Industrial bonds for pollution sopped up a great deal of available tax exempt money. Congressman Moorhead, in your State I recall a bond issue—isn't Bethlehem located in Cumberland County? I saw a bond issue 2 years ago and it had an offering of $75 million for Cumberland County and I said I didn't know they could bring $75 million worth of securities. It was an industrial pollution bond for Bethlehem Steel. At that time, the finance director of Philadelphia screamed that this type of financing was sopping up the available tax exempt funds in Pennsylvania and rather than build a scrubber for Bethlehem Steel plant, we should have a school in Harrisburg, or some other such thing.

I think perhaps the time has come to look at the sanctions put on or the permissions given for the amount of pollution control financing that can be brought by industrial corporations at the tax exempt level. Perhaps it is time to consider the maximum of $5 million which I believe was imposed on industrial revenue bonds 5 or 6 years ago when that got out of hand. So I would submit that, yes, I think perhaps that is something that should be looked at.

Senator TAFT. Mr. Muller, do you have any comments on the suggestion in the state of the union message that depreciation allowances or rate changes be made for areas where there is over 7 percent unemployment? Particularly we have talked about the city unemployment because of unfavorable financial circumstances but also we have a State outflow as well. And I don't know frankly what unit or size the President was referring to, that we are talking about the 7 percent figure. It could vary widely within the States or maybe he is talking about the entire State. I am not sure.

Mr. MULLER. I am not sure but let's assume it is the entire State and communities in the State that fit the category. I think the concept has some merit. I am personally not convinced that such measures would really have a major effect. I think again in your own State of Ohio, the voters turned down a very large bond issue and part of which was really designed——

Senator TAFT. There ought to be some clarification of that. This was a major constitutional amendment sort of thing, not an actual bond issue voted at the local level, and the proposals would have to have been implemented by the legislature and the time issue, et cetera, would have to be set out. It wasn't saying that it was 4.5 percent of the total turnout. That isn't an accurate portrayal.

Mr. HARRIES. That number was included in the 71 percent of voter rejections.

Senator TAFT. I understand. It shows the public attitude, no question about that.

Mr. MULLER. What I was saying is there is some question as to what effect such legislation would have on encouraging additional employment opportunities in the long run in the private sector. We don't really have much to go by. As I suggested earlier, we have had under the Appalachian Regional Commission Act, under EDA, under ARA in the sixties, provisions to really favor areas with high unemployment in terms of essentially preferential treatment in Federal contracts. There were some gains in particular communities as a result of that but the overall picture one has is that it didn't really improve the economic status of those areas substantially.

Part of it is a question of the level of advantage to a firm.

The second issue is that any of these policies which result in a faster tax writeoff or similar tax mechanism. Somebody eventually has to pick up the tab for the cost. The Treasury, for example, receives $1 billion less in revenue as a result of exemptions, and this billion dollars has to be made up by borrowing. What is needed is some analysis on this tradeoff.

Senator TAFT. It only gets to depreciate once and the Government eventually picks it up.

Mr. MULLER. Right. The Treasury eventually is in the same position. So I think the concept is sound. Some mechanism is needed to facilitate private investment in areas where we have chronic unemployment. Outmigration, high unemployment, a high proportion of households below the poverty level seem to go together. Unemployment is something which one can pinpoint since we do have fairly good data on the number of jobless.

Senator TAFT. Thank you very much. Thank you, Mr. Chairman.

Chairman MOORHEAD. Thank you.

Off the record, please.

[Off the record discussion.]

Mr. HARRIES. I wonder if I can be excused about 11:50? I have a pressing———

Chairman MOORHEAD. All right. If anyone has a question to be directed particularly to Mr. Harries I would yield to any member at this point.

If not, let's proceed until 11:50 and then, of course, you may be excused, Mr. Harries.

I would like to ask you gentlemen the question about State and municipal pension programs, particularly because we in the Congress are facing problems in this area. The President has suggested an increase in social security taxes. Last year we had legislation dealing with private pension programs and I am concerned about the State and local pension programs. I, quite frankly, have an understanding of the political process with which a mayor—not trying to point to anyone—may have to deal. Any major in negotiating a settlement, instead of having an immediate wage increase which his administration would have to finance, would probably opt for a settlement which would cause a mayor or other political figures in the future to absorb the cost. In this connection I would like to ask you whether, in your judgment, the benefits and funding of State and local pensions are comparable to those we find in private industry?

Mr. HARRIES. The answer to that I think is an unequivocal no. There has just been a study done in your own State, Congressman Moorhead, and I will be happy to send you a copy of it if you haven't seen it, and it cites unfunded pension liability in cities like Harrisburg and Bethlehem. They are talking in terms of $50 million to $100 million for cities of that size. It is going to become an increasing problem.

Let's look at Massachusetts for a moment. In Massachusetts a State employee never goes off the payroll until he dies or is fired, in effect, because there is a pension which carries through as long as he lives, payable out of the current operating budgets.

Now, the unfunded pension liability in Massachusetts is somewhere between $8 billion and $11 billion. Incidentally the unfunded pension liability, social security, I read is about $2.4 trillion, so the problem is at all levels.

Senator TAFT. Do you think it ought to be funded?

Mr. HARRIES. I don't see how it could. $2.4 trillion is about a third of our national wealth.

Senator TAFT. Yes. I don't think it would be practicable.

Mr. HARRIES. That is a good question, should pensions be funded. There is a bill, if I am correct, in the Congress now, what I will call a municipal ERISA which is patterned after the ERISA bill to require funding if local pensions aren't funded. I think some studies could be made as to what it would mean to municipal budgets just as it will mean to the Federal Government and employers as to how much we will be paying out forever in order to meet these pension obligations. It is a very serious problem.

One of the problems I cite in another speech that I have given from time to time deals with the changing dimensions of assessing municipal credits. Unfunded pensions is one of these dimensions.

We are requiring municipalities now to give us an unfunded pension indication each time they come in for a rating.

Chairman MOORHEAD. The Chair would like to make an announcement. I have some more questions. I presume I can submit them to you gentlemen in writing?

Mr. MULLER. Delighted.

Chairman MOORHEAD. I have just gotten an urgent call from another committee to come there to provide a quorum and I will ask Mr. Long to preside. I thank all of you very much. I remind you, Congressman Long, that Mr. Harries wants to be excused at 11:50.

Senator TAFT. Mr. Chairman, I have some written questions I would like to submit to the witnesses too, if I may have permission from the Chair.

Chairman MOORHEAD. Yes, and I think possibly Senator Javits might have some questions also.

I turn the Chair over to Mr. Long. Thank you very much, gentlemen. I think it has been an extremely interesting panel and you have given us a great deal of help. I appreciate it.

Representative LONG [presiding]. Thank you, Mr. Chairman.

One question that I would like to discuss in the 5 or 6 minutes that we are going to continue here is to some extent a philosophical question and I would be interested in your views as to whether it can be brought out of the philosophical range and down into something that might be more meaningful and that we can get a better hold on.

In this continuing debate that exists, we have it here in Washington now between Montgomery County and the District of Columbia. We have it in very specific form in Prince George's County, offering enticements to business to move out of the District and move into Prince George's County. But in this continuing debate that exists in that regard about who struck John, who provides what services to whom, and whether or not the District, on one hand really is providing services to the residents of the suburbs. Whether they work in the city or not, the suburbanites write letters saying that people that live in outlying areas journey into the city and buy goods there and therefore they are paying their fair share of the tax.

First, have any of you ever seen a substantive study in this regard, and second, can a real, substantive, fairly definitive position be arrived at in this regard? Mr. Harries, you have got to leave, I know, so why don't we go to you first. If you have any comments, we will be happy for you to respond.

Mr. HARRIES. I have never seen a study. In fact, I have heard problems in that regard. The only thing I can point to is again fiscal disparities statute. The law in Minnesota could be a model.

Chairman MOORHEAD. What you pointed out is what brought it to my mind.

Let me ask you a question in that regard. Was this an attempt by the entire communities to do that or was this something imposed on them by the State government?

Mr. HARRIES. No, sir; it was an attempt by those good Minnesota people to try to solve that problem.

Chairman MOORHEAD. They are to be admired for their willingness to cooperate and resolve these problems. Thank you, Mr. Harries. I know you have to go. We are very appreciative for your most enlightening testimony.

Mr. HARRIES. Thank you.

Chairman MOORHEAD. Mr. Muller.

Mr. MULLER. Well, sir, at the Urban Institute we did undertake such a study—I would not call it definitive—in the Washington, D.C., metropolitan area 2 years ago in which I was involved which did examine the fiscal flow between Washington, D.C., and the surrounding areas. In the last few days I testified in Federal court on the Richmond annexation which dealt with the United States Supreme Court ruling on the importance of this issue. Do the suburban residents annexed to city require more in city services than they provide in taxes?

In the case of the results of our study of the Washington metropolitan area, it indicated that, in fact, commuters, tourists, and shoppers provide more revenue to the city of Washington, D.C., than they require in public services.

This is primarily because shoppers, commuters, et cetera, do not require social or educational services. What they essentially receive are police and fire protection, the use of roads, and the use of general government services.

Chairman MOORHEAD. Did you include tourists in that category?

Mr. MULLER. Tourists were included but we separate tourists out and even in the absence of tourism we found that revenues the city received exceeded the cost of providing services, this was a fairly exhaustive study of the subject although by no means definitive.

In our study of Richmond which annexed a portion of Chesterfield County—the U.S. Supreme Court ruled that if we have also found that, in fact, the revenues coming to the central city from the area which was annexed exceeded the cost of providing services to these residents the annexation would be upheld. I would be glad to send a copy of these to you.

Chairman MOORHEAD. Would you? We would be most appreciative if you would.

Mr. MULLER. I certainly will.

Chairman MOORHEAD. Thank you.

Mr. Bahl.

Mr. BAHL. Yes; on that same point I would agree that there is not a good definitive study on that subject. The work he was speaking of and its extensions by Professor William Neenan, University of Wisconsin, are as good as there are but I think more important is that that is not the right question, the question of whether or not commuters, suburban residents, provide more by way of revenues than they eat up in costs. I think the real question has to do with equity. There is a reason why the central cities are poor and the suburbs are wealthy and it may have to do with suburban policy. That is one part of it.

The other part is that maybe there are things that a city provides to an area that simply aren't measured. Let me give you what I think to be an interesting example, and I hate to call New York actually because we know it is an exaggaration but this is not so atypical.

You know, New York's employment decline, the city's job losses are phenomenal. It is lower than other cities in the Northeast which is lower than the national average. In fact, if you look at all of New York State including New York City you see that New York State is losing jobs faster than the rest of the Northeast. So New York State looks even worse. But if you take New York City out of the State and you view it as two separate things. New York City and the rest of the State, the rest of the State is doing about as well as the national average and better than the rest of the Northeast. So your first reaction to that would be that the city is a real millstone in terms of economic growth.

But then you look further and you find that most of the growth in the rest of the State is occurring in suburban New York City and in no small part has got to be attributable to a location nearby the city and how does one measure a benefit like that?

Representative LONG. Which brings into consideration many things that are intangible with respect to that relationship.

Mr. BAHL. That is right and doesn't that really mean that a city has a claim on part of that regional tax base? I think it must mean that.

Representative LONG. Mr. Muller.

Mr. MULLER. I would like to just elaborate because I certainly agree with Mr. Bahl. There are two questions, the narrow fiscal question, direct dollars and cents transfers between the suburbs and cities, but I agree the most important question is the whole regional economy.

Most of the movements we have in jobs is from the city to outer suburbs, not the inner suburbs. This is above and beyond the regional migration and at the present time we don't have a mechanism to take this into account.

The agreements in Minnesota are in the right direction. Frankly I don't believe that most other regions are willing to share their tax base, for two reasons. One has to do with minority power. For example, the Michigan Legislature is considering such legislation for the Detroit area but the mayor of Detroit is arguing that this will take away power from the city. The suburbs are saying all we are doing is subsidizing the city without benefit to us.

There are two different views on the metropolitan issue. One is a question of political power and one of economic power. The combination of the two factors makes it unrealistic to expect most but perhaps not all regions to agree to a tax base sharing among the central city and its suburbs.

Representative LONG. I had always thought recognizing the practical political problems that you outlined here as being the very real, that one of the roles that the Federal Government could play in this, and I regret that they didn't a number of years ago, is in directing their program more toward the regional concept than they did and requiring some degree of the political head knocking that is required to currently—currently required in order to really be able to approach the problems in that way because it seems to me the problems are basically regional types of problems.

Mr. MULLER. That is correct.

Representative LONG. I don't mean region in the form of the all the entire Eastern United States or the entire corridor from here all the way to Baltimore and New York but the metropolitan area's problems. It seems to me this is well justified. Any question to you is really going to be in two parts. One is the simple way in which I put it, the exconomic as against economic, and then second those intangibles that have a relationship and directly bears and are so difficult to put a dollar price on but the fact that Kennedy Center is available in downtown Washington, it is awfully important to the people who live in Bethesda. There is no denying that it does, and measuring it in dollars gets to be difficult but it is important.

One of the reasons the people like to come here is because of that example.

Mr. MULLER. In fact, there are two parts to that, taking the example of Washington, D.C. I happen to live in the suburbs so I feel unbiased in taking this approach. In the absence of the District of

Columbia being the Nation's capital, the high income found in the surrounding suburbs would not exist. The suburbs have developed around the District and this is the case in New Orleans, Chicago, and in other places. The reason for the suburbs is the location of the central city.

Second, suburbs in a sense benefit by the concentration of relatively lower income households and services costs borne, in part, by central cities because in the absence these services more low income families would redistribute themselves throughout the entire region. One would, in this situation, find a substantial shift in tax burden from the cities to the suburbs. Since we recognize there is a concentration in the cities of the Northeastern and North Central States of lower income families that require social services, this in itself could justify some form of regional revenue sharing. But I agree with you that the way to get such concepts is through the pocketbook. When the Federal Government requires that such cooperation exist as a condition for aid is one means by which one could force a change.

Representative LONG. Gentlemen, on behalf of the subcommittee I am most appreciative and express the subcommittee's appreciation to you. I think, as Chairman Moorhead said, it has been a meaningful contribution and we are grateful to you in that regard.

The subcommittee will reconvene tomorrow in this room. The witnesses for tomorrow are Under Secretary Edward Yeo, Department of the Treasury, Assistant Secretary Charles Orlebeke, HUD; and Mr. Robert Merriam, Chairman, Advisory Commission, Intergovernmental Relations, and until that time this subcommittee is adjourned.

