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*Member, Executive Committee
NEW YORK CITY'S DEBT PROBLEM

JULY, 1973

CITIZENS BUDGET COMMISSION, INC.

110 East 42nd Street
New York, N.Y. 10017
(212) 687-0711
(This C.B.C. report has been prepared primarily by Dr. Herbert J. Ranschburg, Assistant Executive Director, under the supervision of Dr. David Bernstein, Executive Director.)
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NEW YORK CITY'S DEBT PROBLEM

Introduction

The City's debt policies have dangerous implications for the future. The present situation can be quickly summarized.

While the City's net funded (long-term) debt has grown 57% in the decade, from $3.5 billion on June 30, 1962 to $5.5 billion on June 30, 1972, debt service on this funded debt has grown 145%, two and one-half times as fast, from $460 million in 1963-64 to $1,125 million estimated for 1973-74.

At first glance, these figures do not seem to represent an alarming situation. There is little risk of the City failing to meet its debt service obligations. The City's praiseworthy and successful efforts to strengthen the rate of its bonds, and the subsequent decrease in the interest paid on those bonds, indicate that the bond market has considerable confidence in the basic economy that supports the City. Thus, it would certainly not be justified to say that the present levels of debt are endangering the City's financial status.

However, it isn't the present level of indebtedness or of debt service that primarily concerns CEC. What deeply concerns us is the increasing trend of the City's authorities and the City's legislators, aided and abetted by what we believe to be overly permissive legislation by the State Legislature, to the increasing use of long-term debt, for ever-increasing amounts of what we believe are clearly operating expenses. We believe that the use of funded debt in the Capital Budget for daily operations is unsound as a matter of principle and should be phased out gradually.

Any operating item which is funded by borrowing represents a greater expense for that item by the amount of annual interest involved. This, of course, is a loss to the taxpayer. This is only part of the cost of circumventing the Constitutional tax limit by such unsound borrowing. Any operating item which is funded out of the Capital Budget reduces the amount of funds in the Capital Budget available for legitimate capital projects. In the 1972-73 Capital Budget, 25% of the total was used for operating expenses. In 1973-74, we estimate that about $500 million out of a total of $1,560 million -- or almost one-third will be used for operating expenses. This quantum jump comes perilously close to a perversion of the basic purposes of the Capital Budget. The use of funded debt for maintaining the infrastructure of this City, upon which the entire economy of the City so greatly depends, is absolutely essential. Continued invasion of that budget for operating expenses dangerously reduces the capacity of the City to
carry out necessary capital construction. We believe this to be a most dangerous trend which should be reversed at the earliest possible moment.

By diverting the City's debt-incurring capacity to pay for operating expenses, pressure is put on the City to seek other devices -- such as the Transit Construction Fund and the City University Construction Fund -- for financing capital improvements. Unfortunately, these special borrowing funds have no sources of revenue and cannot pay their own debt service. The City must then cover the debt service, and it does so by more borrowing. This involves making one loan to repay another. Whenever funded debt is used to pay off other debts, the end result is paying interest on interest, an obviously wasteful practice.

Probably the most dangerous aspect of the present pervasive practice of using funded debt for operating expenses is its impact on real estate taxes. Under the law, the payment of debt service by the City must come virtually entirely out of real estate taxes. More funded debt means ever-increasing pressure on the real estate tax rate, which may well be the Achilles heel of the City. Unhappily, the present escalation of borrowing is the major element forcing up the real estate tax rate. This is the most dangerous aspect of increased borrowing.

The Citizens Budget Commission tried hard in this year's budget debates to get the City to accept the basic principle that it must live within its means. We pointed out that the 8% increase in revenues over the next several years means that the City—without any increase in tax rates or new taxes—could expect to enjoy additional revenues of $300 million to $1 billion annually over the next three fiscal years. These very substantial additional revenues should be sufficient to finance a reasonable level of City services for our citizens. It should also remove the need for additional borrowing for operating expenses.

Borrowing for operating purposes undermines the City's finances by enabling it to live beyond its means in a particular fiscal year. In later years, the recurring expenses financed by borrowing must be financed in one of two ways, both undesirable. The borrowing may become a permanent means of financing such items, with its attendant extra costs and other adverse affects. Alternatively, the added expenses may be financed by new taxes. This results in encumbering future fiscal years with a double burden from the past: (1) the need to repay prior borrowing; and (2) the need to maintain expenditure levels reached in prior years through the use of borrowing. These needs become the mandatory inescapable items of subsequent budgets.

