

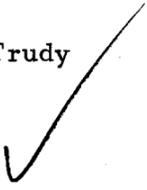
---

Jim

You will note that  
a copy of the Cannon  
memo on New York City  
was in the President's  
Briefing folder --

Another decision paper  
--- no decisions however.

Trudy



THE PRESIDENT HAS SEEN....  
THE WHITE HOUSE  
WASHINGTON

DECISION

September 9, 1975

MEMORANDUM FOR THE PRESIDENT

FROM: JIM CANNON *JAC*  
SUBJECT: New York State Emergency Executive Board

The purpose of this memorandum is to recommend that you establish a Domestic Council Task Force to cooperate with the newly established New York State Control Board in any problems they encounter with Federally assisted programs.

Arguments Pro

1. If the State Board encounters unreasonable delay or disapproval of their attempts to reduce New York City program costs, they may be able to blame the Federal government for their inability to reduce costs.
2. The establishment of a Federal effort with New York City's Federally assisted programs would give more tangible evidence of concern than our present posture.
3. Since the problem of Federal regulation of State and local programs which are Federally assisted is a national problem, the things learned as a result of this review and process will likely have nationwide applicability.

Arguments Con

1. The argument that New York will blame us can be turned in our favor; i.e., it is the Congress who set unworkable program requirements--HEW and others are only carrying out law.

2. Governor Jerry Brown, Mayor Coleman Young, and many Republican mayors have also been asking for relief from Federal regulations. If we must establish a task force, do it for all cities, not just New York.
3. The major problem is that this will raise expectations in New York City/State that we may not be able to deliver on because of Congressional mandates.
4. No need to do with public statement; could be accomplished informally.

Decision

If you approve this, a proposed statement is attached at Tab A which could be used by you or a spokesman.

Approve \_\_\_\_\_

Disapprove \_\_\_\_\_

To assist New York City and the State of New York in their efforts to resolve the City's fiscal problems, I have today asked all Federal departments and agencies to make an intensive effort of cooperation with the newly created New York State Emergency Executive Board.

To facilitate and expedite this cooperation, I am establishing a special task force of the Domestic Council which will be chaired by the Director of the Office of Management and Budget, and will include the Secretary of Health, Education and Welfare and the Executive Director of the Domestic Council. This task force will work directly with the State Board to provide all appropriate assistance in regard to the Board's proposals for changes in Federally funded programs conducted by the City of New York.

In many of these Federal programs, there are current requirements of law, rules and regulations which might ordinarily impair, impede or delay responsible changes which are compelled by the City's present fiscal circumstances. The Domestic Council Task Force will seek to enable effective and responsive assistance as New York City proceeds with the program reductions, changes and modifications it must make. It will be the special responsibility of the task force to respond to the State Executive Board recommendations speedily and expeditiously.

While it is obvious that the primary goal of this task force will be to provide timely and responsive cooperation in this process of change which is compelled by the special circumstances arising from New York City's fiscal problems, it is also our hope that we can learn much about the effect and impact of the Federal rules, regulations, mandate and procedures on all state and local governments.

As this review identifies needed changes in Federal policy, it will propose improvements which will be of benefit to state and local governments across the nation.

This is a further step in advancing the policy of this Administration to make the Federal system of intergovernmental relations more effective and to reduce unnecessary Federal rules and regulations.

THE PRESIDENT HAS SEEN.....

THE WHITE HOUSE

WASHINGTON

September 8, 1975

ECONOMIC AND ENERGY MEETING

September 9, 1975

2:00 p.m.

Cabinet Room

From: L. William Seidman

*LWS*

I. PURPOSE

To review the current status of the New York City financial situation.

II. BACKGROUND, PARTICIPANTS AND PRESS PLAN

- A. Background: The Economic Policy Board Weekly Report is attached at Tab A.