[Whereupon, at 1:55 p.m., the subcommittee recessed, to reconvene at 10 a.m., Friday, January 23, 1976.]

[The following information was subsequently supplied for the record:]

RESPONSE OF BRENTON W. HARRIES TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR TAFT

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., January 27, 1976.

Mr. BRENTON HARRIES,
President, Standard and Poors,
New York, N.Y.

DEAR MR. HARRIES: Senator Taft has requested that the following question be asked of you for inclusion in the Joint Economic Committee hearing of January 22, 1976, on the future outlook for State and local government finances.

In your prepared statement you advocate complete takeover of welfare by the Federal Government in order to eliminate disparate problems between urban and rural areas. Have you prepared any cost estimates of that burden? Wouldn't the cost of maintaining those programs be ultimately borne by the taxpayer, whether federally or State administered? Which taxpayers would be paying more and which less?

It will be appreciated if you will reply as soon as possible so that the answer can be inserted in the final transcript.

Sincerely,

JOHN R. STARK.
Executive Director.

STANDARD & POOR'S CORP.,
New York, N.Y., February 10, 1976.

MR. JOHN R. STARK,
Executive Director, Congress of the United States,
Joint Economic Committee, Washington, D.C.

DEAR MR. STARK: In reply to Senator Taft's request for additional comment concerning my advocation of the complete takeover of welfare by the Federal Government, I am submitting the following:

A complete takeover of welfare by the Federal Government would do much to revitalize the nation's urban centers and lessen the strain on those states with heavy concentrations of urban dwellers. The financial predicament of New York City is a case in point. New York City spends approximately $2 billion of its $12.3 billion budget just to service the needy and although the city represents only 3% of the nation's population, it contains an astronomical 10% of those needing government aid. New York City, however, is not unique in this respect but is distressingly typical of many of the nation's cities, which bear a cruelly disportionate share of America's social and economic burdens.

A complete takeover by the Federal Government would allow large metropolitan areas breathing space in their fight to survive and become economically competitive with suburban and semi-rural areas.

While no cost estimates are available as to what the burden would be for the federal government if it were nationalized, the costs as well as benefits would be equalized regardless of residence-location of the recipient. On a national basis, the taxpayers would be supporting the system upon their ability to pay much in the same way as they now support the national defense or other nationally supported programs, such as various national subsidiary programs in agriculture, transportation and the like.

I trust the above satisfactorily meets Senator Taft's request.

Respectfully yours,

BRENTON W. HARRIES.

RESPONSE OF ROY BAHL TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR TAFT

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., January 27, 1976.

DR. ROY BAHL,
Director, Metropolitan Studies Program,
Maxwell School. Syracuse, N.Y.

DEAR DR. BAHL: Senator Taft has requested that the following questions be asked of you for inclusion in the Joint Economic Committee hearing of January 22, 1976, on the future outlook for State and local government finances.

(1) In Mr. Harries prepared statement he advocated complete takeover of welfare by the Federal Government in order to eliminate disparate problems between urban and rural areas. Would you agree or disagree with him? Also, what would you feel would be the cost estimates of such a burden? Do you feel that the cost of maintaining those programs would ultimately be borne by the taxpayer, whether federally or state administered? Which taxpayers would, in your opinion, be paying more and which less?

(2) You express considerable concern that State and local governments are not currently setting funds aside in amounts that reflect the true rate at which pension benefits are being accrued by employees now on their payrolls. (pp 25–26) Do you think that the proposed increase by the Administration in the base for social insurance from $14,100 to $16,500 in two years plus an increase in the combined employer/employee social security tax rate is a step in the right direction? Does it go far enough and what is the significance of the actuarial deficits reported by such publications as the Wall Street Journal?

(3) Do you agree with the position which was advanced by Treasury Under Secretary Yeo that the fiscal plight of our cities is due more to inflation than to recession?

It will be appreciated if you will reply as soon as possible so that the answers can be inserted in the final transcript.

Sincerely,

JOHN R. STARK,
Executive Director.

SYRACUSE UNIVERSITY,
MAXWELL SCHOOL OF CITIZENSHIP AND PUBLIC AFFAIRS,
Syracuse, N.Y., February 3, 1976.

MR. JOHN R. STARK,
Executive Director, Joint Economic Committee,
Congress of the United States, Washington, D.C.

DEAR MR. STARK: Our answers to Senator Taft's questions are enclosed. We hope they are helpful.

Sincerely,

ROY W. BAHL,
Director.
BERNARD JUMP, Jr.
Senior Research Associate and
Visiting Professor of Economics
and Public Administration.
DAVID L. PURYEAR,
Assistant Professor of Economics.

Enclosure.

Response to Senator Taft's Questions

(1) We would agree with Mr. Harries that a complete takeover of welfare by the Federal Government is desirable. This would distribute the burden of welfare financing more fairly between central city and suburban areas and between rich and poor states as well as between urban and rural areas. Since the problem spills over the boundaries of local and regional jurisdictions, it is both appropriate and efficient to deal with it at the national level. Taxpayers ultimately bear the burden of welfare programs regardless of the jurisdiction which raises or administers the funds, so the important policy question is whether a state-local system can handle the problem without unfair differences among jurisdictions in the costs of welfare programs.

The cost of a federal welfare takeover would depend heavily on the level of benefits and the nature of the program (negative income tax, workfare, current system, etc.) and we have not worked on this question. The distribution of burdens among taxpayers is a very difficult question to answer and once again we have not studied this particular problem.

(2) Our comments about failure to set aside funds for employee retirement benefits at the true rate at which benefits are being accrued was directed exclusively at state and local government retirement systems. Hence, the Administration's proposals to raise the wage base from $14,100 to $16,500 in two years (the 1976 level being $15,300) will do nothing to alleviate the incipient trouble at the state and local level. (Of course, the increase in the Social Security wage base and the Administration's proposal to raise the payroll tax will add to the costs of those governments which provide Social Security coverage to their employees.)

We do not think the proposed increase in the Social Security wage base is high enough. Without being wedded to a specific number, we favor a wage base above $20,000. But even this might not long assure that cash inflows into the Social Security fund equal the benefits being paid. In general, an actuarial deficit in the Social Security system need not be a cause for concern in the same way that it would be at the state and local government level because of the sharp differences in the underlying ability of the federal government to finance any of its obligations. Much more troublesome, in view, is the probable cost to future working taxpayers that will result both because of higher average benefits and because demographic data suggest that a relatively smaller pool of employed persons will be supporting a relatively (as well as absolutely) larger pool of persons drawing Social Security benefits.

To conclude, we think the host of issues surrounding the federal government's Social Security program will constitute one of the most important and most difficult fiscal and social debates to face the Congress in the years immediately ahead.

(3) We do not have enough information to permit us to decide which of the twin evils—inflation and recession—has done the most damage to cities. Though our research has focused on the impact of inflation on cities and states, and has led us to the conclusion that inflation during the 1970's has severely debilitated many large central cities and counties, we are convinced that recession has also cut deep. Unfortunately, it is impossible to identify the impact of either inflation or recession on city fiscal problems until some agency begins routinely collecting some basic economic data (e.g., employment data) for at least major cities. At the present, such information is reported only for counties, hence, unless a city happens to be coterminous with a county there is not a great deal of information available about the city's economic situation.

THE FUTURE OF STATE AND LOCAL GOVERNMENT FINANCES

FRIDAY, JANUARY 23, 1976

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON URBAN AFFAIRS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10 a.m., in room 5302, Dirksen Senate Office Building, Hon. William S. Moorhead (chairman of the subcommittee) presiding.

Present: Representatives Moorhead and Brown of Ohio; and Senator Javits.

Also present: Ralph L. Schlosstein, professional staff member; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority professional staff member.

OPENING STATEMENT OF CHAIRMAN MOORHEAD

Chairman MOORHEAD. The Subcommittee on Urban Affairs will come to order.

Today the Urban Affairs Subcommittee holds the second in a series of hearings on the future of State and local government finances. The hearings are designed to develop a detailed and factual analysis of the prospects for State and local government budgets in the next 5 to 10 years. We will examine the aggregate State and local sector, but we also hope to focus our attention on specific governments that may encounter severe financial problems in the near future.

Certainly, everyone is aware that 1975 was not a very good year for State and local government. The combination of inflation and recession caused expenditures by these governments to rise much faster than revenues, opening a widening deficit in their budgets.

To be realistic, States and localities have only three alternative policies for dealing with this widening gap. First, a few States and cities are operating with deficits this year in the hope that rapid economic recovery will make up the revenue shortfall next year. But this practice is not very widespread or desirable, as State and local governments become more cautious in the aftermath of the New York City crisis. Second, these governments can live on the fat of previous budget surpluses. However, only a few States and cities, predominantly in the energy producing and farm belt regions, have enough money in the bank to choose this approach. Finally, States and localities can raise taxes and cut services to keep their budgets in balance. According to Joint Economic Committee surveys, two-thirds of all State and local governments are adopting this approach. Looking beyond this year, however, the outlook is less clear.

Yesterday, the subcommittee received testimony from several distinguished experts in State and local finances about their respective views of the future. While their analysis may be clouded somewhat by the uncertainties embodied in existing forecasting techniques, three unanimous conclusions emerged from the discussion.

First, all of our witnesses agreed that the outlook for the aggregate State and local government sector will improve as the economic recovery gains strength and as inflation is controlled. While difficulty was expected in the upcoming year, the experts seemed to agree that beyond that point, the outlook will improve significantly.

However, our witnesses also agreed that even with a vigorous economic recovery, there will still be pockets of severe fiscal problems. These problems will be caused by ongoing population, employment, and income shifts within and among regions, and seem to be concentrated in the Northeastern and Midwestern regions. In the unanimous view of our witnesses, the number of cities and States affected, and the severity of the problem are likely to increase in the near future.

Finally, all of our witnesses agreed that the only permanent solution to the budget problem of these vulnerable governments is a strengthening of their respective economic bases. They also conceded that this will be an extremely difficult task.

Today we will discuss these conclusions with representatives of the executive branch in the hope that the subcommittee will obtain their views of the future of State and local government finances. We have asked our witnesses to discuss the outlook for State and local government finances as well as the adequacy of existing Federal programs to deal with any upcoming problems they foresee.

We are fortunate to have with us today three distinguished witnesses to discuss these important issues. Our first witness is Mr. Edwin Yeo, Under Secretary for Monetary Affairs at the Department of Treasury. While I want to welcome all our witnesses, I'd like to extend a special welcome to Mr. Yeo, who left an excellent position with the Pittsburgh National Bank in my district to come and serve in his new capacity. Our second witness is Mr. Charles Orlebeke, Assistant Secretary for Policy Development and Research at the Department of Housing and Urban Development. Our final witness will be Mr. Robert Merriam, who is chairman of the Advisory Commission for Intergovernmental Relations.

Gentlemen, we welcome you.

We will start with you, Mr. Secretary.

STATEMENT OF HON. EDWIN H. YEO III, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. Yeo. Thank you, Mr. Chairman. It is a pleasure to be here and a pleasure to review with you and the subcommittee a very important crucial subject.

New York City's financial and fiscal problems have given rise to widespread fears that we now face either an epidemic of financial crises or Draconian cuts in services in the State and local sector. But neither is inevitable. We can both avoid financial crises and maintain, and even increase, delivery of local public services, if we act responsibly. At the national level, above all this means we must stop inflation and keep it from rekindling. At the State and local level, governments must manage their fiscal and financial affairs efficiently and prudently. They must resist both pressures to spend annually more than their annual revenues and corollary pressures to hide deficit spending behind budgetary gimmicks.

We think that, even with best management and a noninflationary economy, selected central cities, especially in the East and Midwest, would face difficult socio-economic problems today. Their problems have been growing since World War II. Through the postwar period, employment opportunities have been shifting away from the East and Midwest to the South and West and from central cities to suburban areas. There were many reasons for the shift of job opportunities to the South and West and from central cities to suburban areas. Among the more important and I would like to summarize are the following:

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

Second, the growth of foreign imports of steel, autos, clothing and numerous other goods traditionally manufactured in the East and Midwest.

Third, the growth of oil and natural gas as industrial fuels and the corollary decline of coal.

Fourth, the growth of the petrochemical industry.

Fifth, relative labor costs.

Another major causal factor, construction of water storage, pipeline and irrigation facilities which brought relatively cheap water to the Southwest.

Finally, the growth of Japan and trade with the Far East.

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

These enormous underlying changes and trends are manifestations of progress which benefits the Nation as a whole. It would have been neither possible or desirable to have prevented them. We cannot expect all regions and cities to operate at uniform levels at all times. We live in a world of change.

In other words, economic expansion does not go forward city by city and State by State.

Necessarily because of changing preferences, technology and population and other resources, there always will be some regions and cities which prosper relative to others.

From the end of World War II until recently, coal-producing regions and the cities located in them, for example, declined relative to other regions and cities. But now these same coal regions and cities appear to be growing relatively rapidly. Clearly, it would be a mistake to try to block the normal forces of change and progress from working their way through the economy. Nonetheless, we have to recognize that the changes and trends which dominated the post-War period raised problems for some central cities, especially in the East and Midwest. In specific, these cities have been faced with demands for government services that have been growing faster than their tax bases.

But this squeeze has been with us for some time. It is only recently that problems in the State and local sector have awakened fears of widespread crises.

And I submit, Mr. Chairman, the question is why? The reason is that there are two new elements in the picture. One is inflation. The second is the New Cork City experience.

In my view the major source of present financial and fiscal problems which afflict elements of the State and local government sector is inflation. I recognize of course that recession also raises problems for State and local governments, particularly by increasing their welfare and loads and decreasing cyclically sensitive scales and income-tax revenues. But the evidence is persuasive, as I hope to be able to show, that inflation is the major root of State and local government financial and fiscal problems.

On the expenditure side, inflation raises demands for both more and increased services supplied by government. Inflation squeezes people financially in two ways. It erodes the purchasing power of our cash balances and fixed income bonds and other assets. Second, it increases the real taxes we pay by putting us in higher-tax brackets without necessarily increasing real incomes. One consequence of the efiects of inflation on purchasing power and after-tax income is that the public demands more and increased government supplied services which, because they are publicly supplied, appear to be free. During the past 10 years—marked by relatively rapid inflation—we have seen relatively rapid growth in State and local expenditures on higher education, health, hospitals, and vendor payments for medical care.

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

In other words, unlike certain sectors of the private sector, industry for example, municipalities don't have the same capacity to substitute machines, to hold productivity and reduce or contain unit costs.

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

This would not be a problem if State and local government revenues were income-elastic. But they are not. It is administratively difficult to reassess property fast enough to keep pace with inflation.