Roderic L. O'Connor
President
Highlights

Few taxpayers realize the importance to them of New York City's debt, and the cost of servicing that debt. The subject is particularly timely in view of the decisions that the City has made regarding the 1973-74 Expense Budget.

Instead of focusing on finding real economies in City government operations, as urged by the Citizens Budget Commission, the City resorted to borrowing $200 million for operating purposes, which, in our view, is an unjustifiable use of funded debt.

In addition to the points made above, the City's persistent use of long-term borrowing to meet recurring operating expenses sets in train a number of harmful effects:

(1) It increases the interest costs of City operations, a loss to the taxpayer.

(2) It circumvents the State Constitutional tax limit (2% of the five-year average of full valuations of real estate), and is producing higher real estate tax rates.

(3) It perverts the basic purposes of the Capital Budget and reduces the funds available for legitimate capital projects.

(4) It encourages the development of further unsound devices, such as the Transit Construction Fund and the City University Construction Fund.

(5) These devices result in further City borrowing to pay off the debt service of these special funds, thereby paying interest on interest.

Unless this vicious cycle is stopped, the end-result will be ever-increasing borrowing and debt service, and ever-increasing real estate taxes. Every knowledgeable person in the City is aware of the danger of increasing already excessive taxes, forcing more businesses, more jobs and more taxpaying residents to leave the City. This sets up another vicious cycle by which fewer and fewer
taxpayers will be asked to pay higher and higher taxes, obviously a prescription for disaster.

In our judgment, the time has now come when the resort to borrowing for operating expenses must at least be slowed, if not stopped. We believe it is entirely feasible for the City to schedule gradual phasing out of all borrowing for operating expenses and a return to the original and fiscally sound distinction between the Capital Budget and the Expense Budget. The City must learn to live within its means. The normal growth of 8% in its revenues, without any new or increased tax rates, would support a growth of from $800 million to $1 billion annually over the next three fiscal years—sufficient to finance a reasonable level of City services for our citizens.

Once the rate of expenditure growth is limited to the rate of revenue growth, the need for long-term borrowing for operating expenses, as well as the need for excessive reliance on short-term (budget note) borrowing, will be eliminated and the City will have taken a vital step toward restoring fiscal prudence into its budget-making process. This will be a bright day for all New Yorkers.
I. **How Much Does New York City Owe?**

On April 30, 1973, the City's total funded debt amounted to $6,675 million. This is about double the amount of $3,353 million outstanding on June 30, 1952.*

The biggest single purpose for which debt has been incurred (as of June 30, 1972) is Transit ($1,893 million), followed by Schools ($851 million) and Water Supply ($696 million). It should be noted that these are functions which in many cities are either handled by separate governmental districts (i.e. schools) or simply non-existent (i.e. transit).

There exists also another type of City debt, temporary (short-term) debt. On April 30, 1973, this debt amounted to an additional $2,686 million. Most of it consists of short-term paper issued in anticipation of tax receipts or in advance of regular City bond sales, to be redeemed once the receipts come in or, as the case may be, bonds are issued. There is another type of temporary debt which is especially designed to take care of unanticipated expense increases for which no budgetary allowances had been provided -- the so-called Budget Notes. On April 30, 1973, budget notes outstanding amounted to $408 million. As will be discussed below, thereby hangs a tale of misuse of borrowing authority.

---

* The "total (gross) funded debt," when reduced by sinking fund assets, results in the "net funded debt," which determines the City's capacity to incur debt.
II. How Much Can The City Borrow?

The issuance of funded debt as controlled by the State Constitution, Article 8, Section 4, provides that New York City may borrow, for City purposes, an amount equal to ten percent of the 5-year average of full valuation of taxable real estate. This is generally referred to as the ten percent general debt-incurring margin or limit.

In addition, the City may borrow, for public housing purposes, an amount equal to two percent of the 5-year average of assessed valuation of taxable real estate. This is generally referred to as the two percent housing margin or limit.