On September 2 you met with Governor Carey and other New York officials who explained their view of the New York City financial situation and the financial borrowing package which Governor Carey proposed to a special session of the New York State Legislature on September 4. You indicated at that time that you had requested Secretary Simon and other Administration officials to closely monitor developments and keep you advised.

A memorandum summarizing Secretary Simon's assessment of the current situation is attached at Tab B. A memorandum, prepared by the Department of the Treasury, reviewing options for Federal financial intervention in the New York City crisis is attached at Tab C. An information paper on the structure of the municipal market is attached at Tab D.

- B. Participants: The Vice President, William E. Simon, L. William Seidman, James T. Lynn, John T. Dunlop, Rogers C.B. Morton, Alan Greenspan, Frank G. Zarb, Arthur F. Burns, Richard Dunham, Brent Scowcroft.
- C. Press Plan: White House Press Corps Photo Opportunity.

III. AGENDAA. Review of New York City Financial Situation

Secretary Simon will review the current status of the New York City financial situation and possible options for Federal financial intervention.



ECONOMIC POLICY BOARD WEEKLY REPORT

Issues Considered by the EPB During the Week of September 1

1. U.S. Grain Policy  
Reviewed the grain situation focusing on estimated Soviet demands, U.S. estimated grain supply and demand, and the food price outlook, and the carry over forecast.
2. New York City Financial Situation  
Reviewed the current financial situation and the proposed MAC financial borrowing package. Seidman to coordinate the preparation of a status report to the President.
3. Robinson-Patman Act  
Reviewed an options memorandum on repeal of the Robinson-Patman Act. Commerce and Justice will outline format and schedule for how public hearings on the Act might be structured. Regulatory Reform Review Group will explore interest on the Hill in sponsoring legislation repealing the Act.
4. Situs Picketing and Construction Industry Collective Bargaining Bill  
Reviewed the legislative situation with respect to situs picketing legislation and the Construction Industry Collective Bargaining Bill.

Task Force Status Reports

1. Interagency Fertilizer Task Force Report
  - o Export contracts for nitrogen fertilizer have declined significantly and the U.S. has become a net importer of nitrogen fertilizer by approximately 95,000 tons for the 1975 crop year.
  - o New plant capacity is also now anticipated to be lower than previously expected due to construction delays in the largest new units originally expected on stream in February 1976.

Major Upcoming Agenda Items

1. Capital Formation Study Report
2. Tax Cut Extension Alternatives
3. U.S. Grain Policy
4. Multinational Corporations Policy

*B*



THE SECRETARY OF THE TREASURY  
WASHINGTON

SEP 8 1975

MEMORANDUM FOR THE PRESIDENT

Subject: New York City

The attached paper reviews options for Federal financial intervention in the NYC crisis. This crisis originated in an inability of the political mechanism in NYC to reconcile expenditures with available revenues. For years, the gaps have been financed through the issuance of short term debt, but investors will now no longer finance these gaps. A stagnant tax base resulting from NYC's structural economic problems intensifies the problems, by foreclosing substantial new revenue sources. And entrenched political interests inhibit actions to reduce expenditures substantially.

Governor Carey and other interests -- e.g. banks, city labor unions, representatives of welfare and other social services interests -- have dealt with the issue of default adroitly, at least in a political sense. Drawing on widespread apprehension as a result of the crunch of '74 and the financial impact of the recession, they have coupled NYC's default with the integrity of the banking system, the ability of municipalities and states to raise money in the future and the continuance of the present upswing in economic activity.

They have designed a "financial plan" which mandates use of state and city employee pension fund money and the purchase of Big MAC obligations by the State. This "plan" has a dual trigger mechanism. The approximately \$2.0 billion raised under "the plan" would carry the City through the end of November. By that time the reconciliation process mentioned above would have had to progress sufficiently so as to enable the City to reenter the public markets to finance \$3.7 billion in additional funds to carry it through the first half of calendar '76. Second, Big MAC will, under the plan, have to be able to tap the bond market for \$750 million to repay the State by the end of its fiscal year (3/31/76).