As a result, inflation reduces local governments' real revenues and they must make up the loss by increasing tax rates. But in this kind of context, Mr. Chairman, they find it difficult to do so. This is because taxpayers, who tend to lose in inflation, revolt, very bluntly revolt. Those with incomes fixed by contract or otherwise must continually try to catch-up with living costs. Also, as indicated already, those taxable incomes rise at the same rate as living costs find that nonetheless they too have to catch-up because their incomes are taxed at progressively higher rates. And everyone loses because inflation erodes the value of money and fixed-income assets. Thus, inflation strengthens resistance to higher taxes, and hence local governments find it difficult to extract additional tax revenues from their tax bases during inflationary periods.

In short, inflation puts State and local governments in a vise between on the one hand rising demands for more and increased services, which incidentally cost more to deliver, and on the other hand diministed revenue capacity.

Mr. Chairman, I don't plan to cover the statistics in exhibit A unless you want me to. They support the point made.

Chairman MOORHEAD. Without objection, exhibit A will be included in the record as part of your prepared statement at the conclusion of your oral statement.

Mr. YEO. Thank you.

We find that real State and local government expenditures rose on average 4.8 percent and real revenue from their own sources 2.7 percent in the high inflation years, as compared to 6.0 percent for real expenditures and 5.8 percent for real own-sources 2.7 percent in low inflation years.

In effect this is, I'm afraid, a highly statistical way of supporting our initial statement, Mr. Chairman.

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

Moreover, in those recession years when the inflation rates for goods and services purchased by State and local governments was 3 percent or less, real State and local expenditures rose on average 6.2 percent and real own-sources revenue 4.7 percent.

I would like to skip ahead and say that in addition to inflation, that management is an essential ingredient. And as the subcommittee looks ahead over the next 5 years, this is likely to be the decisive factor in determining whether we are going to have additional large-scale municipal financial problems.

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

For years it was widely held that tradition and laws constraining cities to balance their operating expenses and revenues, precluded other than accidental transient operating budget deficits. But New

York showed that it is possible for a city to spend more than its revenues as a routine and habitual matters. New York was able to hide large consecutive deficits behind budget gimmicks including especially by accruing revenues designated receivable from the Federal Government which were in fact not due.

The source of New York's deficits was the response of its elected officials to the problems of rising demands by residents on the one hand for more and increased public services and by employees for higher wages and fringe benefits. The measures New York adopted were uncommon, uncalled for and operated to undermine its financial position and economic capacity. The evidence on this is presented in the Congressional Budget Office's widely read study entitled "New York City's Fiscal Problem". The relevant data have been duplicated in table 1 of my prepared statement.

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

I think if it is all right with the chairman, I would like to go ahead. We have all examined the New York City situation in detail. It is set forth in my prepared statement and is accompanied by tables. I would like to move to another city, Seattle. There is a point I'm trying to make, Mr. Chairman, and it is a major point and has to do with some of the early testimony that the subcommittee has heard.

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

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

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

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

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

In summary, the evidence while not proving that none of the 11 covered central county jurisdictions other than New York are without problems, shows that none exhibits the levels of expenditures, employment and debt which New York did in the 1972–74 period.

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

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

Short term borrowing to finance deficits even if by one large issuer, can also cause major problems. The process of short term local government financing and the shocks to it last year broadly parallel the commercial paper crisis early in the decade in 1970. There the cause was a major credit problem that quickly focussed attention on the liquidity positions of other issuers of commercial paper. Investors examined other issuers, not in terms of whether they had the earning power over time to pay back their 30-day notes or if someone else would buy them or in effect refund them in other words, if the market was open. They looked to see only if they could pay when due, and under circumstances where the market wasn't open. In a number of instances, they concluded the answer was no; and a run started on the commercial paper issuing entities.

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

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

Another serious problem that has come out the last 18 months involves moral obligation bonds. The UDC technical default a year ago was only a first step in exposing the tenuous nature of this obligation. Like short term debt, it is used to pay for things that parts of the electorate may want, but which taxpayers will not buy. As such, it is not a surprise that some legislatures have not moved promptly to use tax money to carry the moral obligation bond must be viewed primarily as a revenue bond.

I would like to talk about disclosure, which has become very, very prominent over the last 18 months and I might say belatedly in my own opinion.

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

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

I don't wish to suggest, Mr. Chairman, that the electorate is familiar in any detail with these devices, but I do believe that they have become very sensitive to the ability of the managers that they in effect elected in order to preserve their communitis' credit standing.

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

One of the distinguishing characteristics of the municipal bond market in the future will be a continuing interest in credits as the result of the experience of the last 18 months. Not the broad shift to only the very highest rated credits that characterized the closing months of last year. In time, this will be seen to have been a temporary response—a response characterized by the word "fear"—followed by a continuing selection process in which those municipalities that are judged to be doing an inferior job in handling their affairs will have their status reflected in higher borrowing costs and, in extreme cases, limited access to markets—both of which will also be visible to the voters of these entities.

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

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

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

A mandatory reporting program need not be burdensome or expensive. An audited annual report, updated by quarterly reports of significant events, in between is all that would seem to be required.

I would like to close by saying a word about New York's future. The city has been through a terrible crisis. But as a result, there seems to have been a constructive change in attitudes about is accounting and financing practices. The city is beginning to take the steps it must take to regain access to the credit and capital markets and of course primarily to regain control if its own affairs. It has a strong economic base on which to build. I wish the change in attitudes could have come about differently, but the important thing is that positive financial and fiscal change is beginning to happen. For our part, we shall closely monitor what is happening not only to protect the Federal loans but to make constructive suggestions whenever we can.

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

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

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

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

Mr. Chairman, I'm sure I don't need to tell you how I feel about the present system and how I feel that it can be made to work. I would like to add several personal comments.

I reviewed the testimony yesterday before the committee. I think that (1) That there is an important distinction that needs to be made between relative rate of economic growth and credit problems. You and I, Mr. Chairman, are from a city that did not enjoy economic growth and an area that did not enjoy economic, as we discussed many times in the times in the past, until about 1965. As a matter of fact the Pittsburgh area declined from 1950 through 1965. And yet through successive administrations in that area, for instance, Governor Lawrence, we did not have a situation in which we had an erosion in the areas' credit or the city's credit.

In other words, it is not enough to look at relative changes in economic development. It is a leap from that, a big quantum jump to the conclusion that slow growth automatically means financial problems because it does not.

As a matter of fact, there are areas in this country which are characterized by rapid economic growth and attendant financial problems. And without naming any today, we can all go back to the 1920's and the developments in the Southeast part of the country particularly Florida where we saw rapid growth accompanied by credit difficulties.

The second major point is that there seems to be an underlying premise in some of the material that I have read that the country stands uniformally, and it just is not.

By definition there are some areas that are expanding very rapidly and there are others that are expanding moderately and there are still others that are declining.

So that I submit that these two points can be the foundation of some misinterpretation.

The third point I would like to make is that in my view what happened to our system involved a diminution of the sensitivity of the credit markets to difficulties. Under our system as it is presently constituted, Mr. Chairman, early warning signals are suppose to go up when a community starts to run into difficulty. And the fact is that in several notable instances those early warning signals did not go up.

The fourth point is that I think that we are in a situation involving State and municipal finance roughly analogous to the events that followed Penn Central. I think there is an element of fear that continues to affect certain parts of the market.

My own judgment is that we will get over some of the extreme jitters that we have had and at the end we will have a much better system and that, even relatively stable crisis, we will have significantly fewer municipal financial difficulties in the next 5 years—that is, after we handle the few that need to be dealt with as the result of the current situation—than we had in the 5 years preceding.

Thank you Mr. Chairman.

Chairman MOORHEAD. Thank you, Mr. Secretary. Your prepared statement will be included in the hearing record at this point.

[The prepared statement of Mr. Yeo follows:]

PREPARED STATEMENT OF HON. EDWIN H. YEO III

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

BACKGROUND

Even with the best management in a noninflationary economy selected central cities, especially in the east and midwest, would face difficult socioeconomic problems today. Their problems have been growing since World War II. Throughout the post-war period, employment opportunities have been shifting away from the east and midwest to the south and west and from central cities to suburban areas. There were many reasons for the shift of job opportunities to the south and west and from central cities to suburban areas. Among the more important were the following.

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

Second, the growth of foreign imports of steel, autos, clothing, and numerous other goods traditionally manufactured in the east and midwest.

Third, the growth of oil and natural gas as industrial fuels and the corollary decline of coal.

Fourth, the growth of the petrochemical industry.

Fifth, relative labor costs.

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

Seventh, the growth of Japan and trade with the Far East.

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

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

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

INFLATION

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

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

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

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

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

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

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

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

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

Moreover, in those recession years when the inflation rates for goods and services purchased by State and local governments was 3 percent or less, real State and local expenditures rose on average 6.2 percent and real own-sources revenue 4.7 percent. Only in the recessions of 1969–70 and 1974–75 when the inflation rate was 6 percent or more, did real State and local government expenditures and own-sources revenue grow less than average for the post-war period.

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

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

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

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

MANAGEMENT

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

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

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

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

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

Consider the city's 1975–76 fiscal year budget as it was originally submitted. That budget provided $1.8 billion for debt service and $1.3 billion for pensions. In addition, of the remaining $10.1 billion expenditures, the 1975–76 budget, as submitted, provided $477 million for higher education, $586 million for charitable institutions, $890 million for city hospitals, $137 million for various housing activities and $180 million in subsidies for the transit system. The grand total of these uncommon items is $2.3 billion, and of this amount $802 million represents tax levy funds.

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

SEATTLE

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

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

OTHER CITIES

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

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

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

In summary, the evidence while not proving that none of the eleven covered central county jurisdictions other than New York are without problems, shows that none exhibits the levels of expenditures, employment and debt which New York did in the 1972–74 period.

DEBT

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

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

Short term borrowing to finance deficits even if by one large issuer, can also cause major problems. The process of short term local government financing and the shocks to it last year broadly parallel the commercial paper crisis early in 1970. There the cause was a major credit problem that quickly focused attention on the liquidity positions of other issuers of commercial paper. Investors examined other issuers, not in terms of whether they had the earning power over time to pay back their thirty day notes or if someone else would buy them or in effect refund them. In other words, if the market was open. They looked to see only if they could pay when due, and under circumstances where the market wasn't open. In a number of instances, they concluded the answer was no; and a run started on the commercial paper issuing entities.

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

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

Another serious problem that has come out the last 18 months involves moral obligation bonds. The UDC technical default a year ago was only a first step in exposing the tenuous nature of this obligation. Like short term debt, it is used to pay for things that parts of the electorate may want, but which taxpayers will not buy. As such, it is not a surprise that some legislatures have not moved promptly to use tax money to carry the moral pledge. A moral obligation bond must be viewed primarily as a revenue bond.

DISCLOSURE

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

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

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

One of the distinguishing characteristics of the municipal bond market in the future will be a continuing interest in credits as the result of the experience of the last 18 months. Not the broad shift to only the very highest rated credits that characterized the closing months of last year. In time, this will be seen to have been a temporary response, followed by a continuing selection process in which those municipalities that are judged to be doing an inferior job in handling their affairs will have their status reflected in higher borrowing costs and, in extreme cases, limited access to markets—both of which will also be visible to the voters of these entities. In the future, because of the new sensitivity to changing conditions, the process with respect to particular credits is likely to be gradual: The warning signals will go up earlier.

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

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

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

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

CLOSING COMMENTS

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

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

Third, our financial markets have proven to be tough, resilient and discriminating. Despite the UDC and New York City episodes, markets absorbed record amounts of state and municipal securities last year, totalling nearly $60 billion. Furthermore, interest rates on municipals were not out of line relative to corporate yields considering that 1975 was a recession-recovery year. For example, as reported by the Joint Economic Committee in its study of "New York City's Financial Crisis," in 1970 the ratio of yields on all long-term tax-exempt securities to yields on long-term taxable corporate securities was .754. In the July–October period last year, it averaged .764. Moreover, in the case of AAA municipals, the ratio was .761 in 1970 and averaged .738 in the July–October period last year. Even in the first three weeks of October last year when the New York crisis peaked, the ratios were only .784 for all municipals and .762 for AAA rated securities.

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

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

EXHIBIT A

	Inflation rate			
	3 or less	4 or less	4 or more	6 or more
Percent growth in—				
Real expenditures	6.0	6.2	4.7	4.8
Real own-sources revenue	5.8	5.4	3.4	2.7
During recessions:				
Real expenditures	6.2			4.0
Real own-source revenue	4.7			3.6

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TABLE 1.—COMPARISON OF NEW YORK TO 11 CITIES, SELECTED DATA[1]

City[2]	Per capita expenditures, 1972–73	Employment per 10,000 population, 1974	Debt per capita, 1972–73	
			Total	Short term
New York	1,286	528.2	1,676	352
Boston	756	465.0	1,385	334
Chicago	600	352.5	733	169
Newark	827	421.5	616	112
Los Angeles	759	401.1	650	14
Philadelphia	653	414.5	1,015	101
San Francisco	1,073	488.3	1,225	151
New Orleans	471	357.7	770	39
St. Louis	610	424.6	731	49
Denver	721	410.5	786	52
Baltimore	814	434.1	609	45
Detroit	650	354.3	658	63

[1] Source: Congressional Budget Office, "New York City's Fiscal Problem," table 7.
[2] Data are for all local governments serving the central county area where the city is located.

TABLE 2.—INDICES OF THE DATA IN TABLE 1

City[2]	Per capita expenditures, 1972–73	Employment per 10,000 population, 1974	Debt per capita, 1972–73	
			Total	Short term
New York	100	100	100	100
San Francisco	83	92	73	43
Newark	64	80	37	32
Baltimore	63	82	36	13
Boston	59	88	83	95
Los Angeles	59	76	39	4
Denver	56	78	47	15
New Orleans	55	68	46	11
Detroit	51	67	39	18
Philadelphia	51	78	61	29
St. Louis	47	80	44	14
Chicago	47	67	44	48

Chairman MOORHEAD. The subcommittee would prefer to hear from the other witnesses and then direct questions to all of you. I hope to conclude the hearing by noon. Can you stay or would you like us to excuse you early and direct our questions to you now?

Mr. YEO. If it is agreeable with the subcommittee it would be helpful to me—although of course I would not want the subcommittee to accommodate me—but it would be helpful if I could try and answer questions now. But if the subcommittee feels otherwise, I would be happy to stay.