Finally, there are certain borrowings which are specifically excluded from the general ten-percent debt limitation. Among them are water supply (no limit), revenue producing projects such as docks, markets, parking facilities to the extent that they earn sufficient net revenues to cover all or part of the debt service, certain transit and hospital projects as well as sewage treatment facilities which were put into construction not later than January 1, 1973.

The determination of the maximum amount of debt the City can incur in any given fiscal year under any one or all of these authorities is the responsibility of the Comptroller as well as of the Mayor, each of whom issues specific reports on this subject during the last quarter of each calendar year.

The prime determinants are the amount of debt previously issued, the amount needed for planned capital projects as well as a reserve for what are called "unanticipated needs." What is left is the unencumbered (unreserved) debt margin.

What actually matters in these computations is the amount reserved for unanticipated needs because it is this amount which gives a clear indication of the amount of borrowing the City could do over and above the amounts planned in the
Capital Budget. The Mayor has allowed half a billion dollars as a reserve for unanticipated needs in 1973-74, leaving an unreserved debt margin of $290,000 for July 1, 1974.

Limits on the various types of temporary debt are contained in the New York State Local Finance Law. As a consequence, changes in these limits are a matter of passing a law in the Legislature—much simpler than the requirements for changing constitutional debt limits (or exclusion from such limits) for funded debt, which requires affirmative action by two separately elected State legislatures and subsequent approval in a State-wide popular referendum.
III. How Much Does It Cost For The City To Borrow?

Plenty. For the 1973-74 fiscal year, debt service (i.e. provisions for redemption of that part of the debt which comes due during the period, legally required in-payments to the sinking funds, plus interest on all outstanding debt) will amount to $1,187 million, broken down as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Interest on funded debt</td>
<td>$407</td>
</tr>
<tr>
<td>Interest on temporary debt</td>
<td>62</td>
</tr>
<tr>
<td><strong>Total interest</strong></td>
<td><strong>$469</strong></td>
</tr>
<tr>
<td>Redemption of funded debt (plus capital notes)</td>
<td>$717</td>
</tr>
<tr>
<td>Sinking Fund in-payments</td>
<td>1</td>
</tr>
<tr>
<td>Redemption of temporary debt</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total redemption</strong></td>
<td><strong>718</strong></td>
</tr>
<tr>
<td><strong>Total debt service</strong></td>
<td><strong>$1,187</strong></td>
</tr>
</tbody>
</table>

Put another way, in 1973-74, debt service will take about twelve cents out of every expense budget dollar. However, the proportion used to be higher in the past. For example, in 1962-63, it was 14 percent. The lowering has come about in part because the City's credit rating has improved in long-overdue recognition of the City's efficient debt managing techniques. Interest rates on City bonds have dropped from a high of 7\% in 1971 to about 5\%. However, it is also true that other expenditure categories have increased faster than debt service, hence accounting for a smaller percentage of debt in relation to the total budget.

Of this $1,187 million total, $1,113 million is a charge against real estate and $74 million is raised (pursuant to law) from other sources. The $1,113 million payable by real estate is the equivalent of a real estate tax rate of $2.88 per $100 of assessed value. In other words, out of a 1973-74 real estate tax rate of $6.89 per $100 of assessed value, over 40 percent ($2.88) is accounted for by the need to repay past indebtedness with interest.
IV. Is Borrowing Permissible?

Yes, says the Local Finance Law. Yet, two essential points need be
made when judging the validity of any borrowing. One, any dollar borrowed and
spent on operating expenditures is one dollar less which, pending repayment, can
be spent on public construction projects. Two, borrowing even under the best of
circumstances, is costly. Interest costs should not be incurred for purposes
which, while legal, are economically unjustifiable.

Section eleven of the law sets criteria for probable usefulness: the
maximum amount of time for which indebtedness can be contracted for various
purposes. For example: certain water systems are deemed to have a 50-year period
of probable usefulness while the replacement of ornamental shade trees gets a
five-year period. Bonds, of course, need not be sold with a maximum maturity
equal to the ascribed period of probable usefulness. As a matter of fact, one of
the major debt-managing reforms initiated by the City is the present policy to
limit terms of bonds with few exceptions to no more than one-half of the appli-
cable period of probable usefulness.
V. Misuse Of Borrowing Power

There are close to eighty subsections which list bondable purposes and their periods of probable usefulness. In the opinion of many experts, this classification system has gotten out of hand because an increasing number of these bondable purposes turn out, on closer investigation, to be plain operating expenses. Their inclusion in the Capital Budget seriously impinges on the City's ability to borrow for fiscally legitimate purposes such as public construction projects.

