FINANCING MUNICIPAL FACILITIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC PROGRESS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETIETH CONGRESS

FIRST SESSION

DECEMBER 5, 6, AND 7, 1967

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FINANCING MUNICIPAL FACILITIES

TUESDAY, DECEMBER 5, 1967

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC PROGRESS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room S-407, the Capitol, Hon. Wright Patman (chairman of the subcommittee) presiding.

Present: Representatives Patman and Brock.

Also present: John R. Stark, executive director, and Arnold H. Diamond, consulting economist.

Chairman PATMAN. The Subcommittee on Economic Progress will please come to order.

Our hearings today are concerned with a very important problem that faces our towns, cities, and counties. They all face serious difficulties in marketing their bonds. According to earlier studies of this subcommittee, the problem will very likely get more serious. We estimate that over the next 10 years State and local public agencies will have to invest over $300 billion in public facilities. Most of this money has to be financed by borrowing in the municipal securities market.

It is appropriate that the subcommittee hear first from those who are directly affected by the credit problems of small municipalities—the mayors and municipal officials. At the same time, the problem affects all cities, big and small—particularly such problems as bond ratings. For that reason, we have invited representatives of some large cities.

We had hoped that Mayor Vern W. Miller, of Salem, Oreg., would be able to join our witnesses today, but he is a surgeon as well as a mayor, and his medical duties have delayed him in Oregon. We have, therefore, arranged for him to appear with other witnesses on Thursday.

At this point, without objection, I would like to submit a longer statement for the record outlining some of the background to our hearings, particularly our findings in the two-volume study entitled "State and Local Public Facility Needs and Financing" which we published a year ago. Copies of these volumes have been made available at the press table.

We will also include notice of hearings and schedule of witnesses.

(The documents referred to follow:)

STATEMENT OF HON. WRIGHT PATMAN, CHAIRMAN OF THE SUBCOMMITTEE ON ECONOMIC PROGRESS

Chairman PATMAN. One of the important responsibilities of the Joint Economic Committee is to carry on a continuing assessment of

the growth potential of the American economy. In this connection, the Subcommittee on Economic Progress of the Joint Economic Committee issued earlier this year a two-volume study on "State and Local Public Facility Needs and Financing." The first volume estimated capital requirements over the next decade for essential public facilities, and the second volume analyzed the prospective sources of credit funds to finance construction of these facilities.

This study focused attention upon an often neglected, but highly important sector of our economy; namely, the provision of adequate public facilities in the Nation's communities. Our cities, suburbs, small towns, and even rural areas are dependent upon the availability of public facilities. Industrial plants, commercial establishments, and farms need an ever increasing supply of water, adequate sewage collection and disposal, electric and gas power. They need a modern network of streets, roads, and highways to bring in materials and labor and to ship out finished products.

Within the larger cities, with their complexes of office buildings, factories, and downtown shopping, there is a need for urban mass transportation, offstreet parking, airports, and marine shipping facilities. Modern schools are needed to educate our children, and well-equipped hospitals are needed to help care for the sick. We need parks, playgrounds, libraries, neighborhood centers, museums, and related recreational facilities; and our police and fire departments, as well as other public service units need to be housed in up-to-date buildings.

All told, the estimated capital requirements reflecting the Nation's public facility needs for the decade ending in 1975 total $499 billion; of this amount, $328 billion are estimated for State and local public agencies. For these State and local public agencies, about half of their capital requirements are expected to be financed by borrowings in the tax-exempt municipal securities market. Volume 2 of the committee's study concentrated upon the capacity of the municipal securities market to meet these anticipated capital requirements.

The subcommittee's study was addressed to three basic questions:

First, is there likely to be an adequate supply of investment funds in the municipal securities market, or, to put it more succinctly, who will buy the expanding volume of tax-exempt municipal bonds?

Second, is a tax-exempt security best suited to obtain the requisite funds needed to meet projected future capital requirements?

Third, can the existing marketing machinery expand sufficiently to accommodate an increasing volume of securities?

With respect to the first question, the projections underlying the committee's study indicated that sufficient funds would be available for the requirements projected, if commercial banks continue to acquire most of the municipal securities issued. In spite of the unexpectedly heavy volume of corporate bond flotations, the committee's projections for 1967 municipal security issues, which were made over a year ago, are coming out close to realization by actual developments. For 1967, the study projected that long-term municipal debt issues would total $15.1 billion, without regard to industrial development bonds. In terms of municipal bonds tabulated by the Bond Buyer, this works out to $13.4 billion of bonds sold. On the basis of 10 months' actual data, municipal bonds sold in 1967 are expected to total about $14.5 billion, including about $1 billion of industrial development bonds. Subtrac-

tion of these tax-exempt bonds for private purposes results in traditional municipal bond sales of about $13.5 billion, or very close to the $13.4 billion projected in the committee study.

Our hearings today and in the next 2 days are concerned with the difficulties experienced by small municipalities in marketing their bonds and with the consequences of bond ratings. We plan to hear from several mayors and other municipal officials on how these institutional forces have affected their own cities. It is appropriate that we hear first from those who are directly affected by bond ratings and the credit problems of small municipalities—the mayors and municipal officials.

Turning first to the credit problems of small municipalities, our subcommittee study found that small municipalities tend to pay higher interest rates on their long-term bond issues because of such factors as unfamiliarity by large investors, inadequate financial information supplied to investors and bond analysts, failure to obtain expert advice regarding bond specifications and mechanics of sale, absence of a bond rating and high overhead costs in bond marketing relative to the small size of the bond issue. The relatively small size of bond issue and infrequent sales by the small municipalities, in turn, lead to unfamiliarity, lack of technical know-how as to bond marketing, and to comparatively high marketing and advisory costs on a per bond basis.

The subcommittee study also found that, out of a total of approximately 92,000 issuers of municipal bonds, ratings have been assigned to only about 20,000, leaving many issuers, generally small communities, in the nonrated category. Approximately 70 percent of the bond issues rated by the two rating services have similar ratings, but the other 30 percent have different ratings. The difference of a notch in a rating, or the fact that bonds are unrated, may cost the public agency as much as one-quarter to one-half percent in the annual interest cost on its borrowing.

THURSDAY, NOVEMBER 30, 1967.

CONGRESS OF THE UNITED STATES, JOINT ECONOMIC COMMITTEE,
SUBCOMMITTEE ON ECONOMIC PROGRESS

CHAIRMAN PATMAN ANNOUNCES MUNICIPAL FINANCE WITNESSES

Representative Wright Patman (D-Tex.), Vice Chairman of the Joint Economic Committee, and Chairman of its Subcommittee on Economic Progress, today announced the witnesses for the forthcoming hearings on municipal finance.

The hearings will be held at 10 a.m. on December 5, 6, and 7, 1967, in the Atomic Energy Committee hearing room in the Capitol (room S-407). The witnesses are as follows:

Tuesday, December 5, 1967, 10 a.m.

J. CLIFTON HURLBERT, Mayor of Aberdeen, South Dakota.
ROY M. GOODMAN, Director of Finance, New York City.

Wednesday, December 6, 1967, 10 a.m.

TRAVIS H. TOMLINSON, Mayor of Raleigh, North Carolina.
HERBERT H. BEHREL, Mayor of Des Plaines, Illinois.
ELMER H. DODSON, Mayor of Charleston, West Virginia.

Thursday, December 7, 1967, 10 a.m.

CHARLES W. WHALEN, Jr., U.S. Representative from Ohio.
DAVE HALL, Mayor of Dayton, Ohio, accompanied by GRAHAM WATT, City Manager, and WINTON PARENT, Finance Director.
VERN MILLER, Mayor of Salem, Oregon, accompanied by DOUGLAS AYRES, City Manager.
DUANE SCOTT, Executive Director of Ohio Municipal Advisory Council, Cleveland.

Chairman PATMAN. Our first witness today is J. Clifton Hurlbert, mayor of Aberdeen, S. Dak. Mayor Hurlbert, we are delighted to have you here, sir. You may proceed in your own way.

STATEMENT OF J. CLIFTON HURLBERT, MAYOR OF THE CITY OF ABERDEEN, S. DAK.

Mayor HURLBERT. Mr. Chairman, I am J. Clifton Hurlbert, mayor of Aberdeen, S. Dak.

By way of background, and for your information, I graduated from Pace Institute, now Pace College, New York City. I am a licensed public accountant in the State of South Dakota, and for 20 years have been engaged in general contracting. For the past 12 years, on a part-time basis, I have been serving as mayor of the city of Aberdeen, S. Dak.

Aberdeen has a population of approximately 25,000 people. It is a wholesale, retail, cultural, and medical center. It is placed in a predominantly agricultural area.

I personally, on behalf of Aberdeen and the other small communities, wish to stress our thanks for being given this opportunity to come to you and talk about a subject that has become so important, I am sure, to all municipalities.

It is of vital interest to me, as mayor of the city of Aberdeen, and because of that I am here today.

Certainly, after serving 12 years as mayor of the city of Aberdeen, I come and speak from experience, not from what I have learned in the textbooks.

Mr. Chairman, my written testimony will follow; I was in a big hurry to leave Aberdeen, and I was not able to bring it with me. It will be coming soon.

Chairman PATMAN. It will be inserted in the record.

Mayor HURLBERT. Those of us who are involved in local government often ask ourselves how—how are we going to finance the many facilities that are requested, desired, and needed by the citizens of the community if we are to keep progress? And we also ask ourselves how can we stretch the real estate and property tax dollar to cover all of these needed facilities—always keeping in mind, of course, that in South Dakota, the city of Aberdeen—and I speak about Aberdeen, because this I know—only about 40 percent of the tax dollar that is raised goes to the municipalities. The balance goes to the schools and counties.

To illustrate the problem that we have—and again, I will speak about Aberdeen, because it is the community I know, and also because I feel that Aberdeen is an average community—the question that you want answered today—or one of the questions—is: What does the bond rating mean to the city of Aberdeen; what does it mean to the small community?

In Aberdeen, we are sort of on the breakpoint. We are above the small, the real small communities, and we are, of course, at the bottom of the larger communities.

We in Aberdeen have always had an A rating. How we have actually obtained this, and why we have maintained it, seems to be something none of us really know. Without much effort, we have maintained it.

It is my understanding from the experts, from those who know the difference between an A and a double A rating, it would mean approximately one-fifth of 1 percent. On the face of it, this does not seem like much. But if we were to go the other way, of course, we would run into a lot more trouble—if we went to the BAA, BA, and then on down to the unrated. So although we are not too concerned possibly right at this moment, we seem to hold a good A. However, you never know what might come.

I have some figures that I have quoted that will bear out this problem, this question of the bond rate.

In Aberdeen, S. Dak., we have an assessed value of approximately $80 million. We have a current bonded indebtedness today of $2,319,000. We are well within our statutory limits. So we have no particular problem there.

The levy to pay off this bond debt and interest retirement for 1968 is $220,422.

Now, roughly speaking, approximately $70,000 of this is interest, the balance is the capital retirement.

If we had had a double A rating, this interest figure, I gather, would be approximately $65,000. So we are talking about a $5,000 difference between the A and the double A which we cannot understand why we do not have and certainly we will attempt to get.

Now, you go over a 20-year period—again realizing that your interest payments are not constant, but it conceivably would be a hundred thousand dollar savings to the city of Aberdeen, over a 20-year period.

Further, the total tax levy for Aberdeen in 1968 is $1,427,000 plus, just under $1,500,000. Therefore, approximately 15 percent of this tax levy is used to pay for the capital facilities that we have—the interest and bond redemption.

Leaving those figures for just a second—2 years ago the city of Aberdeen did employ the Leo A. Daly Co. of Omaha Nebr., professional planners, to develop a comprehensive plan for the city of Aberdeen. Two reasons possible—one, because we figured we needed it for orderly growth. The second, if we were ever to get into urban renewal, or make application for other Federal grants, one of the things you have to show is your comprehensive plan. We did use the 701 funds on this. We worked through the Government.

Among other things that they provided was a 5-year capital improvement program. They estimate the cost—and this is the minimum cost that the city of Aberdeen should expend for capital improvements over the next 5 years—to be $8,614,500. This, together with our present bonded indebtedness—and I believe we can safely use this, because the majority of the present indebtedness is not to be paid off until 1987, so the bulk of this will carry through. If this were to happen on one day, it would give us approximately $11 million bonded indebtedness. This, too, would come just within the statutory limits. So from a statutory position we could issue this amount of bonds.

Basically the debt retirement, if we were to go into a program such as this, would be somewhat over a million dollars a year. That would be increased from the $220,000, and also, then—it would go from 15 percent of our tax money to actually 50 percent, or approximately 50 percent would be required.

To bring that closer to home, and to point out where the problem actually comes in, we feel—and I am sure all communities do—that the

real estate and property tax has reached its maximum—just about as high as we can go.

A home in Aberdeen today that would sell for approximately $20,000 will pay about $600 real estate tax. If we were to make this increase, it would increase to approximately $800 to $900. The reason it is almost double on the tax—only about a third of this $600 tax is actually municipal financing. The other is for the county and the schools. And we must keep in mind that the school, too, is faced with an expansion program—according to Leo A. Daly, something over $4 million to $5 million in the next 5 years. This added to the tax load would be absolutely beyond our ability to pay. We just cannot proceed with this type of a program without another method of finance.

So then we might ask ourselves what is the answer; where do we go from here? Are we going to give up and allow ourselves just to drift along, or are we to put our shoulder to the wheel and do everything possible to accomplish these goals if our society is to improve? We must continue to work.

I have listed three items that I think we should be giving some serious thought to, and one, of course, is your bond ratings.

If it is true—and apparently it is—it is almost impossible to sell bonds without some kind of a rating, and preferably an A rating or above. To the communities in South Dakota that are smaller than Aberdeen, this is almost an impossible accomplishment, because they do not have a $600,000 bond issue, and they do not have and cannot have a million dollar bonded indebtedness. So it is impossible for them to get a rating.

It would seem to me that somehow we would have to make bond rating a more exact science. If we, the seller, we the cities depend upon the bond rating, if the investor depends upon the bond rating, it must be more exact instead of as it is today, apparently an estimate, or based upon figures that are not too exact.

I feel that we must continue—the small municipalities must continue to look to the Federal Government for loan programs. In this case I am thinking of the Housing and Home Finance Agency. I know this has worked, and quite successfully, throughout South Dakota for the building of dormitories, and for the building of union buildings at our colleges.

Not included in our capital improvement plan as outlined by Leo A. Daly is the construction of a sports complex that we may be forced into within the next year or two. If this should come to pass, we certainly hope and plan to look to the HHFA for funds to supplement what we have in the building.

I think also that we must look to the Federal grant to help us through this program.

I feel that somehow or other it would be good for us if they could simplify the application for Federal grants. We have just completed, in Aberdeen, the construction of an airport improvement, just slightly under a million dollars, with about 52 percent of it paid by the Federal. And but for that grant, I do not know how we could have done it. I do not think we could have accomplished it, because you are going to the bond issue which requires, in South Dakota, 60 percent election approval, and you are selling something, although very much needed for the community, that possibly is not felt so by many of the people that seldom use the airlines. But for the Federal grant,

Aberdeen would not be ready with a runway that is adequate to take care of the jet planes when they come in the spring.

We did just complete a sewer improvement where we had the 30 percent grant for antistream pollution—is where it came from, except for the Federal participation. And this, too, would never have been accomplished. It took three attempts at the selling of bonds to do this.

So if we are to improve our cities, we are going to have to look for sources of income—in the first place, controlled bond ratings—and sources other than the real and personal property tax.

Now, this fairly well completes the prepared portion of my statement.

If there are any questions, I will certainly try to answer them.

Chairman PATMAN. We will have questions, sir. But our policy is to hear the witnesses first. We will hear Mr. Goodman after you conclude. And after he finishes, Representative Brock and I will ask questions, and if other members come in, they will want to ask questions, too.

Senator Proxmire will probably be in here directly.

Have you concluded your preliminary statement?

Mayor HURLBERT. I have.

Chairman PATMAN. Thank you, sir.

(The prepared statement of Mr. Hurlbert follows:)

PREPARED STATEMENT OF MAYOR HURLBERT

I wish to thank you for giving me an opportunity to appear before you today, representing Aberdeen and all other smaller communities. I am here because I am vitally interested in the problems surrounding municipal finance. For twelve years, while serving as Mayor of Aberdeen, I have lived with this problem; therefore I speak from experience not theory.

The first question we ask ourselves is, how are we going to finance the necessary municipal facilities? The second question is, just how far can we stretch the real and personal property tax dollar, a dollar we feel has already been stretched to the limit?

Today we are to discuss the bond rating and what it means to the smaller community. Aberdeen has an "A" rating which on the face of it is good. However, it is our feeling that with sufficient study our rating should be double or possibly triple "A," thus saving the city from $5,000.00 to $10,000.00 annually in interest.

The following is a schedule of this bonded indebtedness of the city of Aberdeen as of June 30, 1967:

Issue.	Interest	Balance, July 30, 1967	Paid
1948 water and sewer ($651,000)	2 to 2¼ percent	$55,000	July 1968.
1951 grandstand ($65,000)	2.40 percent	16,000	July 1971.
1954 swimming pool ($95,000)	Bonds: 1 to 55, 1.97 percent; 56 to 95, 2 percent	30,000	January 1970.
1957 water bond A ($125,000)	Coupon A: 3.25 percent, $40,000, 3.75 percent, $85,000. Coupon B: 1.65 percent.	45,000	January 1972.
1957 street improvement	Coupon A: 3¼ percent, $75,000; 3¾ percent, $145,000. Coupon B: 1.65 percent.	80,000	Do.
1957 water bond B ($200,000)	4 percent, $125,000; 3.75 percent, $30,000; 3.80 percent, $30,000; 3.90 percent, $15,000.	75,000	Do.
1957 storm sewer ($250,000)	4 percent, $155,000; 3¾ percent, $40,000; 3.8 percent, $35,000; 3.9 percent, $20,000.	95,000	June 1972.
1958 water bond C ($400,000)	percent	393,000	January 1987.
1958 water bond D ($1,375,000)	Bonds: 1 to 265, 3.70 percent; 266 to 495, 3.50 percent; 496 to 925, 3.80 percent; 926 to 1,375, 3.90 percent.	1,170,000	Do.
1965 sanitary sewer ($360,000)	3.20 to 3.25 percent	360,000	January 1985.
Total		2,319,000	

Included in that schedule is the interest rate, repayment period, date of sale, amount and purpose of bond issue. It has been our experience to receive from three to four bids at each letting. We did not hire a financial consultant, however we did use consulting engineering services in arriving at the costs and the bonds were approved by our local city attorney and bond counsel. We did not receive any assistance from either the Federal or State governments in the preparation and issuance of the bonds or the obtaining of the bond rating. The bond rating was obtained solely by the submission of information to the rating companies.

Two years ago the city of Aberdeen did employ the Leo A. Daly Co., Planning Consultants, to prepare a comprehensive plan. This plan was necessary to provide for the orderly development of our City and to aid in the application for Federal grants. It was the planning consultant's estimate that we would require $8,614,500 for capital improvements for the next 5 years. This in addition to our present indebtedness would total over $11,000,000—thus we would be faced with the necessity of levying over $1,000,000 per year for debt and interest retirement, or, approximately 50 percent of our tax dollar would go for this cause. This becomes really serious to us because, and for example, a $20,000 home in Aberdeen pays approximately $600 in taxes. This would increase to approximately $900, an amount far beyond what we feel to be the average individual's ability to pay.

In closing, we may ask ourselves what is the answer to our financial problem—should we give up, or attempt to keep pace in the competitive society in which we live? The answer, of course, must be to continue our effort to improve.

I will offer the following suggestions that I believe will help:

(1) Bond ratings as such, since they play such an important part in bond sales, must be developed into a near exact science.

(2) Long-term Federal loan programs must be made more available to municipalities (example: Housing and Home Finance Agency.)

(3) Federal grants must be simplified and increased in amounts.

This concludes my prepared statement. Again I wish to express my appreciation for being allowed to appear before this committee. I will be happy to answer any questions you may have.

Chairman PATMAN. Our next witness is Commissioner Roy M. Goodman, director of finance, New York City. You have a mighty big job, and I understand you are doing it well. We will be glad to hear from you, sir.

STATEMENT OF ROY M. GOODMAN, DIRECTOR OF FINANCE, NEW YORK, N.Y.

Mr. GOODMAN. Chairman Patman, Representative Brock, distinguished members of this subcommittee and its staff, I am very deeply appreciative of the opportunity which you afford me this morning to appear before this committee to discuss with you certain thoughts which I have been developing in the 2 years since Mayor John Lindsay, of New York, appointed me to the position which I now hold.

May I say that the mayor has asked me particularly to convey to you his warm wishes and high regard, and his regrets that the press of his business in New York rendered it impossible for him to be here.

The statement which I make to you, although as seen through the spectacles of the commissioner of finance of the city of New York, I think in a sense applies as much to Mayor Hurlbert's problems and to those of thousands of small municipalities across the country, as it does to the megalopolis-like giants, such as New York, Boston, Detroit, and other major cities.

I have prepared for your reference testimony which you have before you in bound form which covers a number of facets of two very critical problems. I have become convinced that a double-barreled financial

threat confronts the municipalities of our great Nation. It is for the purpose of describing that threat that I have accepted your gracious invitation to testify in Washington this morning. First, I shall discuss the astonishing and little-understood impact of bond ratings upon the borrowing costs of municipalities. Second, I shall cover the serious impairment of the functioning of the municipal bond market in 1967 by industrial revenue financing—the sale of tax-exempt municipal obligations for the benefiit of private profit corporations—the so-called industrial revenue financing.

Now, broadly my thesis this morning will be to you that the combination of these two factors, the extremely difficult problems arising from ratings, and the introduction of more than a billion-dollar flood of industrial revenue bonds into the municipal bond market of the United States has created a very great additional upward pressure upon interest rates which all municipalities must pay when they seek credit.

I would like to start by quantifying what I think this means to New York, and it will give you some feel for the kinds of things we are worried about.

I would estimate, based upon detailed conversations with a number of municipal bonds experts, that the pressure of lowered rating and of added volume in our market is costing New York somewhere between three-quarters of 1 percent and 1 percent more to borrow its money each year.

Now, may I respectfully invite you to stop for a moment to consider what the implication of that fact is.

New York borrows half a billion dollars a year, each and every year. This is its approximate capital requirement. In some years it is even greater for housing bonds.

One percent of that sum of money, multiplied by the 8-year average life of our bonds, adds up to somewhere between $30 million and $40 million a year of extra expense which the people of the city of New York, already heavily burdened with a debt load which amounts to about 13 cents on every dollar, are confronted with. And what this means tangibly in terms of services which might be bought, even taking the lower and more conservative figure, is something that would involve, for example, 3,000 policemen on the beat, or 700—facilities for 750 patients, or the building of 10 schools, in each and every year. That is what $30 million translates into in New York's terms.

