

THE HISTORY OF THE PAY-AS-YOU-GO POLICY

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THE HISTORY OF THE PAY-AS-YOU-GO POLICY¹

ARTHUR M. ANDERSON, J. P. Morgan & Company: The remarks which Controller Craig has made about the "Pay-as-you-go" policy in New York city take me back very vividly to the conditions prevailing at the time the "Pay-as-you-go" policy was instituted. In October 1914, three months after the outbreak of the European War, the financial world was, so to speak, standing on its head. The City of New York, in accordance with its practice for a series of years, had borrowed quite extensively on short-term paper. A part of this borrowing, in fact about \$80,000,000 of it, was represented by obligations payable in London and in Paris. Under normal circumstances these maturities would have been met by purchases of exchange, but, due to the extreme confusion in international finance, exchange was almost unobtainable, and what little dealings took place were far above the normal par of exchange. The quotations, however, really meant nothing, because exchange was not available in an amount sufficient to cover the city's obligations.

The controller set forth the situation in great detail to some of his banking friends and a syndicate was organized to purchase \$100,000,000 of New York city bonds running for one, two and three years, bearing 6 per cent interest. Participation in the syndicate was pro-rated over the banking institutions at a fixed ratio of about 4 per cent of the net deposits of each institution, and you will be interested to know that of the 128 commercial banking institutions in Greater New York all but four were so much interested in the credit of the city and so willing to protect it in times of stress that they agreed to purchase their pro-rata share of bonds and make a payment therefor to the extent of about 80 per cent, if called upon, in gold, the gold to be shipped to Ottawa for the credit of the Bank of England to create deposits in London upon which the city could rely in meeting its indebtedness abroad. The value to the city of this agreement of the banks to pay in gold if required was measured by the premium on the pound sterling which at the time of this agreement was in the neighborhood of 4 per cent, so that the possible 2 per cent profit to the syndicate on the exchange operation (beyond which point all profit was to accrue to the city), was about one-half what any one of the institutions could have made by shipping its own gold to Ottawa and selling bills on London against deposits so created.

One reason for the demoralization in the exchange market at this time was the general knowledge that New York city was

¹ Discussion at the National Conference on War Economy, June 6, 1918.

obligated for very large amounts abroad, and the psychological effect of the formation of a syndicate to supply gold if necessary to meet the city's debt in London was immediate. Of the \$80,000,000 which the banks agreed to furnish in gold, if required, there was called from them about \$35,000,000. The [p.107] balance was furnished either in foreign exchange which the banks had the right to supply, in lieu of gold, or, when the exchange market had again resumed a semi-normal basis of operation, by clearing-house funds. The City of New York received back from the operations of the syndicate over half a million dollars, and the distribution of notes to investors was an overwhelming success. In short, a very dangerous situation was met by courageous and immediate action on the part both of the city and of the bankers of New York city.

At the time the negotiations between the controller and the bankers were undertaken, the market had indicated that the bonds of the city were not so eagerly sought as had been the case in earlier years. While all municipal bonds had declined in selling price as measured by their annual yield during the ten years from 1904 to 1914, the decline in prices for New York city bonds was considerably more pronounced than in the average price of the bonds of about twenty cities whose obligations are used by statisticians in charting market movements.

The greater extent of the decline in New York city bonds was not due to any question as to the safety of New York city's obligations, but the city had put out more bonds than the market wanted to absorb; in other words, it had reached more or less of a point of saturation. From 1904 to 1914 inclusive the city marketed publicly a total of \$681,800,000 bonds, which represented a ratio varying from 10 per cent to over 20 per cent of all the municipal financing in the country during that period. This seemed too large a share for any one municipality to absorb without some effect on quotations and the market prices reflected this fact. It is true that the city's expenditures were in large measure along constructive lines

-the building of the great subway system, the enlargement of the water supply facilities and the construction of docks-but the purposes for which the bonds were being put out had nothing to do with the effect on the market price. The city's debt was suffering from growing pains.