Chairman MOORHEAD. Well then we will endeavor under hopefully strict limits, Mr. Secretary, to direct our questions first to you. If you have to leave, we will understand that.

It seems to me, Mr. Secretary, that while we would all agree that inflation is a very, very significant factor, possibly even the most important factor, that your testimony really downgrades the importance of the recession and unemployment as a factor in the problems that face the cities.

I think we would all agree by and large inflation is more or less uniform nationally whereas unemployment rates vary greatly from region to region. The areas which you identify as having more problems, such as the East and the Middle West, we recognize as having the higher rates of unemployment and these are the areas where we have the more serious finance problems of State and localities.

Of course all cities face inflation, but some are hit with inflation plus recession and that is where we have the trouble. And it just seems to me that the Treasury's mentality has completely captured my friend from Pittsburgh in his statement. At least as to inflation being the only problem that is facing the country.

You mentioned as a fine example, Mr. Secretary, the situation in Seattle but of the major Western cities, as you know, Seattle, recently had the lowest rate of employment. It was below Los Angeles and below Phoenix and below San Diego and below San Francisco. So that I would think that your statement, while I think it is an excellent one, does not give adequate recognition to the recession factor.

Mr. YEO. Well Mr. Chairman, I think that in my statement I attempted to make a distinction between cyclical developments and structural developments. We have had inflation at what I would call relatively rate for 10 years. It has varied, but overall it has been 10 years of inflation. We have had a recession and now a recovery for about 18 months. If we were in a period of economic stagnation, of no recovery, of something that would prevail for a long period of time—which I certainly do not believe is the case—then that stagnation would in my view rank with inflation as a source or a breeding box for financial difficulties.

I'm not suggesting that the recent recession did not fall harshly on many areas and I'm not suggesting that it and the forces that produced it has not been terribly important; what I am saying is that in taking apart the municipal financial structure, which I have been doing for some 17 years, this recession has not had a particularly marked impact on the structure. It has hurt lots of people; but what has had a marked impact on the structure, on the underlying structure of municipalities, Mr. Chairman, on the financial side has been —and this is something that I believed long before I joined the Treasury and is my judgment—has been inflation.

Chairman MOORHEAD. Well the figures that this subcommittee has developed showed that in certain areas of the country, particularly areas based on agriculture or energy, there were no financial difficulties; that is, that financial difficulties in those cities were rare compared to those in areas which were hit hardest by the recession. And the recovery, and hopefully we are in a recovery, will not be uniform. I think you even testified to this, Mr. Secretary. So there still will be areas which are going to be suffering from a recession. I think these are the areas that we have got to keep our eye on. We must not think exclusively in terms of inflation, as your testimony seems to imply, but also about the impact of the recession.

At one point in your testimony, you referred to "socioeconomic problems." And again the Treasury mentality seems to have gotten to you for the word "socioeconomic" disappears from the testimony.

If you look just at the figures, I would say we could possibly say the city of Newark, New Jersey is a healthy city because under New Jersey law it can't have its current budget in deficit. Yet I think anybody looking at the Newark city's situation, putting a little stress on the word "socio," which as I say appears only once in your testimony, would say this is not a healthy city whatsoever. This is not primarily because of inflation, Mr. Secretary; but because of entirely different sorts of problems, one of which is inflation.

Mr. YEO. Well, I'm glad you added, "one of which is inflation" because I think that the people of Newark in particular are hard-hit by inflation.

I would like to try and clarify the relative values, the weight given. If we want to have an aggregate economic climate that facilitates orderly conditions or orderly circumstances among States and local governments, there are two prerequisites in my judgment: (1) The first would be an orderly rate of economic growth over a long period of time; (2) economic growth without inflation.

Now as you know, in my judgment the two are interrelated and you can't have one without the other. So I would summarize by saying that, as we look ahead for 5 years, a prerequisite for orderly financial circumstances for city and local governments will be orderly underlying economic conditions.

Chairman MOORHEAD. Mr. Secretary, before my time expires let me direct one more question to you.

While this subcommittee is primarily looking ahead and not looking at the New York City crisis, nevertheless we cannot ignore that, you are, as I understand it, in charge of administering the New York City loan program. Are you satisfied with the progress that the city of New York has made in meeting the commitments to its financial plan?

Mr. YEO. We are satisfied with the developing efforts. I cannot say that on the basis of the information we have in hand now, Mr. Chairman, that the city is on target in terms of meeting their criteria as well as ours. Now we expect to be receiving more up-to-date information. I will be happy to come up and discuss that information with this subcommittee. But I don't want to go further than that because I am hopeful that that information that is being sent down to us. I'm hopeful that will reflect that they are making, and by their own plan, more progress than earlier had been the case.

Chairman MOORHEAD. Thank you, Mr. Secretary. My time is expired.

Congressman Brown.

Representative BROWN of Ohio. Thank you, Mr. Chairman. Following up a bit on what Mr. Moorhead has asked, Mr. Secretary, would you compare crime and the social atmosphere vis-a-vis tax ramifications of staying or leaving from the cities?

In other words, you seem to have stressed economic ramifications such as inflation, but are you saying that the outward migration primarily occurs because of the economic impact to the extent that cities have to levy more taxes and the taxes are not as high in the subrban areas, so therefore, you have an outward migration of a tax base?

Mr. YEO. The first point I'm saying is there is a distinction at least in my mind—and perhaps I am the only one who has made this distinction—between economic developments of the type we are all concerned about, Congressman Brown, and State and local government financial circumstances. There is a relationship but it isn't clear to some.

And a great deal of the analysis that I have seen—and maybe this is why I am leaning a little over the other way—in effect assumes that if you had a declining economy, by definition you have financial troubles. Now that just isn't the case. That has not been the case and it will not be the case. In terms of outward migration, in terms of people's voting with their feet, there are a number of circumstances that produce this phenomena; some of which you mentioned and some of which I mentioned.

I think that there are factors. But I try to adjust it from the standpoint of—well, I admit, Mr. Chairman, I looked at the numbers and I addressed it from that perspective. But there is no question but that living conditions are a factor in attracting and keeping people who pay taxes, yes.

Representative BROWN of Ohio. All right. Now then if we agree—and I think we do—that cities must rely to a great extent on property taxes and if property taxes then are a particular problem of the cities, should not the income tax laws be changed to provide a better offstep against income for the paying of property taxes? Just let me follow up further and ask: What about an investment tax credit for improvement of properties in selected deteriorating areas such as we have with respect to areas with high unemployment? We give them special breaks, special advantages, special Federal funds. What is wrong with an idea such as that?

Mr. YEO. Conceptually it is the kind of idea I think I would have to think about. And also since I am depicted as a bookkeeper here this morning, I would have to look at the costs.

Representative BROWN of Ohio. I was, of course, a little disturbed with the administration when it originally advocated changes in the bankruptcy law with respect to the New York situation when it originally had been limited to cities of over 1 million I believe, Mr. Secretary, and then it was to be made applicable to all cities. With respect to the New York City affirmative assistance. I felt it should be a New York City bill, which finally the administration came around to. I thought that the bankruptcy provision—to the extent we could under the constitutional authority, Mr. Secretary, to pass bankruptcy laws—it should be limited to New York City.

You have here this morning criticized the problem of moral obligation bonds. And I respectfully suggest when you spread the bankruptcy laws to all cities and give greater access to the bankruptcy laws, you are changing GO's all over the country to moral obligation bonds; the moral obligation not to go into bankruptcy.

You also said in your statement that moral obligation bonds must be viewed primarily as a revenue bond. I suggest they are not as good as revenue bonds because a revenue bond is more closely examined with respect to the potential for payment under that revenue bond. So you can zero in on its potential much better than you can on GO or a moral obligation bond.

Let me suggest something else. Banks presently are restricted in their holdings; that is, national banks are restricted in their holdings of revenue bonds but there is no regulation of how much they will hold in GO's nor is there any regulation of how much of any particular issue or one city's issue may be held by banks. And I think across the board today—and maybe you don't agree—that across the board today do you think the revenue bonds are a much worse investment than GO?

Mr. YEO. I think that there are some revenue bonds that are extremely good investments. But I could not generalize, no.

Representative BROWN of Ohio. Would you generalize to say that GO's are much beter than revenues?

Mr. YEO. You have accurately described the underlying premise behind the distinction in the National Banking Act. The underlying premise is that: (1) Secured by the unlimited taxing power of municipality; and (2) secured by specific revenues. And that almost by definition, everything else being constant, produces a different credit situation.

Representative BROWN of Ohio. But may I ask——

Mr. YEO. In terms of the Bankruptcy Act, the proposed amendments and your question to general obligation bonds, I have to confess that I do not share to the same degree, Representative Brown, the fears that are held in certain parts of the financial community, And I can say this, namely, that when I used to buy general obligation bonds, I always assumed that there was a possibility that there could be a default and I always assumed that there was a possibility that in a budgetary crisis, that when it got to be either me as a bondholder or the policeman, that it might come up the policeman.

But in answering your question regarding revenue bonds, and GO's, conceptually the unlimited taxing power behind a general obligation bond provides the basis for the distinction made in the National Banking Act.

Representative BROWN of Ohio. But would you not agree that although a revenue bond is restricted in the revenues to which it will have access, it also receives almost a priority with respect to those revenues whereas, on GO's, general functions and operations of cities have access to those revenues.

So I think there is a plus and minus on each side of those.

Mr. YEO. I agree.

Representative BROWN of Ohio. Michigan has a municipal finance commission and no public body may issue paper and instruments of indebtedness without getting the approval of the municipal finance commission. And there is basically one firm of attorneys there and you can't sell your bonds if you don't get the approval of that bond house. You are apparently not advocating something like that from your statement but, as I understand your proposal, it is that you would have a Federal body that would be a kind of a reservoir of information and that the information would speak for itself. There would be approval function or anything of that nature. Am I correct in what you are proposing?

Mr. YEO. My proposal in one sense is a little more than you described and in another sense a little less. We are advocating that investors, that constituents be provided on a regular basis and on a consistent basic financial information by municipalities. In my judgment we have an investment community, namely, individual investors and constituents, who are up on their toes. They are looking very carefully but there is nothing to look at in some cases. In some cases this financial data that is provided is very, very limited. The city of

Seattle puts together its own financial accounts, and I can tell you from experience they do it in a totally different manner than does Pittsburgh. So that we don't have an informational mechanism for investors to make distinctions. And it is this process of making distinctions which in my judgment we need to try and facilitate. Because if we do that, with people as concerned as they have been, why we will have a very efficient system which will ensure fewer financial problems in the next 5 years than we had in the last.

Representative BROWN of Ohio. Well my time has expired. I would like to pursue these things with you but thank you. Thank you, Mr. Chairman.

Chairman MOORHEAD. Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

Mr. Yeo, would you agree that New York City's biggest problems—and New York has taken quite a beating and takes a beating all of the time including this morning—its biggest problem is to keep business in New York and to keep its taxpaying citizens in New York?

Mr. YEO. Well, Senator, if I gave a city that I'm very fond of a beating, why I regret that. I didn't take it as a beating but——

Senator JAVITS. Well perhaps in your enthusiasm for showing what bad boys we have been as an example to others, zealousness in that course may have gone a little beyond what is needed. That is why I asked the question.

Mr. YEO. I think if I have to give an immediate set of priorities, if that is what you are asking me, I think that the most important priority today is to demonstrate an ability within the city, which I am personally confident is there although I think it is in the woodwork, demonstrate the ability of the city to manage its affairs in such a way that financial confidence can return to the city. And that will probably do more than any other single thing to keep its major economic constituents in the city.

Senator JAVITS. Well——

Mr. YEO. So that would be my priority. I agree that, as an end result, as a given, the city of New York or any city has to keep its financial base, its economic base.

Senator JAVITS. Well what about its base of police and firemen? We are, as you know, hearing a lot of advertising about New York in terms of the crime rates yet when you look at the comparable crime rates among the largest cities, it doesn't look so bad. Shouldn't we have a very keen concern about at least helding that end up?

Mr. YEO. Senator, I am not suggesting that some level of services, and very frankly a level of service that the community wishes to be afforded, should or should not be maintained. I think the question really—and I don't know the answer to it although perhaps others do—but there has to be an equilibrium between the level of services that a community wants and what they are willing to pay for.

Senator JAVITS. Well that is very true. But when a city of 8 million has gotten into the jam that New York City has—and you know I never gilded that lilly.

Mr. YEO. No, you did not.

Senator JAVITS. It also has to have a certain amount of assistance to get itself off the ground unless it is constantly going to be in the syndrome of poverty. That is all I'm talking about. I hope very much that in the administration of the New York City Act, which you have such a heavy responsibility for, that it will be understood that we are not only a city which has been the victim of these practices—which are heartedly condemned by you and me and all of us—but it is a fact, however, that we also lost half million in employment, and that is about half a million out of about 3½ million, which is a tremendous number. We lost that during 5 years. And there is a demographic shift which took place in New York City of about 3 million, and these are very heavily welfare impacted, which brought the city to its knees. And there is no provision in the United States for dealing with that kind of demographic shift, which has nothing to do with what the people of New York City do or do not want. They just had it, and these people came out of the South and out of Puerto Rico. That was the reason why we invoked the aid of the United States really.

And in addition really you have to consider the impact upon the total economy of the country.

So the thing that is worrying me is whether, Mr. Secretary, in the administration of this act, it is being kept in mind that somehow we have to afford a level of services which will keep business and employment in New York City as well as to tax ourselves to the hilt.

And by the way, that is self-defeating too because the business firms we want to keep also are taxpayers and hence it diminishes the attractiveness of New York as a place to do business, which is a very, very serious thing for all of us.

And you know I have tried to be very constructive about this just you have and Secretary Simon has once. We all got on the same base so to speak. I would appreciate your ideas and thoughts about this whole subject.

Mr. YEO. Well as you know, as a veteran of many, many sessions on the city, if you look at just the expenditure side, it is usually very difficult to identify something that at least isn't desirable or at least something that is undesirable. And if you look on the revenue side, taxes by definition are too high. And we all know the relationship between higher taxes and people voting with their feet, and of course how that is self-defeating.

And the art—and I'm trying to explain it to three practioners I guess—the art, as I understand, is to reconcile the two. And it was that art that temporarily disappeared from our large cities.

It isn't a matter of accounting type analyses, Senator Javits. That isn't the art that I am talking about. It is getting equilibrium, or as young people would say, getting it right in terms of what people want and what they are willing to pay for. And in each case that involves credit difficulties, the source has been a political collage where the equilibrium between what people wanted and what they were willing to pay for got out of whack and a deficit resulted.