Now, Mr. Chairman, what I would like to do, if you permit me in the time allotted to me, is to divide my comments dealing, part one, with the inadequacies of the bond rating system.

Chairman PATMAN. And any part of your statement you do not cover, will be inserted in the record.

Mr. GOODMAN. Thank you, Mr. Chairman. I think that the statement is so lengthy it would not be feasible for me to read it in its entirety, but I would like to invite you on a little helicopter trip over the statement, to look at the broad topography of this terrain, and try to bring out a few major points.

The inadequacies of our bond rating system can best be understood if we give you a little, quick historical sketch of how the system arose in the first place.

In 1909, the firm of Moody's first started to rate railroads. It was not long before it added to its roster corporations and public utilities, industrials in 1914; by 1922 Poors had entered the field. Prior to that, in 1919, Moody's began rating municipals. And in 1941 Standard and Poors both merged.

The early history of municipal ratings is at best a dubious one. Prior to the depression the rating services were indeed generous in handing out ratings of AAA and AA. And it is interesting to note that 48 percent of the number of defaulted issues in the 1930's, almost half were rated AAA. And if we add to that the AA ratings, that constitutes 78 percent of all the issues rated. So self-evidently, there was something egregiously wrong with the rating system which had to be remedied, and certain modifications in the use of tools have been undertaken by these services through the years.

Now, in order to be sure that I bring out to you what I believe to be the most important shortcomings of the rating services, will you permit me to invite your attention to my report, in which there is a summary covering seven points of what we believe to be inadequacies of the existing system.

I would like to cover those first, and then I would like to touch upon some specifics in connection with them.

First of all, ratings of municipal credits cover only about 70 percent of the outstanding bonds, and about 10 percent of the municipalities capable of selling bonds. So at the very outset, we see that there is a large band of unrated cities who suffer certain very severe disadvantages because of their lack of a rating. I will go into those disadvantages in greater detail with you in a moment.

Second, the ratings themselves resemble in a sense the ratings which you see in some of the better gastronomic guidebooks. Instead of stars they assign letters. Moody's assigns a triple A for the best credit, a double A for the second best, a single A for the third best, and so on down the scale, which is basically divided into eight gradations, and the Standard & Poor's system resembles this.

These are such broad bands that even with a fairly long record it is difficult to tell whether a credit is improving or deteriorating. For example, there is such a wide swing between the top of the A-rated group and the bottom of the B-double-A category, that the only time the investor would know whether his bond is getting better or worse would be at that unhappy moment when it crosses the river Styx between the A and the BAA band, and that very event triggers a form of municipal catastrophe which I am going to tell you about in the case of New York in a moment—a very dire circumstance when you drop from AA to a BAA.

Third, no one, including some of the analysts involved, with whom we have spoken, with whom others that we know have spoken at very great length indeed, are quite sure what a rating is based upon. The criteria are foggy. The rating services maintain a sort of an aloofness and are not too willing to discuss with the representatives in municipal offices of cities what it is about the city that occasions the upward or downward move in a rating. This is a very frustrating and vexatious problem.

Fourth, there is no way to relate quality rating to the market. Any bond is attractive at a price. A bond, for example, which is going to mature in 6 month, which bears a BA rating, is probably a vastly better and safer and more reliable investment than a bond which bears a triple A rating, but which will not mature for 30 or 40 years. Obviously the element of time enters very importantly into the chances for repayment.

Gentlemen, may I ask you to keep in mind one fundamental theorem with respect to a bond. It is not a common stock, it is not supposed to grow. It is supposed to do one thing, and only one thing. It is a moneymaking machine. It is supposed to pay interest at regular intervals, and it is supposed to pay off at maturity, and in the process it is not supposed to dip severely in market value, preferably it should maintain its market value during the period that it is on the market, and hold its liquidity.

It seems to me that a municipal bond rating has as its sole purpose not the use of any common stock growth psychology, but the determination of one simple question—will the bond pay its interest on time, will it pay off at maturity, and in the interim period will it maintain its liquidity.

The rating should not concern itself with broad questions of sociology unrelated to this specific. It should only concern itself with the physical trends and other trends which may or may not affect the production of the money machine of its prime mission, which is interest and principal repayment.

I fear that we are in an era where bond ratings have forgotten that fundamental principle, and have wandered far from that target.

The ratings make no allowance for the fact that a short maturity of a triple B bond—I am sorry—I have made that point. I should go on to my sixth point. The rating services are basically unprofitable.

Now, I should make clear to you that I mean no—to defame in no way the rating services or their integrity. On the whole they are a well-intentioned group of men—and by the way a very small handful of men—there are only a dozen analysts in the leading national bond rating service. They are well intentioned. They have been founded for a solely private purpose—that of providing a service to their clients for which they are paid a fee or a subscription rate. And the shocking thing is that over the years the two principal private bond rating services have taken on almost Biblical authority in the extent to which they are relied upon around the Nation, by the Nation's banks, its institutional investors, individuals who must make decisions, trustees who must make decisions—in short, the question of whether you have a triple A bond or a BAA bond is relied upon as a form of intellectual and appraisitive shorthand which is the underlying mainstay of the whole broad public appraisal of debt securities.

Now, no one is saying that it is the fault of the bond rating services that this state of facts has come to exist. But I think the time has come, long past the time, for us to point out these are private services, solely to deliver services to their clients, and the public has placed upon them a degree of reliance which neither their facilities nor their economic posture permits us to continue.

Now, specifically the services cannot derive from their fees or from their subscription prices sufficient revenues to do the kind of thorough-

going research which the public is entitled to have in the rating of its securities. A little simple arithmetic would illustrate the point.

Out of the 16,000 municipal securities in the Moody's manual, about 12,000 are rated. With 12 principal analysts assigned to this rating task, you will readily see, if we consider there is about a 250-day work year, that each analyst can only devote somewhere between 15 and 30 minutes to each municipality, assuming a minimum of a quarterly review. And it shocks me to think that certain municipalities have the whole matter of their interest rate, which will cost them thousands or even millions of dollars a year in interest, related to the 15- or 30-minute review, if that, which an analyst can give.

It also rather shocks me that analysts only visit on an average each municipality once about every 5 years.

I think it fair to suggest that within a period of 5 months there might be significant changes in a municipality affecting its physical viability. But the thought of having a visit only once every 5 years is patently preposterous. And for the rating services to have to rely upon solely questionnaire data, which it has substantial difficulty in equating and in evaluating properly, leaves a gigantic and abysmal void of knowledge which is working to the detriment of cities all around the country.

Now, the fact of the unprofitability of the services brings the point to the fore that we are not, alas, able to pay going competitive wages to their analysts that the downtown Wall Street firms, for example, can pay to the analysts of their securities. And hence there is very rapid employee turnover. With that kind of turnover, it is self-evident that in the critical—and the critical desks of analysts, you have men who in many cases are tyros, and have not had an opportunity, fully, to acquaint themselves with the vast complexities of the economics of our American cities.

My seventh point is that the present systems were set up in the 1930's and forties principally designed to solve the problems of the big depression with the tools that were then available. Since that time, there have been modifications in these tools, but certainly an insufficient amount to gear in with the problems of today's age.

To sum up this point, I would say that we are attempting in a jet age to use horse and buggy methods for the rating of municipal securities.

Now, that may sound harsh. I do not mean it to be. And I certainly do not wish to criticize private agencies performing what their clients believe to be an adequate private service. But as a physical officer in the Nation's largest city, I am shocked and very deeply concerned about the implications of this for the present and future of New York.

For example, there is no use of computer technology for the amassing and evaluation of data relating to the cities. No one is here to suggest for a moment that computers can think, and that computers can assign the rate. But there is no question from the experience we have had directly in New York in the use of the most advanced computer hardware that the utilization of this kind of equipment would greatly assist the rating agencies in the screening which they must do, and the classification which they must do of no less than 16,000 municipalities around the Nation.

I have developed a set of recommendations to which I invite your attention, and which I submit to you most respectfully. They appear in my formal testimony.

First, I would urge you to consider the feasibility of arranging or encouraging a searching study to be undertaken by a leading and objective research institution, such as the Brookings Institution or the National Bureau for Economic Research, which would have as its purpose generating answers to the following kinds of questions.

How can bond rating services be adequately financed without either involving them in conflicts of interest or subjecting them to political pressure? How can staffing inadequacies be overcome to deal with the gigantic statistical analytical workloads occasioned by the twelvefold increase in municipal finance since 1946? How can fact-gathering techniques be improved through the use of computer technology? How can a rating scale be devised to more sensitively reflect whether a credit is improving or deteriorating, and which will also take into account the vital question of maturity which I touched upon? And what can be done to develop more explicit rating criteria, rather than the present system in which no one, including the analyists themselves, can be quite sure what a rating is based upon?

Those are questions which I believe The Brookings Institution or some other institution of its high caliber above the smoke of battle could consider dispassionately, and could answer with a degree of clarity which would be most helpful.

Secondly, I propose that interested parties, such as municipal finance officers, institutional investors, municipal bond dealers, the three Government regulatory agencies concerned with bank regulation and inspection, specifically the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Comptroller of the Currency, as well as representatives of the rating services themselves, should form and ad hoc committee to activate the findings of The Brookings Institution or whatever the research institution is that takes a careful look at this problem.

Third, it seems to me that the bond rating service or services, in whatever form emerges from the study and appraisal by this ad hoc committee, should be financed from contributions to be made by municipalities, which are after all at the basis of this problem, the banks, institutional investors, and municipal securities dealers themselves. The individual subscriptions could be in modest amounts, if this were spread across the spectrum I have mentioned. The form of financing would fully insulate the rating agencies from any possibility of political interference or conflicts of interest. It could permit a staff large enough to make continuing on-the-spot inspections and use computerized techniques of fact gathering.

Now, with that very rapid summary, I will pass on, if I may, to the second part of my observations this morning, which will be briefer than the first, but I think possibly of far greater moment in the long run.

Mr. Chairman, and Representative Brock, the problem of industrial revenue financing threatens over a period of time—and I do not I think have to have on a pair of binoculars to see this—it threatens to undermine the vary basis of our existing municipal securities market as we know it.

May I respectfully invite your attention to a statistical exhibit, marked "Exhibit 1" at the back of this report, which is a table of comparative statistics and a graph of interest rates. I don't want to involve you in a detailed statistical consideration, but I think two points jump off this page, and are worthy of consideration.

First of all, may I ask you to look at the graph at the bottom of the page I mention. It is a graph of interest rates, and the heavy black line, as you can see, within the last decade, has tended to show—or in fact indeed over a longer period of time, starting in long-term trend definition—from 1946 onward, if you take a pencil and place it over the trend line, which could be fitted by the statistical method of the least squares—merely by inspection we see the increment and continuing increase in interest rates and decline in bond prices. You will note this is an inverse scale, typically used by the investing industry, to reflect bond price. On the right-hand side you will see yield percentage.

Gentlemen, may I point out on November 30, the 20 bond index showed a 33-year high in interest rates and how this bond rises at 4.42 percent.

Now, what this means is that the cities as of this month, regardless of the influence of bond ratings, and regardless of industrial revenue financing's choking effects on this market, are already in grave trouble when it comes to raising money.

I cite to you the examples of New York City, which at the moment, I am informed, probably could not float a long-term issue for less than something in the area of 5.20 percent, and I city to you the case of Jersey City, N. J., which just a short while ago had to pay 5.4 percent or more for its money, an unparalleled state of affairs within the recent history of the entire bond market.

Now, the point about industrial revenue financing will be seen to be an aggravating fact, for if you will note in the column on this exhibit called Industrial—it would actually be eight columns over from the far left-hand column, or two over from the right in the first major block of statistics—you will note that in 1967—this is at June 30—the issues had amounted to $697 million. But far more important, the total amount of industrial revenue bonds which will be issued this year will exceed $1 billion, which will be about one-thirteenth of the total business done in the entire municipal bond field.

The implications of this, and coupled with the fact that other experts have predicted this volume will probably double in the very near future, is perfectly plain.

What is happening is that a new form of corporate tax exempt security is creeping into this market, and threatens to choke it.

Now, the point to be stressed is that there are only limited resources to take up municipal bonds when they are offered into this market; this is a sponge, and it can only hold so much of the fluid of municipal financial offerings each year. In the current year there will have been about $13 billion of offerings.

The sad fact is that with the additional burden which is being posed by the industrial revenue bond, this market may fall of its own weight.

Now, the specific situation which confronts us is essentially this:

Expert estimates have indicated to me that New York City is probably having to pay at this very moment, along with all the other cities of the Nation, approximately three-eighths to maybe even 40 basis

points, or four-tenths of 1 percent of annual interest rate because of the extra burden being placed upon it by this billion dollar flood of tax exempt corporate securities.

Taken together with the problems of bond ratings which I have pointed out earlier, this will amount to an extra tab for a city like New York of $30 million to $40 million a year alone in interest.

My recommendation as to what ought to be done about this is relatively simple.

The solution to this problem is congressional action to deny the corporations the deductibility of lease rental payments which support tax-exempt debt. In one stroke I believe the Congress with such action could remedy this grave problem.

Now, the industrial revenue bond proceeds, I would remind you, are used to build an industrial facility, usually a single factory, for the private corporation which leases this facility under a long-term contract with rental payments pledged to amortize and pay interest on the bonds. Without getting into a technical dissertation of how these contracts are written, suffice to say that the practical effect of this is to permit a private corporation, on far more favorable terms than heretofore undertaken, to build a gigantic new plant.

Let me just conclude by giving you a little recent history of what these issues have looked like. It is rather shocking to one who has followed the bond market for a number of years, and who has rarely found such towns as Middletown, Ohio, or Madison, Iowa, or Grossett, Ark., or Cheyenne, Wyo., in the bond market. And now what do we see? Just in 1967 alone—in February—$82½ million Armco Steel issue, from Middletown, Ohio. In May, a $60 million Sinclair Petrochemical issue, for Madison, Iowa. We go on to June, $30 million for Firestone Tire, $80 million for West Virginia Pulp & Paper, $75 million for Georgia Pacific, $130 million for Lytton Industries in Mississippi, $53 million for Firestone Tire, and $83 million for U.S. Plywood Champion Paper.

What is happening is that America's corporations, at first the very small ones, only in some of our rural areas, but now an increasing flood, some of the blue chip giants, are stepping in to avail themselves of this new technique, and it is going to deal a very direct blow to the cities all around the Nation who must compete in that market, and who cannot do it at a time when interest rates are already at an extraordinarily high level.

We even have the phenomenon that certain foreign corporations are availing themselves of this market, in partnership with American corporations. I cite to you a $140 million issue pending of the Northwest Aluminum Co., which is a subsidiary of Bell Intercontinental, and the Yawata Iron & Steel Co. of Japan. I further cite to you an issue involving Farbenwerke Hoechst which is a German company, that will be undertaking some financing in connection with another American company.

Now, this is well and good if you take it strictly within a closed container and say we want to encourage industrial development. But if the encouragement of industrial development in a few isolated areas is going to place a noose around the neck of the entire American municipal bond market already struggling to keep up on the swelling

seas of all-time-high interest rates, then I submit to you there is something wrong and deserving of your most critical examination.

I would like to conclude my testimony, or the formal part of it, by showing you an advertisement which was placed in a New York financial newspaper not long ago when New York City's rating was dropped from AA to a BAA. The caption is "BAA, Bah!"

It reflects the ire which a municipal bond expert felt at seeing such a city as New York downgraded to a classification which in his opinion grossly disregarded its posture as America's major commercial center, which has had more new office building construction since the end of World War II than has occurred in all the rest of the Nation put together.

I have tried to outline here, and will not elaborate at this time, on the impressive financial strengths of the city of New York. These are enumerated in some detail in the first portion of this report.

Suffice to say that the combination of municipal bonds rating inadequacies, and industrial revenue financing are a one-two punch which we believe threatens to knock out cities such as ours, and others all around the country. And it is for that reason I was particularly gratified at an opportunity to come here this morning, Mr. Chairman, to share with you my thoughts on this vital question.

Chairman PATMAN. Thank you very much, sir. Your statement is very interesting. It will all be inserted in the record, including the tables and charts and so forth.

(The prepared statement of Mr. Goodman follows:)

PREPARED STATEMENT OF ROY M. GOODMAN

Chairman Patman and distinguished members of the Joint Economic Committee's Subcommittee on Economic Progress:

I have become increasingly concerned about the inadequacies of the private bond-rating system and the incursions of industrial revenue financing during the two years since Mayor John V. Lindsay appointed me Commissioner of Finance (Treasurer and Tax Administrator) of New York City; but I speak to you today not merely on behalf of my home city but of all the cities and towns around the country which are being dreadfully buffeted as they try to float their bonds on the increasingly stormy seas of fast rising interest rates which have just reached a 33-year high.

PART I—THE INADEQUACIES OF OUR BOND RATING SYSTEM

Last April 20th, speaking before an audience of 600 leading municipal officials and institutional investors in Hartford, Connecticut, I touched off a national debate on bond rating when I called for a comprehensive overhaul of the private municipal credit-rating system. I had become convinced that it was causing leading cities to be shortchanged out of hundreds of millions of dollars in unwarranted interest charges vitally needed for basic services. Since then, much has been written about bond rating and a thorough examination of the subject would obviously require a dissertation beyond the scope of this testimony. I shall limit myself to a concise summary of the problem and a set of specific recommendations as to what I think should be done about it.

THE RAPID GROWTH OF MUNICIPAL BOND FINANCING

As of June 30, 1966, there was $104.8 billion of tax-exempt State and municipal debt outstanding. There has been a steady upward trend in the offering of new state and municipal bond issues. Offerings of such issues will exceed $12 billion in 1967, a twelvefold increase in 20 years. Exhibit I, a table of comparative statistics, taken from the November 28, 1967 issue of "The Bond Buyer" shows that the two key trends over the last decade have been increasing volume of municipal financing and steadily rising interest rates.

THE IMPORTANCE OF BOND RATING

Bond ratings are of great public concern since they are assigned to a substantial number of the issues now outstanding. An increased rating increases the value of a bond and a decreased rating decreases it. Rating changes also have an enormous effect on the interest charges which issuers must pay when they borrow money from the public.

HISTORY OF RATINGS AND WHAT THEY MEAN

Municipal credit ratings are an outgrowth of corporate bond ratings. The birth of bond ratings occurred in 1909 when Moody's first rated railroads. In 1914, it expanded its service to cover public utilities and industrials. In 1922, Poor's began to rate industrials. In 1924, Standard's Statistics and Fitch entered the field. In 1941, Standard & Poor's merged. In 1919, Moody's began rating municipalities. In the late 1920's, Standard and Fitch followed suit.

The early history of municipal rating is a dubious one. Prior to the depression, Moody's rated most issues AAA or AA. Defaults during the 1930's caused Moody's to re-evaluate its standards and adopt a more conservative approach. Forty-eight percent of the number of defaulting issues in the 1930's were rated AAA and 1929 and 78 percent of the defaulted issues were rated AA or AAA.

Explanations of the Moody's and Standard & Poor's bond ratings are given in Exhibit II, reproduced directly from the manuals of the two services. Moody's does not rate issues under $600,000. More than 16,000 public bodies are currently included in Moody's Municipal and Government Manual, although all are not rated. Standard & Poor's rates issues of governmental bodies having at least $1 million of debt outstanding. It rates about 7,000 issues. Dun & Bradstreet, Inc., does not rate municipal bonds per se. It does issue a series of credit surveys. It labels both tax and revenue-secured bonds either "above average," "favorable," "fair," "poor," etc., according to principal factors. Fitch Investor Service issues municipal bond ratings only on a specific request basis. Other agencies rate bonds but confine their activities to specific areas. Among these are the North Carolina, Oklahoma, California, Ohio, Michigan, Iowa, and Kansas Advisory Councils. The agencies with the broadest influence are Moody's and Standard & Poor's since they issue comparable letter ratings which are widely available to the public.

THE ENORMOUS INFLUENCE OF THE PRIVATE RATING SERVICES

Moody's and Standard & Poor's render a private service to their clients in return for a fee or subscription to their publications. Through a series of circumstances, *they have assumed almost Biblical authority throughout the American investing economy and have an enormous influence on banks, trustees, institutional investors, and individuals.* The issuer, underwriter, and taxpaying public are also directly affected by the decisions reached by the small handful of men in each organization.

Ratings normally are assigned to large, widely-known issues of municipal bonds prior to public sale by the issuer. Investors are so accustomed to the system that almost automatically, a rating will determine within certain limits the interest rate the issuer must pay on its bonds. Many states have legislatively enacted the "Prudent Man Rule" under which trustees and other fiduciaries are held liable for their negligence in the handling of investments. To avoid charges of negligence, they "play it safe" by investing in bonds rated A or better.

Similarly, many institutional investment committees, as a matter of policy, will only buy A or better or not even both to look at a BAA or unrated bond.

Last May 4th, I conferred with high officials of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. I learned from them that their bank examiners who supervise practices throughout the United States commercial banking system are heavily influenced in their regulation of bank portfolios by the letter ratings assigned by the two leading services. Most issues assigned less than BAA by both rating agencies are rejected out of hand for bank investment. Issues rated BAA are felt by some to have a faint odor which places a burden of proof upon the banks to justify the investment. Obviously bankers would prefer to avoid having to defend in detail their bank selections. Therefore, woe be to the city which

slips below an A rating, and woe be to its taxpayers who must pay a much higher borrowing cost occasioned by the distasterous slip from an A to a BAA.

The rating agencies unwittingly have come to be looked upon by banks and the public at large as official bodies serving a public rather than private purpose. Of course, they are not official. Their only responsibility is to their clients and subscribers. Nevertheless, in today's market, the difference of a notch in a rating or between similar rated and unrated issues can range between 25 and 50 basis points or more (between one fourth and one half of 1 percent in annual interest rate). Thus, ratings also effect the economic development of municipalities which pay widely varying rates of interest per dollar borrowed.

INADEQUATE FACT GATHERING

Are rating agencies able to obtain the data they must have in order to fulfill their important responsibility of issuing accurate ratings? A little simple arithmetic suggests no. Moody's, for example, has 12 analysts on its staff and rates 12,000 out of the 16,000 municipalities in its manual. Hence, each analyst on average rates 1,000 municipalities. There are 250 working days per year. This means four municipalities must be rated each day. Presumably, to be at all thorough, the agency would have to review ratings quarterly which would mean at least 16 credit reviews per day per analyst. Assuming complete efficiency and an 8-hour day, this would mean that each analyst would have to review one credit every half hour. Obviously an impossibility.

Unless an agency representative visits each community personally, there can be no assurance that information supplied is complete and unbiased. The lack of any uniform procedure for financial reporting between the several states makes the task of the agencies extremely difficult. The rating agencies must rely in large measure upon questionnaire information supplied by fiscal officers. There is no way to be certain of the completeness or accuracy of the information supplied.