In addition to the great amount of bonds issued for purposes such as water supply, rapid transit and docks, there was a large volume of debt created for other purposes, the thousand and one things that go into the plant of a great municipality like New York-schools, parks, museums, streets, fire houses, police stations and the like, the total of which in the years 1904-1914 inclusive, was no less than \$386,000,000. This sum of \$386,000,000 borrowed for non-revenue-producing purposes is an enormous sum of money and it seems

particularly so in comparison with what has been spent elsewhere. The city of London appears to me to be possibly the best city to use for purposes of comparison, although, naturally, the different practices on the two sides of the Atlantic make any such comparison difficult as to specific points. The London County Council corresponds somewhat to the Greater City of New York in general administrative powers and the area does not vary greatly in population. Since 1856- over sixty years- the total amounts of money raised and applied by the London County Council have been about \$545,000,000 and, of this amount, about \$115,000,000 has been repaid, leaving an existing gross debt of say \$430,000,000, of which the sinking fund and other accounts applicable to [p.108] the redemption of debt hold about \$175,000,000, leaving a little over \$250,000,000 in debt outstanding as of March 31, 1916. This is debt outstanding for all purposes, revenue-producing and non-revenue-producing, and represents an existing debt of a little over \$50 per capita. It compares with over \$1,000,000,000 of New York city outstanding debt in the hands of the public, equivalent to over \$175 per capita. One might expect that with this relatively low debt the tax rate of London would be proportionately higher than that of New York city, but while the basis of assessing taxes in London is at variance with that followed in this country, the tax rate in London in the year 1916-1917 figures out about 1.6 percent of the estimated capital value of the real estate and not much over 1% of the estimated value of all property in London, including personal property. This is considerably below the present tax rate of New York city, which is over 2%, and also considerably below what the rate has been in any one of the last few years. I understand that in London the only increase in taxes in the last ten years has been due to expenditures for educational purposes.

Moreover, in the London budget of 1917 the interest charges were estimated at approximately one-eighth of the city's total expenditures and an amount slightly larger than one-eighth was devoted to redemption, making a total of a little over one-quarter of the budget devoted to the service of the debt. In New York city the total debt service in 1917 was approximately 29% of the city's revenue, but it was divided between 21% for interest and only 8% for retirement of principal. It is true that London has not gone so far as New York in municipal undertakings. Only about one-fifth as much debt has been issued for revenue-producing undertakings as for welfare, education, health, streets and such purposes. The city owns tramways, but not the subways nor the water supply, and it has adopted a housing scheme. In some of the other English cities, however, much the greater part of the issuance of debt has been for purposes which are self-supporting. In Manchester

and Sheffield about 66% of the debt outstanding represents revenue-producing undertakings; in Liverpool, nearly 70%; in Bristol, about 80%.

With regard to the \$386,000,000 which New York city borrowed from 1904 to 1914 inclusive, however, a large part of the amount was expended for purposes directly connected with the public welfare, health and education, and no one would contemplate any reductions in expenditures for such purposes. But there were large expenditures of other characters during this period, and while I have not the figures showing the detail of this \$386,000,000 between 1904 and 1914, the reports of the controller indicate that during the years 1908-1917, inclusive, bonds were issued for what might be termed luxuries, as follows :

Libraries and sites.....	\$6,200,000
City parks and places.....	13,400,000
Public buildings, except schools and libraries..	21,500,000
New Municipal Building.....	17,100,000
New County Court House.....	11,400,000

Expenditures of this sort, while desirable in themselves, had no small part [p.109] in increasing the city's debt to the figure which was the subject of discussion in 1914.

The officers of the city, despite the fact that for some time they had discontinued the practice of paying for non-permanent improvements out of the proceeds of long-term bonds, and since 1911 had limited the life of bonds for repaving to a maximum of ten years, coinciding with the anticipated life of the pavement, felt with the bankers that further curtailment was necessary. There was substantial agreement that the purposes of such expenditures were very desirable in themselves, but the fact that they were not of a self-supporting nature made it appear wise to make them charges against current revenue, or to eliminate for the time being such of them as could be postponed. The city administration, after some two weeks of discussion, proposed an acceptable plan. This plan, subsequently enacted into law, provided that for a period of three years an increasing proportion of the cost of non-revenue-producing improvements should be paid from current revenue, until at the expiration of that period the total should be paid from current revenue. The mechanism for financing the share of the cost to be charged to current revenue was a one-year note, to be provided for in the city tax budget of the following year. The balance of the cost of such improvements was to be financed by a fifteen-year serial bond to be taken up as it matured in equal annual installments, also through the budget. This policy was adopted on two theories: first, that a

city-like an individual-should not buy luxuries except such as it was able to pay for out of its current income, viz., its tax collections; and second, that if the city continued to put out long-term bonds for purposes that might be dispensed with, the legal debt-incurring power, already very much reduced through large issues since consolidation, might disappear and-so to speak-hamstring the city financially.