To be specific:

Section 11, Paragraph 62 provides a 3-year period of probable usefulness for "Planning for Future Capital Improvements." The 1973-74 Capital Budget uses Paragraph 62 for such purposes as:

Administrative Costs of Community Boards (in the amount of $10,000 per year per Community Board).

- President, Borough of Bronx: $140,000
- President, Borough of Brooklyn: $180,000
- President, Borough of Manhattan: $120,000
- President, Borough of Queens: $140,000
- President, Borough of Richmond: $40,000

Total: $620,000

But that is not all. The same borough presidents also got Paragraph 62 funds for "studies having to do with any aspect of Capital Budget development and/or borough planning. . . . (and) for Administrative costs of Borough Improvement Board."

- President, Borough of Bronx: $150,000
- President, Borough of Brooklyn: $150,000
- President, Borough of Manhattan: $400,000
- President, Borough of Queens: $250,000
- President, Borough of Richmond: $150,000

Total: $1,100,000

Not to be left out, the President of the City Council also gets Paragraph 62 funds for "Planning and Research Assistance for the President of the Council on Capital Budgets" amounting to $50,000.

There can be no doubt that Paragraph 62 in the above cited instances
simply provides a convenient method to switch operating expense into the Capital Budget.

Section 11, Paragraph 73 provides a 30-year period of probable usefulness for the following purpose:

Job and business opportunity expansion programs of municipalities. The planning and effectuation of any program, activity or project by a municipality, either directly by the municipality or by contract or by any other lawful means, to create, improve or expand job or business opportunities or job or business training, or both, for persons in the municipality as to whom such opportunities or training are lacking or inadequate, so as to enable such persons to earn enough to maintain a decent standard of living, thirty years. Nothing herein contained however shall prevent the application of the period of probable usefulness prescribed in any other subdivision of this section for any object or purpose constituting a separable part of such program, activity or project.

The City is using the authority granted pursuant to this paragraph to allocate $42,000,000 in the 1973-74 Capital Budget for manpower training programs. It is generally agreed that these programs as presently constituted are not working, although this could change for the better. What is more ominous is the concept of treating educational expenses as Capital Budget items. The City has argued that this expenditure is a long-term investment in creating taxpaying residents; the City has never explained how many graduates are likely to continue to live in New York. The potential for fiscal mischief by use of this justification, is practically unlimited. Why bother raising taxes for any facets of education or higher education? After all, is it not true that education is the prime avenue for the attainment by anyone of a decent standard of living? The City has already taken steps in this direction. Part of the balancing act involving the 1973-74 Expense Budget consists of shifting into the Capital Budget $139 million for vocational education programs in high schools and community colleges.

How much in Expense Budget items has been switched into the 1973-74 Capital Budget or is simply to be paid out of borrowed funds without necessarily
showing up in any budget document is next to impossible to determine, but it is conservatively estimated to reach $500 million at an annual rate. Inasmuch as these processes are perfectly legal -- thanks to the State Legislature's willingness to continue adding new paragraphs to Section 11 of the Local Finance Law-- the magnitude of the amount involved depends on one's fiscal judgment of what is and what is not a proper purpose for the expenditure of borrowed funds.

For example: the operating budget for the City Planning Commission is about $7.5 million. Over $5.0 million of that amount is financed out of Capital Budget funds, i.e. borrowed money.

Another example: All of the annual $10 million expenses of the Board of Water Supply not only are financed out of borrowed funds, but the bonds issued to raise these funds are exempt from the constitutional debt limit.

Recommendation: Section 11 of the Local Finance Law should be purged of paragraphs granting periods of probable usefulness, and thus borrowing authority, to purposes which in fact constitute merely recurring annual operating expenses. Because of the heavy reliance by the City on this kind of borrowing at this time, it is not feasible to abruptly end such borrowing, but it can and should be phased out gradually over a reasonable number of years.
VI. Circumvention of Constitutional Debt Limit

To this date, the City has avoided most of the evasive tactics used in other jurisdictions to get around debt limit restrictions. What the City has done, however, is to stretch its constitutionally available borrowing power through recourse to legal but fiscally questionable devices.