Peoria, Illinois provides a case in point. For many years, the general obligations of Peoria had been rated A. Just before the city came to the market in July 1965 to borrow $4.2 million in serial bonds. Moody's withdrew the AA rating. Claiming insufficient credit information, no rating at all was given. After the sale, Moody's obtained additional information and assigned an "A". But in September, 1965, the rating was restored to AA. New information revealed that for almost a year, Peoria had neglected to report a 20 percent increase in taxable valuations resulting from the annexation of a high school district. Also not reported was a favorable restatement of the city's tax collection experience. Moody's had neither the staff nor the funds to find the correct information itself.

An official at Dun & Bradstreet has estimated that a proper investigation of a municipality would cost between $1,500 and $2,000. Rating agencies cannot afford such a price. Well-informed professionals have advised me that rating is an unprofitable business. The agencies have inadequate staffs and suffer a high employee turnover because they cannot afford to pay competitive salaries with Wall Street. *Municipalities are rarely visited more than once every five years.* Also, despite its obvious adaptability to the statistical problems involved, computerization has not yet been utilized for bond rating.

NOT ENOUGH BONDS RECEIVE RATINGS

Serious problems stem from the inability of the rating agencies to rate many projects worthy of rating. For the most part, only bonds rated BAA or better are acceptable to banks and insurance companies. If a bank wishes to buy an unrated bond, it must show the bank examiner the merits of that bond in great detail. Only about 2,000 out of the Nation's 12,000 banks are big enough to take on such a burden and only a few of them bother. It is always easier to "play it safe." When a community is forced to offer higher interest rates, the investor benefits but the added cost to the community means less public improvements for its people.

DISAGREEMENTS IN RATINGS BETWEEN THE AGENCIES

The two major rating agencies often look at data through different lenses and arrive at different conclusions. Approximately 70 percent of all issues rated by both Moody's and Standard & Poor's have similar ratings. But 20 percent receive higher ratings from Standard & Poor's and 10 percent are given higher ratings by Moody's.

CONFLICT OF INTEREST

The common practice of employing rating services as fiscal consultant creates conflicts of interest. On November 10, 1964, the Florida Securities Dealers Association passed a resolution condemning this practice. The FSDA stated that the issuance of ratings by rating services having a confidential and fiduciary relationship with municipalities would creat a serious conflict with those entitled to rely on the integrity of such ratings.

VARIATIONS IN REPORTING PRACTICES

Certain municipalities have suffered due to variations in reporting practices. In Minnesota, for example, generally lower credit ratings are assigned than similar towns receive in neighboring states. The disparity occurs not because Minnesota's economic condition is worse than her neighbor's, but because of her statewide practice of setting the assessed value of property at 8 to 10 percent of market value. In contrast, assessed valuations in Wisconsin average above 90 percent of market value. Of 266 Minnesota municipalities rated by Moody's, 19 are classified as AA and 109 as A, 108 as BAA, and 30 as BA. Wisconsin, on the other hand, has 58 municipalities rated AA, 155 as A, and only 7 rated BAA. There are no BA ratings in the State. Minnesota is thus being penalized by Moody's for the State's property assessment procedures. With so many municipalities to rate, the extra effort involved in the research needed to put municipalities on a comparable rating basis is apparently not feasible. Yet unless rating agencies dig for the facts, others must be found who will, since the public is too greatly penalized under the present system.

THE NEW YORK CITY RATING FIASCO

A classic example of inadequate rating analysis is provided by New York City. On July 19, 1965, Moody's lowered the rating of New York City's tax-secured bonds from A to BAA. The action was triggered by a $250 million borrow-now, pay-later financing undertaken by a prior administration to balance its current expense budget through the flotation of serial bonds. A number of municipal finance experts in the investment banking and institutional investing fraternities took issue with Moody's action arguing that the Nation's largest city and economic capital could not possibly be reduced below an A rating by the transitory policy of the administration. A most vigorous defense of the city's strength was made by James Reilly, senior partner of the respected municipal bond firm of Goodbody & Co., who cited seven reasons reflecting New York's ability to pay its indebtedness. These were:

1. The assessed value of real property owned by the city of New York is almost double the total municipal debt. Only a modest development of some of these properties could result in the creation of enormous values;
2. Only $3.0 billion of New York's $4,875 billion debt is held by the public—the rest is held by the city itself in pension and trust funds. New York has almost $2 billion invested in itself;
3. More than 60 percent of New York's bonds have been issued to construct and acquire revenue-producing improvements such as parking facilities, water and sewer properties. Increases in only a few of the currently subsidized rate structures on these utility enterprises could produce immense earnings to meet future needs;
4. New York's present debt structure is heavily weighted in short maturities and more than 50 percent of the debt is scheduled for payment by 1975. A slight lengthening of the debt to a mere 15 years average life could have resulted in a 1965–66 budget surplus compared to the $250 million deficit experienced.
5. More than 8 percent of New York's debt outstanding as of July 1, 1964 was pair off by July 1, 1965. This suggests an unusual ability to adequately meet debt requirements even if economic conditions in the future warrant expenditure cutbacks;
6. The ratio of debt to assessed valuation is less now than it was in 1944, or, for that matter, in 1939;
7. As of June 30, 1965, only 1.6 percent of all real estate taxes levied during the past 5 years had not been collected. New York City bonds remain as full faith and credit general obligations payable from unlimited real estate taxes levied on all taxable property within the city's boundaries.

A year after Moody's lowered New York City's credit rating, Standard & Poor's followed suit. They chose July 25, 1966, the day before New York City borrowed $112,929,000 to lower the city's credit rating from A to BBB. In so doing, Standard & Poor's, according to a fair sampling of Wall Street experts, added some 10 basis point to the interest cost New York City had to bear. The rating agency, in effect, told investors that New York City's bonds were risker than in the past.

But, Standard & Poor's also said:

"* * * the city's continuing ability to meet debt service requirements is of course not questioned. Its bonds are payable from unlimited property taxes, and debt service is unhampered by rigid constitutional limitations. Net debt has increased less rapidly than estimated full property valuation, currently standing at about 8.9 percent, compared with 10.4 percent in fiscal 1962. This is still a heavy load, but the rapid schedule of principal payments permit flexibility in planning future requirements as additional borrowing power is generated, within the debt limit."

While Standard & Poor's was lowering New York City's rating, Wade S. Smith, Vice President and Director of the Municipal Research Service of Dun & Bradstreet, one of the two agencies which had downgraded New York City last year, was saying how much better the city's credit looked. The New York Times reported that even Moody's, though not yet prepared to change its rating upward, was encouraged by the city's current fiscal position.

According to all the agencies, New York's credit is better today than it was a year ago for four principal reasons:

1. A policy, instituted during the Wagner Administration, to borrow to meet operating expenditures has been ended. The new administration is determined that it shall not be reinstituted.
2. The city's floating debt has been reduced by $40 million.
3. The city has, for the first time in three years, lived within the estimates of the general fund without having to borrow from reserves.
4. The city finished its 1965-1966 fiscal year without the issuance of budget notes for the first time in more than 20 years.

In Standard & Poor's *Outlook*, the following appears relative to New York City's ability to increase revenues:

"With the advent of the income levy the tax pattern is set for some time to come. Offtrack betting and the legalized lottery are possible escape hatches, but the likelihood that these will be adopted is tenuous in the existing socio-political climate. Except for these areas, virtually every known form of taxation has now been tapped."

Yet, the very next page of the bond *Outlook* offers this contradiction: "Economically, New York enjoys a unique status * * * By every measure, New York's resources remain unmatched."

Standard & Poor's is unhappy that "since 1962, the share of revenues afforded by Federal grants and State aid has risen from 20.8 percent to 28.8 percent." For years, ever since Federal and State income taxes were instituted, New York City has rightly complained that its share of benefits was in no way commensurate with its payments. Now, finally, something is being done to end this inequality. An office was opened in Washington to help assure New York City its fair share of Federal disbursements.

Mr. Reilly included his commentary on New York City as follows:

"The biggest city of all must have the biggest problems. But New York City has more than demonstrated its ability to meet its obligations. Much of the New York City experience is directly applicable to other great cities such as Boston, Los Angeles, and Detroit, which have, of late, been so rudely jostled by ratings. What needs emphasizing is the public welfare and the significance of a notch on the rating scale. How many schools would 25 less basis points have built over 20 years? This is the question of prime importance, for it once again points up the heavy responsibility carried by rating agencies."

WHAT THE LOWER RATING COSTS NEW YORK CITY

At today's interest rates, bond experts have advised me that a BAA bond carries a 5.20 percent net interest cost versus an A-rated bond's 4.70 percent. This is a difference of 50 basis points or one-half of one percent annual interest. Since New York City floats $500 million per year of new debt, the extra interest cost occasioned by the lowering of New York City's rating will be $2.5 million per year on each issue. Since the average life of recent issues has been about 8

years, this will mean about $20 million per year total extra cost. This is enough to provide hospital space for 500 patients or build seven elementary schools or put 2,000 policemen on the beat.

ATTEMPTS AT CORRECTIVE MEASURES

Certain steps have been taken to dispel misimpressions about New York City's creditworthiness. Exhibits III, IV, and V reflect efforts to take our story direct to the investing public. The exhibits include a public rebuttal to the Moody's commentary of May, 1967; the first two issues of a new Fiscal Newsletter.

ELEMENTS OF NEW YORK CITY'S FISCAL STRENGTH

The committee has specifically requested certain data about New York City and it is provided herewith. Under the New York State constitution, taxes on real estate to pay interest and principal installments on the city's debt may be levied without limit. Debt service has, therefore, remained consistently outside recurrent expense budget problems because the city has the power to levy, and has levied, adequate taxes for its payment.

The provision of the State constitution in Article VIII, Section 2, providing that the chief fiscal officer of any city or other political subdivision in the State shall apply the first revenues received to debt service is a strong protective bulwark for New York City bondholders. This enduring provision requires that New York City's funded debt shall be backed by the full faith and credit of the municipality. Thus, payment of the city's debt service is the first lien on its revenues. These revenues include $1.66 billion real estate tax and the $1.69 billion General Fund (including sales, business, personal income, utility, water, commercial rent, and a wide range of taxes and other charges). The city must pay its debt service before it meets its payroll or any other expense. The taxpayer's obligation to pay real estate taxes to the city takes precedence over the obligation to pay debt service on the many billions of dollars of private mortgages held by banks, insurance companies, and other institutional investors. Paradoxically, however, the rating of much of that indebtedness is substantially higher than is the rating of New York City which has a prior lien on revenues required for debt service.

In view of the unusual protection afforded to New York City bondholders under the State constitution, we have felt it appropriate to present a chart indicating the history of New York City's debt service coverage from 1929 to the present. At the depths of the Depression in 1932, when debt service totalled $201 million, city revenues aggregated $611 million. The coverage ratio was then 3.04. This was the low point for the entire 39-year period. The long-term in this ratio has been generally upward. In 1966–67, the coverage ratio was 4.70, and we envisage a ratio of approximately 4.89 in fiscal 1967–68.

THE REVENUE SYSTEM

Overall, the city's revenue system is growing and is becoming broader-based. The table below shows the changes that have occurred in 1965–66, 1966–67 (estimated) and 1967–68 (estimated). Each component of the city's revenue system has grown except "other funds," which in 1965–66 were made up chiefly of borrowed funds.

GROWTH OF NEW YORK CITY'S REVENUE SYSTEM 1965–66—1967–68

[In millions of dollars]

	1965–66	Estimated, 1966–67	Estimated, 1967–68	Percent change estimated, 1967–68 versus 1965–66
Real estate taxes	$1,408.1	$1,573.0	$1,659.0	+17.8
General fund, other than aid items	1,028.9	1,378.7	1,543.4	+50.0
State and Federal aid	1,107.8	1,458.4	1,895.5	+71.1
Other funds	[1] 330.5	143.7	85.6	−74.1
Total	3,875.3	4,553.9	5,183.5	+33.8

[1] Includes $255,600,000 5-year serial bond borrowing.

Because the city real estate tax is its largest single source of revenue and the major single provider of coverage for debt service, the growth in taxable real estate valuations assumes special significance. In the fiscal year 1956–57 the full value of taxable real estate was $24.1 billion compared to a value of $44.0 billion in 1966–67. The amount of commercial office space added to Manhatton alone since World War II is greater than that of the rest of the Nation put together.

SUMMARY

Walter H. Tyler, for 25 years the head of Standard & Poor's Municipal Bond Rating Department and now president of his own bond rating service, summed up the inadequacies of the existing system of bond rating, as follows:

1. Ratings cover only about 70 percent of the outstanding bonds and about 10 percent of the municipalities capable of selling bonds.
2. They are expressed in such broad bands that even with a fairly long record, it is difficult to tell whether a credit is improving or deteriorating. There is a real wide swing between the top of the A group and the bottom of the Baa category and the only time an investor would know his bond was getting better or worse would be if it crossed the single dividing line.
3. No one, including some of the analysts involved, is quite sure what a rating is based on. This is particularly frustrating for the municipalities or their financial advisors.
4. There is no way to relate quality ratings to market. Any bond is attractive at a price. A good rating system should permit comparison of rating with market.
5. Ratings make no allowance for the fact that a short maturity of a BBB bond is more attractive than the 1996 maturity of an AAA bond.
6. The rating services are basically unprofitable and hence cannot develop the staffs and the automation and the on-the-spot inspection services required to generate consistent and reliable information.
7. The present systems were set up in the 1930's and 1940's designed to solve the problems of the big depression with the tools then available. They have been modified from time to time as new problems became apparent or new tools became available but changes have only contributed to the overall confusion. Tyler has provided a questionnaire, labeled Exhibit VI, which sets forth the kinds of information he believes a rating agency should be equipped to consider.

RECOMMENDATIONS

1. A searching study should be undertaken by a leading and objective research institution such as The Brookings Institution or the National Bureau for Economic Research to answer the following kinds of questions:

"(a) How can bond rating services be adequately financed without either involving them in conflicts of interest or subjecting them to political pressure?

"(b) How can staffing inadequacies be overcome to deal with the gigantic statistical and analytical workloads occasioned by the eleven-fold increase in municipal financing since 1946?

"(c) How can fact-gathering techniques be improved through the use of computer technology not now employed by any of the rating services?

"(d) How can a rating scale be devised which will more sensitively reflect whether a credit is improving or deteriorating, relate quality of rating to bond price, and make allowance for the fact that short maturity of a Baa bond might be a better risk than a 30-year maturity of a AAA bond?

"(e) What can be done to develop more explicit rating criteria rather than the present system in which no one, including some of the analysts involved, is quite sure what a rating is based on?"

2. Interested parties such as municipal finance officers, institutional investors, municipal bond dealers, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Comptroller of the Currency, as well as representatives of the rating services, should form an ad hoc committee to activate the findings of the research institution.
3. Bond rating service, in whatever form the study deems best, should be financed from contributions to be made by municipalities, banks, institutional investors, and municipal securities dealers. The individual subscriptions could be in modest amounts if enough were willing to participate. This form of financing would fully insulate the rating agency(ies) from political interference and conflicts of interest. It could permit a staff large enough to make

continuing on-the-spot inspections and computerized techniques of fact-gathering.

PART II—THE GRAVE THREAT OF INDUSTRIAL REVENUE FINANCING

An even more serious threat to our cities' financial condition is posed by a relatively new kind of tax-exempt security known as the industrial revenue bond. Industrial revenue financing involves the sale of tax-exempt, municipal obligations for the benefit of private profit corporations. It has seriously impaired the functioning of the municipal bond market in 1967, accounting for $1 billion out of a total of approximately $12 billion of tax-exempt issues. The added volume and high interest rates of these hybrid securities threaten the ability of many municipalities to borrow for schools, hospitals, roads, and other long-accepted public purposes.

Industrial revenue bond proceeds are used to build an industrial facility for a private corporation which leases it for a long-term contract, with the rental payments pledged to amortize and pay interest on the bonds. Exhibit VII provides a quick history of industrial-aid financing. As more and more States and municipalities offer tax exemption to attract new industry, the practice will become self-defeating. Great damage will be done to the independence of local government and to all taxpayers.

Further descriptions of industrial-aid financing are provided in Exhibits VIII and IX which are memoranda prepared by experts on the subject. Exhibit X is an article from the Wall Street Journal of December 4, 1967 giving an up-to-date survey of the industrial revenue scene. Taken together, all of these documents provide comprehensive data on the subject.

THE DAMAGE BEING DONE TO NEW YORK BY INDUSTRIAL-AID FINANCING

Expert estimates as to how much more New York City must pay in interest because of the mounting pressure of industrial revenue financing range from 25–40 basis points. Assuming the true figure lies in between, New York's annual interest penalty this year amounted to three-eighths of 1 percent. This extra interest equals $1.9 million. Taken together with the effect of its BAA rating, the combined damage amounts to no less than three-fourths of 1 percent which is $3.75 billion a year. If something is not done to stem this double threat, New York will soon be faced with a total interest of $30 million a year. That is enough to put 3,000 policemen on the beat or provide hospital space for 750 patients or build ten schools.

RECOMMENDATION

The solution to the industrial revenue problem is Congressional action to deny to corporations the deductibility of lease rental payments which support tax-exempt debt. This approach would be far more acceptable to those who hold that exemption of local debt derives from sovereignty of the States as preserved by our national constitution and would have a far better chance for a quick passage by Congress. This route appears more acceptable than the Treasury's approach which involves a withholding of tax exemption from industrial bonds by amendment to the Internal Revenue statute. A bill for this purpose has been introduced by Representative John W. Byrnes.

CONCLUSION

With tax-exempt interest rates now at a 33-year high, we cannot afford the luxury of protracted debate while ou rcities are forced to cut basic services. High interest rates are choking us and with the two steps I have suggested we can ease the pressure. This must be done before it is too late.

[From the New York Times, May 8, 1967]

RATING THE CITIES

City Finance Administrator Roy M. Goodman's charge that the present system of rating municipal bonds is inadequate has found a sympathetic audience at the Federal Reserve Board and other Government agencies. Mr. Goodman, of course, is chiefly concerned with the comparatively poor rating given New York City. But the Federal authorities rightly consider that inadequacies in the rating system pose a problem for municipalities across the nation.

Unquestionably, Standard & Poor's and Moody's, the two private rating agencies, have certain deficiencies. They lack the manpower for searching examinations; they are frequently subjective in their decisions, and they often disagree among themselves. Yet their obvious fallibilities have little influence on investors, who treat their ratings with an awesome respect.

Mr. Goodman has recognized that there is little to be gained by asking Washington to set up a brand-new rating system. In the first place, neither the Federal Reserve nor any other independent agency has special competence in the field, so that a great deal of time and money would have to be spent to provide it. Even more important, it is questionable that investors will regard as objective the findings of a Government agency facing all sorts of pressure.

A nongovernmental expert body, such as the National Bureau of Economic Research, would represent a much superior choice for setting up some clear and open standards for rating the nation's cities. It could win the market's acceptance of its findings much more readily than would a study by Washington.

The nation's banking community, which is deeply involved in municipal bonds as sellers and investors, ought to consider financing such a study. Apart from serving their own economic interests, the banks would be demonstrating a sense of civic responsibility in seeking improvements in the rating system.

New York City cannot wait, however, until a painstaking investigation of ratings is carried out. It can help itself by enlisting the support of the financial community and campaigning more effectively with investors, acquainting them with the facts about the city's unparalleled wealth and the changes that have been made to restore its fiscal integrity. It must also press for greater aid—and increased authority—from Albany. The goal must not merely be restoring the city's old rating but gaining acceptance for its status in a class by itself.

Fairer Municipal Ratings

New York City has had to postpone a projected sale of $96 million in bonds because of "unfavorable conditions in the money markets." And it has come under renewed criticism from Moody's Investor Service, Inc., one of the major credit rating agencies. Since New York's downgrading by Moody's and Standard & Poor's, the city has attracted fewer bidders for its obligations even though it has offered very generous rates of interest.

While the City Council's politicking in respect to the operating budget has not helped, Mayor Lindsay's administration has launched a series of constructive and responsible financial reforms to repair the previous damage done to New York City's credit standing. And because the rating agencies have been slow to recognize the prudent new look in the city's fiscal program, the Mayor has decided to tell the story to the nation's investment community.

He has started a fiscal newsletter that will acquaint potential investors with what has been done and what will be done. He is planning official visits to market centers across the country in order to increase receptivity for the city's issues. And he proposes to invite institutional investors to New York to make their own appraisals of the city's determination and ability to pay its capital debts.

But apart from continuing to initiate fiscal reform, the most important proposal of all is City Finance Administrator Roy M. Goodman's call for an improvement in the present system of credit rating. There is a demonstrable need for more current and comprehensive ratings of all municipalities, large and small. More adequate rating will not always make it easy to borrow. When money is tight and interest rates are rising, any municipality will have a hard time. But cities should not be unduly penalized by inadequate or improper ratings.

The municipal market should itself take the lead in establishing more adequate ratings, preferably by financing a thorough study by an objective and expert body. The goal should not be to make things easier for New York City, but to provide more accurate assessments of all cities so that the municipal market can function more effectively.

Standard & Poor's Bond Ratings

In the Standard & Poor's bond quality ratings system, interest-paying bonds are graded into eight classifications ranging from AAA for the highest quality designation through AA, A, BBB, BB, B, CCC to CC for the lowest. Bonds on which no interest is being paid, either because of default or because of "income" characteristics, are given C, DDD, DD and D ratings. Rating symbols are the

COMPARATIVE STATISTICS OF INTEREST TO THE MUNICIPAL BOND BUYER

Compiled from the files of THE BOND BUYER and other sources

(These statistics for the years 1912 through 1939 appeared in this section every year from 1946 through 1966.)

