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

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June 28, 1976

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

Pursuant to provisions of the New York City Seasonal Financing Act of 1975 (Public Law 94-143) we have been reviewing New York City's progress under its 3-year financial plan. This report is the first of a series which we will submit to the Congress.

The plan, drawn together during a period of crisis, was a first step toward fiscal recovery. In our opinion, however, it did not recognize some major problems facing the city both during and after the 3-year period. We believe that the inclusion of the following items in the plan would contribute to the city's chance of recovery.

--An arrangement for retiring the debt in moratorium.

--The matter of employee compensation for fiscal year 1979.

--The additional operating deficit represented by the operating expenses included in the capital budget.

--Plans for contingencies such as a possible increase in city pension contributions and the anticipated deficit in the New York City Transit Authority's operations.

Federal short-term loans to the city are authorized only through June 30, 1978--the termination date of the city's financial plan. However, the magnitude of the above factors points to the need for a city plan covering a period longer than 3 years. A longer plan, if properly detailed, should provide a more realistic view of the city's financial picture. By recognizing its problems and planning for their resolution, the city should be able to improve its credibility, increase investor confidence, and enhance its chances to reenter the private credit market when the Federal loans terminate.

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We believe that the Secretary of the Treasury should require that city and State officials revise the plan to make it as comprehensive and realistic as possible by recognizing factors such as those identified in this report. A summary of our observations is enclosed.

The contents of this report have been discussed with city, State, and Treasury officials, and their comments were considered in the preparation of the report.

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

Elmer B. Staats
Comptroller General
of the United States

Enclosure

GAO OBSERVATIONS ON PROBLEMS NEEDING TO BE ADDRESSED BY NEW YORK CITY'S FINANCIAL PLAN

New York City's financial crisis became widely known when the city found itself no longer able to borrow money in the private credit market to meet its cash needs.

New York, like other cities, must borrow to fund expenses during periods of cash shortfall which result from the mismatch in the timing of revenue collections and expenditures. When it was unable to do so in early 1975, New York City was faced with a crisis. New York's problem was complicated by the fact that it was borrowing not only for short-term cash needs but other purposes as well. Prior years' deficits had been funded with short-term borrowings and these had to be refinanced as they matured. In addition, the city had borrowed on short-term bond anticipation notes to pay for capital construction projects. These notes also had to be refinanced when they came due. Therefore, the city was borrowing to pay off previous loans as well as to meet current needs.

The cumulative effect of all this borrowing put New York City in the position of having $5.3 billion in short-term notes outstanding as of June 1, 1975. This represented about 29 percent of the national total of short-term municipal debt outstanding at that time. At the same time, municipal borrowings nationwide had reached an all time high in early 1975. This, coupled with public charges of poor city management, undoubtedly contributed to a lack of demand for New York City's securities. In any case, a so-called crisis of confidence developed and investors stopped buying New York City's securities.

Initially, New York State advanced funds to the city to make up for its immediate cash shortfalls in April and May 1975. Subsequently, the State created the Municipal Assistance Corporation (MAC) to alleviate the problem by consolidating the city's short-term debt and issuing moral obligation bonds of the State. When these actions fell short of solving the problem, the Legislature passed the New York State Financial Emergency Act in September 1975, which created an Emergency Financial Control Board to control and supervise the financial management of the city and to approve a 3-year plan to be developed by the city to provide for its recovery. The Control Board approved the plan in October 1975.

The plan had to be drawn in a crisis situation. The data available from the city was sketchy and questionable, and the threat that the city would be unable to meet its payrolls was ever present. In addition, about $2.6 billion in short-term notes were due to mature at about that same time. The spectre of default was real.

The Financial Emergency Act required that the city's budget be balanced for the fiscal year ending June 30, 1978. The approved plan conformed to that legislative requirement and provided for substantial budget cuts in fiscal years 1976, 1977, and 1978 to meet the goal. The Control Board set the overall goals for the budget cuts but left to the city the requirement to translate those overall amounts to specific program cuts.

The plan and the cuts dictated by the Control Board in October 1975 can be summarized as follows:

	Fiscal years ($ in millions)		
	1976 (partial)	1977	1978
Revenues	$ 8,392	$ 11,992	$ 12,294
Expenditures	(9,148)	(12,924)	(12,988)
Deficit	(756)	(932)	(694)
Planned cuts	92	462	724
Revised deficit	$ (664)	$ (470)	$ 30

As part of the plan, the Control Board assumed Federal assistance in the form of long-term loan guarantees, and city officials appealed to the Federal Government for help. In December 1975, the Congress passed the New York City Seasonal Financing Act of 1975 which provided only for short-term loans to make up for the city's seasonal cash shortfalls rather than the proposed long-term loan guarantees. Under the act, seasonal loans of up to $2.. billion per year were to be made to the city for cash shortfalls occuring within a fiscal year and repaid to the Treasury at the end of each of the city's fiscal years.