In terms of the city, I think the most important single thing that needs to be done, I think the thing that will restore most confidence and restore the self-respect of the city and the respect of others and thereby make a contribution to holding the city's economic base, Senator, I think that this most important thing is to regain the ability to gear together what people want and what they are willing to pay for.

As far as we are concerned, we are administering a lending program for seasonal finance.

We plan under the terms that Congress legislated, Senator, to follow that scrupulously. We hope to make constructive suggestions too. If we find that the reasonable probability of repayment, which you gentlemen legislated, is slipping away from us, then under the terms of legislation we will have to respond in terms of future extentions of credit. So that I think that I would summarize our position by saying that I agree with the interrelationship which you described. I personally believe that the city can make very substantial progress. I believe that it has made progress. I personally believe it is going to be necessary to make more progress.

Senator JAVITS. Well, thank you. Mr. Yeo, my time is up. I just wanted to straighten one thing out on the figures because you have drawn some important conclusions from these figures. The reason I bring these figures up is because the comparisons respecting New York City have been based upon assuming certain obligations which many other cities don't assume, for example, in the field of welfare and education. In many comparable cities welfare is a State matter, that is the part that isn't paid for by the feds, and schools are also a State matter. And of course New York City carries all of that.

In addition, there are certain calculations respecting individual compensation for workers in the city as well as fringe benefits that are important. And of course New York has very terribly cut its municipal employment.

Chairman MOORHEAD. Mr. Yeo, I assume you would be willing to answer questions of the members of the committee, which are submitted to you in writing?

Mr. YEO. Yes, sir, I would.

Chairman MOORHEAD. I would hope in view of the fact that we have more witnesses, the members would forego a second round of questioning of Mr. Yeo and take advantage of his willingness to answer questions in writing. Thank you, Mr. Yeo.

Mr. YEO. Thank you, Mr. Chairman.

Chairman MOORHEAD. The subcommittee would now like to hear from Mr. Orlebeke of the Department of Housing and Urban Development.

STATEMENT OF HON. CHARLES J. ORLEBEKE, ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY JOHN C. WEICHER, DEPUTY ASSISTANT SECRETARY FOR ECONOMIC AFFAIRS

Mr. ORLEBEKE. Thank you, Mr. Chairman.

I appreciate the opportunity to participate in these very significant hearings. Before I make my statement I would like to introduce my colleague, John C. Weicher, who is the Deputy Assistant Secretary for Economic Affairs in the Department and is the Department's chief economist.

Chairman MOORHEAD. We are pleased to have you with us.

Mr. ORLEBEKE. Mr. Chairman, if you have no objection and in the interest of time, I will summarize my statement.

Chairman MOORHEAD. Without objection your entire statement will be made a part of the record.

Please proceed, Mr. Orlebeke.

Mr. ORLEBEKE. Thank you for the opportunity to testify on the fiscal outlook for State and local governments.

Fiscal projection is an inexact science at best, and very small changes in assumptions about the future result in big differences in projected outcomes. In addition, as Under Secretary Yeo's testimony indicates, the data we have on local fiscal conditions lack timeliness and comparability, and we clearly must improve our ability to collect the information we need to assess future public policy options.

Based on what we do know, however, and based on our view of the future, our best judgment is that the New York crisis need not, and probably will not, lead inexorably up to a general fiscal crisis. I do not mean to suggest that the prospect is uniformly rosy for all cities; I do mean that an improving national economy and increased fiscal restraint at the State and local level should work toward staving off a widespread replication of the New York experience.

First, as the economy recovers from the recession, State and local revenues will be increasing at more rapid rates.

Second, on the expenditure side, the rapid rates of growth in recent years have been stabilizd and in some cases reduced.

If historical patterns prevail, as the economy recovers the revenue increases will precede expenditure increases. Indeed, it appears as your committee's surveys suggested that most State and local executives proposed either standstill or reduced budgets for fiscal 1976. The net effect should be a reduction in State and local deficits, and a more favorable fiscal picture.

Third, the bond market seems to have weathered its roughest year since the 1930's, and confidence is being restored. It appears that sales in 1976 will be reduced somewhat from 1975. However, long-term bond sales reached an historical high of $29.2 billion last year, up 28 percent from the $22.8 billion in 1974. Currently, we estimate that bond sales will be in the $25 billion range; one investment firm, Solomon Brothers, predicts new bond sales as high as $26.5 billion. Of course, not all governments will be able to participate easily in this market. Most investors will be looking for quality issues. Those State and local governments that can show sound financial management will fare well; those that cannot will have to pay more to borrow. In general, however, it seems clear that the New York City situation did not destroy the municipal bond market.

Let me turn now to the questions of types of governments and localities that seem somewhat more vulnerable to fiscal problems.

Unfortunately, adequate data are not yet available to allow us to identify those specific States and cities that are likely to have insufficient revenues to meet basic needs in the future.

Studies which have been done of local fiscal trends tend to point toward the older, large cities of the Northeast and Midwest as being somewhat more vulnerable to future fiscal problems. Within HUD, we have been working with a simplified analytical model of the urban economy which we believe provides some insight into the fiscal problems of such cities. The model examines how various characteristics of cities influence their service demands, tax base, and financial condition. Our analysis suggests that the fiscal positions of these cities differ substantially from the positions of the newer cities of the South and West, and from small cities generally.

There are differences in both revenue and expenditure patterns which are significant. Typically the tax structureso f the older large cities make greater use of income and sales taxes, while most cities rely more heavily on property taxes. As a result, the tax revenues of the older cities are more responsive to economic changes. This responsiveness means that the older cities suffer more during recessions, such as the one just past, but it also means that their revenues increase by a greater amount during economic recoveries and expansions. The improved economic conditions which I discussed earlier are therefore particularly important to these cities.

The large cities have also come to rely more heavily on Federal and State aid and so are more vulnerable to the elimination or reduction in such assistance. General revenue sharing is particularly important to such cities, and I urge you to act quickly on the extension of revenue sharing so that they, and other units of government, can plan their fiscal futures with more confidence. Continued general revenue sharing will reduce the danger of further fiscal crises.

We do not anticipate that the newer centers of economic activity in the South and West face serious fiscal problems. They have experienced strong employment and population increases. Their main revenue problem may be the development of local tax structures which permit them to tap the potential tax revenue available to them. On the expenditure side of the budget, they may need to build capital facilities to service their growing populations and employment. While some fiscal stresses may arise in these processes, the problems should not be severe.

The fiscal situations of the older, Northeastern and Midwestern cities are partly generated by their economic characteristics. Our analysis shows that fiscal pressures have been increasing most rapidly for cities which have large poverty populations, cities which provide services to large surrounding metropolitan areas, cities with declining populations, as well as cities with declining employment in the private sector.

These factors often occur simultaneously and interact in many of the older, larger central cities of these regions. They have undergone a decline in employment and change in the composition of the remaining employment from high-taxable businesses, particularly manufacturing, to low-taxable business and Government sectors. Their population has declined concurrently, with the decline accompanied by an increase in the number and proportion of poorer residents.

The decline in population typically increases the per capita cost of providing services to the remaining residents. Cities cannot easily cut back on their expenditures, since the existing facilities still cost almost as much to maintain. In addition, the change in the composition of the population increases the demand for Government services, while at the same time making it harder for cities to raise tax revenue. The fiscal problems are complicated by the fact that the older and larger cities frequently maintain to a greater extent than most smaller cities the responsibility for administering, and to some extent financing, human resources programs.

Another problem common to nearly all local governments is that the rate of productivity growth is lower in the public sector than in the private. Since the public sector must pay wages competitive with private enterprise, costs in the public sector tend to increase at a faster rate. In the absence of an improvement in productivity—or increased taxes or intergovernmental grants—expenditures in large cities will increase at a faster rate than revenus. An important objective of HUD's community development research program is to work with State and local officials to improve productivity in the public sector. Mr. Chairman, I list a couple of these examples in my prepared statement.

Even in the older large cities, not all trends are negative. Energy costs, demographic trends, and changing life style preferences appear to be creating an increase in the development potential of central cities. A recent survey by the Urban Land Institute has found that many if not most such cities are now benefitting from significant private-market housing renovations and rehabilitation, and are pulling back numbers of middle- and upper-income households, particularly young people with few children. This phenomenon is easily overlooked, because the amount of renovation is small compared to the amount of new construction, but it is substantial compared to past renovation and it appears to be increasing. In many cities, there is a concentration of renovation activity in one or several neighborhoods which are coming back. These neighborhoods are usually virtually unknown outside their own cities. Again, in this critically important area of neighborhood preservation, HUD has an active program of research and demonstration aimed both at understanding and stimulating the revitalization of urban neighborhoods. In addition, as HUD has recently reported, cities are electing to use a substantial proportion of community development block grant funds for preservation activities.

If the hopeful trends we are seeing continue, the long term fiscal positions of many central cities in the Northeast and Midwest may well prove to be much better than they have been in the recent past.

In conclusion, I would like to emphasize that our analysis identifies problems which some cities confront; it does not predict fiscal disaster for any city. The experience of New York last year has in my opinion been therapeutic for other cities; it has sharply reduced the likelihood that they will permit their cash-flow problems to reach the stage of crisis. There is increasing evidence that other cities are prepared to make hard choices, including cutting public expenditures and payrolls. Promising less has become good politics as well as good fiscal policy. As a result, public officials now seem willing to face their problems directly, rather than to sit back passively and hope for outside help while expenditures outrun revenues from year to year.

If cities are able to hold the line more effectively on expenditures, while their revenues increase in the normal pattern of an economic recovery, then their financial positions will improve markedly. The New York experience should be beneficial to other cities, showing them forcefully that, as Governor Carey expressed it in his annual message last year, "the time of plenty, the days of wine and roses are over". So they are; but fiscal sobriety, not fiscal crisis, should be the result.

Chairman MOORHEAD. Thank you very much, Mr. Orlebeke. Your prepared statement will be printed in the hearing record at this point.

[The prepared statement of Mr. Orlebeke follows:]

PREPARED STATEMENT OF HON. CHARLES J. ORLEBEKE

Thank you for the opportunity to testify on the fiscal outlook for state and local governments.

Fiscal projection is an inexact science at best and very small changes in assumptions about the future result in big differences in projected outcomes. In addition, as Under Secretary Yeo's testimony indicates, the data we have on local fiscal conditions lack timeliness and comparability, and we clearly must improve our ability to collect the information we need to assess future public policy options.

Based on what we do know, however, and based on our view of the future, our best judgment is that the New York crisis need not, and probably will not, lead inexorably to a general fiscal crisis. I do not mean to suggest that the prospect is uniformly rosy for all cities; I do mean that an improving national economy and increased fiscal restraint at the state and local level should work toward staving off a widespread replication of the New York experience.

First, as the economy recovers from the recession, state and local revenues will be increasing at more rapid rates. For example, one important indicator of economic growth is taxable personal income, which appears to have risen steadily during the last nine months of 1975. For the year overall, it rose at 5 percent, and for 1976, it is projected to rise at 12½ percent. This rise in income will be translated into higher state and local income tax revenues directly, and into higher sales and excise tax revenues as consumers increase their spending.

Second, on the expenditure side, the rapid rates of growth in recent years have been stabilized and in some cases reduced. Since mid-1974, state and local expenditures for employee salaries have been rising less rapidly than the rate of inflation; in real terms, total salaries declined by 0.4 percent. This pattern can be expected to continue for about another year, partly because school enrollment should decline further during the next year, and partly because local governments are looking at their employment rolls carefully to see where reductions can be made. Similarly, the rate of growth in state and local government purchases should be less than the rate of growth in state and local tax revenues.

If historical patterns prevail, as the economy recovers the revenue increases will precede expenditure increases. Indeed, it appears that most state and local executives proposed either standstill or reduced budgets for fiscal 1976. The net effect should be a reduction in state and local deficits, and a more favorable fiscal picture for these governments.

Third, the bond market seems to have weathered its roughest year since the 1930's, and confidence is being restored. It appears that sales in 1976 will be reduced somewhat from 1975. However, long-term bond sales reached an historical high of $29.2 billion last year, up 28 percent from the $22.8 billion in 1974. Currently, we estimate that bond sales will be in the $25 billion range; one investment firm (Solomon Bros.) predicts new bond sales as high as $26.5 billion. Of course, not all governments will be able to participate easily in this market. Most investors will be looking for quality issues. Those state and local governments that can show sound financial management will fare well; those that cannot will have to pay more to borrow. In general, however, it seems clear that the New York City situation did not destroy the municipal bond market.

The general picture is therefore encouraging. With this as background, I would like to turn to the questions of what types of governments and localities are somewhat more vulnerable to fiscal problems.

Unfortunately, adequate data are not yet available to allow us to identify those specific states and cities that are likely to have insufficient revenues to meet basic needs in the future. Until such data are available, we cannot be sure that other cities will or will not have problems in the future, just as we could not predict very far in advance the severity of the fiscal crisis in New York.

Studies which have been done of local fiscal trends tend to point toward the older, large cities of the Northeast and Midwest as being somewhat more vulnerable to future fiscal problems. Within HUD, we have been working with a simplified analytical model of the urban economy which we believe provides some insight into the fiscal problems of such cities. The model examines how various characteristics of cities influence their service demands, tax base, and financial condition. Our analysis suggests that the fiscal positions of these cities differ substantially from the positions of the newer cities of the South and West, and from smaller cities generally.

There are differences in both revenue and expenditure patterns which are significant. Typically the tax structures of the older large cities make greater use of income and sales taxes, while most cities rely more heavily on property taxes. As a result, the tax revenues of the older cities are more responsive to economic changes. This responsiveness means that the older cities suffer more during recessions, such as the one just past, but it also means that their revenues increase by a greater amount during economic recoveries and expansions. The improved economic conditions which I discussed earlier are therefore particularly important to these cities.

The large cities have also come to rely more heavily on Federal and State aid and so are more vulnerable to the elimination or reduction in such assistance. General revenue sharing is particularly important to such cities, and I urge you to act quickly on its extension so that they, and other units of government, can plan their fiscal futures with more confidence. Continued general revenue sharing will reduce the danger of further fiscal crises.

We do not anticipate that the newer centers of economic activity in the South and West face serious fiscal problems. They have experienced strong employment and population increases. Their main revenue problem may be the development of local tax structures which permit them to tap the potential tax revenue available to them. On the expenditure side of the budget, they may need to build capital facilities to service their growing populations and employment. While some fiscal stresses may arise in these processes, the problems should not be severe.