NEW STATE AND MUNICIPAL BOND ISSUES (Excluding short-term notes having a maturity of a year or less)

Year	No. of Issues	Amount	Of Which the Following Amounts Were for— Revenue (Incl. Refunding)	G. O. Refunding‡	Revenue Refunding	Local Housing Authority	Industrial •	Veterans Aid
			(,000 omitted)					
1967*	4,878	$11,839,604	$3,940,111	$ 58,944	$112,690	$339,045	$697,057	$135,000
1966	5,594	11,088,938	4,076,022	43,375	177,198	439,705	504,460	90,000
1965	6,059	11,084,188	3,639,219	251,009	537,979	464,045	211,631	50,000
1964	6,314	10,544,127	3,657,790	160,887	496,571	635,745	191,351	120,000
1963	6,577	10,106,665	4,037,470	223,514	1,053,126	254,015	119,120	25,000
1962	6,515	8,558,200	2,666,012	89,228	171,806	381,800	84,317	125,000
1961	6,400	8,359,512	2,598,007	26,404	27,534	188,810	71,711	477,676
1960	6,529	7,229,500	2,194,820	35,393	17,569	382,755	46,867	200,000
1959	6,711	7,681,053	2,521,397	29,696	28,927	310,400	22,946	323,250
1958	6,855	7,448,803	1,724,026	73,599	69,172	182,280	12,740	339,441
1957	6,888	6,958,152	2,024,911	30,505	29,080	64,750	7,612	332,750
1956	6,495	5,446,419	1,670,488	26,216	49,747	198,535	6,421	113,100
1955	6,660	5,976,503	1,732,414	29,592	46,034	473,810	11,790	161,600
1954	6,526	6,968,641	3,214,381	61,526	96,357	374,145	4,759	160,600
1953	5,795	5,557,887	1,567,256	35,578	90,960	496,165	9,300	140,500
1952	5,313	4,401,317	1,463,450	89,685	239,828	304,505	8,790	189,200
1951	5,281	3,278,153	730,095	49,635	48,243	328,019	6,920	81,500
1950	5,861	3,693,604	599,923	67,612	53,631	59,210		645,000
1949	5,107	2,995,425	682,953	82,987	22,047	143,300		260,500
1948	4,706	2,989,731	549,501	136,436	50,698	65,770		647,250
1947	3,803	2,353,771	385,690	46,443	16,731	4,366		684,600
1946	3,319	1,203,557	205,860	114,899	91,088	18,950		38,900
1945	1,876	818,781	203,399	175,501	145,849	2,956		16,000
1944	1,275	712,305	241,839	275,829	200,286	12,799		
1943	1,036	507,566	156,066	242,268	110,116	60,558		
1942	2,565	575,588	96,921	215,528	7,479	88,978	..	
1941	5,548	1,229,493	107,506	511,339	37,927	22,388		
1940	5,100	1,497,683	188,228	340,702	87,751	21,569		

Year	State and Municipal Debt Outstanding (as of June 30) Total	Privately Held*	U. S. Interest Bearing Securities** (Not including special issues to Federal Agencies and Trust Funds or securities of Federal Instrumentalities) (as of June 30) Total Outstanding: Taxable	Wholly and Partially Tax Exempt	Held by State and Municipal Funds	Insured Commercial Bank Holdings of State and Municipal Bonds (as of Dec. 31)
	(000,000 omitted)		(000,000 omitted)		(000,000 omitted)	(000,000 omitted)
1967*	$......	$.....	$266,131	$.....	$14,835	$46,679 (6/30)
1966	101,800	99,300	264,311		23,900	40,831
1965	99,200	93,400	264,463		24,100	38,480
1964	91,300	85,100	260,730		21,500	33,343
1963	85,900	78,900	257,758		20,600	29,611
1962	80,131	72,403	248,463	1,485	19,400	24,582
1961	71,730	63,977	239,383	1,485	18,600	20,103
1960	66,425	58,976	236,946	1,535	18,832	17,336
1959	61,675	54,571	235,653	1,535	16,856	16,753
1958	56,500	49,906	227,017	1,535	16,285	16,316
1957	51,840	45,803	219,311	2,454	16,825	13,732
1956	47,400	41,880	221,406	3,436	16,130	12,713
1955	42,600	37,500	225,078	3,457	14,731	12,582
1954	37,300	32,448	220,668	6,093	13,930	12,387
1953	32,200	27,300	216,657	6,802	12,025	10,620
1952	29,111	24,529	211,623	7,544	10,357	10,006
1951	26,592	22,340	208,794	9,432	9,408	9,016
1950	23,722	19,832	209,833	13,037	8,743	7,958
1949	20,481	17,349	201,660	16,349	8,000	6,420
1948	18,354	15,373	201,931	17,990	7,786	5,511
1947	16,529	13,633	206,725	21,105	7,109	5,130
1946	15,626	12,809	224,732	21,515	6,458	4,300
1945	16,293	12,938	212,103	25,852	5,256	3,874
1944	17,194	13,215	157,869	28,903	3,190	3,423
1943	18,406	13,964	93,336	35,265	1,460	3,287
1942	19,379	14,800	31,386	37,247	875	3,533
1941	19,860	15,279	7,853	40,774	619	3,651
1940	19,891	15,630	4	43,095	424	3,608

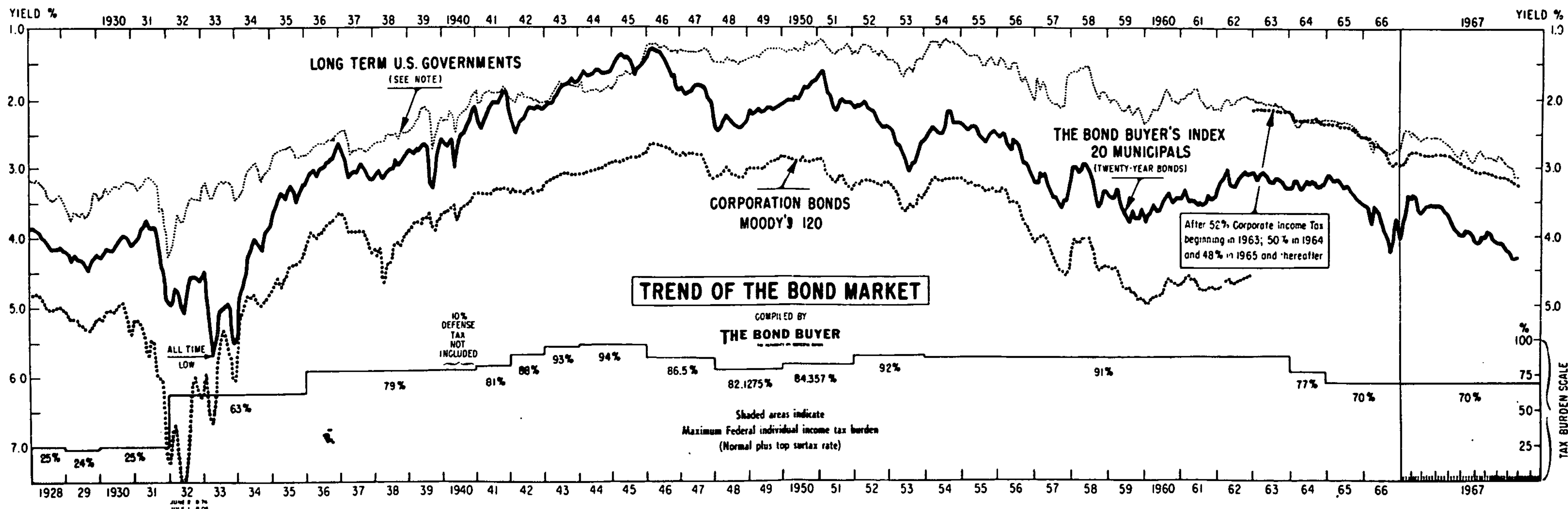
Year	Life Insurance Company Bond Holdings (49 U. S. Legal Reserve Companies as of Dec. 31) Total Bonds of All Kinds	State and Municipal Bonds	Income Tax Rates: Individual Top Normal and Surtax Rate %	Top Corporate Tax Rate %	The Bond Buyer's 20 Bond Index (at Jan. 2)† %	Computed Annual Int. Rate on Total Federal Public Debt (as of June 30) %	Moody's Corporate Bond Yield Index‡ %
	(000,000 omitted)						
*1967	$......	$.....	70	48	3.76	4.039	5.68
1966	59,864	1,301	70	48	3.53	3.988	4.88
1965	59,024	1,649	70	48	3.07	3.678	4.58
1964	57,619	1,859	77	50	3.26	3.560	4.57
1963	56,506	2,027	91	52	3.05	3.360	4.50
1962	54,882	2,249	91	52	3.37	3.239	4.71
1961	52,750	2,190	91	52	3.39	3.072	4.66
1960	50,901	2,076	91	52	3.78	3.297	4.90
1959	49,533	1,910	91	52	3.40	2.867	4.40
1958	47,705	1,634	91	52	2.97	2.638	4.17
1957	45,571	1,512	91	52	3.23	2.730	4.05
1956	43,990	1,487	91	52	2.56	2.576	3.33
1955	42,972	1,341	91	52	2.38	2.351	3.14
1954	41,826	1,244	91	52	2.54	2.342	3.38
1953	40,350	845	92	52	2.40	2.438	3.20
1952	38,315	779	92	52	2.11	2.329	3.27
1951	36,428	830	85.63††	50.75††	1.66	2.270	2.87
1950	36,249	823	84.357††	42††	2.07	2.200	2.84
1949	36,250	757	82.1275	38	2.19	2.236	3.06
1948	35,175	641	82.1275	38	2.36	2.182	3.16
1947	34,028	445	86.45	38	1.85	2.107	2.81
1946	32,761	460	86.45	38	1.42	1.996	2.77
1945	30,109	574	94	40	1.62	1.936	2.98
1944	26,682	903	94	40	1.77	1.929	3.13
1943	23,307	1,216	93	40	2.17	1.979	3.31
1942	20,432	1,479	88	40	2.24	2.285	3.39
1941	18,154	1,703	81	31	2.14	2.518	3.35
1940	16,381	1,736	79§	24	2.59	2.583	3.64

* 10 mos.
• Yearly totals for the years 1951-1966 furnished by the Investment Bankers Association.
‡ For years 1940-45 amounts exclude holdings of State and local trust and investment funds.

*Source: Annual Report of the Secretary of the Treasury.)
** Direct and guaranteed issues.
†† Individual top normal and surtax rate was a combination of 82.1275% to Sept. 30, 1950 and 91% thereafter. In 1951 individual top normal and surtax rate was 91% through Oct. 31, 1951, and 92% thereafter. Top corporate tax rate was a combination of 38% to June 30, 1950 and 45% thereafter. In 1951 top corporate tax rate was 47% from Jan. 1, 1951 through March 31, 1951, and 52% thereafter.

§ Does not include 10% Defense Tax.
† Figure is as first Thursday in January from 1946 to date. For the years 1940 through 1945 the yield is of the first trading day in January.
‡ Yields are of the first trading day of January.

NOTE: Long Term U. S. Governments—The line for Governments for the years 1928 through October, 1941 was average based on prices of bonds due or callable after twelve years. From November, 1941 through March 14, 1944 average used was based on long term partially tax-exempt issues. Beginning in 1941, averages are expressed in terms of after tax consideration. On March 15, 1944 through 1945 the yields on the 2½s of 1965/60 was used. From February, 1958 to date, the line is based on yield of 3½s of 2/15/90.



Corporation Bonds — For years 1928 and 1929 yields are based on averages of bi-weekly closing prices; from January, 1930 through October, 1931 yields are averages of weekly prices. From November, 1931 through 1945, yields are as of the first trading day of the month. Beginning in 1946, the yields are as of the close of business each Thursday. The yield from 1963 to date is after corporate income tax. For earlier years, yield is before corporate income tax.

same for corporate and municipal bonds, and every effort has been made to keep the two systems on a comparable basis. United States Government bonds are not rated, but are considered as a yardstick against which to measure all other issues.

BANK QUALITY BONDS

Under present commercial bank regulations bonds rated in the top four categories (AAA, AA, A, BBB or their equivalent) generally are regarded as eligible for bank investment.

AAA: Bonds rated AAA are highest grade obligations. They possess the ultimate degree of protection as to principal and interest. Marketwise, they move with interest rates, and hence provide the maximum safety on all counts.

AA: Bonds rated AA also qualify as high grade obligations, and in the majority of instances differ from AAA issues only in small degree. Here, too, prices move with the long term money market.

A: Bonds rated A are regarded as upper medium grade. They have considerable investment strength but are not entirely free from adverse effects of changes in economic and trade conditions. Interest and principal are regarded as safe. They predominantly reflect money rates in their market behavior, but to some extent, also economic conditions.

BBB: The BBB or medium grade category is borderline between definitely sound obligations and those where the speculative element begins to predominate. These bonds have adequate asset coverage and normally are protected by satisfactory earnings. Their susceptibility to changing conditions, particularly to depressions, necessitates constant watching. Marketwise, the bonds are more responsive to business and trade conditions than to interest rates. This group is the lowest which qualifies for commercial bank investment.

SUBSTANDARD BONDS

As we move down the rating scale, beginning with BB, investment characteristics weaken and the speculative elements become progressively stronger. The fortunes of the obligors change rapidly with economic and trade conditions and in adverse periods interest requirements may not be earned. Investment in bonds in this group must be under constant surveillance. Prices fluctuate widely with changing business conditions and with little regard for the money market.

BB: Bonds given a BB rating are regarded as lower medium grade. They have only minor investment characteristics. In the case of utilities, interest is earned consistently but by narrow margins. In the case of other types of obligors, charges are earned on average by a fair margin, but in poor periods deficit operations are possible.

B: Bonds rated as low as B are speculative. Payment of interest cannot be assured under difficult economic conditions.

CCC–CC: Bonds rated CCC and CC are outright speculations, with the lower rating denoting the more speculative. Interest is paid, but continuation is questionable in periods of poor trade conditions. In the case of CC ratings the bonds may be on an income basis and the payment may be small.

C: The rating of C is reserved for income bonds on which no interest is being paid.

DDD–D: All bonds rated DDD, DD and D are in default, with the rating indicating the relative salvage value.

MOODY'S BOND RATINGS

Purpose: The system of rating securities was originated by John Moody in 1909.

The purpose of Moody's Ratings is to provide the American investor with a simple system of gradation by which the relative investment qualities of bonds may be noted.

Rating Symbols: Gradations of investment quality are indicated by rating symbols, each symbol representing a group in which the quality characteristics are broadly the same. There are nine symbols as shown below, from that used to designate least investment risk (i.e., highest investment quality) to that denoting greatest investment risk (i.e., lowest investment quality):

Aaa Aa A Baa Ba B Caa Ca C

Absence of Rating: Occasionally no rating is assigned or a rating is withdrawn or cancelled. This may occur if new circumstances arise, the effects of which are not satisfactorily analyzable, if there is no longer available reasonably up to date data to permit a judgment to be formed, if a bond is called for redemption, or for other reasons.

Where no rating has been assigned or where a rating has been cancelled, that fact alone must not in any way be taken as a reflection on the quality of a bond.

Where no rating has been assigned to a bond the reason is usually one of the following:

1. The bond belongs to a group of securities which are not rated as a matter of policy, viz. real estate bonds, obligations of investment trusts and of financial companies, bonds of educational and philanthropic or other "non-profit" organizations, bonds payable in currencies other than American dollars, and bonds of European debtors.

2. Excluded from the rating system are many bonds which were sold privately or in which there is only a minimum of public interest; also bonds of many small debtors, because experience shows it is impossible to rate every issue and an arbitrary line has to be drawn. For example, beginning with the 1949 issues of Manuals, Moody's has pursued a policy of rating no class of debt of any corporation or governmental subdivision where such class of debt is outstanding in an amount less than $600,000.

3. Bonds are not rated in the absence of data deemed to be essential for a sound judgment on the investment quality of the issues.

Changes in Rating: The quality of most bonds is not fixed and steady over a period of time, but tends to undergo change. For this reason changes in ratings occur so as to reflect these variations in the intrinsic position of individual bonds.

A change in rating may thus occur at any time in the case of an individual issue. Such rating change should serve notice that Moody's observes some alteration in the investment risks of the bond or that the previous rating did not fully reflect the quality of the bond as now seen. While because of their very nature, changes are to be expected more frequently among bonds of lower ratings than among bonds of higher ratings, nevertheless the user of bond ratings should keep close and constant check on all ratings—both high and low ratings—thereby to be able to note promptly any signs of change in investment status which may occur.

Limitations to Uses of Ratings: Bonds carrying the same rating are not claimed to be of absolutely equal quality. In a broad sense they are alike in position but since there are only nine rating classes used in grading thousands of bonds it follows that the symbols cannot reflect the fine shadings of risks which actually exist. Therefore, it should be evident to the user of ratings that two bonds identically rated are most unlikely to be precisely identical in investment quality.

As ratings are designed exclusively for the purpose of grading bonds according to their investment qualities, they should not be used alone as a basis for investment operations. For example, they have no value in forecasting the direction of future movements of market prices. Market price movements in bonds are influenced not only by the quality of individual issues but also by changes in money rates and general economic trends, as well as by the length of maturity, etc. During its life even the best quality bond may have wide price movements, although its high investment status remains unchanged.

The matter of market price has no bearing whatsoever on the determination of a rating and ratings themselves are not to be construed as a recommendation with respect to "attractiveness." The attractiveness of a given bond may depend on its yield, its maturity date or on other factors for which the investor may search, as well as on its investment quality which is the only characteristic to which the rating refers.

Since ratings involve a judgment about the future, on the one hand, and since they are used by investors as a means of protection, on the other, the effort is made when assigning ratings, to look at "worst" potentialities in the "visible" future rather than solely at the past record and the status of the present. Investors using the rating should not, therefore, expect to find in them a reflection of statistical factors alone. They are not statistical ratings but an appraisal of long term risks, such appraisal giving recognition to many non-statistical factors.

Though ratings may be used by the banking authorities to determine legal eligibility of corporate and municipal revenue bonds for bank purchase, etc.,

Moody's Ratings are not made with these bank regulations in view. Moody's Investors Service, Inc. own judgment as to desirability or nondesirability of a bond for bank investment purposes is not indicated by Moody's Ratings.

Moody's Ratings represent the mature opinion of Moody's Investors Service, Inc. as to the relative investment classification of bonds. As such they should be used in conjunction with the description and statistics appearing in Moody's Manuals. Reference should be made to these statements for information regarding the issuer. Moody's Ratings are not commercial credit ratings. In no case is default, receivership, or insolvency to be imputed unless expressly so stated in the Manual.

Key to Moody's Ratings

Aaa: Bonds which are rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as "gilt edge." Interest payments are protected by a large or by an exceptionally stable margin and principal in secure. While the various protective elements are likely to change, such changes as can be visualized are mostly ulikely to impair the fundamentally strong position of such issues.

Aa: Bonds which are rated Aa are judged to be of high quality by all standards. Together with the Aaa group they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long term risks appear somewhat larger than in Aaa securities.

A: Bonds which are rated A possess many favorable investment attributes and are to be considered as higher medium grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggest a susceptibility to impairment sometime in the future.

Baa: Bonds which are rated Baa are considered as lower medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characeristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

Ba: Bonds which are rated Ba are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.

B: Bonds which are rated B generally lack characteristics of the desirable investment. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.

Caa: Bonds which are rated Caa are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.

Ca: Bonds which are rated Ca represent obligations which are speculative in a high degree. Such issues are often in default or have other marked shortcomings.

C: Bonds which are rated C are the lowest rated class of bonds and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

Note: Unless otherwise noted, municipal ratings are for "general obligations" whic hare defined as validly issued and legally binding evidences of indebtedness secured by the full faith, credit and taxing power of the issuer.

[News release, May 28, 1967]

The City of New York Finance Administration

Roy M. Goodman, Finance Administrator of the City of New York

Decrying the stubborn willingness of the major bond rating service to face the fiscal facts relating to New York City, Finance Administrator Roy M. Goodman today outlined a four-point program to deal with the rating problem. He said the "BAA" rating assigned the city by the rating service has already committed New Yorkers to over $50 million in extra expenses and will cost many millions more unless something is done promptly. We must take our story about New York's impressive credit worthiness direct to the investment public, because

the major rating service either does not understand or continues to disregard the true underlying strength of our City and our bonds. Whoever wrote their latest comment must have been in a time machine which took him back to the fall of 1965. He ignored everything constructive that happened since.

The four specific measures advocated by Commissioner Goodman to improve the City's credit were as follows:

1. *Intensive credit review* involving a detailed study of the New York credit picture including comparisons with other cities of the nation to be made by the city's newly created Fiscal Research Center in cooperation with the Comptroller and the Bureau of the Budget.
2. *Investor Education* providing the investing public and rating agencies with periodic fiscal newsletters and regular financial reports. The first Newsletter was issued last week.
3. *Trips to major financial centers* such as Hartford, Boston, Chicago and San Francisco by the mayor or the city's principal fiscal officials to confer with dealers and investors who control decisions affecting billions of dollars of investments.
4. *Special institutional investor tours of New York City* to meet fiscal officials and inspect the city's major facilities at first hand by helicopter, boat and automobile.

Simultaneously with the announcement of the program, Commissioner Goodman issued a memorandum rebutting incomplete and inaccurate statements made by the major rating service on May 22d when it announced the continuance of the city's "BAA" rating. A summary of the major areas covered in the eight-page memorandum follows:

1. Strong defense of the legal protection offered bondholders by the State constitution.
2. Statistical evidence supporting the historic and continuing strength of the city's real estate tax as its basic revenue source.
3. Discussion of business tax reform and statistical evidence of New York's enormous business growth, accompanied by a debunking of the myth of the so-called business exodus from New York.
4. Rebuttal to the assertion that the city does not spend enough for education.
5. Rebuttal to the suggestion that the city's planning is deficient, pointing to three major areas in which the Lindsay Administration has overhauled the City's planning.
6. Assertion of the Lindsay administration's determination to repudiate the borrow-now pay-later financing of the prior administration and description of the job freeze and the ending of the twenty year practice of financing budget over-runs with budget notes, as well as the replenishment of depleted reserves.
7. Demonstration of the favorable aspects of the City's short debt life and steady improvement in the ratio of debt service to total expenditures.
8. Explanation of the healthy growth and broadening of the base of the City's revenue system and explanation of the steady trend to the improvement of coverage of debt service by revenues from 1932 to the present.
9. Explanation of the Lindsay administration's efforts to offset over-subsidization through increases in the transit fare, doubling of water frontage rates, and announced policy on universal water metering.
10. Vigorous exception taken to the notion that because the city's unfavorable fiscal trends may have been a long time in the making that they will be a long time in resolution.

Statement by Finance Administrator Roy M. Goodman on a Recently Issued New York City Credit Rating

On May 22, 1967, one of the major bond credit rating services renewed New York City's rating at the same reduced level, "BAA," assigned in 1965 after the city had borrowed $256 million for operating purposes. According to an independent rating expert, the "BAA" rating will cost New Yorkers an estimated $50 million in extra debt service costs over the life of the serial bonds issued from January 1, 1966 to date. In view of the serious implications of the lowered rating the reasons advanced for keeping it require a detailed analysis and evaluation. As the following point by point rebuttal will suggest, strong exception is taken on a factual basis to many of the reasons advanced for its continued "BAA" rating.

There follows a series of direct quotations from the bond rating service commentary and Commissioner Goodman's comments in reply.

The statement of the bond service:

"Unfortunately, from the vantage point of the investor, New York City, as evidenced in the accompanying chart, is enmeshed in a worrisome trend which cannot be disregarded despite a statutory recital which seemingly makes the payment of debt service a first lien on city revenues.

"A sovereign government is charged with several paramount responsibilities; namely, to exercise its police power, to maintain public health and safety, and to educate. Any recital which purports to impose the obligation to service debt as a first charge of government may be in conflict with these duties should its exercise of priority be allowed to impair public health, safety or education. These functions encompass virtually all services of government, even public transportation, when construed in the broadest terms."