The policy of the city administration in adopting this course was one of the bravest things politically that has ever been done in New York city. The mayor and the controller both knew that the course which was being adopted would mean one of two things, or possibly both of them. First, a reduction in the supply of the things which the people of any city like to have: fine public buildings, good streets, and public facilities of the highest grade. Second, as the non-revenue-producing expenditures could not be eliminated entirely, there would be an increase in the tax rate, but the mayor and the controller and the members of the Board of Estimate were clearly of the opinion that such a change was wise in order to correct what had possibly been a too rapid rate of expansion in the city's expenditures, and the proposed plan was adopted.

There are, naturally, at least two views on any such question, but my feeling is that the results to the city of the "Pay-as-you-go" policy up to the time of our entrance into the war were distinctly beneficial. The report of the chief accountant of the finance department, one of the few men living who understands the city's accounts and the only one able to fathom the city's Sinking Fund and General Fund practice, stated that because of the adoption of this plan the city's outstanding debt remaining out of that created since 1914 is \$10,000,000 less than it would have been [p. 110] under the old fifty-year Sinking Fund plan, while the interest payments during the three years, 1916, 1917 and 1918 are over \$500,000 less than they would have been under the former method of finance and, up to the present year, the increase in the tax rate was only nominal.

With our entrance into the war, however, conditions changed materially. All calculations were upset. Lord Kitchener's statement that the war would last three years was decried, and a policy which was adopted two months after the beginning of the European conflict could not necessarily stand under the changed conditions existing after over three years of destruction of property and increase in costs of almost everything that goes into the city's accounts.

New York city is a very large business corporation, with an income and expenditure of over \$200,000,000, about one-fifth of the federal government pre-war budget. Quite a little of this money goes into the purchase of materials and supplies, and with an increase in Dun's index price of about 100% since the

beginning of the European War, the city had the choice of stopping practically all expenditures, of deferring payment for some of them, or of raising the tax rate to a degree that would have been alarming. There were objections to all three courses, but such an increase in the city's budget as would cause a reduction in the values of real estate through a too sudden increase in the tax rate, involved the immediate risk of eliminating the city's margin for new borrowing for construction purposes and creating a situation which the "Pay-as-you-go" policy had been intended to prevent. Rather than risk the development of an unhealthy situation in real estate conditions, Controller Craig suggested that at least for the period of the war the provision requiring the city to pay its non-revenue-producing expenditures out of current income should be modified in favor of a policy which would permit the city to fund such expenditures over a period not longer than the life of the improvements created.

This policy, while less conservative than the "Pay-as-you-go" policy adopted in 1914, is a great improvement on the plan which had been followed for years. The legislation which has been passed permitting this change will permit the city for the period of the war and one year afterward to issue corporate stock and serial bonds up to \$15,000,000 annually for non-revenue-producing improvements, provided they mature and are redeemed within the estimated life of the improvement as certified in the resolution authorizing it. Its estimated useful life varies from fifty years for property believed to be permanent, such as water supply, rapid transit or sewers, down to fifteen years for expenditures for machinery and ten years for purposes not otherwise specified. This plan of procedure follows the most advanced legislation on municipal financing in Massachusetts and New Jersey and, accepting the theory that all improvements are to be paid for by bonds, it represents almost an ideal policy.

The present plan is infinitely more scientific and conservative than the old method of financing New York city's improvements, and is also more scientific, though less conservative, than the "Pay-as-you-go" policy adopted in 1914. It is something like the difference between the national policies [p. 111] adopted by the belligerents in this war. England has been paying all of the interest on her debt and about 12% of her share of the actual cost of the war out of taxation. Germany, until recently at least, was not paying out of her income from taxation any of the cost of the war, nor even interest on her huge war debt, trusting to collect these enormous sums from the indemnities paid by her defeated enemies, which expectation will never be realized so long as we have men who can bear arms and fight. The United States, however, it is estimated, will pay out of taxation somewhat over 40% of the

actual cash expenditures for the first year of war, exclusive of the loans to our Allies, and President Wilson has intimated that he hoped to pay 40% of the cost of the war in this manner.

Because we want to see New York conservative-not merely scientific, I hope that when conditions shall have returned to normal, it will again go beyond the bare amortization of non-revenue-producing improvements within their life, and either pay out of its income from taxation a substantial portion of these expenditures which do not bring in revenue, or else go without-at least until the city valuations of property give it a respectable debt margin, not a mere 1% or 2% of its outstanding debt.