The fiscal situations of the older, Northeastern and Midwestern cities are partly generated by their economic characteristics. Our analysis shows that fiscal pressures have been increasing most rapidly for cities which have large poverty populations, cities which provide services to large surrounding metropolitan areas, cities with declining populations, and cities with declining employment in the private sector.

These factors often occur simultaneously and interact in many of the older, larger central cities of these regions. They have undergone a decline in employment and change in the composition of the remaining employment from high-taxable businesses, particularly manufacturing, to low-taxable business and government sectors. Their population has declined concurrently, with the decline accompanied by an increase in the number and proportion of poorer residents.

The decline in population typically increases the per capita cost of providing services to the remaining residents. Cities cannot easily cut back on their expenditures, since the existing facilities still cost almost as much to maintain. In addition, the change in the composition of the population increases the demand for government services, while at the same time making it harder for cities to raise tax revenue. The fiscal problems are complicated by the fact that the older and larger cities frequently maintain to a greater extent than most smaller cities the responsibility for administering, and to some extent financing, human resources programs.

Another problem common to nearly all local governments is that the rate of productivity growth is lower in the public sector than in the private. Since the public sector must pay wages competitive with private enterprise, costs in the public sector tend to increase at a faster rate. In the absence of an improvement in productivity—or increased taxes or intergovernmental grants—expenditures in large cities will increase at a faster rate than revenues. An important objective of HUD's community development research program is to work with State and local officials to improve productivity in the public sector. For example, we have funded the development of improved methods of providing fire protection; a demonstration for local officials to measure the effectiveness and efficiency of local government operations; a demonstration project on improved maintenance methods for streets, parks and recreation facilities; and the preparation of a productivity handbook for local officials.

Even in the older large cities, not all trends are negative. Energy costs, demographic trends, and changing life style preferences appear to be creating an increase in the development potential of central cities. A recent survey by the Urban Land Institute has found that many if not most such cities are now benefitting from significant private-market housing renovations and rehabilitation, and are pulling back numbers of middle- and upper-income households, particularly young people with few children. This phenomenon is easily overlooked, because the amount of renovation is small compared to the amount of new construction, but it is substantial compared to past renovation and it appears to be increasing. In many cities, there is a concentration of renovation activity in one or several neighborhoods which are "coming back." These neighborhoods are usually virtually unknown outside their own cities. Again, in this critically important area of neighborhood preservation, HUD has an active program of research and demonstration aimed both at understanding and stimulating the revitalization of urban neighborhoods. In addition, as HUD has recently reported, cities are electing to use a substantial proportion of community development block grant funds for preservation activities.

If the hopeful trends we are seeing continue, the long term fiscal positions of many central cities in the Northeast and Midwest may well prove to be much better than they have been in the recent past.

In conclusion, I would like to emphasize that our analysis identifies problems which some cities confront; it does not predict fiscal disaster for any city. The experience of New York last year has in my opinion been therapeutic for other cities; it has sharply reduced the likelihood that they will permit their cash-flow problems to reach the stage of crisis. There is increasing evidence that other cities are prepared to make hard choices, including cutting public expenditures and payrolls. Promising less has become good politics as well as good fiscal policy. As a result, public officials now seem willing to face their problems directly, rather than to sit back passively and hope for outside help while expenditures outrun revenues from year to year.

If cities are able to hold the line more effectively on expenditures, while their revenues increase in the normal pattern of an economic recovery, then their financial positions will improve markedly. The New York experience should be beneficial to other cities, showing them forcefully that, as Governor Carey expressed it in his annual message last year, "the times of plenty, the days of wine and roses, are over." So they are; but fiscal sobriety, not fiscal crisis, should be the result.

Chairman MOORHEAD. The subcommittee will now hear from Mr. Robert E. Merriam, chairman of the Advisory Commission on Intergovernmental Relations.

Mr. Merriam.

STATEMENT OF HON. ROBERT E. MERRIAM, CHAIRMAN, ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, ACCOMPANIED BY JOHN SHANNON, ASSISTANT DIRECTOR

Mr. MERRIAM. Mr. Chairman, and members of the subcommittee, I should perhaps at the outset clear up one matter so that my remarks are fully understood.

The Advisory Commission on Intergovernmental Relations is a bipartisan body. I am its chairman by virtue of Presidential appointment, but I have a full-time responsibility as a developer, with headquarters in Chicago.

I mention this only because you said that was administration testimony but mine is not. My thoughts represent the work of a bipartisan body which has been in existence for some 16 years as a result of a congressional action authorizing a permanent commission to monitor the workings of our Federal system.

The Commission is composed of representatives of Federal, State and local governments, and there are three of us who are called public members.

I wanted to mention these facts so that neither you nor those listening today would think the administration was quarreling with itself.

Chairman MOORHEAD. I was aware of the composition of the Commission and I'm glad you made it clear for the record.

Mr. MERRIAM. Before I go on to my formal testimony, which I will also capsulize, I would ask that it be printed in full.

Representative MOORHEAD. Without objection your prepared statement will be printed in the hearing record.

Mr. MERRIAM. I would like to put your discussion in a somewhat broader context for a moment or two if I may. Our Commission over the years of its existence—and I am accompanied here by Mr. John Shannon, who is assistant director of the Commission's staff and a full-time member of that staff.

Chairman MOORHEAD. We are pleased to have you with us, Mr. Shannon.

Mr. MERRIAM. Our Commission has been dealing in a variety of ways with the very basic problem that your subcommittee is addressing today and has come up with a host of suggestions for a realinement of functions of government; suggestions that we think are very critical.

For example, we have for some years felt that the welfare function should essentially be a Federal responsibility. We have made some progress of course, in that direction already. We have held that the States should pay a much larger role in the financing of the public education system. And we are seeing a very important trend in that direction, albeit there is still a major reliance on the local property tax to finance schools, as we all know. We have recommended that Federal grants to local governments should be of a mixed variety; that is, categoricals, block grants, and revenue sharing.

And like Mr. Orlebeke, I would strongly emphasize the importance of revenue sharing as a part of this delivery package.

We have recommended, most importantly and most germanely to your discussion today, Mr. Chairman, that the States continue to extend their role not only in the oversight of local government activities, but also in the provision of funds through its own revenue sharing for local government programs. The States, by and large, have assigned these tasks, to local governments which they have created for the delivery of services to people.

In this context I think that it is important to note that there has been a little noticed but really fantastic revolution over the past 20 years in the whole domestic public sector. The State and local governments now have so dramatically increased their own involvement in financing public services that when one looks at the present expenditures from own-sources—not taking into account the transfer payments from the Federal Government—the combined State and local tax effort now substantially is the equal to that of the Federal domestic expenditure effort.

States have, over this past 10 to 20 years, enacted tremendous tax increases, as have many local governments as well. And we have seen this happen despite the political hazards that are involved. So, Mr. Chairman, most States have now enacted a State income tax as well as a broadly based general sales tax.

And as we know, some localities, some local governments are also now entering into that field.

I mention this only to say that this expansion is reflected in the fact that the State and local area is the fastest growing area of government employment, and in fact the fastest area of employment of any of the sectors, either public or private in this country.

From 1955 to date, just to give you an example, State and local employment has increased by some 119 percent. This is just one measure of the increased involvement of State and local governments in the domestic sector.

Now with that as a general background, let me just very quickly respond to some of the questions which you posed to us.

First of all, you asked what is the realistic outlook for the aggregate State and local government expenditures in the years ahead?

Our indications are that $1 billion increase in gross national product produces more or less automatic increases in State and local receipts from their own-sources of about 10 percent or $100 million. If the administration's proposed increase of $185 billion in GNP for calendar year 1976 is accurate, State and local receipts should increase by approximately $18 billion. When corrected for inflation, this represents 3 and 4 percent real growth and a significant increase over the 1975 performance.

I would like to call your attention to the table which is attached to my prepared statement. I think the most significant thing on that table is that it indicates from 1948, which is where we started collecting significant data, until today, Mr. Chairman, State and local expenditures from their own-sources as a percentage has doubled from 6 percent to 12 percent of the total GNP, which again reflects this dramatic change I mentioned earlier.

In view of the public resistance to higher taxes and the presence of a large Federal deficit, it is obvious that State and local governments can't realistically anticipate substantial revenue increments either from tax hikes or from the Federal grant route.

In short, we would say that economic recovery appears to be the only major source for additional revenues for most State and local governments over the next year or two.

Next on the expenditure side, we would certainly feel, Mr. Chairman, that the presence of relatively high unemployment as well as inflation will continue to place heavy pressure on most State and local governments in general and on the health and welfare programs in particular.

So to sum up, we see some improvement but would not say that the State and local fiscal picture can be described as bright.

Second, you asked us to comment on which State and local governments are most likely to experience special fiscal difficulties and why.

It has already been noted that, in general, major central cities of the Northeast and Midwest are the ones with the most severe fiscal tensions. One could say that when the Nation comes down with a heavy economic cold, the central cities in the Northeast and Midwest quickly develop fiscal pneumonia. They will certainly be the last to show marked fiscal improvement when the economy recovers.

Mr. Chairman, and gentlemen of the committee, we made a very extensive study about 3 years ago of the whole problem of municipal financial emergencies. I smile because at the time the study came up, it was called "A Study of Municipal Bankruptcy". The members of our Commission were so horrified by that thought, that we changed the title to "Financial Emergencies". It is a little ironic that 3 years later we would be discussing the problem of municipal bankruptcy Nationwide. I commend that study for your consideration because in it we attempted to highlight the caution flags, which were mentioned here earlier, which should be raised when pending financial emergencies are on the horizon. We do have a series of criteria.

I might say parenthetically that New York City at that time as I recall it, showed five of the six caution flags that we said should be raised. It is not a satisfaction to us, but it was there to be seen even 3 years ago.

We proposed most importantly, Mr. Chairman, that the States improve their early-warning system, their monitoring of local finances. And I would like to say that I think this is the way to go rather than looking at a vast Federal program either of aid or collection of data.

The States have the prime responsibility. We suggested that they not only setup an early-warning system but have contingency plans in existence so that the horrible wrestling that we saw for 9 months of 1975 in New York would not have to go on.

However, despite the general concern that properly has been expressed over the New York City situation, our studies did not uncover evidence to suggest that other major central cities will suddenly collapse. And this is not to suggest that there are not indeed problems, because there are. Some municipalities are apt to mirror New York City. They will continue to pay their bills on time but not be able to check the steadily increasing deterioration of their economic base. And this was of course was the question Senator Javits was quite appropriately raising. So there is a very delicate balance here.

Sure, you can keep your budget balanced but what is it doing to the future of the city? That is a key question.

Third, you asked what are the policy recommendations for strengthening our State-local system. I could spend a great deal of time talking to you in broader terms. We have, and I did bring with me, a whole series of reports on various aspects. I have touched on just a few today.

First of all, in terms of specific things that you might consider, it is our very strong belief as a Commission that revenue sharing is an important part of the Federal aid system and ought to be reenacted.

To put it more directly, the failure of Congress to renew the program, in our opinion, would cause a severe fiscal shock to the entire State and local system.

Second, I also mentioned the Federal involvement in or takeover of the welfare program which in our opinion in the long run an absolute must.

Additionally, we believe that the Congress can assist State and local governments through a consolidation of categorical programs into more manageable bloc grants. We are undertaking some very detailed studies of this whole question at the preesnt time and will have some more detailed recommendaions to give to the Congress.

Finally, I would like to suggest that Congress itself consider a policy of restraint in selecting those areas in which it mandates directly or indirectly, Mr. Chairman, added costs to our State and local governments.

In the recent past, for example, the application of the Federal minimum wage requirements to State and local hospital employees, added significant cost to some governments. The application of the Fair Labor Standards Act affecting wages for fire employees and most other employees is now in litigation, but it could, if the courts uphold that, add substantially to the cost of operating State and local governments.

You now have before you legislation to require collective bargaining in the public sector, which is again a development that could well result in additional State and local government costs.

So you see every time a congressional mandate occurs it does have a vital effect on State and local expenditures. And in this regard, Mr. Chairman, I would simply like to strongly urge that your subcommittee and the whole Joint Economic Committee consider the fact that right now we really have no mechanisms to look at what I like to call a national fiscal policy. We have no overall relationship of tax policy, and therefore expenditures, between the Federal Government, the States and the localities. Income tax changes are usually made without regard to their effect on State and local governments.

Also, one is sometimes a little awed at the fact that our taxing policies at the various levels are not coordinated at all. I do not suggest by this that there should be an overall Federal tax program without State and local initiatives, but I do suggest that the impact, one on the other that is, could be very important. And if nothing else came out of the New York City crisis, than this kind of dialogue, I think it might have had a useful effect.

In this regard, Mr. Chairman, I simply want to say that States are exercising considerable innovation and initiative in dealing with some of their own metropolitan area problems and the problems of the central cities, which has been concentrated on here today. And I called your attention in my formal remarks actions taken recently by the State of Minnesota as a very dramatic example where in effect in the St. Paul-Minneapolis area, Mr. Chairman, taxes which are generated by new industry in the whole area are split amongst all of the jurisdictions. In this way, the competition between city and suburbs for industrial and commercial growth and development is somewhat mitigated by the fact that the increased taxes from this new growth will be split between all of the areas.

This is one of several significant innovations which the Minneapolis-St. Paul area has taken. This certainly suggests there is a very prominent role for State initiative in this area.

Finally, I would like to say, again in the area of congressional mandating and policy, that one must think through the effect of all these actions on municipal bond markets, which have been talked about at greath length here today.

I would give you a quick example relating to the $29.2 billion of municipal bonding last year. Approximately $5 billion of those bonds were in pollution control bonds floated by major industries, and in hospital and industrial revenue bonds. All of these are good purposes, and therefore were given tax exempt status by the Congress, but I would suggest that perhaps in terms of the municipal bond market one ought to think about other ways than tax exemptions as the meanso f achieving proper social objectives.

I have an informant in the bond market who tells me that this overburden of $5 billion of special purpose tax-exempt bonds was a major depressant upon the municipal bond market last year.

These are just random thoughts on very vital and complex subjects. I would hope that our Commission, which wrestles with these problems day in and day out, might have further dialogue with you on some of the very critical subjects.

Thank you.

Chairman MOORHEAD. Thank you, Mr. Merriam, your prepared statement will be printed in the hearing record at this point.