If the reconciliation process is not well underway by the end of November, NYC will default and this event creates the risk of, but will not necessarily result in, a default by the State and its agencies as well.

A solution pressed upon us is Federal involvement, through a direct loan, a partial guarantee of City or Big MAC securities or a full guarantee. A guarantee or direct assistance would eliminate the threat of default. Unfortunately, it is inconceivable that a guarantee could be limited to NYC or Big MAC securities. First, it would be unfair to exempt NYC from the painful process of reconciling income with outgo. Second, it would be difficult to pass legislation limited only to NYC. There are other municipalities where the pain of reconciliation is just as extreme as that felt by NYC, but where the totals involved are not nearly so dramatic.

If this assumption is correct, a guarantee for NYC would only begin the process of guarantees and/or direct loans for state and local governments. As this developed, the incentive for other municipalities to endure the stress of reconciling income with outgo would be reduced. Structural deficits in countless municipalities would be the end result of this process. A substantial increase in Federally-guaranteed debt of states and municipalities would be the end result. And why not a guarantee for Atlanta's badly needed rapid transit system or Detroit's partially completed major hospital. This in turn would crowd out those sectors of our economy that do not enjoy a guarantee; for example, much of the housing sector, individuals and corporations. In turn, these groups would bring to bear strong pressures to obtain guarantees for themselves.

The economic aspects of structural municipal deficits financed through the issuance of guaranteed securities would parallel to a significant degree the impact of large direct deficits by the Federal Government. Strong additional pressure would be brought on the Federal Reserve to provide reserves to facilitate the financing of those deficits and to reduce the incidence of crowding out.

If the Federal Government attempted to control local finances to protect it from exposure under guarantees, it would become enmeshed in the local politics of thousands of political subdivisions. Direct Federal aid, a guarantee or a partial guarantee might avoid default. But it also would begin the Federalization of state and local affairs.

  
William W. Simon

C

THE WHITE HOUSE

WASHINGTON

September 8, 1975

MEMORANDUM FOR THE PRESIDENT

FROM: L. WILLIAM SEIDMAN

SUBJECT: Financial Assistance for New York City

The Department of the Treasury has prepared the attached memorandum on possible methods of providing financial assistance to New York City and/or New York State. The alternatives outlined in the memorandum are listed below.

New Programs of Direct Financial Assistance

Approve      Disapprove

Option 1: Guarantees involving agreement by the U.S. Government to pay the debt service on a loan if the underlying borrower fails to pay.

\_\_\_\_\_

\_\_\_\_\_

Option 2: Direct Federal loans or purchases of securities.

\_\_\_\_\_

\_\_\_\_\_

Option 3: Three year advance of New York City's share of welfare costs.

\_\_\_\_\_

\_\_\_\_\_

Utilizing Existing Resources

Option 1: Direct Federal loans through the Federal Reserve.

\_\_\_\_\_

\_\_\_\_\_

Option 2: GNMA purchase of city-owned mortgages.

\_\_\_\_\_

\_\_\_\_\_

Option 3: Shifting Medicaid hospital payments from a reimbursement to an advance basis.

\_\_\_\_\_

\_\_\_\_\_

Option 4: Advance Quarterly Revenue Sharing Payments.

\_\_\_\_\_

\_\_\_\_\_

SEP 8 1975

DECISION MEMORANDUM

SUBJECT: Financial Assistance for New York City

This memorandum has been prepared in light of the pending action by the New York State Legislature to provide funds for New York City -- primarily through State borrowing and through purchases of City and/or MAC debt by public employee pension funds. The Legislation poses a risk to the State's credit and increases the likelihood that the State (and various State agencies) would be severely impacted in the event New York City defaults.

These concerns have led to more strident demands that the USG indicate a willingness to provide financial assistance to New York City to avoid a default in December. This memorandum sets forth the options available (with appropriate legislation) at the Federal level.

