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No credit, scant revenue

State and city governments are being squeezed out of borrowing markets at the same time recession hits their income, reports Leif Johnson.

U.S. urban residents may soon have little difficulty understanding the meaning of IMF and World Bank credit cutbacks to the Third World. Changes in budget and tax policy combined with high interest rates and lowered bond ratings are making it impossible for America's cities to provide even the basic services needed for survival.

For more than a decade, cities and states have been forced to cut back their spending on capital goods, the water mains, sewerage systems, school buildings, recreation facilities, old age homes, bridges, and highways. In 1980, cities were spending less than one-half the dollars per capita that they had spent in 1970—and it was steadily downhill all through the decade.

Changes brought by the recently passed Federal Budget Bill and the Tax Act of 1981, coupled with interest rates that now even exceed usury for usually low-interest tax-free municipal bonds, make new borrowing by America's cities nearly impossible. It was this borrowing that paid for municipal and state capital construction.

The clamp on municipal spending was a three-round assault. The Omnibus Budget Reconciliation Act, passed with such great fanfare on Aug. 13, cut federal spending by $35 billion. One-third of that amount had gone in grant form to the nation's localities. Those localities in turn depend on the federal government for 43 percent of all their capital spending dollars.

In the next round of federal budget cutting, it is expected that half of the $13 billion cut will come from capital spending grants to municipalities.

If local public construction is to continue, the local authorities will have to borrow substantially increased amounts on the municipal bond market. That option, however, has been nearly eliminated by the Tax Act of 1981.

For the first nine months of 1981, 75 percent of municipal bonds, expected to be about $70 billion, were purchased by wealthy individuals. These bonds, since they are tax free, have been the traditional method of tax avoidance for such individuals. In turn, the localities received a lower interest rate which reflected the tax savings to the buyers.

The Tax Act reduced the top bracket tax from 70 to 50 percent, reducing the amount of income wealthy individuals would try to shelter from taxes, while reducing the capital gains taxes in order to improve the attractiveness of equity as opposed to fixed income securities like municipal bonds. It has also reduced estate and gift taxes, expanding tax avoidance through individual retirement and savings plans like IRA and Keogh plans.

All Savers

Most important the Tax Act created the All-Savers Certificate granting tax exemption for investments that are far more liquid than long term general obligation bonds of states and cities.

Figure 1

State and local borrowing, 1970-81

(billions of dollars)

Year	Total in current dollars	Total in 1970 dollars	Total in 1970 dollars discounted for first-year interest
1970	$35.7	$35.7	$33.5
1971	50.7	43.6	41.0
1972	48.1	39.7	37.3
1973	47.7	35.8	33.4
1974	51.8	35.0	32.5
1975	58.3	36.2	29.8
1976	55.4	32.5	29.4
1977	71.5	39.4	35.4
1978	69.7	35.7	31.9
1979	65.0	29.9	26.1
1980	76.1	30.8	24.9
1981* ...	70.6	26.0	17.6

*Projected from first seven months.
Source: Public Securities Association; Bureau of Labor Statistics

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Further, the Tax Act's expansion of leasing tax shelters, increases in "investment" credit, and accelerated depreciation will give commercial banks, previously large buyers of municipals, more profitable, short-term avenues of tax avoidance than the municipal bond market.

Property and casualty insurance companies, which currently hold about a quarter of the $325 billion in outstanding municipal debt will probably be out of the municipal market entirely in 1982. In addition to more lucrative alternative investments made possible by the Tax Act, the casualty companies have been running increasing deficits on their underwriting since 1979. Losses in 1981 are expected to be $6 billion while next year's are estimated by the industry at over $7 billion.

This would not be such a problem if there were alternative means for financing cities' needs. But the deliberate depression policy of the Federal Reserve under Paul Adolph Volcker's chairmanship has ensured that there are not.

For a municipality to issue a 20 or 30 year bond at current rates of 13 percent interest, is to incur an extraordinary future debt that must be serviced from revenues that decline as the recession deepens. No matter how badly a bridge, firehouse, water main, school building, or public swimming pool needs rebuilding or replacement, local authorities will be hard pressed to accept a 13 percent interest rate burden.

Because of the economic impoverishment of the state and local governments, the risk ratings have gone down. Contrary to the trend since World War II, of general improvement in bond ratings for municipalities, last year Moody's Bond Service, the nation's largest rating service, *downgraded three times as many communities as it upgraded.* The lower a municipality's bond rating, the higher interest rate it must pay.

Figure 2

Per capita public works investments
(1972 constant dollars)

Year	Dollars
1968	$183
1970	154
1972	144
1974	137
1976	123
1978	121
1980	109
1982	86

Note: Public works includes highways, industrial and port development financed by municipal bonds, and military building, in addition to traditional municipal and state public construction.
Source: Statistical Abstract of the United States. 1982 estimate based on impact of Tax Act, federal budget cuts, and weakness of municipal bond market.

Proposition 13

For some localities, borrowing becomes all the more necessary as it becomes simultaneously impossible. Municipalities in the state of California for example, which is spending the last of its multibillion dollar surplus, will soon feel the brunt of Proposition 13 passed two years ago. That amendment to the state constitution drastically cut local taxes and prevented new increases. Now without state grants and a seriously weakened real estate market particularly in Los Angeles and San Diego, the municipalities are doubly hit. They cannot borrow to continue capital spending since their ability to borrow depends on their ability to tax which has been pinched off by Proposition 13. Such legislation in recession-wracked industrial states like Michigan and Massachusetts has stopped nearly all capital spending and put former municipal workers on the welfare lines.

Borrowing cut in half

A short hiatus in local and state capital spending would not be so serious if it were not for the decade long decline suffered throughout the nation.

In 1979 state and local capital borrowing was $35.7 billion from which we deduct the cost of the first year's interest to give a true picture of the worth of that borrowing.

By 1981, projecting the first seven months' figures, borrowing in constant 1970 dollars, discounted for the first year's interest charges, was only $17.6 billion. Thus total borrowing, short- and long-term combined was only half of what it was a decade earlier.

Not only has borrowing halved, but the purpose of the borrowing has changed radically. In 1970 two-thirds of all municipal bond borrowings were general obligation bonds which went to fund school buildings, sewers, waste treatment or police stations. By 1980 only 30 percent of municipal bonds were general obligation issues—the rest were revenue bonds attached to projects that generate income. These include industrial revenue bonds for industrial parks, bonds for airports, bridges, docks, and other facilities from which the municipality or public authority can collect user fees.

Revenue bonds cannot be sold for schools or other traditional public works like roads and sewers which do not generate revenues.

In 1970 total borrowing for education was $5 billion; in 1980 that figure was $4.9 billion. Adjusted for inflation, the 1980 borrowing was only $1.8 billion or 36 percent of the 1970 figure. By 1979 education borrowing was only 5 percent of the municipal bond market even though this is traditionally the largest local expense.