Commissioner Goodman's reply:

"The provision in the New York State Constitution in Article VIII, Section 2, providing that the chief fiscal officer of any city or any political subdivision in the state shall apply the first revenues received to debt service, is a strong protective bulwark for New York City bondholders. This enduring provision requires that New York City funded debt shall be backed by the full faith and credit of the municipality. Thus, payment of the city's debt service is the first lien on its revenues. The city must pay its debt service before it meets payroll or any other expense. The taxpayer's obligation to pay real estate taxes to the city takes precedence over the obligation to pay debt service on the many billions of dollars on private mortgages held by banks, insurance companies, and other institutional investors.

"Article VIII, Section 2 cannot be altered at the whim of any city government. It can only be altered by the action of two successive State legislatures, separated by a general election, followed by a statewide referendum, or by the action of a plenary Constitutional Convention followed by a statewide referendum. It ill becomes a bond-rating service to practice law and to cast unsupported and unjustified aspersions upon both the City of New York and the New York State Constitution.

"The 'worrisome trend' shown by the chart presented by the rating service was the more rapid rise in the city's expenditures and net debt than in the City's assessed values in the past ten years. No mention was made of the fact that both the city's general fund (composed mainly of non-property taxes) and its receipts from state and federal aid have been growing much more rapidly than expenditures in the past decade. The day is long gone when real estate taxes were the only significant source of funds protecting the bondholder's investment. The chart is also misleading if one attempts to judge how property values in New York City have grown, since it omits all tax-exempt values (city-owned property and facilities, tax-exempt housing and property of such agencies as the Port Authority). These properties greatly enhance the value, productivity and livability of the city. When total property values are compared on an equalized full-value basis for proper comparability, it can be seen that values nearly doubled over the decade. Even then, the comparison omits non-real estate property values, which no doubt increased greatly."

The statement of the bond rating service:

"In the opinion of a recognized authority '* * * the real estate tax has been raised to the point where it is not only regressive in its effect on income groups, but also is inequitably administered * * *.' "

Commissioner Goodman's reply:

"The possible regressivity or inequitable administration of the city's real estate tax are almost wholly irrelevant to the city's credit rating. Many cities to which this rating service assigns a rating of AAA have the same problems. The Mayor has already instituted a searching study of the effects of the real estate tax and the obvious inequities in assessment procedures. The rating service has failed to note the recommendation of the Schwulst Commission and the Mayor's Task Force on the Constitutional Convention that the State constitution should be amended to raise the real estate tax limit from 2½ percent to 3 percent and to shorten the valuation base period for the limit from 5 to 3 years. This would enable a possible increase in the tax levy for current purposes within the limit of over $270 million. Of far greater relevance is the fact that in the fiscal year 1966–67, New York City's real estate tax will yield over $160 million more revenue than in the prior fiscal year. The rating service has also failed to note that the New York City real estate tax is not excessive compared to surrounding areas like Nassau County or with other localities which must pay multiple taxes to over-

lapping city, county, and district government. The basis of assessment varies drastically in different municipalities. Notice should also have been taken of the fact that New York City's tax collection record is good. As of April 30, 1967, only 1.2 percent of the taxes levied for the last 5 completed fiscal years had not been collected.

"The city of New York, relative to its governmental responsibilities, has the tightest tax limit of any community in the State. This is one of the basic reasons for recurring operating budget problems, but it does not affect debt service, which is outside the limit."

The statement of the bond rating service:

"Excessive and inequitable taxation of business is an important factor in the migration of many city businesses to the suburbs."

Commissioner Goodman's reply:

"This statement overlooks Mayor Lindsay's major tax reform which substituted a business net income tax for the long-criticized gross receipts tax in July, 1966. This reform was widely hailed by business leaders. In its reference to the migration of many city businesses to the suburbs, the rating service failed to take into account that between 1947 and 1965, 66½ million square feet (182 buildings) of office space were built in New York City. This is the equivalent of 31 Empire State Buildings and exceeded the amount of the rentable space built in the rest of the United States during the same period. It failed to take into account the projection reported by the First National City Bank that over 80 million square feet will have been built between 1947 and 1970, roughly equalling all of the city's pre-War rental office space. Nowhere does the rating service report the consensus of leading real estate firms that demand for space in New York City is greater now than ever before. Prime office space is at a premium, and according to projected building plans, it will be a long time before this need for space will be reduced. In 1967, there is a 98 percent occupancy rate, the highest in history (for office space). Forty-eight million square feet of office space are on the drawing boards for the next 5 years. 6,800,000 square feet were rented in 1966. As the First National City Bank pointed out, growth is not the only yardstick for measuring performance of an economy. It is also important to examine degree of stability in face of cyclical swings affecting the nation as a whole. The New York region shows relative stability. In years when the Nation's employment went down—1954, 1958, and 1961—employment in the New York region was less adversely affected than in the rest of the Nation. Durable goods manufacturing which generally fluctuate cyclically, accounts for a significantly smaller share in the region than the nation as a whole. Many of New York City's activities, such as apparel manufacturing, are consumer oriented and less sensitive to cycles than business investment or defense spending. Employment in New York City's central administrative offices is more cyclically stable than jobs on the assembly line. In 1963, there were approximately 213,000 commercial firms in New York City and in 1966, approximately 225,000 firms, an increase of 12,000.

"In short, the rating service overlooks that New York City is the headquarters for the Nation's business, the major focal point for national and international trade, the Nation's primary money and capital market, the center of its mass communications and advertising, the fashion center of the United States, and the leading city in arts, entertainment, and culture.

"Of the top 100 industrial companies in the United States, 89 have headquarters or branches in New York City."

The statement of the bond rating service:

"Compounding the cost-revenue squeeze is the city's proclivity toward providing both free and subsidized services. Subsidies dissipate the city's limited revenues. The principle that users pay for the benefits that they receive is a widely accepted one. Yet, each year the city allocates millions of dollars to education systems. Maintenance of obsolete plant is, in the long run, far costlier consumers, city water is unmetered, and retailed at flat rates."

Commissioner Goodman's reply:

"The subway fare has been raised over the years from 5¢ to 20¢, water frontage rates were doubled, and the mayor announced his intention to institute universal water metering as soon as it was technologically feasible to do so."

The statement of the bond rating service:

"* * * the city fails to spend enough to remedy the serious deficiencies in the regular and special education programs."

Commissioner Goodman's reply:

"Ten years ago in fiscal 1956-57, the city's education budget was $457 million. In the current fiscal year, 1966-67, the city's education budget is $1,131 million.

In the executive budget for 1967-68, the mayor allocated $1,219 million for the city's public school system. This is more than 20 percent of the total budget. Overall, public school enrollment is not increasing substantially, but in the executive budget for 1967–68, there has been a sizable increase of $88 million over the current year in the proposed allocation to the Board of Education. For 1967-68 executive budget for the Board of Higher Education provided $144 million, an increase of $25 million over 1966-67.

"The rating service also fails to mention that there will be a significant change in the source of revenues devoted to public education. The State legislature has enacted into law a city-proposed measure which changes the formula under which State aid is given to local school boards, bringing New York City much closer to a per capita parity with other localities in the State. This increased aid is contingent on the development by the City of a plan for decentralizing the citywide school system. It treats New York City as five separate school districts instead of one. It has major long-range implications."

The statement of the bond rating service:

"City planning tends to be short-term. The city's record of budgeting dollars rather than fundamental planning is only too evident in the transportation and education systems. Maintenance of obsolete plant is, in the long run, far costlier than constructing new facilities, notwithstanding ever-increasing construction costs."

Commissioner Goodman's reply:

"This statement ignores the proposed reorganization program of the Lindsay administration through which long-range planning will be effected by 10 administrations instead of the presently existing 49 widely dispersed city Departments. Also, the Bureau of the Budget is engaged in an improvement of the budget process, moving toward the planning-programming-budgeting system now being introduced in the Federal Government. In addition, the City Planning Commission is committed to completing the city's comprehensive plan in fiscal 1967–68. The mayor has assigned this project the highest priority.

"The comment on obsolete plant overlooks the fact that replacement of such plant is the principal reason the city undertakes $500 million per year of long-term borrowing. Such borrowing is for capital expenditures and will go to modernize the city's plant. Also ignored is the fact that more than 60 percent of New York's bonds have been issued to construct partly or fully self-sustaining improvements such as parking facilities, water and sewer plants, and waterfront enterprises."

The statement of the bond rating service:

"In recent years, not only have capital outlays from current financing been virtually nonexistent, but a substantial volume of current expenses has been wrongfully defined as capital outlays. Moreover, bonding financed the 1965 expense budget deficit."

Commissioner Goodman's reply:

"One of the cardinal fiscal tenets of the Lindsay administration has been the dismissal of borrow-now, pay-later philosophy. Apparently the rating service blames the present administration for the $256 million borrow-now, pay-later 5-year serial indebtedness incurred by its predecessor to meet current operating expenses. It overlooks the fact that to avoid the recurrence of such an unsound approach, the current administration instituted a job freeze which has saved $53 million to date and put an end to a 20-year practice of financing budget over-runs with emergency budget notes. Such notes were reduced from an all-time high of $68.8 million on June 30, 1965 to $21 million on June 30, 1966."

The statement of the bond rating service:

"In recent years partially due to the city's fairly rapid bond retirement policy, annual debt servce charges have been inordinately high."

Commissioner Goodman's reply:

"There has been a long-term trend downward in the percentage which debt service bears to the total budget. The share of the budget devoted to debt service is down from 13.6 percent in 1966–67 to 12.5 percent in 1967–68. Debt service in 1956–57 was 16.7 percent. With regard to the city's rapid bond retirement policy, this is an asset rather than a liability in evaluating the city's credit. New York's present debt structure is heavily weighted in the short end to the point that more than 50 percent is scheduled for repayment by 1975. It is true that a slight lengthening of the average maturity of debt to a mere 15 years average life would result in substantial savings in the current expense budget, but this would

result in higher total future interest costs. More than 8 percent of New York's funded debt outstanding as of July 1, 1965 was paid out by June 30, 1966. This suggests an unusual ability to meet debt requirements even if economic conditions in the future warrant expenditure cutbacks."

The statement of the bond rating service:

"The fiscal legacy inherited by the Nation's older population centers—governmental expenses that are rising far faster than income—is accentuated in New York City, which recently has dramatized its plight by resorting to the avails of eight of the monthly State-run lotteries."

Commissioner Goodman's reply:

"This places undue emphasis on the proceeds of State lotteries. Men may differ philosophically on the appropriateness of utilizing the proceeds of lotteries for education, but in the case of New York, the total contribution in the prospective 1967–68 budget is an estimated $55 million, just a fraction over 1 percent of the total budget of $5,185.5 million. Why this utilization of the lottery is thought to be such a dramatic indication of New York's plight is difficult to understand in the light of the excellent overall growth and increasingly broad base of the city's revenue system. The table below shows the changes that have occurred in 1965–66, 1966–67 (estimated) and 1967–68 (estimated). Each component of the city's revenue system has grown except 'other funds,' which in 1965–66 were made up chiefly of borrowed funds.

GROWTH OF NEW YORK CITY'S REVENUE SYSTEM, 1965-66—1967-68

[In millions of dollars]

	1965–66	Estimated, 1966–67	Estimated, 1967–68	Change estimated, 1967–68 vs. 1965–66
				(percent)
Real estate taxes	$1,408.1	$1,573.0	$1,659.0	+17.8
General fund, other than aid items	1,028.9	1,378.7	1,543.4	+50.0
State and Federal aid	1,107.8	1,458.5	1,895.5	+71.1
Other funds	[1] 330.5	143.7	85.6	−74.1
Total	3,875.3	4,553.9	5,183.5	+33.8

[1] Includes $255,600,000, 5-year serial bond borrowing.

"The rating service overlooks not only the expanding broader-based revenue system but the most fundamental revenue point of all, the relationship of the city's total general revenues to its debt service. Although such a relationship is normally associated with a limited group of revenue bonds, we think it appropriate in view of the unusual protection afforded to New York City bondholders under the New York State constitution to review the history of New York City debt service coverage from 1929 to the present. At the depth of the depression in 1932, when debt service totalled $201 million, city revenues aggregated $611 million. The coverage ratio was then 3.04. This was the low point for the entire 39-year period. The long-term trend in this ratio has been generally upward. In 1966–67, the coverage ratio was 4.70, and we envisage a ratio of approximately 4.89 in fiscal 1967-68."

The statement of the bond rating service:

"Far more disturbing from the aspect of credit implications, and more difficult to resolve, is the continuing exodus of the educated middle class. Implicit in this trend is the potential loss of an electorate with a desire for efficient, conservative, sophisticated government."

Commissioner Goodman's reply:

"This statement is interested in the light of the election results of November, 1965 in which the voters brought into office the first Republican-Liberal-Fusion government since the highly respected LaGuardia administration of the 1930's. The rating service fails to mention that this administratino has achieved economies totaling $100 million per year; avoided the issuance of emergency budget notes for two years in a row: advanced the first plans in several decades for a basic streamlining of the city government; undertaken a strong program of economic development with emphasis on building business and employment in the city; established a Manpower and Career Development Agency to develop job training programs and to take people off welfare relief in New York

City, instituted a personal income tax on residents and an earnings tax on nonresidents (commuters); substituted a new business net income tax for an outworn gross receipts tax; doubled water charges; and increased the transit fare."

The statement of the bond rating service:

"These trends were a long time in the making and will likely be a long time in the resolution."

Commissioner Goodman's reply:

"Although it is true that certain of the city's fiscal trends were a long time in the making, many will not be a long time in the resolution. The positive actions already enumerated speak louder than words."

FISCAL NEWSLETTER, THE CITY OF NEW YORK, MAY 1967

(From the office of the Mayor, John V. Lindsay, City Hall, New York, N.Y.)

My fiscal advisors have suggested that New York City provide owners and distributors of its bonds with a newsletter to be issued from time to time as important developments occur. Since assuming office on January 1, 1966, this Administration has grappled with a wide variety of fiscal problems. A description of these problems and the policies devised to meet them will be the subject of this and ensuing newsletters.

I enclose my 1967–68 Budget Message. I urge you to read the first 15 pages for important general background and commend the balance of the pamphlet if you have an interest in the specifics of the city's program and in the statistics presented in the appendix.

In providing the reader with the facts necessary to judge our actions we hope that we will induce and be deserving of enhanced investor confidence in New York City bonds.

JOHN V. LINDSAY, *Mayor.*

SOME BASIC CONSIDERATIONS FOR BONDHOLDERS

Unlimited Real Estate Taxing Power For Debt Service

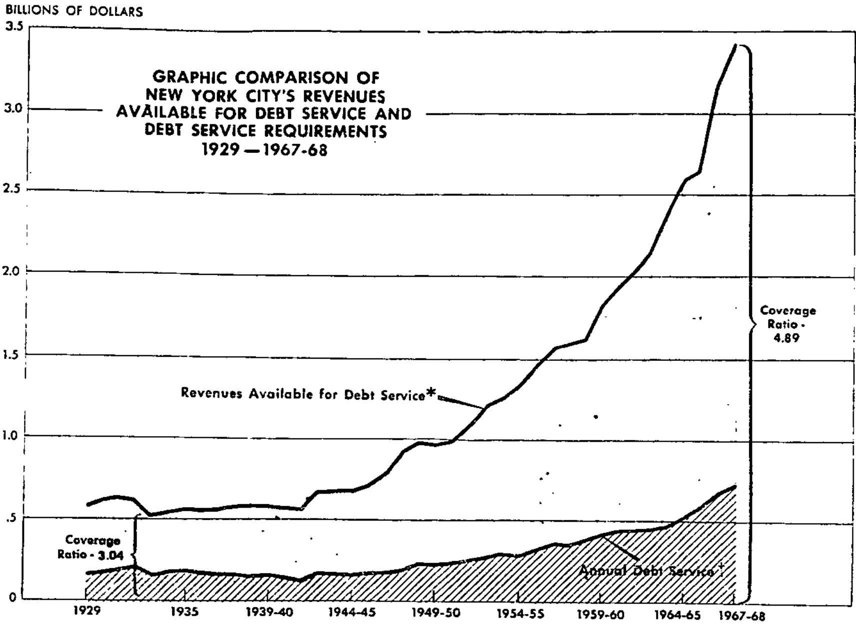
Under the New York State Constitution, taxes on real estate to pay interest and principal installments on the city's debt may be levied without limit. Debt service has, therefore, consistently remained outside recurring expense budget problems because the city has the power to levy, and has levied, adequate taxes for its payment.

Legal Protection

The provision of the State Constitution in Article VIII, Section 2, providing that the chief fiscal officer of any city or other political subdivision in the State shall apply the first revenues received to debt service, is a strong protective bulwark for New York City bondholders. This enduring provision requires that New York City's funded debt shall be backed by the full faith and credit of the municipality. Thus, payment of the city's debt service is the first lien on its revenues. These revenues include the $1.66 billion real estate tax and the $1.69 billion general fund (including sales, business, personal income, utility, water, commercial rent, and a wide range of other taxes and charges). The city must pay its debt service before it meets payroll or any other expense. The taxpayer's obligation to pay real estate taxes to the city takes precedence over the obligation to pay debt service on the many billions of dollars of private mortgages held by banks, insurance companies, and other institutional investors.

Debt Service Coverage

It is perhaps unusual to speak of debt service in relation to a city's gross revenues, a measure which is traditionally associated with a limited group of revenue bonds. Nevertheless we think it appropriate, in view of the unusual protection afforded to New York City bondholders under the New York State Constitution, to present a chart below indicating the history of New York City's debt service coverage from 1929 to the present. At the depths of the depression in 1932, when debt service totalled $201 million, city revenues aggregated $611 million. The coverage ratio was then 3.04. This was the low point for the entire 39-year period. The long-term trend in this ratio has been generally upward. In 1966–67, the coverage ratio was 4.70, and we envisage a ratio of approximately 4.89 in fiscal 1967–68.



* "Revenues available for debt service" include real estate taxes, general fund revenues, and revenues other than the preceding specifically earmarked for debt service such as certain dock, market, and parking meter revenues.
† "Annual debt service" includes temporary and long term debt.
New York City went on a July 1-June 30 fiscal year on July 1, 1939. Figures for the half-year January 1-June 30, 1939 have been shown at the full annual rate.

The Revenue System

Overall, the city's revenue system is growing and is becoming broader-based. The table below shows the changes that have occurred in 1965–66, 1966–67 (estimated) and 1967–68 (estimated). Each component of the city's revenue system has grown except "other funds," which in 1965–66 were made up chiefly of borrowed funds.

GROWTH OF NEW YORK CITY'S REVENUE SYSTEM, 1965-66—1967-68

[In millions of dollars]

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Other funds	[1] 330.5	143.7	85.6	−74.1
Total	3,875.3	4,553.9	5,183.5	+33.8

[1] Includes $255,600,000 5-year serial-bond borrowing.

Because the city real estate tax is its largest single source of revenue and the major single provider of coverage for debt service, the growth in taxable real estate valuations assumes special significance. In the fiscal year 1956–57 the full value of taxable real estate was $24.1 billion compared to a value of $44.0 billion in 1966–67. The amount of commercial office space added to Manhattan alone since World War II is greater than that of the rest of the nation put together.

A TALE OF TWO BUDGETS

The present administration has had an opportunity to work on two city budgets, that for the fiscal year beginning July 1, 1966 and that projected for the fiscal year which will begin July 1, 1967.

The 1965–66 budget was prepared by the prior administration. It totalled $3.88 billion. As the new administration took office it was confronted with $66 million in projected over-runs and the heavy millstone of $256 million borrow-now—pay-later five year serial indebtedness incurred to meet current operating expenses.

A job freeze was instituted. It has saved $53 million to date.

A twenty-year practice of financing budget over-runs with emergency budget notes was stopped and such notes were reduced from an all-time high of $68.8 million on June 30, 1965 to $21.0 million on June 30, 1966.

1966–67 Budget

The 1966–67 budget totalled $4.55 billion, up 15%. Its most important features were:

New sources of revenue with good potential for growth along with the economy were adopted, including a personal income tax on residents, an earnings tax on non-residents (commuters), and a series of business net income taxes. The old inequitable business gross receipts tax was rescinded.

Borrow-now—pay-later long term borrowing for current operating purposes was stopped.

For the second year in a row the issuance of emergency budget notes was avoided.

A planned economy program of $76 million was instituted.

Basic streamlining of the city government structure was begun under Mayor's Executive Orders.

A strong program of economic development was begun, with emphasis on building business and employment in New York City.

The Manpower and Career Development Agency was established to develop job-training programs.

1967–68 Budget

The proposed 1967–68 budget totals $5.18 billion, up 12.7 percent.

State and Federal aid increases provide 67 percent of the additional funds required. Normal increases in general fund revenues and real estate taxes plus transfers of unneeded balances in certain accounts provide most of the remaining increases. No new taxes are proposed.

The share of the budget devoted to debt service is down from 13.6 percent in 1966–67 to 12.5 percent in 1967–68. This continues a long-term trend. Debt service in 1956–57 was 16.7 percent.

Important new management techniques being considered in the current budget include:

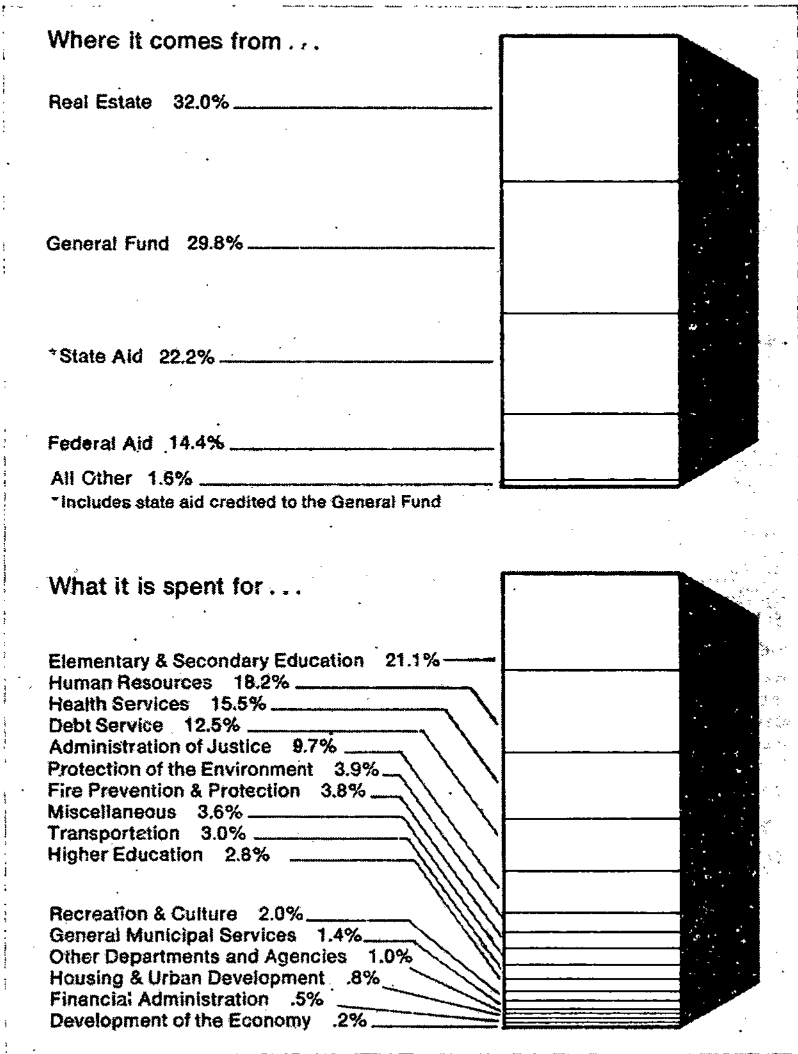
Consolidation of 49 city agencies and departments into a compact set of ten Administrations;

Development of a modern planning-programming-budgeting system and decentralization of budgetary controls;

Consolidation of capital and operating budgets, and expanded long-range planning.