This memorandum is in two parts. Part I sets forth the options for a new program of direct Federal financial assistance to New York City. Part II explores the possibility of using existing Federal resources to ameliorate the problems.

Part I: Direct Financial Assistance

Background

The analysis contained herein is premised upon the following assumptions:

1. The State Legislature will enact the Governor's legislative package, providing sufficient funds (approximately \$2 billion) to carry the City through December 1.
2. Implementation of the package will exhaust the cash flow resources of the State, its pension funds and the banking system in New York State with respect to additional financial assistance to New York City.
3. New York City will not be able to borrow in the public market by December 1.

As a practical matter, enactment of the Legislation will impose two market access requirements:

- the City will be required to borrow \$3.7 billion in net new cash between December 1 and June 30, 1976, the end of its fiscal year;
- Big MAC will be required to borrow \$750 million by March 31, 1976 (the end of the State's fiscal year) to refund the State TAN issue.

Forms of Assistance - General

There are two basic options:

1. A Federal guarantee of securities issued by the City, the State or MAC; or
2. A direct Federal grant or loan to the City, the State or MAC.

Either basic option will require legislation. As discussed more fully in the treatment of options, an important consideration is the breadth of any assistance program. Since, as a practical matter, any proposal involves a Federal allocation of credit, it is essential that constraints closely approximating free market constraints be imposed. If constraints on the amount of and eligibility for assistance are not imposed, any assistance program will be abused by borrowers attempting to use such assistance as their primary source of financing.

Before evaluating specific forms of assistance, the threshold question of whether to provide any form of Federal financial assistance is presented.

Pros

- Would avert a default by the City and/or the State.
- Would eliminate the risk of a major financial collapse precipitated by a City and/or State default.
- Would show Administration concern for urban problems.
- Would protect banks from losses, thus reducing the risk of a series of insolvencies leading to a loss of confidence in the banking system.

Cons

- Would eliminate requirement for limiting expenditures to level of revenues at State and local government level.
- Would increase USG borrowing costs by increasing USG demand for credit.
- Would increase the borrowing costs of all other borrowers, and could close the credit market to certain marginal borrowers.
- Would conflict with Administration policy against new spending.
- Would set a bad precedent by opening the door to any borrower (or class of borrowers) in financial difficulties who can claim potential impact on financial system.

I. Guarantees

A guarantee would involve an agreement by the USG to pay the debt service on a loan (evidenced by a note or bond) if the underlying borrower failed to pay. Within the guarantee concept, there are numerous sub-options. A guarantee can be full (an agreement to pay all unpaid debt service) or partial (an agreement to pay a specified percentage of unpaid debt service). A Federal guarantee program could be made available (1) to all municipal debt; (2) to a specified annual dollar amount outstanding; or (3) to a single issue of New York debt to finance New York City's \$3.7 billion shortfall.

Evaluation of Options

1. General Guarantee Concept

Pros

- Makes N.Y. Securities marketable
- Requires no immediate USG cash outlay
- May be more palatable to Congress than cash outlays.

Cons

- Requires extensive supervision if USG's contingent financial interests are to be protected.
- Expansion of Federal credit drives up USG borrowing costs.
- Could reduce or deny market access to borrowers (crowding out).
- Eliminates incentives for fiscal restraint; i.e., balancing of revenues and expenditures.

2. Full vs. Partial

Full Guarantee

Pros

- Easier to administer
- More certain to insure a market for the bonds.
- Lowest borrowing cost for issuer.

Cons

- More USG contingent exposure
- More adverse impact on other borrowers.

Partial Guarantee

Pros

- Less USG contingent exposure.
- Less adverse impact on other borrowers.

Cons

- More difficult to administer.
- May not create a market for the bonds.
- Higher borrowing cost to issuer.

3. Scope of Program

All Municipal Debt

Pros

- Most fair.
- Provides greatest amount of assistance nationwide.
- Easy to administer, no allocation or eligibility decisions.
- No prejudice to municipalities which need to borrow.