In March 1976, the city submitted a proposed revision to the October 1975 plan which provided for additional budget cuts of $117 million in fiscal year 1977, and $221 million in fiscal year 1978, for a cumulative total of $1.062 billion, instead of the originally planned $724 million. At the time of our review these revisions had not yet been totally approved by the Control Board.

In summary, the objective of the State and Federal legislation is to assist the city in maintaining its services while it restructures and retrenches financially between October 1975 and June 1978. Subsequent to that time, assuming all parts of the plan are successful, the city is supposed to be in a position to return to the private credit market to borrow funds in the normal course of business, and the Federal assistance is to cease.

PROBLEMS NOT ADEQUATELY RECOGNIZED IN THE PLAN

On April 2, 1976, we expressed concern before the Senate Committee on Banking, Housing, and Urban Affairs about the city's progress and adherence to the financial plan. We also stated that we were equally concerned whether such adherence would necessarily result in a balanced budget in future years and the restoration of investor confidence. We suggested that it may not be too early to consider the need for a more realistic and comprehensive plan.

The city has been operating under the plan for several months, and various observers have had opportunities to assess city compliance. Reports addressing this subject have been issued by MAC, the Control Board, and the State of New York. Each of these reports concluded there is a strong possibility that planned budget cuts will not be sufficient to eliminate the deficit by June 30, 1978. Recommendations have been made for the city to plan and effect additional budget cuts.

On June 16, 1976, the Secretary of the Treasury, who administers the Federal seasonal loan program, requested the Control Board to begin addressing broader problems such as a plan for fiscal year 1979 and beyond, erosion of the tax base, and similar longer range concerns. We agree with the need for such plans. Moreover, we believe that the city should develop and incorporate into its current plan, policies and plans for resolving a number of problems which may immediately impact on its ability to reenter the private credit market when the Federal seasonal loan program terminates in June 1978. These problems include

--the large amount of debt in moratorium which is due after the plan's end,

--the matter of employee compensation in fiscal year 1979,

--the additional operating deficit represented by the operating expenses included in the capital budget,

--the need to plan for contingencies such as possible increased pension contributions, and the anticipated deficit in the city Transit Authority's operations.

Moratorium debt

Toward the end of 1975 about $2.6 billion in city short-term notes were outstanding. Most of the notes were scheduled to mature between December 1975 and March 1976. Because the city did not have the funds to redeem the notes, and because it was unable to borrow funds to refinance the notes, the city appealed to the State for assistance. The State Legislature on November 14, 1975, passed the New York State Emergency Moratorium Act for the city of New York which postponed the maturity of the notes until November 1978. The act required the city to offer its noteholders the option to convert their notes in moratorium to long-term MAC bonds.

The city notes had interest rates which ranged from 7.5 percent to 9.5 percent. If a noteholder chose to convert to MAC bonds he received interest at the rate of 8 percent, but if he chose not to convert he would receive only 6 percent during the moratorium.

Some noteholders protested the Legislature's action and are pursuing a remedy in the courts. Some, however, did convert, but after the expiration of the option period, about $1.961 billion in notes were still outstanding and subject to the moratorium.

The city had meanwhile entered into an agreement for an extended repayment period with five city pension funds and 11 New York clearing house banks which held a total of $819 million in notes. That agreement called for repayment on notes in installments of about $96 million per year between fiscal years 1979 and 1987. The holders of the remaining notes, which amount to about $1.1 billion, are due payment of the total amount in November 1978.

Although the city's original problem was solved by the moratorium, the solution may have created another problem almost as serious--the $1.1 billion of notes coming due in November 1978. MAC is currently offering long-term bonds in exchange for $500 million of the outstanding notes in moratorium. If MAC is successful, the city's problem will be somewhat alleviated. The financial plan makes no provision for accumulating the funds necessary to repay the notes; therefore, we believe the existence of the debt in moratorium should be recognized in the plan along with the city's proposed method for dealing with any amounts due in 1978. This would enable investors and the general public to be fully informed as to the city's planned course of action.

Employee compensation

The 3-year financial plan assumed there would be no wage increases for employees during the plan period and no cost of living adjustments beyond the one already granted for 1976. The Control Board modified this policy somewhat by providing that increases or adjustments could be given if their total costs were offset by measurable savings over and above those already provided for in the financial plan. The need for such a policy is clear, and adherence to it is crucial for successful completion of the plan.

The financial plan, and therefore the wage policy, applies only to the period ending June 30, 1978. The city is currently negotiating contracts with employee unions and the effect of agreements reached will have a direct impact on Treasury's decision to make the next seasonal loan. Likewise, the matter of wages may have a direct bearing on the city's ability to reenter the private credit market after the Federal loans terminate in June 1978. To bolster investor confidence in the stability of its fiscal future, the city should develop plans for wage policies sufficiently in advance of July 1, 1978, so that the fiscal impact of wage increases, if any, can be adequately provided for in the budget for fiscal year 1979.