The relative importance of each of the major categories of revenues and expenses in the proposed 1967–68 budget is shown in the following chart.

THE BUDGET DOLLAR



Future newsletters will report fiscal developments as they occur, and examine other basic factors in New York City's fiscal position.

FISCAL NEWSLETTER, THE CITY OF NEW YORK, SEPTEMBER 1967

(From Mayor John V. Lindsay, City Hall, New York, N.Y.)

The New York State Constitution provides the legal keystone of New York City's credit worthiness: Funded debt service will be met by taxes on real estate without limit. Thus, payment of debt service is unaffected by annual budget-balancing problems. Article VIII, Section 2 of the New York State Constitution requires that if the annual appropriation for debt service is not made by City authorities then they must set aside "a sufficient sum from the first revenues thereafter received" for such purposes.

A SATISFACTORY CONCLUSION TO THE 1966–1967 BUDGET STORY

When in June, 1966, the city concluded its fiscal year without invading its rainy day reserves or continuing the long standing practice of issuing budget notes to cover unforeseen expenses, observers wondered whether all this was a "flash in the pan". The answer came on June 28, 1967 when the mayor and the comptroller announced that, for the second consecutive year, the city's expense budget would be balanced without using reserve funds or issuing budget notes. This was achieved by savings of $29 million through the city's vacancy freeze program and other economies, and $12 million from increased State and Federal funds.

The city faces difficult problems in continuing the same record during the current fiscal year which began July 1. Collective bargaining settlements will create substantial budgetary overruns and the State lottery is expected to fall $35 million below the budgeted estimate of $55 million.

A fiscal plan has been developed to increase forced saving by city agencies and to seek increased State and Federal aid. Barring presently unforeseen emergencies, the city has a fighting chance under this plan to balance the 1967–68 budget without issuing emergency budget notes or invading reserves.

STABILIZATION RESERVE FUND BUILD-UP

Cash in the Tax Appropriation and General Fund Stabilization Reserve Fund was increased during the past two years from $154 thousand to $80 million. This fund was created to provide for emergencies arising from shortfalls in General Fund revenues, and to provide reserves which can be employed to minimize the need for borrowing in anticipation of real estate and other taxes.

The following table shows the cash balances in the Stabilization Fund over the past six years:

Stabilization fund cash balance as of June 30

	Millions
1962	$66.7
1963	74.2
1964	9.0
1965	.2
1966	25.4
1967 (July 1)	80.0

Current available cash in the fund almost equals the highest amount in the history of the fund, which was $84.1 million as of June 30, 1960.

APPLYING THE ECONOMY BRAKES

Governmental economy in a city as large at New York is not an easy job. The momentum built into its expenditure structure can be reversed only with real determination. The savings realized to date by the present Administration since it took office on January 1, 1966 are as follows:

	1966–67 and 1967–68 (millions)
Vacancy freeze	$65.0
Positions eliminated	15.0
Lower salaries in existing positions	18.3
Increased accruals and savings through program reorientation; reduced absenteeism; improved methods; reduction of work groups—public works, water supply, gas and electricity, etc	36.8

	1966–67 and 1967–68—Con. (*millions*)
Savings in lump-sum appropriations provided for new and expanded programs	$38.1
Total Savings	173.2

These savings were substantially greater than economies in the city's five preceding budgets.

THE CITY'S NEW TAX PROGRAM IS LAUNCHED

On July 1, 1966, the State legislature passed a new tax package for New York City. This included a resident income tax, a commuter earnings tax, a new general corporation tax based on business net income instead of gross receipts, an unincorporated business tax, a financial tax, an insurance tax, and a transportation tax. Although the city urged the State to administer these new levies since they were largely patterned on existing State taxes, the legislature gave the responsibility to the city, at least for the time being.

The new taxes were originally estimated to yield $440 million for the General Fund. Receipts, at approximately $408 million including revenue anticipation notes, fell short of estimates by about $32 million. Refunds of $15.5 million were made, and an additional $12 million reserve was established for anticipated refunds to be made in the current fiscal year.

The breakdown of 1966–67 receipts and 1967–68 estimates is as follows:

	1966–67 [1]			
	Cash receipts	Revenue anticipation	Total	Total, 1967–68 [2]
Personal income, commuter earnings, and unincorporated business tax	$153	$10	$163	$201
General corporation and financial corporation	197	35	232	227
Insurance	12	0	12	12
Transportation	1	0	1	1
Total	363	45	408	441

[1] Exclusive of credits from rescinded gross receipts tax. Revenue anticipation notes were issued for accrued payments for 1966–67 which were collected after the close of the fiscal year on June 30.
[2] Estimate.

The 1966-67 cash collections were abnormally low because of the existence of credits issued to taxpayers when the old gross receipts tax was rescinded. Cash receipts for 1967-68 are expected to be substantially above 1966-67 because most of these credits have been submitted with 1966-67 returns.

NEW YORK CITY'S DEBT PICTURE

For the bondholder, the changing picture of New York City's debt shown in Table 1 is of special interest.

Long-Term Debt

The increase of $8 million in the net funded debt during the fiscal year 1966-67 is the smallest since 1960-61.

Despite the fact that there has been an increase of $100 million in Bond Anticipation Notes (to be funded into Limited Profit Housing Bonds), the total increase of $108 million in bonds issued or to-be-issued is the smallest in the last six years.

This small increase is attributable in part to the current high level of bond redemptions under a policy inaugurated by previous city administrations of issuing bonds for a much shorter term than the probable life of the assets. *During the last fiscal year, approximately $438 million of funded debt (including $5 million in capital notes) were redeemed.*

Temporary Debt

The administration is not satisfied with the size of the total temporary debt which stood at $260 million at the end of fiscal 1966-67. However, it should be pointed out that this figure is not as bad as it would appear.

First, tax anticipation notes issued in anticipation of real estate tax collections increased approximately $36 million from $100 to $136 million, as a result of a rise in real estate tax delinquencies from 3.8 percent to 5.2 percent.

Collections of real estate tax arrears for the first 11 weeks of 1967-68, however, have been excellent. Over $17.7 million of 1966-67 tax arrears have been collected,

more than double the $8.8 million collected against 1965-66 tax arrears in the same period last year.*

Second, revenue anticipation notes (borrowings in anticipation of revenues other than real estate taxes) rose by approximately $49 million, (up from $45 million in 1966 to $94 million in 1967). A part of this increase was caused by the fact that corporate income tax payments for the second quarter of the calendar year 1967 were not due until July 15, 1967, after the end of the city's fiscal year. Under the old gross receipts tax, these payments were due May 15th. The city could have collected its business tax before June 30th but this would have been out of phase with State collection dates and would have imposed a great hardship on businesses.

Recently, steps have been taken to reduce the amount of revenue anticipation notes outstanding. As of July 31, 1967, the amount of revenue anticipation notes still outstanding was reduced to $38 million, or $7 million less than on July 31, 1966.

TABLE 1.—NEW YORK CITY DEBT (AS OF JUNE 30)

[In millions of dollars]

	1961	1962	1963	1964	1965	1966	1967
Funded debt:							
Gross funded debt	4,170	4,301	4,428	4,539	4,704	5,019	5,070
Less cash and investments of sinking fund	828	810	808	784	785	773	[1] 816
Net funded debt	3,342	3,491	3,620	3,755	3,920	4,246	4,254
To be funded: Bond anticipation notes	52	66	114	143	226	275	375
Total debt funded, and to be funded	3,394	3,557	3,734	3,898	4,146	4,521	4,629
Temporary debt:							
Tax anticipation notes	43	52	63	77	89	100	136
Revenue anticipation notes	------	------	------	40	119	45	94
Budget notes	5	10	34	44	69	21	------
Urban renewal notes	------	------	20	11	24	26	30
Total temporary debt	48	62	117	172	300	192	260
Grand total—Net funded, to be funded, and temporary debt	3,442	3,619	3,851	4,070	4,446	4,713	4,889
Increase over previous year	------	177	232	219	376	267	176

[1] Does not include $5,333,000 accrued interest due, which if applied would reduce net debt by a like amount.

Additional favorable factors which partly offset the year-end increases in temporary debt noted above are the elimination of $21 million in budget notes outstanding and a growth in reserves. (Both commented upon in detail above.)

The total of all forms of debt shows only a moderate increase for 1967, at a rate below the increases in total debt in each of the five previous years. Viewed in this light, and considering the increase in reserves during the last few years, *it may be said that New York City's debt picture has improved.*

RECENT NEW YORK CITY BOND SALES

Table 2 reveals the interest rates the city has paid on its bond sales since January 1, 1966 and the gradual improvement that has been effected in recent months both in absolute terms and in relation to the Bond Buyer 20 Bond Index. The relatively high interest rates the city has paid are attributable to a number of factors, some temporary and some more lasting.

The large supply of bonds offered by the city is a major determinant of its interest rate. During 1966, approximately $11 billion of bonds were issued by all

*The tax anticipation notes now outstanding are against taxes which have been in arrears only a comparatively short time. Of the $136 million of New York City tax anticipation notes outstanding, $80 million were issued against taxes delinquent less than one year and an additional $25 million against delinquent less than two years. Provision is made in the current budget for redemption of an additional $15 million of tax anticipation notes. This can be used to redeem all tax anticipation notes issued to date for the years prior to 1964–65.

Steps to further improve collections of arrears are now being taken. For the first time, taxpayers will be separately billed for taxes in arrears. Current tax bills are being sent out earlier, and this should also improve future tax collections.

States and their political subdivisions, of which New York City sold over $731 million.

The tightness of money, which reached a critical stage in August, 1966, also affected the city's interest rates. As credit restraint was eased early in 1967 and the city evidenced its determination to live within its means (higher taxes, transit fare increase, doubling of water frontage rates, and stringent economies), the differential between the Bond Buyer Index and the city's average rate has lessened, and for the most recent sale stands at 45 basis points.

New York City bond holders enjoy extraordinary protection under the State Constitution, which requires application of first revenues received to payment of debt service. (See masthead statement on page 1.)

TABLE 2.—NEW YORK CITY BOND SALES JANUARY 1966–JULY 1967

Date	Amount	Net interest cost, percent	Bond buyer 20-bond index, percent	Difference net cost to index, percent
Jan. 27, 1966	$253,240	4.18	3.51	0.67
Apr. 28, 1966	241,755	4.24	3.62	.62
July 26, 1966	112,925	4.65	3.96	.69
Oct. 25, 1966	123,330	4.76	3.83	.93
Jan. 19, 1967	114,050	3.91	3.40	.51
Apr. 18, 1967	104,765	3.98	3.54	.44
July 13, 1967	102,030	4.52	4.07	.45

NOTE.—This does not include the sale on June 6, 1967, of $28,890,000 housing bonds maturing in 1 to 50 years, because this was an atypical issue whose long average life is not comparable with the issues listed here.

EDUCATION

ELEMENTARY SCHOOLS (K–6) (K–8)

1. Estimated population of appropriate age.
2. Enrollment.
3. Number of available classrooms.
4. Number of classroom teachers.
5. Number of principals, supervisors, guidance personnel, and others assigned to a specific school, but not meeting classes.
6. Number of superintendents, business managers, secretarial and clerical personnel, and others not assigned to a specific school.
7. Number of custodial and maintenance personnel.
8. Number of other employees (please specify function, if possible).
9. Income from property taxes.
10. Income received from the State.
11. Income received from the Federal government.
12. Income received from fees and charges.
13. Income received from other sources.
14. Long term borrowing.
15. Teachers' salaries (as in line 4).
16. Supervisors' salaries (as in line 5).
17. Administrative salaries (as in line 6).
18. Custodial and maintenance salaries (as in line 7).
19. Other salaries (as in line 8).
20. Expenditures for textbooks and education materials.
21. Expenditures for plant maintenance and operation (excluding line 18).
22. Expenditures for transportation (excluding any salaries in line 19).
23. Your contributions to pension funds.
24. Capital outlay (excluding long term borrowing).
25. Interest on debt.
26. Long term debt retired.
27. Other expenses (please specify, if possible).

SECONDARY SCHOOLS (7–12) (9–12)

28. Estimated population of appropriate age.
29. Enrollment.
30. Number of available classrooms.
31. Number of classroom teachers.
32. Number of principals, supervisors, guidance personnel, and others assigned to a specific school, but not meeting classes.
33. Number of superintendents, business managers, secretarial and clerical personnel, and others not assigned to a specific school.
34. Number of custodial and maintenance personnel.
35. Number of other employees (please specify function, if possible).
36. Income from property taxes (if separate from line 9).
37. Income received from the State (if separate from line 10).
38. Income received from the Federal government (if separate from line 11).
39. Income received from fees and charges (if separate from line 12).
40. Income received from other sources (if separate from line 13).
41. Long term borrowing (if separate from line 14).
42. Teachers' salaries (as in line 31).
43. Supervisors' salaries (as in line 32).
44. Administrative salaries (as in line 33).
45. Custodial and maintenance salaries (as in line 34).
46. Other Salaries (as in line 35).
47. Expenditures for textbooks and educational materials.
48. Expenditures for plant maintenance and operation (excluding line 45).
49. Expenditures for transportation (excluding any salaries in line 46).
50. Your contributions to pension funds.
51. Capital outlay (excluding long term borrowing).
52. Interest on debt.
53. Long term debt retired.
54. Other expenses (specify, if possible).

HIGHER EDUCATION

55. Enrollment in two-year colleges.
56. Enrollment in four-year colleges.
57. Enrolled for graduate studies.
58. Number of professors and instructors.
59. Number of supervisory and administrative personnel.
60. Number of other employees (specify function, if possible).
61. Income from property taxes.
62. Income received from the State.
63. Income received for the Federal government.
64. Income received from fees, charges, etc.
65. Income received from other sources.
66. Long term borrowing.
67. Salaries of professors and instructors (as in line 58).
68. Salaries of supervisory and administrative personnel (as in line 59).
69. Salaries of other employees (as in line 60).
70. Expenditures for plant maintenance and operation (excluding salaries in line 69).
71. Your contributions to pension funds.
72. Capital outlay (excluding long term borrowing).
73. Interest on debt.
74. Long term debt retired.
75. Other expenses (specify, if possible).

OTHER EDUCATION

76. Enrolled in schools for the handicapped.
77. Enrolled in special or vocational schools not covered above.
78. Enrolled in adult education classes.
79. Number of classroom teachers.
80. Number of supervisory and administrative personnel.
81. Number of other employees (specify function, if possible).
82. Income from property taxes (if not included above).
83. Income received from the State.
84. Income received from the Federal government.
85. Income received from fees, charges, etc.

86. Income received from other sources.
87. Long term borrowing.
88. Teachers' salaries (as in line 79).
89. Supervisory and administrative salaries (as in line 80).
90. Other salaries (as in line 81).
91. Expenditures for textbooks and educational materials.
92. Expenditures for plant maintenance and operation (excluding line 90).
93. Expenditures for transportation (excluding line 90).
94. Your contributions to pension funds.
95. Capital outlay (excluding long term borrowing).
96. Interest on debt.
97. Long term debt retired.
98. Other expenses (please specify, if possible).

HIGHWAYS

99. Miles of city streets maintained.
100. Miles of expressways maintained.
101. Number of employees.
102. Income from property taxes.
103. Income from motor fuel taxes.
104. Income from excise taxes or licenses.
105. Other highway income from local tax sources.
106. Income received from the State.
107. Income received from the Federal Government.
108. Income received from fees, charges, etc.
109. Other income (please specify, if possible).
110. Long term borrowing.
111. Cost of maintenance by own forces (excluding salaries & wages).
112. Cost of contract maintenance.
113. Salaries & wages (as in line 101).
114. Snow removal costs (excluding line 113).
115. Your contributions to pension funds.
116. Capital outlay (excluding long term borrowing).
117. Interest on debt.
118. Long term debt retired.
119. Other highway expenses (please specify, if possible).

SANITARY SEWERAGE

120. Miles of laterals and mains maintained.
121. Depreciated value of treatment plants..
122. Number of employees.
123. Income from property taxes.
124. Income received from assessments or sewer charges.
125. Income received from the State.
126. Income received from the Federal Government.
127. Income received from other governmental units.
128. Other sanitary sewerage income (please specify, if possible).
129. Salaries & wages (as in line 122).
130. Your contributions to pension funds.
131. Cost of maintaining the collection system (excluding line 129).
132. Cost of operating and maintaining treatment plant (excluding line 129).
133. Capital outlay (excluding long term borrowing).
134. Long term borrowing.
135. Interest on debt.
136. Long term debt retired.
137. Other sanitary sewerage expenses (please specify, if possible).

STORM DRAINAGE

138. Miles of mains maintained.
139. Depreciated value of flood control works, etc.
140. Number of employees.
141. Income from property taxes.
142. Income received from assessments or charges.
143. Income received from the State.
144. Income received from the Federal Government.

145. Income received from other governmental units.
146. Other storm drainage income (please specify, if possible).
147. Salaries and wages (as in line 140).
148. Operation and maintenance costs (excluding line 147).
149. Capital outlay (excluding long term borrowing).
150. Long term borrowing.
151. Interest on debt.
152. Long term debt retired.
153. Your contributions to pension funds.
154. Other expenses (please specify, if possible).

OTHER SANITATION

155. Average pickups per week.
156. Depreciated value of equipment.
157. Number of employees.
158. Income from property taxes.
159. Income received from other governmental units.
160. Income received from fees or charges.
161. Other income (please specify, if possible).
162. Salaries and wages (as in line 157).
163. Operation and maintenance costs (excluding line 162).
164. Capital outlay (excluding long term borrowing).
165. Long term borrowing.
166. Interest on debt.
167. Long term debt retired.
168. Your contributions to pension funds.
169. Other expenses (please specify, if possible).

WATER

170. Number of retail water customers.
171. Number of wholesale customers, including other systems.
172. Storage capacity.
173. Maximum daily treatment capability.
174. Peak daily demand.
175. Average daily demand.
176. Income received from fees and charges (retail).
177. Income received from wholesale customers.
178. Income received from other governmental units.
179. Income received from property taxes.
180. Other water income (please specify, if possible).
181. Number of employees.
182. Salaries and wages (as in line 181).
183. Operation and maintenance cost (excluding line 182).
184. Capital outlay (excluding long term borrowing).
185. Long term borrowing.
186. Interest on debt.
187. Long term debt retired.
188. Your contributions to pension funds.
189. Other water expenses (please specify, if possible).

TRANSPORTATION

190. Miles of bus lines operated.
191. Miles of trolleys or trolley buses operated.
192. Miles of subway or elevated line operated.
193. Total passengers carried in year.
194. Depreciated value of rolling stock.
195. Income from fares.
196. Income from property taxes.
197. Income received from other governmental units.
198. Other income (please specify, if possible).
199. Number of employees.
200. Salaries and wages (as in line 199).
201. Operation and maintenance costs (excluding line 200).
202. Capital outlay (excluding long term borrowing).
203. Long term borrowing.

204. Interest on debt.
205. Long term debt retired.
206. Your contributions to pension funds.
207. Other transportation expenses (please specify, if possible).

HEALTH AND HOSPITALS

208. Beds in own hospitals.
209. Beds in other hospitals to which you contribute.
210. Average daily occupancy of own hospitals.
211. Licensed personnel in own hospitals.
212. Other employees in own hospitals.
213. Income received from fees and charges.
214. Income received from property taxes.
215. Income received from the State.
216. Income received from the Federal Government.
217. Other income (please specify, if possible).
218. Salaries of licensed personnel (as in line 211).
219. Salaries and wages of other employees (as in line 212).
220. Operation and maintenance of own hospitals (excluding lines 218 and 219).
221. Contributions to other hospitals.
222. Cost of inspections and other health services.
223. Capital outlay (excluding long term borrowing).
224. Long term borrowing.
225. Interest on debt.
226. Long term debt retired.
227. Your contributions to pension funds.
228. Other health and hospital expenses (please specify, if possible).

PUBLIC WELFARE

229. Number of welfare recipients.
230. Resident requirements.
231. Number of case workers and other employees.
232. Income received from property taxes.
233. Income received from the State.
234. Income received from the Federal government.
235. Other income (please specify, if possible).
236. Salaries and wages (as in line 231).
237. Other costs (excluding line 236).
238. Cash payments to welfare recipients.
239. Payments to vendors.
240. "War on Poverty".
241. Your contributions to pension funds.
242. Other welfare expenditures (please specify, if possible).
243. Contributions to charitable institutions.

PROTECTION

244. Number of policemen.
245. Number of civilian police employees.
246. Number of crimes reported (please specify, if possible).
247. Number of arrests made.
248. Depreciated value of police stations and equipment.
249. Police salaries and wages (as in line 244).
250. Other police salaries (as in line 245).
251. Other police costs (please specify, if possible).
253. Number of firemen.
254. Number of civilian fire employees.
255. Number of fire alarms answered.
256. Fire losses.
257. Depreciated value of fire stations and equipment.
258. Fire department salaries and wages (as in line 253).
259. Other fire department salaries (as in line 254).
260. Your contributions to fire pension funds.
261. Other fire department costs (please specify, if possible).

CORRECTION

262. Population of prisons.
263. Population of asylums.
264. Population of other correctional institutions.
265. Number of prison personnel.
266. Number of asylum personnel.
267. Number of other correctional personnel.
268. Income from property taxes.
269. Income received from the State.
270. Income received from the Federal government.
271. Other income (please specify, if possible).
272. Salaries & wages of prison personnel (as in line 265).
273. Operating & maintenance costs of prisons (excluding line 272).
274. Salaries & wages of asylum personnel (as in line 266).
275. Operating & maintenance costs of asylums (excluding line 274).
276. Salaries & wages of other correctional personnel (as in line 267).
277. Other correctional operating costs (excluding line 276).
278. Capital outlay (excluding long term borrowing).
279. Long term borrowing.
280. Interest on debt.
281. Long term debt retired.
282. Your contributions to pension funds.
283. Other expenses (please specify, if possible).