A recent example of these questionable fiscal tactics is contained in Chapter 576 of the Laws of 1972, creating the Transit Construction Fund. This fund has been designed to become the financing vehicle for $250 million of transit improvements. As now contemplated, bonds (not in any way guaranteed by the City) will be issued by the Metropolitan Transportation Authority (MTA); The New York City Transit Authority will construct the new facilities; the MTA will lease the new facilities to the Transit Construction Fund (TCF); the TCF pays "rent" for the use of the leased facilities to the MTA. The MTA then uses these lease receipts to pay off its bonds, (with interest, of course).

How does the TCF get the funds to pay the MTA? From the City of New York. If, per chance, the City were to refuse to pay, the State Comptroller must take it out of State Aid funds otherwise receivable by the City. If, moreover, the City is unable or unwilling to make these payments out of current Expense Budget funds, the law permits the City to sell its own bonds (with terms of 5 years or less) to raise the necessary funds sufficient to pay for each year's debt service on the bonds issued by the MTA. In short: to pay back \textit{with interest} the debt incurred by MTA, the City will borrow that amount and \textit{pay interest} once again on it. This system of paying interest on interest is, of course, quite expensive—for example;

If $100 million has to be raised for transit projects:

** It will cost $200.8 million if financed with 30-year, 6.5 percent City bonds.

** It will cost $233.9 million if financed initially with MTA bonds which then will be repaid over 35 years with 5-year, 5.5 percent City bonds.
Obviously, the 5-year financing scheme, in the above example, is $33.1 million more expensive than straight 30-year financing through long-term City bonds. These $33.1 million constitute an added and unnecessary charge on real estate.

There is a simple rationale for the City's desire to use the TCF mechanisms. Whenever the City issues $1 worth of debt, the constitutional debt limit is encumbered with $1 until such time as the $1 debt is paid off. Most of the City's debt issues are in the form of serial bonds. A serial bond issue with a 10-year term roughly means that, each year, one tenth of the debt is repaid—and as soon as one tenth is repaid, an equivalent amount can be borrowed again. Thus, the longer the term of a serial bond issued, the smaller each year's repayment; the slower the reduction in the encumbrance of the debt limit and the slower the rate at which new debt can be issued. For example:

If $100 million has to be raised for transit projects:

** Encumbrance of the debt limit declines in a straight line from a maximum of $100 million in year 1 to zero at the end of 30 years, if 30-year City serial bonds are used.

** Encumbrance of the debt limit rises to a maximum of $28 million in year 5 then declines gradually to about $11 million in year 30 and then sinks rapidly to zero after 35 years if MTA bonds are repaid by 5-year City serial bonds.

This then is the true reason for the City's use of the TCF mechanism: to keep down as much as possible any one year's encumbrance of the debt limit in order to be able to borrow as much as possible for other Capital Budget projects.

Similar procedures were authorized by Chapter 655 of the Laws of 1962 which permitted the TA to issue its own revenue obligations to buy new subway cars. The TA used about $89 million for this purpose. The law, realizing that
a deficit-ridden operation such as the TA truly has no revenues which could de facto be used for debt service purposes, permitted the City to purchase some cars from the TA by issuing its own obligations. Needless to say, the value of the cars purchased by the City annually was identical with the amount it took to pay the annual debt service on the TA bonds.

At this time, this method of financing (again a case of paying interest on interest) has now been extended with the blessing of the New York State Legislature to the City University. The City is now empowered to borrow the funds needed by the City University Construction Fund to repay agency debt issued for CUNY construction projects. The 1973-74 Capital Budget carries an §8,832,000 appropriation for that purpose. Similar borrowing for the repayment of agency debt issued for the construction of hospitals is now in the offing.

Recommendation: The Legislature should rescind the power of the City to borrow funds for the payment of debt service. The additional interest costs which are payable under these schemes constitute an unnecessary burden on the taxpayer.

In order to prevent any undue disruption of ongoing capital construction programs, the proposed rescission should take place gradually over time.