[The prepared statement of Mr. Merriam follows:]

PREPARED STATEMENT OF HON. ROBERT E. MERRIAM*

I am pleased to be given this opportunity to respond to the Committee's questions about the fiscal prognosis for State and local governments;

(1) *What is the realistic outlook for the aggregate State-local government sector?*

If the Administration's forecast for steady improvement in the Nation's economy proves accurate, most State and local governments will soon experience some easing of fiscal tensions. Based on recent experience, a $100 billion increase in gross national product produces an automatic increase in State-local receipts from own source of approximately $10 billion. Thus, the predicted increase of $185 billion in gross national product for calendar 1976 should increase State and local receipts by approximately $18 billion. When corrected for inflation, this increase in own source revenue represents a 3 to 4 percent real growth and a significant increase over the 1975 performance (See table 1.)

In view of stiffening public resistance to higher taxes and the presence of a large Federal deficit, State and local governments cannot realistically look to substantial revenue increments via the tax hike and Federal grant routes. To put the issue more directly, economic recovery appears to be the only major source for additional revenue for most State and local governments over the next year or two.

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*The Advisory Commission Intergovernmental Relations, of which Mr. Merriam is chairman, is a permanent bi-partisan body established by Congress in 1959 to give continuing attention to Federal-State-local relations. It is comprised of 26 members from all three levels of government, mainly elected officials, including Senators Muskie, Hollings, and Roth and Representatives Fountain, Corman, and Brown. The Commission meets about four times each year to consider policy studies in areas the Commission identifies as potential trouble spots in our Federal system.

TABLE 1.—STATE-LOCAL EXPENDITURE TRENDS, 1948–75

Calendar year	Based on constant dollars—1958=100 [1] Gross national product	Annual percent change, State-local Expenditures excluding Federal aid	Annual percent change, State-local expenditures including Federal aid	State-local expenditures as a percent of GNP, excluding Federal aid
1948	4.5	[2] 10.8	10.4	6.0
1949	.1	[2] 12.4	11.8	6.9
1950	9.6	9.1	8.4	7.0
1951	7.9	−1.4	−1.3	6.5
1952	3.1	2.2	2.0	6.5
1953	4.5	3.6	3.9	6.6
1954	−1.4	[2] 8.7	7.7	7.4
1955	7.6	7.3	6.9	7.4
1956	1.8	[2] 3.0	3.0	7.7
1957	1.4	[2] 4.6	6.0	8.0
1958	−1.1	[2] 5.5	8.4	8.6
1959	6.4	2.1	4.3	8.3
1960	2.5	[2] 4.1	2.6	8.6
1961	1.9	[2] 5.9	6.0	9.0
1962	6.6	2.1	2.8	8.9
1963	4.0	[2] 4.3	5.3	9.0
1964	5.5	5.4	6.1	9.1
1965	6.3	[2] 7.0	6.5	9.3
1966	6.5	4.8	7.7	9.3
1967	2.6	[2] 8.3	7.6	10.0
1968	4.7	[2] 5.8	6.8	10.3
1969	2.7	[2] 5.0	4.5	10.6
1970	−.4	[2] 3.4	5.0	11.1
1971	3.3	[2] 4.3	5.9	11.4
1972	6.2	1.3	5.5	11.0
1973	5.9	[2] 6.2	5.1	11.1
1974	−2.1	[2] 1.7	.8	11.6
1975 [3]	−3.9	[2] .3	2.9	12.0

[1] Based on the following implicit price deflators for gross national product: gross national product—total GNP deflator; Federal Government expenditures, (1) purchases of goods and services—GNP deflator for Federal purchases of goods and services, (2) all other Federal expenditures (mainly transfer payments and Federal aid)—GNP deflator for personal consumption expenditures; State-local government expenditures, (1) purchases of goods and services—GNP deflator for State-local purchases of goods and services, (4) all other State-local expenditures (mainly transfer payments)—GNP deflator for personal consumption expenditures.

[2] Real growth own source State-local expenditures greater than real growth GNP.

[3] 1st 9 months of calendar year. Based on quarterly totals, seasonally adjusted at annual rates.

On the expenditure side, the presence of relatively high unemployment and inflation rates will continue to place heavy pressure on most State and local governments in general and on the health and welfare programs in particular.

To sum up, 1976 and 1977 should bring about some strengthening of the general State and local fiscal position—but the picture certainly does not look bright.

(2) *Which State-local governments are most likely to experience special fiscal difficulty and why?*

The major central cities of the Northeast and Midwest clearly stand out as the governments that are most likely to continue to experience severe fiscal tensions over the next few years. When the National comes down with a heavy economic cold they quickly develop fiscal pneumonia. By the same token, the major central cities will probably be the last to show marked fiscal improvement when the economy recovers.

Despite this rather bleak prognosis, our Commission has not uncovered evidence to suggest that other major central cities will suddenly collapse—a la New York City. At least some of these cities are more apt to mirror Newark's situation. They will continue to pay their bills on time but will not be able to check the steady deterioration of their economic base.

(3) *What are the policy recommendations for strengthening our State-local fiscal system?*

As is usually the case in public affairs, it is far easier to point up the problem areas than it is to prescribe effective and politically acceptable solutions. Nevertheless, I believe that the Advisory Commission on Intergovernmental Relations has developed policy recommendations that deserve serious consideration by both Federal and State policymakers.

Without a major increase in Federal outlays, the Congress can certainly help the State-local sector by renewing general revenue sharing along the general lines of the present program. To put the issue more directly, the failure of the Congress to renew this program could cause a severe fiscal shock to the entire State-local fiscal system.

Although it would require some additional Federal outlay, Congress can also relieve State and local fiscal stress by moving incrementally, at least, toward Federal takeover of welfare. While it is true that Federal action in this area would prove a most immediate benefit to the States, this type of remedial action would then place such States as New York, Massachusetts, and Michigan in a better position to come to the aid of their hard pressed localities.

A consolidation of categorical programs into more manageable block grants stands out as another way that Congress can strengthen the State-local fiscal system without materially increasing Federal outlays. Our staff is presently studying this issue and has noted that this approach is not without some problems. For example, there is an inevitable tendency for the Congress to attach more and more strings to block grant programs. As a result, these block grants can take on more of the character of categorical aids over time. Despite this tendency, however, the current trend toward "blocking" categorical grants represents a step in the right direction.

A policy of restraint by the Congress especially in directly or indirectly mandating added costs for State and local governments has special appeal at this time of fiscal stress. In the recent past, the application of Federal minimum wage requirements to State and local hospital employees added costs for some governments. The application of the Fair Labor Standards Act regulating hours of employment for firemen and other public employees is now in litigation and, depending upon the outcome, may also add substantially to the costs of operating State and local governments.

Congress now has before it legislation to require collective bargaining in the public sector, a development that could well result in additional State and local government costs. The Commission in its study, *Labor-Management Policies for State and Local Government*, urged that Congress desist from any further mandating of requirements affecting either the working conditions of employees of State and local governments or the authority of such jurisdictions to deal freely or to refrain from dealing with their respective personnel.

In conclusion, Mr. Chairman, I would like to point up a pioneering piece of legislation recently enacted by the State of Minnesota for insuring a more equitable distribution of fiscal resources among all local jurisdictions within the St. Paul-Minneapolis metropolitan area. In this seven-county region, 40 percent of the value of all new commercial and industrial property is shared in relation to the fiscal needs of all the local governments within that region. This "Share-the-Growth" plan stands out as a promising method for reducing the very real fiscal disparities within our metropolitan areas.

Chairman MOORHEAD. Let me say that it was my intention that these 2 days of hearings be merely preliminary to get the dialogue started and that we are going to commission some papers to be written and have a chance for the members to review those. We will hold hearings hopefully this coming June to review those papers. We hope that we can continue the dialogue with you. I say that because one of the things that seems to come out of the testimony, as Mr. Orlebeke said, is that you don't have adequate figures for analysis yet. You do have a working model.

But as I understand your testimony, Mr. Orlebeke, you really wish you had more accurate and complete data. Is that correct, sir?

Mr. ORLEBEKE. Yes, in fact our model utilized data for 1968 to 1973, which was the most recent period for which adequate data was available.

Chairman MOORHEAD. Well speaking of the overall Joint Economic Committee, our concern has been with adequate economic statistics. And I think when we get to the Urban Affairs subcommittee, which is this subcommittee, that adequate figures should be available before we can really make rational decisions.

Mr. MERRIAM. May I comment on that just quickly, Mr. Chairman?

Chairman MOORHEAD. Yes.

Mr. MERRIAM. Obviously you have to know the facts before you can begin to draw a conclusion. And we have been working with the administration and the Bureau of the Census to greatly improve the collection of State and local data. There has been some improvement. The Municipal Finance Officers I might say, are involved in a major project right now through voluntary efforts, Mr. Chairman, for more uniform data particularly in the bond area.

And I must say—and this is my personal comment and is one of the reasons why I wanted to separate myself from the administration's testimony—I would be deeply concerned about a federally-mandated program for collecting data for use in the bond market.

Many of these municipal bonds are floated, as you well know, locally. They are not in the national market. And it would be an enormous burden, a burden placed particularly on smaller governments, if you had a vast kind of network of informational data required. Maybe there is a happy medium. Perhaps this is something the States should be urged more strictly to do.

I had some concern though when I heard today the suggestion that there be a total Federal program monitoring State and local borrowing.

Chairman MOORHEAD. You anticipated one of the questions I was going to ask you, because yesterday we had a witness from Standard & Poors who was very opposed to this. His point was that each State should attempt to, in effect, monitor or get reports from municipalities because ultimately the States would be responsible, as was New York State for New York City. Do you have any feelings?

Mr. MERRIAM. I would very much agree with him. But I can't resist commenting, and this is not directly responsive to your question, that the law in the State of New York forbids any municipality from incurring a deficit without the specific approval of the State Legislature. And this I mention only to highlight the fact that even in the situation that we have just gone through, there was a remedy. The unfortunate fact was the State did not elect to take its remedy.

I suggest it was not done because perhaps the State was engaged in some of the same practices.

But be that as it may, yes, the State in our opinion should certainly have the prime responsibility for the oversight of municipal financing programs.

And this would include, I should add, a much more effective way than we have now of requiring disclosure of financial information. This we all agree is a critical problem.

I was only quarreling with the idea of the Federal Government getting heavily into this area, Mr. Chairman.

Chairman MOORHEAD. Mr. Orlebeke, do you personally know if HUD has any position on this reporting mechanism? If you don't want to speak for the administration because it hasn't been cleared, I will understand.

Mr. ORLEBEKE. I don't believe the Department has an official position, Mr. Chairman. I think our position is that it is important that the data be generated and collected. The question of where that is done and exactly how, is something on which we have not taken a position. I personally have some sympathy for a strong State role in this area.

Chairman MOORHEAD. Mr. Orlebeke, Mr. Merriam says that at least some of the cities are more apt to mirror Newark, N.J.'s situation, namely, they will continue to pay their bills on time but not be able to check the steady deterioration of their economic base. I think the witnesses yesterday suggested that strengthening the economic base of what I would call potential troublesome cities or cities facing difficulties is the most important solution.

Does the Department have any policies or on-going activities with respect to this? I mentioned Newark, N.J. because it is neither in Mr. Brown's or my States so we are not being parochial about this. We are trying to look at this dispassionately, not involving our own constituents.

Mr. ORLEBEKE. Well, sometimes the problems of cities such as Newark, N.J., are complex, and I don't think that anyone presumes to have all the answers.

The Department's policy, of course, follows the administration's policy with respect to the flexibility that local governments should have in managing their own affairs. This principle is applied not only with respect to the Community Development Block Grant program but also increasingly in other Federal aid programs, and we hope it will be extended. I think one of the clear themes that has emerged in testimony so far is the tremendous variety among cities and communities in both the size and the depth of their problems. This suggests that it would be terribly difficult for a national policy to be developed which would have a general applicability to all local situations, which are, in fact, so bewildering in their variety.

Therefore, I think we should look mainly towards the block grant approach, which places primary responsibility for program development on the individual cities. As I indicated previously in my testimony, if you look at the pattern of the plans for the use of block grant funds, you do see a very definite emphasis in the large cities toward more preservation-type activities as opposed to the past emphasis, which was towards massive clearance and redevelopment. They seem to be taking a more careful approach to their problems, using block grant funds in a way that reflects their own priorities. I think we are observing some positive trends and I'm hopeful that cities will develop them further.

Chairman MOORHEAD. Thank you very much. My time has expired. Congressmen Brown.

Representative BROWN of Ohio. I very much concur with the original administration position towards the problems of the city of New York. Cities are of course creatures of States and these States should assume its responsibility of its child before it asks the Federal Government to do so. It seems to me that Michigan has done that—and I will be parochial for a moment if I may, Mr. Chairman.

We have a municipal finance commission which has to approve all issues. We then have—and Mr. Orlebeke, you possibly can add to this somewhat—we then have a guarantee fund that has very strict criteria and with certain actions required. So that a public entity can have access to that guarantee fund, which is of course a State fund, for temporary problems but access to it is conditioned on the fact that you don't get as far in trouble as New York City did.

Now what is wrong with basically advocating—and you can do this or we can do this—that States have such a body that has authority to approve or reject debt issues?

Mr. MERRIAM. May I answer?

Representative BROWN of Ohio. Especially if it is coupled with the kind of assistance that the guarantee fund provides?

Mr. MERRIAM. My response, Mr. Brown, would be that this is exactly one of the steps that should be taken by the States. And in our report that I referred to earlier, our report on financial emergencies, in addition to proposing setting up an early warning system. Mr. Brown, we suggested State support for local governments that were in trouble through a fund that would be created in advance, if you will, so you don't have to go through a big scramble at the last minute.

One method would be to set up a uniform auditing procedure so that you could flag much earlier where irregular practices are taking place—and I use that not as a legal word but as a word of art—where irregular practices are being engaged in.

Definitely these fiscal practices are the responsibility of the States. And we feel very strongly as a Commission and we urge and have urged, Mr. Brown, the States to act. This year developed a suggested uniform law to which is one of the things our Commission does—which we just circulated to all the States, suggesting a series of actions that would step-up their oversight of local government's total activities without taking away total local autonomy, or home rule.

I might say, Congressman Brown, you perhaps noticed that your Governor on Monday proposed——

Representative BROWN of Ohio. A program similar to that in Minneapolis-St. Paul.

Mr. MERRIAM. Yes, a shared revenue concept for the Detroit area in particular.

Representative BROWN of Ohio. Let me go back first. When I was in the Michigan State Senate, which was several years ago, I proposed, and almost got killed by proposing this, that we equalize industrial tax bases within either counties or in regional areas.