Cons

- Greatest USG exposure.
- Largest adverse impact on USG borrowing costs, borrowing costs of other issuers.
- Broadest elimination of incentives for fiscal restraint.
- If Federal supervision is involved, would require large bureaucracy.

Specified Annual Dollar Limit

Pros

- Limits USG exposure.
- Limits impact on capital markets.
- Limits outlays for Federal supervision.

Cons

- Difficult to administer.
- Severe problems of allocation.
- Depending on allocation mechanism, may not satisfy New York City's requirements.
- Severe prejudice (competitive disadvantage) to tax-exempt borrowers which do not obtain guarantee.

One-Shot Guarantee of Special NYC Issue

Pros

- Least USG exposure.
- Least impact on markets, other borrowers.
- Easiest to administer.

Cons

- Unfair to all other borrowers.
- Rewards NYC for its fiscal irresponsibility.
- May be difficult to obtain Congressional support.

II. Insurance and Re-insurance

Insurance of new issues of municipal bonds cannot be distinguished -- in form or in substance -- from a guarantee. Re-insurance cannot be distinguished -- insofar as the USG is concerned -- from a partial guarantee. Insurance and guarantees involve the identical legal commitment from the insurer or guarantor: an irrevocable agreement effective on the date of issue to make debt service payments if the issuer fails to make such payments. Unlike traditional casualty insurance, once the commitment is made, the insurer never has the opportunity to reevaluate the risk or adjust the premium. All he can do is retain the right to participate in the issuer's affairs (compare the rights the USG reserved under the Lockheed guarantee program).

Under reinsurance, a private entity would be responsible for writing the policy and would bear a portion of the risk. The theory is that the private entity would take on the supervisory role, and would have a financial incentive to supervise vigorously, thus avoiding the problem of excess Federal involvement. However, the resources the private insurance sector is willing to commit to these risks are so limited (maximum exposure of \$8-15 million principal per issue), that with respect to issuers of any size, the Federal share of insurance would have to be close to 100%. In these cases, the market problems outlined above would continue to be present. And, in light of the fact that the option

of withdrawing the insurance is permanently foreclosed at the outset, it is doubtful whether any private insurance company could exercise a degree of effective control over the affairs of a New York, Los Angeles, or Chicago.

#### Pros and Cons

Because insurance and re-insurance are identical to a full guarantee and a partial guarantee, those pros and cons are fully applicable.

### III. Direct Loan or Purchase of Securities

This form of assistance has two distinguishing features. First, it involves an immediate cash outlay by the USG. Second, the City (or other borrower) would not be forced to go into the market itself -- accordingly, the USG would have to borrow in the open market to make the loan.

Apart from these features, the considerations -- and sub-options -- regarding the direct loan approach are virtually identical to those involved with respect to guarantees. The pros and cons of various programmatic features -- e.g. purchase all debt, purchase dollar limit, purchase NYC alone -- are the same.

One different sub-option can be identified. To create incentives for fiscal reform (and restored public market access) the USG could make loans available on a matching basis; i.e., for every \$5 the City raises in the public market, the USG will provide \$1. Recognizing the importance of self-reliance, most existing USG assistance to State and local government is in matching form.

#### Matching Loans

##### Pros

- Preserves incentives for fiscal restraint.
- Requires less funding from USG, reducing adverse market impact.

##### Cons

- If City is unable to restore market confidence, will not be adequate to prevent default.

Direct Loan vs. Guarantee

The similarities notwithstanding, there are certain advantages and disadvantages to a direct loan program which stem from the above-described distinguishing features.

Advantages of Direct Loan

- Does not directly affect the municipal market; indeed, by eliminating a portion of demand from the market, may cause a short term improvement in market conditions for other borrowers.
- Direct cash payment insures City will receive funds.

Disadvantages

- Requirement of actual USG borrowing (as opposed to intangible expansion of USG credit) may have more severe and immediate effect on USG borrowing cost, borrowing costs of other borrowers.
- Direct cash outlay would directly increase USG budget deficit, further lessening USG flexibility regarding fiscal policy.