Understated operating expenses

New York City pays for all normal costs of operations such as salaries, supplies and the like, out of its expense budget. Its capital budget funds the costs of major improvements and new construction.

For a number of years, the city has been following the practice of funding some operating expenses through its capital budget and issuing bonds or bond anticipation notes to raise funds to meet these expenses. When the plan was prepared, this amount approximated $700 million. This practice understates the true cost of operating and providing city services and it overstates the cost of the city's capital budget.

The State recognized this distortion and in 1975 passed legislation requiring that these costs be eliminated from the capital budget over a 10-year period. In order to correct this distortion immediately, the city would have had to either increase revenues or further reduce expenditures or some combination of the two by $700 million per year.

In accordance with the State legislation the 3-year plan provided for the reclassification of these expenses starting with $30 million in the first year. Until the reclassification is completed, however, both the operating and the capital budgets will not disclose their true levels.

In effect, the city is spending $700 million per year for items and services which it is not financing with current revenues. At the end of the 3-year financial plan period the budget will appear to be balanced, as a result of making the planned budget cuts of $1.062 billion, but the city will not have counted all of its expenses. The expense side of the 1978 budget will be understated by about $520 million of operating expenses which will not have been reclassified at that date.

We believe the city's financial plan should clearly indicate the additional operating deficit represented by these expenses and should include proposals for funding these expenses during and after the period covered by the plan.

Contingent pension and transit costs

At the time the plan was drawn together there was a question as to whether the city was contributing a sufficient amount to its employee pension funds. The Mayor had earlier requested his Management Advisory Board to look into this question but the Board had not reported back in time for its findings to be considered during the preparation of the 3-year financial plan.

In April 1976, the Management Advisory Board submitted its report and recommended that the city increase its contribution by $208 million per year. The Board suggested, however, that this contribution could be phased in over several years. The increased contributions would then be something less than the full amount, until 1981 when the city would begin to contribute the full $208 million.

We have not reviewed the pension study as yet, but we noted that there are suggestions in the report that most of the city's additional contributions could be offset by various factors such as increased employee contributions. While the actual impact of this matter on the city is unclear at this time, the extent to which additional contributions may be required should be recognized by the city in its plan.

A similar contingency exists in the transit area. In April 1976 the Control Board learned that the New York City Transit Authority expected deficits of $108.8 million in fiscal year 1977 and $102.3 million in fiscal year 1978. City officials pointed out that the city has no funds to increase its subsidy and that the deficits in question, therefore, will have to be made up by Federal or State subsidies, increased taxes, or transit fare increases. In any case, this will impact on the city's budget or its economy. This impact should be assessed and the city's proposed course of action should be incorporated in the plan.

To the extent that other contingencies such as these exist, the plan document should recognize them and specify what actions the city plans to take. We believe it is particularly important that potential investors and the general public be able to see that city management has recognized and realistically planned for the resolution of all major issues.

CONCLUSIONS

The viability of any plan depends in good part on the adequacy of the data used and the assumptions made in putting the plan together. To ignore some problems or minimize others can reduce the chances of success. To limit the period covered by the plan to the period of Federal seasonal loans can leave too many unanswered questions of a significant nature which will impact heavily on the city's future fiscal stability.

An underlying assumption is that the present plan, if properly executed, will result in a balanced budget for the fiscal year ending June 30, 1978, and enable the city to reenter the private credit market. In our opinion, the city is postponing some of its problems in lieu of addressing them directly with a realistic plan. By failing to address these problems and devise a course of action to resolve them, the city may be unable to restore investor confidence.

The city's plan, in our opinion, should be a blueprint for action by public officials and employees. Equally important, it should be a document which the people of the city and potential investors can use to assess the progress the city is making in solving its fiscal problems. We believe the plan should be drawn on a realistic basis and should include all the foreseeable factors which might impact on the city's future and identify for all concerned the steps which the city will take to correct all identified problems.

The factors discussed in this report are by no means all inclusive. The complicated workings of the New York City Government, combined with its lack of adequate accounting data and management information, make it impossible to assess with certainty all of the problems involved. We believe, however, the types of items discussed here are significant enough to warrant serious consideration as to the need for a revised plan at this point in time. The degree of investor confidence will determine the ability of New York City to reenter the market and also the interest rates to be paid. Leaving major unanswered questions open to speculation will not, in our opinion, help the city.

RECOMMENDATION

The Secretary of the Treasury should require that city and State officials revise the plan and make it as comprehensive and realistic as possible by recognizing factors such as those identified in this report.