HOUSING AND URBAN RENEWAL

284. Number of public housing units maintained.
285. Average number of rooms.
286. Average rent.
287. Vacancy rate.
288. Depreciated value of buildings.
289. Income received from rents.
290. Income received from City government in cash.
291. Income received from the City government in tax abatements, etc.
292. Income received from the State.
293. Income received from the Federal government.
294. Housing receipts other than above.
295. Number of housing police and other employees.
296. Salaries & wages (as in line 295).
297. Other operating & maintenance costs (excluding depreciation & line 296).
298. Capital outlay (excluding long term debt).
299. Long term borrowing.
300. Interest on debt.
301. Long term debt retired.
302. Your contribution to pension funds.
303. Other housing expenses (please specify, if possible).
304. Number of acres involved in urban renewal projects.
305. Value removed from tax rolls in year.
306. Value added to tax rolls in year.
307. Income from property taxes.
308. Income received from the State.
309. Income received from the Federal government.
310. Other receipts, including sales and rentals.
311. Number of urban renewal employees.
312. Salaries & wages (as in line 311).
313. Cost of property acquired.
314. Other capital outlays (excluding long term borrowing).
315. Long term borrowing.
316. Interest on long term debt.
317. Long term debt retired.
318. Other urban renewal expenditures (please specify, if possible).
319. Your contribution to urban renewal employees pension funds.

PARKS AND RECREATION

320. Number of acres of parks maintained.
321. Number of acres of playgrounds maintained.
322. Value of other recreational facilities.

323. Number of park and recreation employees.
324. Income from property taxes.
325. Income received from fees and charges.
326. Income received from the State.
327. Income received from the Federal government.
328. Other park & recreation income (please specify, if possible).
329. Salaries & wages (as in line 323).
330. Operation & maintenance costs (excluding line 329).
331. Capital outlay (excluding long term borrowing).
332. Long term borrowing.
333. Interest on debt.
334. Long term debt retired.
335. Your contributions to pension funds.
336. Other park and recreation expenses (please specify, if possible).

LIBRARIES

337. Number of libraries maintained.
338. Total number of volumes.
339. Number of library employees.
340. Income from property taxes.
341. Income received from fees and charges.
342. Income received from the State.
343. Income received from the Federal government.
344. Other library income (please specify, if possible).
345. Salaries & wages (as in line 339).
346. Operation & maintenance costs (excluding line 345).
347. Capital outlay (excluding long term borrowing).
348. Long term borrowing.
349. Interest on debt.
350. Long term debt retired.
351. Your contributions to pension funds.
352. Other library expenses (please specify, if possible).

UTILITIES OTHER THAN WATER, SEWER AND TRANSPORTATION

353. Services provided.
354. Number of employees.
355. Income from property taxes.
356. Income received from rates and charges.
357. Other income (please specify, if possible).
358. Salaries & wages (as in line 354).
359. Operation & maintenance costs (excluding line 358).
360. Capital outlay (excluding long term borrowing).
361. Long term borrowing.
362. Interest on debt.
363. Long term debt retired.
364. Your contributions to pension funds.
365. Other utility expenses (please specify, if possible).

PARKING

366. Number of on-street parking meters.
367. Number of off-street parking spaces maintained.
368. Parking income from rates and charges.
369. Other parking income (please specify, if possible).
370. Number of employees.
371. Salaries & wages (as in line 370).
372. Operation & maintenance costs (excluding line 371).
373. Capital outlay (excluding long term borrowing).
374. Long term borrowing.
375. Interest on debt.
376. Long term debt retired.
377. Your contributions to pension funds.
378. Other parking expenses (please specify, if possible).

AIRPORT

379. Number of airports maintained.
380. Number of airplane arrivals and departures.
381. Number of passengers enplaned.
382. Income from property taxes.
383. Income received from fees and charges.
384. Income received from the State.
385. Income received from the Federal government.
386. Other airport income (please specify, if possible).
387. Number of employees.
388. Salaries & wages (as in line 387).
389. Operation & maintenance costs (excluding line 388).
390. Capital outlay (excluding long term borrowing).
391. Long term borrowing.
392. Interest on debt.
393. Long term debt retired.
394. Your contributions to pension funds.
395. Other airport expenses (please specify, if possible).

GENERAL

396. Number of employees not elsewhere listed.
397. Assessed valuation of real property.
398. Ratio of assessed to market value.
399. Property tax rated per $1,000.
400. Assessed value of other taxable property.
401. Tax rate or rates.
402. Gross bonded debt payable from full faith and credit (year-end).
403. Debt included above payable from revenues, if earned.
404. Sinking funds applicable to line 402.
405. Sinking funds applicable to line 403.
406. Debt payable solely from revenues.
407. Guaranteed debt.
408. Income received from property taxes.
409. Income received from income taxes.
410. Income received from general sales taxes.
411. Income received from other taxes (please specify, if possible).
412. Income received from the State.
413. Income received from the Federal government.
414. Income received from fees and charges.
415. All other receipts (please specify, if possible).
416. Salaries & wages (as in line 396).
417. Expenditures not elsewhere listed (excluding capital outlay and debt service).
418. Capital outlay not elsewhere listed (excluding long term borrowing).
419. Long term borrowing not elsewhere listed.
420. Interest on debt not elsewhere listed.
421. Long term debt retired not elsewhere listed.
422. Pension fund contributions not elsewhere listed or that could not be segregated under preceding heads.
423. Other expenditures (please specify, if possible).
424. Total cash receipts (excluding borrowing).
425. Total borrowing.
426. Total cash expenditures (excluding debt retirement).
427. Total debt retirement.

A QUICK HISTORY OF INDUSTRIAL AID FINANCING

The device was originated in Mississippi during the 1930's and was soon adopted by several other Southern States. Early financing for industrial purposes was usually backed by the general credit or full faith of the issuing municipality. Total volume was insignificant until the mid-50's.

Now, industrial aid financing is authorized by 40 States. New York and California have been the leading nonconformists; but the New York State constitution proposed for popular vote on November 7 contains enabling clauses. Legisla-

tion is also in process for the States of Massachusetts and Texas, and has been introduced in Florida.

It is estimated by the Investment Bankers Association staff, that a total of more than $2 billion industrial aid bonds is now outstanding, after retirement of earlier serial maturities.

To illustrate the nature of recent actual and proposed issues, they are detailed on the attached list.

Annual amounts of recorded issues[1]

Year	Amount
Prior to 1956	$41,860,000
1956	1,521,000
1957	7,332,000
1958	25,051,000
1959	28,006,000
1960	41,171,000
1961	71,771,000
1962	84,417,000
1963	133,485,000
1964	192,337,000
1965	211,931,000
1966	500,153,000
1967 (to Oct. 15)	700,000,000
Total 1965–67	2,039,035,000

[1] Does not include private placements, which may have amounted to several hundred million dollars.

Historically, industrial aid borrowing has been done most frequently in the following States: Mississippi, Alabama, Kentucky, Tennessee, Arkansas.

And the largest volume of such financing has been originated in Kentucky, Alabama, Iowa, Arkansas, Ohio, Michigan, Arizona, Louisiana, Delaware, West Virginia, Missouri, Kansas.

TAX EXEMPT CORPORATE BONDS, A THREAT TO THE MUNICIPAL BOND MARKET

Industrial revenue financing—the sale of tax exempt municipal obligations for the benefit of private profit corporations—has seriously impaired the functioning of the municipal bond market in 1967. The added volume and high interest rates of these hybrid bonds threaten the ability of many municipalities to borrow for schools, hospitals, roads, and other long accepted public benefit purposes.

The proceeds of industrial revenue bonds are used to build a plant to the specifications of the private corporation which leases it under a long-term contract, with the rental payments pledged to amortize and pay interest on the bonds.

This device is so advantageous to the contracting corporation that it could well afford to pay as high an interest rate as it would on direct taxable borrowing. The investment credit and depreciation credits flow to the leasing corporation, which borrows 100 percent of the cost of plant construction without showing debt on its own balance sheet or affecting its equity capital ratio.

The tax exemption of interest on state and local debt is a keystone in our dual or Federal system of government. It has enabled states and municipalities to borrow at interest costs well below those of the Federal Government. If this advantage is lost through excessive abuse of tax exemption, local government will be tempted to surrender tax exemption in exchange for guaranties or subsidies by the Federal Government, which would tend to bypass existing state control.

On the part of industry, reliance upon state and municipal financing of manufacture and trade is a betrayal of the free enterprise system, a step toward encouraging public ownership. At the very least, competing producers who pay taxes and borrow on their own credit are disadvantaged by the exemptions granted to their competitors.

As more and more states and municipalities offer tax exemption to attract or hold industry, the practice will be self-defeating—but not until great damage has been done to the independence of local government and to taxpayers at all

levels. The abuse of tax exemption must be compensated by greater burdens upon those who do not obtain a selfish gain.

Already, forty states have adopted legislation authorizing industrial revenue bond issues. The practice has spread, and the volume has burgeoned, just within the past two years.

From the beginning in Mississippi in the 1930's, until 1956 only $42 million of industrial financing was recorded. In 1964 and 1965, the annual totals approxi- ~~mated $200 million, in 1966, it jumped to $500 million; 1967 promises to produce~~ well over $1 billion. Until 1964, the contracting corporations were usually of local rather than national stature. But within the past three years, companies of national stature, including some blue-chips, have participated. Their names, plus tax exemption, have for the investor greater attraction than the credits of thousands of small municipalities or even of the problem-racked big cities, which must compete for the investor's dollar. And an addition of $2 billion of industrial revenue issues to the calendar for 1968—easily possible if the trend is not checked—would mean a 30 percent increase in the recent rate of annual growth in tax exempt bonds outstanding. This can be accomplished only at sharply higher relative interest rate levels.

What can be done to save the situation? State governments have supinely surrendered, pleading the need to maintain competitive power. A few state legislatures, while enacting the authorizations, have recorded the pious hope that the Congress will stop the abuses by rescinding tax exemption—but of course, only for this one category of local debt. Businessmen have deplored the trend toward government ownership, but are accepting the tax advantages. Investment bankers in IBA conventions assembled, since 1950 have decried industrial revenue financing—but many important member firms have managed or participated in major offerings of these bonds.

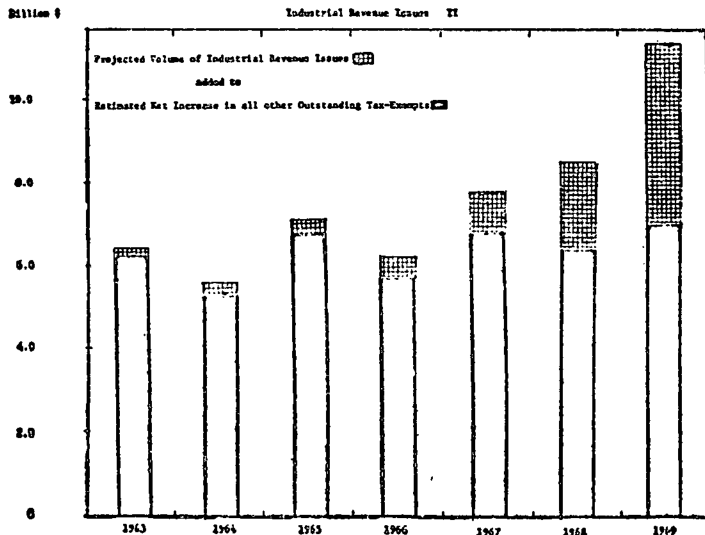
It appears that the only hope is Congressional action to negate the tax advantages. Preferably, this would take the form of denying to corporations the deductibility of lease-rental payments which support tax exempt debt. This route would be by far the more acceptable to those who hold that exemption of local debt derives from sovereigntyof the states as preserved by our national Constitution. It probably would have a far better chance of quick adoption by Congress.

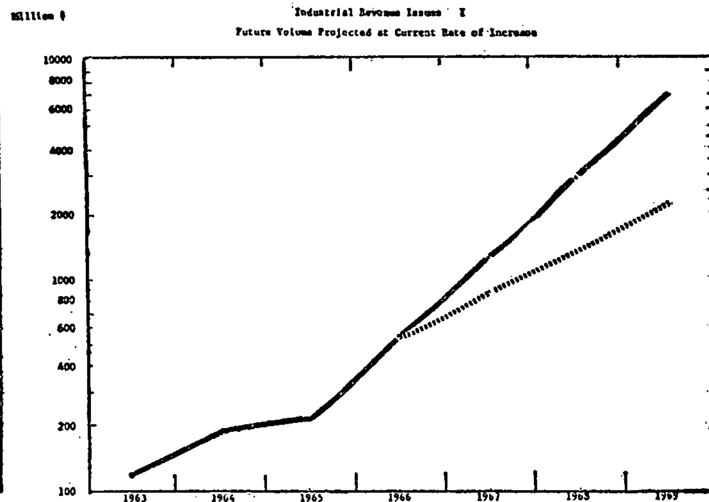
But the Treasury insists upon a withholding of tax exemption from industrai bonds, by amendment of the Internal Revenue statutes. A bill to this purpose has been introduced by Representative John W. Byrnes, with more than twenty co-sponsors.

The Investment Bankers Association supports this bill, on the ground that the threat to state and local financing from an overwhelming volume of new supply is a much more immediate danger than the possibility of litigation on the Constitutional principle.

Discussion by the Business Council should at least improve understanding of the issues at the highest levels of business management; and the council's endorsement of Congressional action might hasten its timing enough to save the beleaguered municipal bond market from complete collapse. There could be extremely serious consequences from the disruption of a market which annually provides $11–13 billion gross, or $6–8 billion net of capital to the public sector of the economy.

Friday, June 23, 1967 THE DAILY BOND BUYER 13 1409





These charts show John F. Thompson's projections of the increase of municipal financing through anticipated sales of industrial aid bonds. In a speech yesterday before the Municipal Forum of New York, Mr. Thompson assailed the Forum's resolution in opposition to any attempt to terminate the exemption from Federal taxation of any bonds and other obligations issued to the states and local government, or the interest received therefrom, by any unilateral action of the Congress or by any department or bureau of the Federal Government. The Forum membership overwhelmingly approved the resolution.

Industrial Aid Bond Debate Renewed at Municipal Forum

(By Robert B. Plante)

It was man against movement at the Municipal Forum of New York yesterday at which a lonely position was defended valiantly but in vain against a steamroller determination to brook no Federal Government interference with the sovereign rights of states and their political subdivisions to issue tax-exempt bonds for any self-designated public purpose.

It all began unspectacularly enough a couple of weeks ago when Eugene Crowley of Lehman Brothers, outgoing Forum president, announced overwhelmingly membership support of a Forum resolution opposing "any attempt to terminate the exemption from Federal taxation of any bonds and other obligations issued by the states and local governments, or the interest received therefrom, by any unilateral action of Congress or by any department of the Federal Government."

The resolution, which had been submitted to the membership by mail, several weeks ago in solicitation of member support, was drafted in response to proposed legislation that would amend the Internal Revenue Code of 1954 in a way that would redefine industrial revenue bonds as something other than valid state and municipal obligations, thus effectively terminating their right to tax exemption.

OVERWHELMING SUPPORT

The results of the poll, as reported by Mr. Crowley, showed that more than 50 percent of the membership's 665 members replied to the question, with 314 supporting the Forum resolution and only 55 in opposition to it.

John F. Thompson, of Scudder, Stevens & Clark, investment counselors, whose opposition to the Forum resolution had been made amply clear in a letter to all members earlier this month, followed Mr. Crowley's announcement with a sharply worded denunciation of the Forum's position and with a motion to conduct meetings in the fall "for the full discussion and debate of this issue after drafts of the proposed legislation are available."

RESOLUTION RAPPED

Terming the resolution a result of "bad history, bad political theory, and very doubtful constitutional law," Mr. Thompson asserted that the primary threat to tax-exemption was financial, not legal. He said that the increasing volume of State and local government bonds through sales of tax-exempts issued for subsidization of private industry would put up the cost of borrowing on all state and local financing to the detriment of every political subdivision.

"I do not propose to sit idly by," Mr. Thompson said, "watching things happen which will unfairly jeopardize the value of hundreds of millions of dollars in tax-exempt bonds which we have recommended to our clients. * * * A lowering of tax rates was one risk. The ebb and flow of commercial banks' appetite has been another. * * * But now we are faced with this mass entry of corporate financing into our market, and perhaps arbitrage with all its damages on top of that. And I say to the investor in tax-exempt bonds that this is a far worse threat. Outstanding and new issues will suffer alike. * * * This is the worst threat that investors in tax-exempts have ever suffered."

REBUTS THOMPSON

In rebuttal of Mr. Thompson's position. Robert R. Maller of the United States Trust Co.. incoming vice president of the Municipal Forum, stated that a large volume of municipal sales was not a sufficient reason for permitting the right of tax-exemption to be arbitrarily terminated. and argued that any future

increase in the volue of tax-exempts may result in the denial of tax privilege for water or sewer obligations or bonds for other valid public purpose.

John F. Dawson of Wood, King, Dawson & Logan argued that which he and his law firm were completely opposed to the principle of public subsidy of private industry through the instrumentality of tax-free financing, he was nevertheless committed to the doctrine of constitutional immunity.

The meeting ended with an agreement to resummit the question to the membership in the fall, after legislation to end tax-exemption for industrial bonds has been introduced in Congress.

[From the Wall Street Journal, Dec. 4, 1967]

Industrial Revenue Bond Sales Proliferate; 1967 Total Is Put at $1 Billion, Double 1966's; Tax-Exempts at Issue

A few years ago, the prospect of a hamlet like Wickliffe, Ky., floating an $80 million bond issue would have struck financial circles a preposterous.

When Wickliffe did indeed sell such an issue last summer, however, not an eyebrow was raised, least of all among Wickliffe's 900 residents.

The reason? The issue was composed of tax-exempt industrial revenue bonds, an increasingly popular instrument of finance for communities desiring to attract new industry and for industries trying to avoid the relatively high interest costs of conventional corporate debt securities. Its estimated that nearly 40 states now permit the issuance of such bonds, double the number in 1960 and up from only three in 1956. The holdouts include New York, New Jersey, Pennsylvania, Connecticut and California.

In Wickliffe's case, the $80 million proceeds from the issue are being used to pay for construction of a processing mill that will be occupied by West Virginia Pulp & Paper Co. under a 25-year lease. Rental payments will be sufficient to retire the issue, and West Virginia Pulp & Paper has an option to buy the plant outright after 10 years. The bonds are backed by the company's credit, so that residents of Wickliffe won't have to pay off the debt if the mill proves a flop.

ADVANTAGES ARE NOTED

Sound like a happy arrangement? It is—at least in the judgment of Wickliffe and West Virginia Pulp & Paper. It's estimated the new mill will infuse $20 million annually into the local economy and provide 300 jobs. And because of the tax-exempt status of the bonds, the company's rental payments to the town will be less than if it had to pay off bonds issued through normal channels.

Other companies and municipal authorities are evidently happy with such arrangements as well. About $1 billion of municipal bonds to finance industrial construction will be sold this year, double the amount last year and up from a mere $1.5 million in 1956. Nearly every new tire plant built in the last 5 years in the U.S. has utilized this type of financing.

But industrial revenue bonds, as they are called, are arousing significant opposition in powerful quarters. The Investment Bankers Association at its annual convention in Miami Beach last week warned that such bonds were placing undue strain on the municipal market as a whole, and the AFL–CIO terms industrial revenue bonds a means of "sophisticated plant piracy" used to lure companies away from areas where unions are well entrenched.

Also, a bill in Congress seeks to prevent states and municipal authorities from issuing tax-free bonds for use in financing industry on the ground that tax-exempt issues were originally intended to encourage development of public facilities.

CONGRESS UNLIKELY TO ACT

It's almost certain, however, that no action will be taken by Congress in the near future to curb the growth of industral revenue bonds. Sources in Washington say that such action would probably come only as part of a general tax reform package. The probability that Congress will get around to even considering such a package next year is considered slim, these sources assert.

The Securities and Exchange Commission is pushing ahead with a study of industrial revenue bonds. Manuel Cohen, chairman of the SEC, told the investment bankers convention last week that the commission "in coming weeks will consider taking action in this area." It's expected, however, that such action would be

limited to extending SEC jurisdiction over industrial revenue bonds in such matters as disclosure to bondholders of the companies' financial results; the SEC doesn't have the authority to prevent local authorities from issuing such bonds.

Meanwhile, industrial revenue bond financing continues to grow apace. A survey of investment bankers at the Miami Beach convention showed that $1.2 billion of such bonds were being readied for the market, indicating that next year will see another spectacular rise in community-financed industrial construction.

The pressures to engage in industrial revenue bond financing are well illustrated by a proposed $75 million issue to finance the building of a pulp and fine paper facility for Weyerhaeuser Co. in North Carolina. Bidding on the issue is awaiting a favorable ruling from the state's supreme court on a recently passed law permitting corporations there to benefit from the tax-exempt feature of municipal bonds.

State officials say they are backing the law only as "a matter of self-defense," in the words of Dan E. Stewart, director of North Carolina's Department of Conservation and Development. Since the legislature approved the law, he notes, "five, six or seven companies come down every day to discuss setting up factories."

MORE BANKS ENTER FIELD

In addition, Weyerhaeuser has identified as a potential manager of the financing Morgan Stanley & Co.—one of the most prestigious members of the Investment Bankers Association, which has opposed such bonds as a matter of principle. It would be Morgan-Stanley's first venture into this method of financing.

Several weeks ago, Chase Manhattan Bank, another prominent IBA member, headed a syndicate that purchased $130 million of Mississippi bonds that will be used to build facilities for lease to Ingalls Shipbuilding Co., a subsidiary of Litton Industries Inc. These bonds, however, unlike the general run of revenue issues, will be backed by the "full faith and credit" of the state.

The advantages of industrial revenue bond financing can be substantial for expanding companies, proponents of the system assert. Companies can obtain 100 percent financing in this manner, whereas they invariably are forced to put up some of their own cash when issuing their own debt securities, and companies that lease plants also enjoy certain tax and depreciation benefits.

COST SAVINGS ARE CONSIDERABLE

Most important, however, are the interest cost savings. Consider, for example, the $82.5 million of bonds sold last February by Middletown, Ohio, to finance the building of a steel mill and provide equipment for Armco Steel Corp. as part of the company's $600 million expansion program.

According to the agreement, the facilities were leased to Middletown Growth Inc., a community improvement corporation, which in turn sublet the mill and equipment to Armco on terms sufficient to pay principal and interest on the bonds. The arrangement was "a way of expressing our thanks to Armco for its previous help to our community," says Richard Slagle, executive vice president of the local chamber of commerce.

Middletown obtained a 4.5 percent annual net interest cost in selling its bonds. "The available rate on this type of financing is certainly below what we could have gotten in the competitive market," says an executive of Armco, "probably at least 1 percent lower." Thus, over the life of the issue, Armco stands to save an estimated $8 million in interest charges.