VII. The Budget Note Problem

Budget notes are issued pursuant to Section 29 of the Local Finance Law. Their usual maturity does not exceed two years except that the Legislature can and does occasionally provide for slightly longer maturities for notes issued at a specific time. Their fundamental purpose is to provide for unforeseen expenses and their repayment comes from within the 2½ percent constitutional tax limit of the City. In other words, a dollar of City funds used for the repayment of a dollar's worth of budget notes means that the City must forego another dollar's worth of regular operating expenditures. The amount of budget notes
is also limited by Section 29 of the Local Finance Law. The usual limit is one percent of the budget with special provision for overruns on welfare expenditures.

The Legislature, however, has seen fit to vary both the amount of and the purpose for which budget notes can be issued. Notes have been issued against federal revenue sharing funds receivable well before there was such a thing as federal revenue sharing. This was (in blunt language) a simple case of deficit financing. Luckily for the City, the Congress of the United State bailed the City out by passing general revenue sharing legislation. Even now, one should realize that in that instance budget notes became notes in anticipation of federal revenues receivable. Imagine the fiscal difficulties which would have arisen caused by failure of the Congress to act. For private industry, at least, the sale of non-existing receivables is not considered a desirable or even legal practice.

The Legislature amended Section 29 to provide that for the fiscal year 1970-71 the limit for the issuance of budget notes should be quadrupled—from one percent to four percent of the budget. On June 16, 1971, the City took advantage of that special power and issued $308,300,000 of such notes. The Legislature also permitted the City to delay repayment of these notes till July 31, 1974 although the City could, of course, repay in part or in whole before that date.

The City has chosen not to repay any part of the $308,300,000 debt so far. Inasmuch as no provision for any repayment has been made in the 1973-74 fiscal year, repayment will have to take place between July 1 and July 31, 1974. This, incidentally, is the first month of the 1974-75 fiscal year.

The question now arises as to how this repayment can be made. Unhappily, the options which now appear to be available also appear to be unpalatable:

Option 1: Repay the notes by decreasing other operating expenditures by an equal amount.
Option 2: Increase taxes (other than real estate) to avoid the expenditure cuts under Option 1.

Option 3: Petition the Legislature to allow for additional renewal (i.e. extend the term) of these notes.

Option 4: Petition the Legislature to pass special legislation to permit "funding" of these notes: i.e. issue City bonds within the constitutional debt limit with a term of from 3 to 10 years.

Option 1 might be possible because a $300 million economy program is not beyond the City's capability. Option 2 should be avoided because of the threat which new taxes constitute to the City's welfare.

Option 3 merely postpones the day of reckoning while interest charges continue to pile up. To opt for continuous renewal until such time as the City can find $308 million in surplus funds is tantamount to adopting a policy of eternal roll overs.

Option 4 flies in the face of sound fiscal principles whose misuse has previously been catalogued in the previous section of this study dealing with Section 11 of the Local Finance Law. It is conceivable that the City and the Legislature will exercise Option 4 because it causes the least political problems. It would, however, constitute another example of increasing the City debt for purposes which, while legal, cannot be defended on grounds of sound financing.

What makes this experience with the $308,300,000 budget note issue particularly poignant is that fundamentally these notes were issued to cover large overestimates of General Fund revenues. The Annual Report of the City Comptroller for 1970-71 states the case in these words:

"The General Fund as shown in the Resolution of the Council of the City of New York fixing the Tax Rate for the fiscal year 1970-71 was $2,500,200,000. In order to balance the 1970-71 expense budget the general fund was reduced by $327,300,000 raising the net General Fund revenues $2,172,900,000. To offset the above reduction $308,300,000 of Budget Notes were issued and certain appropriations were reduced by $19,000,000."
This is a misuse of the power of the City to borrow if unforeseeable expenditures have to be met. What happened here was large-scale borrowing to undo previous overestimates of General Fund Revenues. These overestimates were consciously made to avoid the politically unpalatable Hobson's choice of cutting expenditures or raising taxes.

**Recommendation:** The Legislature should tighten Section 29 of the Local Finance Law to prevent the issuance of budget notes as receivables against unreceivable types of receipts such as taxes or intergovernmental grants of aid. Once the City knows it cannot borrow anymore to cover revenue overestimates, such estimating procedures are likely to become more realistic in a hurry.