IV. Three Year Advance of City's Share of Welfare

It has been claimed that the City's welfare burden is a national concern: the poor and disadvantaged, as well as illegal aliens, gravitate to NYC. Accordingly, it has been suggested that we seek legislation authorizing an advance to the City in an amount equal to the City's share of welfare costs for three years: approximately \$2.7 billion. In return, the USG would receive a 10 year City bond, bearing interest at Treasury bond rates. In addition, beginning three years from now, the City would establish a sinking fund to repay the bond when due.

Pros

- Would provide a substantial portion of the City's cash needs.
- Would not disrupt municipal bond market.

Cons

- Would be difficult politically to confine to NYC.
- Would require substantial borrowing by USG, driving up USG borrowing costs and affecting other borrowers.
- Could be viewed as a concession of broader Federal responsibility in the welfare area, tying our hands with respect to upcoming welfare reform proposals.

Part II: Use of Existing Resources

I. Federal Reserve

Two avenues of assistance are available through the Federal Reserve. First, the Federal Reserve Banks are authorized to supply liquidity to the banking system by accepting for discount financial assets held by the bank. Discounting is in effect a secured loan to the bank, but it is important to note that the bank remains liable to the Fed for the full amount of loan. Accordingly, if a bank were to discount NYC Securities with the Fed, the bank would still bear the risk of loss. Dr. Burns has announced that the "discount window" will be available to banks impacted by the New York crisis.

The discount window is not a source of direct assistance to New York City. However, the Federal Reserve banks are empowered to make direct loans -- secured or unsecured -- to any borrower "in exigent circumstances."

Direct Fed Loan

Pros

- Would provide NYC with the necessary cash.
- Would not require legislation.
- Would eliminate the risk of a major financial collapse precipitated by a City and/or State default.
- Would show Federal concern for urban problems.

Cons

- Would set a bad precedent by opening this avenue of assistance (which has never been used in comparable circumstance) to borrowers who can claim broad impact on financial system.
- Would place Fed in the role of the City's bankers and could lead to pressure for further loans to protect initial loan.

II. GNMA Program

GNMA has the general legal authority to purchase mortgages of all types. It must, however, obtain periodic authority from Congress for actual blocks of purchases. It has recently used up a \$5 billion block; legislation is now pending (and expected to pass soon) giving GNMA an additional block. The City owns \$700 million in mortgages on existing low and moderate income properties ("Mitchell-Lama" projects) which would qualify for GNMA purchase.

Pros

- Provides a substantial Federal commitment.
- Would not disrupt municipal market or disadvantage other borrowers in that market.

Cons

- Would be inconsistent with Congressional purpose to use GNMA to generate new housing starts.
- Would impede recovery in housing sector.
- Would establish dangerous precedent: many state and local agencies own mortgages they have been unable to fund through long term debt.

III. Change Method of Medicaid Reimbursement

By shifting Medicaid hospital payments from a reimbursement to an advance basis, we could provide \$75 million. To make the shift, the State would also have to change its method, requiring a \$37.5 million outlay by the State.

Pros

- Provides some cash assistance.
- Since most Federal assistance is on an advance rather than reimbursement basis, would not represent a basic policy change.

Cons

- Shift nationwide, involving \$500 million, would involve a substantial one time cost to the USG
- Benefit to City small in relation to overall need.
- State matching requirement could burden State.

IV. Advance Revenue Sharing

The third quarter revenue sharing payment (\$64 million to the City, \$57 million to the State) is scheduled to be made in the first week of October. The fourth quarter payment (in the same amounts) is payable in the first week of January. These payments can legally be made any time in the relevant quarter.

Pros

- Provides some financial assistance.

Cons

- Would not provide new cash: NYC's problem is no longer so much one of timing of cash flow, as of total amount.
- Would have to be provided nationwide imposing substantial cost on USG.