I did this because I think the situation of having a plant located in one school district where they get a tax base and having all the children of the employees attend school in my school district, which doesn't have the plant located there, well I think it is totally unfair that we have to educate the kids of the employees of a plant in another district. But Terry Trout—and Mr. Orlebeke, you may remember that he was chairman of your party or at least he was chairman of the local government subcommittee—well he lived over by a Ford plant in Detroit. And he said: "Look, I live in this district. I have to take the smoke and congestion and everything else but I live here partially so that my taxes will be lower. And if you think I am going to take the smoke and your taxes, you are out of your mind."

But I do concur that somthing along this line especially with respect to cities that are basically central cities of SMSA's, I do concur that there should be some consideration given to in some way an equalization of the tax base, of the tax revenues.

Mr. MERRIAM. We made a study, Mr. Brown, in 1973 which is called "Financing Schools and Property Tax Relief: A State Responsibilities". And one recommendation in this report was that there be much greater assumption by the States of responsibility for financing the schools, and an accompanying reduction of the property tax load to eliminate the very kind of inequity which you have suggested.

Chairman MOORHEAD. I just wanted to follow up and ask either one of you gentlemen or both should the Federal Government have any role in encouraging things such as the Minneapolis-St. Paul program or the Michigan program? You don't have to talk about mandating but encouraging. Do either of you have any comments on this?

Mr. MERRIAM. Would you like to go ahead?

Mr. ORLEBEKE. That is exactly the question, Mr. Chairman, whether we try to rely on the persuasion of successful models in other States or whether the Federal Government should become more active in providing incentives for such actions. My own hope is that, as a result of some of the recent experiences in local finance, States will begin to structure themselves more responsibly as to the needs of their local fiscal jurisdictions. I don't know exactly how the Federal Government would encourage State action without actually getting into some kind of a legislative mandate or some kind of assistance program. And I would be reluctant to endorse a direct Federal mandate under present circumstances.

Mr. MERRIAM. Could I just comment on that as well? This is one of the toughest problems in the Federal system. I think we are all very much aware of the fact that the organization of governments in our metropolitan areas and the taxing policies of those governments is as close to disastrous as it can be. And the problem, then, is how you deal with it without wrecking the Federal system. And it is not an easy problem.

Of course, there are some things that have been done. Certain of the categorical programs, the planning funds and so forth, are designed to encourage region-wide planning. That is one way of getting at it. And I think Mr. Orlebeke would agree they have worked to some extent at least.

Our Commission last year proposed that we go a step further. We suggested that certain types of Federal grants, not just planning grants but actually construction grants in the pollution area to give an example, be given only to those metropolitan areas where all the jurisdictions have gotten together and formed a sub-State regional district. And the carrot that we suggested be dangled was that Federal construction grants go only to those areas where the States created a planning district mandatorily, but where the States created it not the Federal Government. I am not totally surprised Congress hasn't rushed to adopt this proposal. But it is a way in which we could, without totally breaking down the system, bend it a little bit.

When I appeared a few weeks ago before Congressman Fountain's Subcommittee on Revenue Sharing, Mr. Chairman, I was asked whether revenue sharing should be used for this purpose. And as tempting as that idea might be to someone who is interested in the reform of metropolitan government, my own conclusion was that this would be a wrong way to go at it. In the first place, precisely what is government reform? What is the right way to organize a metropolitan area? There are all kinds of disagreements on that. You never can get a national pattern and you shouldn't. And one of the real strengths of our country is the freedom to have these kinds of State and local initiatives that we have been talking about. And once you destroy that initiative, you have a total national government with no options at all.

So my own feeling was that revenue sharing was the wrong way to press for such reform. There are other ways I think that one could push for reform without breaking the system.

Chairman MOORHEAD. Thank you.

Representative BROWN of Ohio. Along that line, we do have programs that basically aim at that problem. We have community development funds that are distributed under a formula that tests population, substandard housing, and so on. All of them are sectors particularly unique to cities. Our general revenue sharing funds had a tax effort factor involved in it. And your unemployment compensation and CEDA funds are titlted towards high unemployment areas also and areas of greater poverty.

So I do think there is a little tilting of these programs towards the situation which more frequently occur in larger cities and in the municipal problem areas. Don't you agree?

Mr. MERRIAM. You are absolutely right. I was talking about governmental organizational reform.

Representative BROWN of Ohio. I found an interesting dichotomy in your statement, Mr. Orlebeke, from Mr. Merriam's statement. In your statement, Mr. Orlebeke, you said: "Typically the tax structures of the older larger cities make greater use of income and sales taxes while most cities rely more heavily on property taxes. As a result, the tax revenues of the older cities are more responsive to economic changes." And Mr. Merriam said to the contrary: "By the same token, the major central cities will probably be the last to show marked fiscal improvement when the economy recovers".

In effect you are saying that as we come out of this recession and have economic improvement, that because they rely on sales and income tax—and I tend to concur with you—that they should have a faster recovery. You are saying that these larger cities in the Northeast and Midwest will recover more slowly, correct? Can we reconcile this difference or is there no difference?

Mr. MERRIAM. I think that is easily reconciled. Basically what I was referring to was the deteriorating economic base of many of these cities. And what Mr. Orlebeke was talking about was——

Representative BROWN of Ohio. The way in which they produce the revenue?

Mr. MERRIAM. Yes; and you can produce more revenues but if your base is shrinking, you still have a serious problem.

Representative BROWN of Ohio. In your statement, Mr. Merriam, you said in effect that bloc grants can take on more of the character of categorical aids over time. I would like to respectfully suggest, since I think I am considered one of the authors of Housing Community Development Act of 1974 and Chairman Moorhead actively worked on it, but I think that in that legislation we reversed that trend. You have a different feeling about it? It seems to me—and this was special revenue sharing of sorts—but it seems to me by saying that the Secretary has to give each city, each community, each entitlement, each body its formula share, it seems to me unless the Secretary finds that the city's determination of needs is plainly inconsistent with the facts or that the program that the city has proposed is plainly inappropriate to the meeting of the needs, I just think that the funds have to go. We didn't give any second guessing to the Secretary of HUD. We didn't let the Washington bureaucrats substitute their judgment for local municipal officials' judgment.

It seems to me that is a good example. And I think if you look at the President's message—and I would like to have your comments on this also—the President's message with respect to bloc grants and other areas, it aids the community development formula.

Mr. MERRIAM. I have studied the——

Representative BROWN of Ohio. That is my question. Do you have any comments on the President's bloc-grant proposal?

Mr. MERRIAM. I was reading the article in the New York Times yesterday on my way down here and I haven't really looked at it in enough depth. I agree with you 100 percent that the community development bloc grant probably is the best in terms of giving the kind of flexibility we were hoping for. We had been looking this year, and I think it perhaps reflects my comments, very heavily at the LEAA program and at the Realth bloc grant. And we see in both of those tendencies which suggest to us that they are getting recategorized pretty fast.

Representative BROWN of Ohio. And I think that will happen with respect to community development too if the communities don't very carefully analyze their needs and then have programs that are related to those needs.

Mr. MERRIAM. Right.

Representative BROWN of Ohio. So that this must be fairly closely related and the problem of LEAA—and in our Government Operation subcommittee we have had oversight hearings on it—and they have had all kinds of abuses—isolated abuses I admit—but somebody brought an airplane here with LEAA funds and somebody bought something over here. And as a consequence the Congress reacts to the recitation of these and media publicity of those abuses, and so you get some strains.

So I think that really if you want a kind of hands-off attitude by the Members here in Washington, then I think it is encumbent upon local officials to make sure that the abuses do not occur or at least are not publicized.

Mr. MERRIAM. I hope they don't occur.

Mr. Brown, I can't quarrel with you. But we were putting up a warning flag because, as these programs have matured, we have seen the congressional response to certain pulling and hauling. And it is not all abuses: It is sometimes a question, as in LEAA, where there is a feeling that more should go to the judicial system in terms of their operations. You have a mandate for a certain amount of money there and then you get a limitation on this, and then pretty soon you don't have a bloc grant any more.

I agree with you that if the local officials don't do their jobs and if the States don't do their jobs, you are going to get these kind of pressures. We realize that. And in our studies we spend a great deal of time counseling with State and local governments on how to respond to their responsibilties.

Representative BROWN of Ohio. I respectfully suggest to you, Mr. Merriam, that this Congress as I see it, and recently especially, reacts much more in a visible way to abuses and what have you than it does to judgmental differences. So I just give a word to the wise.

You have advocated a Federal takeover of welfare. We have just had a little experience, a kind of partial experience of this with the SSI program. And I don't recall in all of years the States were handling their portions of the assistance payments that are now covered in SSI that they had anywhere near the problems that the SSI has had with respect to wrong payments, overpayments, and you name it.

With that example before us should we have the Federal government take over the welfare program?

Mr. MERRIAM. Well I can't really comment in detail. I have heard, as you have, of some of the problems that have come up. But I would suggest that those problems could come at any level of government. And I don't think the fact that the Federal Government was involved in them—and perhaps some very serious errors were made as has been suggested—but that fact should not change the reality that with a shifting population of the kind that we have in this country today, Representative Brown, and with the obvious mobility that even poor people have, we should have some national criteria and standards for the welfare program and the financing of it.

And I would say that by and large programs financed at the Federal level have tended to be operated as well as, and in some cases better, than those financed at the State and local levels.

So I would not feel that those very serious problems should deter the general objective we set out.

Representative BROWN of Ohio. Of course I think your case for a Federal takeover as such as been greatly strengthened by a Federal mandate in effect where the Supreme Court decision on residency and things of this nature has come out. So that really the Federal Government through not its legislative chamber but through its judicial arm, but it has in effect dictated a policy with respect to welfare that was not there before. And I think that probably that single item has created as much of a problem for local units meeting their welfare demands more than anything else. Would you concur?

Mr. MERRIAM. That is certainly one part. The mobility question, which this of course refers to, is a very important part of it.

Representative BROWN of Ohio. I still have to be a bit parochial and maybe neanderthal is a better word, and say it seems to me that the welfare systems were more equitably handled and operated the closer they were to home. Public assistance is a little bit like taxes: The more remote the authority, the less equity prevails.

Mr. MERRIAM. Of course the question of who administers the program is another question. We advocate State financing of education but we would certainly strongly and vehemently advocate retention of local responsibility. I think the same can apply in the welfare area. I agree with you, by the way, as to a general concept——

Representative BROWN of Ohio. Let's go back a second to a thing I meant to mention when we were talking about municipal finance.

Last year—and I have forgotten in which bill it was—there was an amendment that provided, I believe, for SEC approval, or a mechanism similar to that, of municipal issues. And the Association of Counties and the League of Cities and the whole bunch came in and got it crushed, got the amendment rejected. Is that consistent with an apparent effort on their part to become more fiscally responsible?

Mr. MERRIAM. Are you talking about bonds?

Representative BROWN of Ohio. Yes. I forget what the legislation was.

Mr. MERRIAM. Well, this is another item where I would feel that the States ought to have the responsibility rather than the SEC.

Representative BROWN of Ohio. As I understand it, it was the very units of government who we are saying have problems because they don't have it, but they are the very ones who came in and defeated the amendments that would require full disclosure.

Mr. MERRIAM. They were fighting full disclosure through SEC, not full disclosure.

Representative BROWN of Ohio. I would respectfully suggest then that they should come forward, recommend that they should have State disclosure.

Mr. MERRIAM. I agree with you, and our Commission has done just that and very strongly urged that the States enact disclosure laws.

Representative BROWN of Ohio. One final thing. How strong would you feel about that aspect of your statement where you said that one of the burdens that is going to be placed upon citizens and local units of government is having public employees under all of the ramifications of private employees?

Mr. MERRIAM. You are talking about the collective bargaining?

Representative BROWN of Ohio. Yes, and minimum wage and overtime, et cetera, which I know there is litigation pending on. How strongly do you feel on that issue?

Mr. MERRIAM. I feel very strongly that this should not be federally mandated. I'm not suggesting that State and local governments underpay or abuse their employees. Obviously, I believe to the contrary. What I'm saying is that the flexibility which the Federal system offers ought to be retained.

I happen to be a part-time resident and taxpayer of the State of Michigan near the town of Menominee where there are 13,000 people as you undoubtedly know. Their problems, and I see their local paper every day, and the problems they have with municipal employment are totally and utterly different from those of New York City or even any of the other larger cities in the State of Michigan. It is the mandating of uniformity requirements that I would certainly be strongly opposed to. I think it is wrong.

Representative BROWN of Ohio. One final question. Mr. Orlebeke, in your statement you talked about there being hope because there has been some inward migration into the cities or into areas and cities that needed renovation and rehabilitation, et cetera. I would only ask what is the significance of that compared with the continuing problem of outmigration and continuing deterioration? Has there been any significant improvement would you say?

Mr. ORLEBEKE. The trends are very recent, Representative Brown, and it is hard to hang specific numbers on them. I just wanted to call attention to the fact that there is not merely flight from the city, but there is also a migration into the city and that the demographic changes in the population with heavy concentration of young adults, who are marrying later and having fewer children, this is demanding the kind of housing which is available in the central cities. And primarily because these are households without children or with very few children, they are not making the kind of service demands that have weighted so heavily in central cities.

As you know, the educational centers are typically the single largest expenditure in a city. And these are people of middle and upper income who are bringing capital into the city. They are improving neighborhoods and they are employed in the city. And while it is very hard to be precise, the trend seems to be widespread and increasing. And I think it is one of the forces of hope which ought to be pointed out.

Mr. MERRIAM. May I respond? I am in the development business and our company has been involved in outlying metropolitan areas. We see our future in the next 10 years being involved more and more in central city developments of one kind or another. We are actually involved at the moment in Chicago, Milwaukee, Atlanta, and Denver inner-city development. So it is occurring. I agree with Mr. Orlebeke that it is still too early to judge precisely what changes will come about, but there is very definitely a trend in some areas, of course not everywhere, but there is a trend.

The trend is not so much bringing people back, but rather giving the newly formed family a choice as to whether it goes to the suburbs or stays in the city, which maybe it wants to do. The ones you bring back are the people with a lot of kids who went to the suburbs and are now "empty-nesters." The real challenge for a city is to keep the families with youngsters and, of course, the gut issue there is the educational system.

Chairman MOORHEAD. Thank you very much. I presume if any members want to submit questions to you in writing that you will respond. I think this dialog we have had today has been extremely helpful. I hope this is just the beginning of a long dialog because I think we are facing a problem here and it is better to face it before it hits us. And this is what we do intend to do. We will have subsequent followup hearings after we have had some study papers done to be better informed on this subject.

Certainly you gentlemen contributed a great deal to the deliberations of the subcommittee and we thank you.

The subcommittee now stands adjourned until the call of the Chair.

[Whereupon, at 12:30 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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