*D*

## STRUCTURE OF THE MUNICIPAL MARKET

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

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

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

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

#### Supply of Tax-Exempt Credit

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

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

1. Offshore operations have accounted for an increasingly large share of income (more than 50 percent in the case

---

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

of Citibank and Morgan Guaranty, for example). Taxes paid to foreign governments on income derived from such operations may be credited against U.S. tax liability, thus reducing the effective U.S. rate and the consequent need for shelter.

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

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

#### Demand for Tax-Exempt Credit

At the same time factors have been at work to moderate the supply of credit available to the municipal market, demand for such credit has grown dramatically. In the last decade, tax-exempt debt outstanding rose from \$100 billion to \$207 billion. In 1974 alone, \$22.8 billion in bonds and an additional \$29 billion of short-term notes came to market.

Much of this debt was issued for traditional public purposes -- e. g., schools, water and sewer facilities, hospitals, etc. But \$2.2 billion, nearly 10 percent of the total bond volume, was used to fund pollution control facilities of private corporations. The financial benefits of the tax-exempt subsidy accrued not to the taxpayers but to corporate shareholders. And an additional \$340 million of publicly issued tax-exempt debt was in the form of industrial development bonds, used to finance everything from warehouses to fast food outlets.

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

#### Impact of Inflation

To this point, we have identified the following sources of disturbance: stagnant supply of tax-exempt credit caused by (1) less institutional need for tax-exempt income, and (2) uncertainty as to the soundness of tax-exempt credits; sharply increased demand for tax-exempt credit, in large part attributable to the use of such credit for nonpublic purposes. To complete the survey, we must look at the impact of inflation on both the supply and demand sides.

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

-- Under our progressive tax system, inflation drives taxpayers into higher brackets without increasing real wealth; a greater proportion of after tax income must be spent rather than saved to maintain a level standard of living.

-- Inflation and its now inevitable handmaiden -- the expectation of future inflation -- makes savers less willing to invest funds for extended periods and causes them to demand higher returns for what is invested.

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

#### Overall Market Impact

All of these phenomena have contributed in varying degrees to the current condition of the market. As of September 1, the Bond Buyer 20-bond index stood at 7.18 percent, within a few basis points of its historical high. Although it is difficult to calculate with precision the level of subsidy such rates provide, it is clear that the subsidy is well below the 35 - 40 percent traditionally thought to be provided by the tax-exemption.

Potential Additional Complications

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

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

Moreover, the New York City situation has focused attention on the need for better information about individual municipal credits. While the new 1975 law expressly forbids the United States Government from requiring issuers to disclose anything, it equally expressly authorizes imposing such a disclosure burden on underwriters and dealers. In addition, a recent lawsuit raises the question whether an underwriter or dealer can be held liable under the antifraud provisions of the securities law (e. g., Rule 10b-5) for failure to inquire behind the Official Statement into the issuers true financial condition.

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

Potential Financial Policy Options for the U.S. Government

A. Reduction in Demand for Tax-Exempt Credits

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

B. Increase in Supply of Credit

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

THE WHITE HOUSE

WASHINGTON

September 20, 1975

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR:

L. WILLIAM SEIDMAN

FROM:

JAMES E. CONNOR 

SUBJECT:

Economic and Energy Meeting  
September 9, 1975

Your Memorandum of Decisions made at the Economic and Energy Meeting held September 9, 1975 has been reviewed.

Please follow-up with appropriate action.

cc: Don Rumsfeld

THE WHITE HOUSE

WASHINGTON

ECONOMIC AND ENERGY MEETING  
September 9, 1975  
2:00 p.m.

MEMORANDUM OF DECISIONS

FROM: L. WILLIAM SEIDMAN

*fwS*

Decision 1: Federal Assistance for New York City

The President indicated that he did not approve of any of the options of ways to provide Federal financial assistance to New York City and reaffirmed his position that New York State and City officials should be given no encouragement with regard to expecting future new Federal assistance.