Georgia-Pacific Corp., Portland, Oreg., is a prime user of industrial revenue bonds. Last July, the city of Crossett, Ark., sold $75 million of 25-year bonds at a net interest cost of 5.65 percent to pay for expansion of Georgia-Pacific's paper manufacturing facilities there. Officials are reluctant to pin down the savings resulting from use of the issue, but one concedes that "something like $10 million over the life of the bonds might be a realistic figure."

CONTRIBUTIONS TO COMMUNITIES

In addition, the new facilities won't be subject to certain local taxes, although an official says the company "will be making a substantial contribution in lieu of taxes." This arrangement is fairly typical: Joy Manufacturing Co., for instance, pays an annual gift to the city of Claremont, N.H., in lieu of taxes on a plant financed through industrial revenue bonds. The amount of the "gift" will vary with the community's tax base, in Joy's case.

Tight credit has also served as a spur to industrial revenue bond financing. During last year's money "crunch," for example, Phoenix Steel Co., a Claymont, Del., concern that had been sustaining losses as recently as 1963, found that bankers were unwilling to finance a $28 million modernization program that the company badly needed to remain competitive.

Instead, the company turned to the Northern Delaware Industrial Development Corp., which promptly marketed $35 million of 5¾ percent first mortgage industrial revenue bonds, the proceeds of which were turned over to Phoenix Steel. The issue "was a godsend to us," says a Phoenix official. "Some people raise eyebrows when you mention an industrial revenue bond, but without it we would have had to close down our Claymont plant," which employs 1,500 people.

OTHER ADVANTAGES CLAIMED

And Jason L. Honigman, chairman of Allied Supermarkets Inc., which has used industrial revenue bonds to finance a new food processing plant and distribution center, contends that although the amount of money available in a tight money market for normal financing is frequently limited, it's usually easier to raise money in the tax-exempt market than through conventional channels.

"Tax-exempts have an entirely different market—a different group of people," Mr. Honigman says. These include wealthy individuals in high tax brackets, who can often profit more from a lower yield but tax-free bond than from a high yield corporate-type issue.

Critics of industrial revenue bonds argue, however, that the sudden and huge volume of industrial revenue bond issues has placed serious pressure on the municipal bond market itself. An official of First Southwest Co., Dallas, notes that industrial revenue bonds attract anywhere from ¾ to 1½ percentage points yield over other municipal securities. "Particularly for the smaller towns that sell (municipal bonds) at higher rates, it's like tilting with windmills," he says.

A special committee of the Investment Bankers Association, formed to look into the situation, claimed in a press conference at the Miami Beach convention last week that the sudden and spectacular increase in industrial revenue bond financing had forced up municipal bond rates generally "on the order of one-quarter of a percentage point."

In terms of the $11.8 billion in "standard" municipal bonds that have been or are in the process of being sold this year, the effect has been to add a hefty $200 million in interest costs, the IBA committee asserted.

Some critics also question whether industrial revenue bonds are really advantageous for most companies. Approval of a bond issue can take up to a year, they note, and state officials, mayors, and voters can sometimes prove more prickly to deal with than professional bankers.

LOOP-HOLES FEARED BY SOME

Says an official of a large Eastern steel company that hasn't yet resorted to industrial revenue bonds: "A lot of these States have legislation on the books (permitting issuance of such bonds), but they haven't ironed out the wrinkles. This might be a fine way to get the money, but when you're involved in a construction of a mill that may cost several hundred million dollars, you don't want to risk getting caught by a subclause somewhere or fight some local councilman who for some reason has a beef about the project."

One company that refuses to use industrial revenue bonds is Southern Co., an Atlanta-based utility holding company with operating units in Georgia, Alabama, Mississippi and Florida. The concern would appear to be a prime candidate for such financing—its construction budget this year totals $240 million, and next year its outlays will total $250 million.

But, notes a spokesman for the company, "we couldn't include the value of the plant or facilities in our rate base" if they were financed through industrial revenue bonds. The company's rate base is the figure on which public service commissions determine how much the utility is allowed to earn.

"Further," says the spokesman, "we're philosophically opposed to government being in any enterprise in which private business can handle itself adequately. Giving a community ownership of a plant with that type of bond puts it in the business of generating electric power."

Chairman PATMAN. This is very helpful to all Members of Congress, and this subcommittee particularly.

Mr. Brock, if it is all right with you, you may go ahead for 10 minutes, and then I will take 10 minutes. We will ask these gentlemen some questions.

Representative BROCK. Let me say, gentlemen, I have been fascinated by your testimony. I hardly know where to begin. You have covered a lot of territory.

One of the things that occurs to me—I think it was during your testimony, Mayor Hurlbert—was the plight of the city in general terms, not just as it relates to ratings, or even municipal bond issues, but the plight of the cities as it relates to their ability to finance the needs of a growing population, of a more sophisticated society, a society which demands more services.

Your comment about the tax burden on the average citizen is particularly relevant.

I was frankly amazed at your comment that a family having a $20,000 home in Aberdeen would be paying $600 a year in property taxes. That is incredible to me.

Do you have a sales tax?

Mayor HURLBERT. State sales tax: yes.

Representative BROCK. From which you receive no revenue?

Mayor HURLBERT. None whatsoever.

Representative BROCK. Do you have a State income tax?

Mayor HURLBERT. No.

Representative BROCK. So your total source of revenue is the property tax?

Mayor HURLBERT. It is not the total. You see, we also collect for services.

Representative BROCK. This would be the great bulk?

Mayor HURLBERT. That is right—from a tax standpoint, that is the only source we have.

Representative BROCK. One of the things that has been most interesting to me—and again it perhaps is not directly related to the subject—has been the proposal that in some form or fashion we must make available to the municipalities, counties, and even States of this country, a broader financial base, specifically in the form of greater block grants or some form of tax sharing—making available to the communities the resources of the income tax, which is in my opinion probably the most equitable tax, and certainly the most productive that we have available in the country.

I wonder if you wanted to comment on something along that line, insofar as it relates to your basic problem?

Mayor HURLBERT. Apparently we are going to have to go to some route such as that if we are to have sufficient revenues to operate and do this capital improvement. Federal grants have been a tremendous help in projects that we have just accomplished. Whether it would mean the return of possibly some income tax, this is a matter that apparently you folks have discussed from time to time. But we need a source other than from the people that are living there—from a tax on them directly. We realize this money has to come from some place. Possibly this Federal borrowing, like HHFA, is a good answer, be-

cause there the entire cost of a facility is borne by the income, and paid off over a longer period of years. This would help.

Representative BROCK. Just as a matter of curiosity, what do you pay on your last bond issue—what rate of interest?

Mayor HURLBERT. I somehow or other do not feel quite so badly. Three and a quarter percent. Actually—this is about 2 years ago—a comparable city, a little larger—Sioux Falls, which I understand has a double A rating, was selling bonds, $600,000—they turned down an offer of a little over 4 percent. They recently were authorized by an election to issue somewhat under $4 million for airport improvement. The maximum, according to law, that they will be able to sell those for—was 5 percent. But here within the past few months they had an offer of just over 4.

Representative BROCK. I am interested in some of Mr. Goodman's charts, and one of the things that disturbs me is that when you are talking anywhere from three and a quarter to 4 percent, you are considerably under what we have to pay here.

Mayor HURLBERT. This I cannot understand.

Representative BROCK. You are tax exempt. We are not. It makes a difference. So I am not entirely sure that going through HHFA or those devices would save you money—it might cost you more.

May I turn to you, Mr. Goodman, just for a moment.

I was flabbergasted to hear you say that they do not use computer technology in these rating services. I do not see how they can calculate the ratings on 16,000 issues without computer techniques.

There is no computer available to these people who have to make the ratings?

Mr. GOODMAN. I understand that Standard and Poor's has a computer, but it is being used for projects other than their bond rating service. They are exploring the use of computers for rating but are not yet using them to my knowledge.

Moody's seemed dubious that a computer could be helpful in rating. I found this very difficult to understand.

Representative BROCK. Well, as a businessman, if you have only got 12 employees, it is very difficult to justify a computer on a cost basis. But in terms of productivity, I do not see how you can have a relative comparison of 16,000 issues without a computer. I do not think it is within the competence of 12 men, no matter who they are.

Mr. GOODMAN. My whole point is that the rating system has grown by accident. The fact that there are only two relatively small private services with limited staffs handling this enormous job is fundamentally unacceptable.

I have placed as an exhibit to this report a questionnaire given me by an expert in bond rating who for a quarter of a century was the chief rater at Standard & Poor's. He parted from Standard & Poor's feeling that the techniques of the present services were not adequate. And he gave me a questionnaire which I place as exhibit 6 to this report. You will notice that it outlines 427 factors which a bond rating service ought to look at in appraising a city.

A city is a very complex mechanism, and to think that it is being studied and rated on an average of about 30 minutes per rating is simply incomprehensible. This illustrates the inadequacy of the strictly private rating facilities now available. A whole new system must be created if the cities are to be properly evaluated.

Representative BROCK. Of course, you are taking 30 minutes—you are dividing all the issues into the number of man-hours available. And in actual fact, probably 10 percent of the issues will receive 90 percent of the attention.

Mr. GOODMAN. Yes, of course, that may be. But if that is true, then the balance of the issues are receiving that much less.

Representative BROCK. No attention whatsoever, in effect.

I am somewhat surprised.

Neither of you gentlemen commented on a bill which is before the House Banking and Currency Committee on the financing of revenue bonds, the underwriting of revenue bonds.

I gather that you feel to the extent that you do not want any industrials, you are relating your comments only to general obligation bonds. Is that a fair statement?

Mayor HURLBERT. I do not think so.

You see, at this time—the last legislative session in South Dakota—they passed enabling legislation giving municipalities this authority to issue revenue bonds for industrial building, and there is a test case now before the courts to see whether or not this will be possible.

There was one other—if I could at this time—point out that we have not quite—our minds have not met. And that is this question of Federal borrowing through the HHFA as it compares to revenue borrowing on the market.

You see, if we did not go through the HHFA, we would have to go to a revenue bond issue. This, of course, would go back to the 60-percent requirement that you would have to have by election, and also it would go into a bond that is not rated, a bond that we would have no experience to substantiate its worth. And we would certainly be paying—up around this 5 percent, or possibly a little more. We feel, in our investigating and visiting on this with people that have the HHFA loans, that certainly there would be 1 to 2 percent difference in interest, plus the fact that you could get it over, say, a 40-year term—where a bond, trying to go that far, I am sure you would have difficulty.

So this was one point that you had asked about.

Representative BROCK. Thank you for clarifying this. My time has expired.

Chairman PATMAN. I want to ask you gentlemen some questions about this.

On the bond question that Mr. Brock mentioned, that is pending before our committee now, that has passed the Senate?

I do not look with favor on that for one or two particular reasons. Of course, I will be glad to hear the testimony and be governed by it—but one that impresses me is that it monetizes a substantial part of our debt.

I know we have gone through a period in this country when people were so afraid of inflation that they looked with disfavor on the monetary authorities monetizing a substantial part of the debt. Even Government bonds at one time were very much limited in that respect. I do not think there is any limit now—I do not know of any. But to reach out and just monetize debts indiscriminately, and without any reason, could cause considerable trouble.

Another thing—the evidence showed, back in 1933, when there was a prohibition against these bonds written into the law, that

oftentimes a small city just dealt with only one bank, one institution—that is the only bid it received. The people generally did not get a square deal, and that is why Congress wrote a prohibition in the law. And I think in determining whether or not we should relax the prohibition, or repeal it entirely, we should at least go back and give consideration to what caused the existence of the law in the beginning.

I notice that in your brief, Mr. Goodman, you mentioned the tax-exempt features, and covered it rather thoroughly. But right now tax exemption is becoming quite a problem.

Take, for instance, tax exempt bonds. I noticed in the Washington Post yesterday morning that they are being offered for sale at 5.75. Well, that is the equivalent of about 11 or 12 or 13 percent to a person who is in the 50-percent income bracket or higher. That is a tremendous return. And I just wonder if we are going to permit these interest rates to go up to where people can double their money in a short time. I think something should be done to stop it.

I have a feeling that the people who are causing high rates should stop it. The Federal Reserve caused it—they have the power to do it. And they have caused the high interest rates.

You know, for 14 years, from the middle of 1939 to the middle of 1953—we had rather good interest rates in this country, low interest rates. We had rates that were two and a half percent and below, all during the 14 years. And the Federal Reserve, working in the interest of the people, and the administration in power, for the people, protected those 2½-percent rates. Anybody who had a bond, 2½ percent or below, and wanted the money, went to the Federal Reserve to furnish the money. They had no problem there. And they kept interest rates down, which helped everybody.

Now, 15 years from that time, interest rates have practically doubled. And, of course, no one contends that there is a free market in Government bonds that knows anything about the subject at all.

Mr. Alan Sproule, the head of the New York Federal Reserve Bank, was the outstanding witness on that. He is, I guess, one of the most knowledgeable persons on Federal Reserve financing that we had in the country. He said it is inconceivable to think that the rates are not fixed by the Federal Reserve on a huge national debt. That is the only way they can be fixed. And as long as our debt is a huge one—and certainly obviously it is a huge one now—the Fed, in fixing the interest rates—which, of course, is the wholesale rate for money, as it has always been in this country, means fixing the rates on the Government bonds and Government securities, because the Government debt is such a large part of it. It is obvious.

Now, we have, I guess, in this country about $1,500 billion in debts, all debts. That is municipal debts, Government debt, private debt, all debts of all kinds. Well, a 1-percent increase in the cost of money means a $15 billion a year increase for servicing the debt. And now we are paying from $75 billion to $125 billion gross interest a year—I mean the people generally in the United States are paying that much interest. That is a huge load. It has been going up terrifically for the last few years. And the question is how long can we survive under that.

A few years ago it was unconceivable interest rates on Government bonds would get to 6 percent. Now, then, of course, it is close to 6 percent on Government bonds. And these municipal bonds, selling at 5¾, and even higher, tax exempt, of course, is a more shocking picture.

I think Congress has failed to do its job on interest rates. I think Congress has failed to do its job on monetary matters. Congress, for some unknown reason, has looked upon the monetary system as somewhat sacrosanct, and we should not deal with it, we should not even discuss it. And if people criticize it, why, of course, they have ways of making it kind of hard on a fellow who will criticize the monetary system or the operation of banks—even the bad practices of banks. They make it pretty hard on people who do that. I know, because I have been a victim. I have been doing it over the years—not criticizing good practices of banks—they have lots of good practices. Banks are very important; they are necessary; they are indispensable; they serve a good cause in time of war and in time of peace; we cannot do without them; they are wonderful. But they can, just, like other people, get engaged in bad practices that will hurt the general welfare. And I think anyone who criticizes those bad practices is rendering a public service. But it is awfully hard to get consideration.

And I think that we are going to have these problems until Congress takes it upon itself the duty and obligation to look into it fairly, evaluate the situation, see what can be done, and if the Fed is not doing its duty—and it is not doing its duty—something should be done about the Fed.

You know, we did not have any central bank in this country in 1913 when the Federal Reserve Act passed. Not until 1935 did the central bank part come in. Woodrow Wilson was against the central bank; Congress was against it. Only a handful of Republicans voted for it. I bet you there were not a dozen Republicans in both the House and Senate who voted for the Federal Reserve Act. They mainly were against it. They were for the Aldridge bill. They failed to get that bill. But efforts were made subsequent to the passage of the law to change it around to where it would be more like the Aldridge bill and be more like a central bank. And by 1935 that had been accomplished; it had been achieved.

I am not just accusing the Republicans of being wholly responsible for it. They are not; because the Democrats could have done more about it than they did. But the memory of Woodrow Wilson did not seem to last too long. And what he was strongly against was turned about and became a reality in 22 years after the passage of the law. So we have a lot of problems to go into.

But I think this municipal bond issue is one of the most worrisome situations that we have right now before us.

Now, the average city, I assume, Mr. Mayor, is about 25,000 to 50,000 in population. Would you consider that to be a fair statement—the average city?

Mayor HURLBERT. I would certainly go along with you.

Chairman PATMAN. And you state, Mr. Goodman, that a bond issue must be at least how much before it is rated—$600,000?

Mr. GOODMAN. Yes; that is right, by Moody's. And a million dollars by Standard & Poor's.

Chairman PATMAN. It is not even rated unless it is at least that much. Therefore, a lot of these issues go unrated.

Now, there is something to the argument, I suspect, that was made in 1933. If you make the municipalities depend on those who have the advantage financially in purchasing those bonds, it is not unusual to be faced with facts that maybe you would have one bidder over the country for all these small communities. And, of course, it is rather easy for a small group in a local community to enter into conspiracies and restraint of trade and to take advantage of the people, where there are just a very few people dealing with a city, and a very few people dealing with a financial institution.

I just wonder if they get proper consideration there. So we have to take that into consideration, too.

But these analysts are rather fascinating to me—the dozen analysts doing all this work. They must be highly paid—they must draw $50,000 a year to do important jobs like that.

Mr. GOODMAN. My understanding is they are considerably below the figure you mentioned, Mr. Chairman.

Chairman PATMAN. I heard the astounding figure the other day of $8,000 a year.

Mr. GOODMAN. I think it would perhaps depend upon the seniority of the analyst.

Chairman PATMAN. Anyway, the amount is rather small for the big job they are doing, isn't it?

Mr. GOODMAN. I think it has been demonstrated over and over that Wall Street firms are in a position to pay considerably higher salaries, and that accounts for the high turnover of personnel which these rating services have reportedly experienced.

Chairman PATMAN. Well, in the controversy between the mutual savings funds—mutual funds, that is—and the banks on some issues that have been before Congress, the Senate and the House, and particularly the Banking and Currency Committees of the respective bodies—hasn't a large part of that come up by reason of the high salaries that the mutual funds can pay in comparison to the banks—kind of upsetting the salary schedule?

Mr. GOODMAN. I am not familiar with that, Mr. Chairman.

Chairman PATMAN. Are you familiar with it, Mayor Hurlbert?

Mayor HURLBERT. I have an idea that enters into it. I do not know how much. But it occurs to me that something should be done if you are going to have a rating system—it ought to be absolutely fair. Certainly and obviously it is not fair as it is.

Chairman PATMAN. You would not consider it fair?

Mr. GOODMAN. Decidedly not, sir.

Mayor HURLBERT. Along with Mr. Goodman's statement—I do not recall of ever having a rating expert or a rating examination in the city of Aberdeen. They have accepted reports all the time.

Chairman PATMAN. And they just reach up out of thin air and pull down these triple A and double A ratings, it appears.

I don't see how—if a city has a perfect record of paying its debts, and never had any problems of any kind, and sold its bond issues, and paid them off—I do not see how they could be low rated on a rating. But evidently they are, aren't they? They are low rated just the same.

Mayor HURLBERT. We cannot justify the "A." However, that is bet-

ter than a "B." So I suppose we would accept it. But we never have had any problems.

Mr. GOODMAN. With all due respect to my distinguished colleague on my right, Mr. Chairman, I think it is interesting to note that his town rates a single A rating, whereas the city of New York, which plays a key role in the economy of the entire Nation, was downgraded to a BAA rating. In the process of that downgrading, the city of New York was subjected to an extra interest cost of one-half of 1 percent a year—50 basis points—which on $500 million of financing annually, adds up to quite a piece of change over a period of years. Taking into account the average 8-year life of our debt, that 50 basis points of extra interest means $20 million. To my mind it is shocking and uninformed when it comes to the rating services judgments.

Chairman PATMAN. Now, I have some questions here I would like to ask Mr. Goodman, and also Mayor Hurlbert, of Aberdeen.

I suspect it would be better to read these questions and have you answer them when you look over the transcript. You would have more time to do it that way. This is being made for the record anyway, principally, because we expect the whole country to benefit from this information that we are obtaining.

If you want to answer them here, you can do it, of course. But otherwise you can answer them when you examine your transcript.

Do bond ratings take into account all of the relevant facts in order to get a realistic assessment of a city's credit—do bond ratings take into account the facts they should?

I notice—did you say 427 factors that should be considered?

Mr. GOODMAN. I have a list which I have submitted to you as an exhibit, which does indeed have that number of factors.

Chairman PATMAN. 427 factors? That is the way I understood it.

Mr. GOODMAN. Your memory is entirely accurate, sir.

Chairman PATMAN. That seems like a lot of factors to be considered.

Mr. GOODMAN. I present this to you as the project of a man who has spent a quarter of a century in the business of bond rating and is concerned about what he thinks is the lack of penetrating analysis in arriving at credit ratings.

Chairman PATMAN. We shall certainly give careful consideration to anything that gentleman says.

For example, do they take into account aid from the Federal and State Governments? Do they take into account the existence of sound businesses and other enterprises in the city. Do the bond rating people reduce a city's rating when some of its middle income population moves to the suburbs?

What are your suggestions as to what we might do to improve the quality of bond ratings?

Now, out of the 427 that you mentioned, from information given to you by this expert, how many of those factors are now considered in ratings, to your knowledge?

Mr. GOODMAN. The problem which the expert underlined was that nobody relly knows, including some of the rating services themselves. He further points out that in the case, for example, of New York, when Standard & Poor downgraded it from a single A to a triple B rating, the decision reportedly involved a number of gentlemen who were not municipal analysts. I am told the final decision in

New York involved stock market analysts, and the then president of the corporation, who was not a municipal man. The majority of votes on whether to downgrade rested with other than municipal analysts.

Since that decision was so important to 8 million New Yorkers, we are deeply concerned it was reached by a small handful of men, in a closed room, and in a private atmosphere.

Chairman PATMAN. Do you think the Federal Government could help more than it does in improving bond ratings?

In connection with that—and I know Representative Brock is interested in this—back when we had an RFC, Reconstruction Finance Corporation, we had some protection for municipal bond interest rates. And I have known the RFC to take the issues of a whole State and refinance them, and reamortize the payments, and open up the schools of the State, where they were closed, and put them in a position where they could pay the money back, by keeping the interest rates low.

But of course now, with no RFC, we do not have any source of funds in large amounts. There is no source of funds in large amounts available. It is just not available.

Now, the small businessman can get enough to fight other small businessmen, and fight among themselves, but never enough to go into any business of any size.

So the absence of a dependable source of funds, I think, enters into this picture, too—a dependable source of funds.

It occurs to me that we could well afford to consider the RFC in cases where the people cannot get financing, and there is no place to turn—that is, when they have been turned down by the banks, insurance companies, and every place they could go. It looks to me as if there ought to be some place where, if they have collateral security, and they have a good plan and a good project, that is worthwhile and in the public interest, that they could get consideration for funds of a sizable amount to help these different localities. But there is no place now.

I think Congress has been probably derelict in its duty in failing to keep up with that situation.

I think it is worthy of consideration.

Now, I have had a little sympathy for some of the towns that voted bonds to attract an industry solely because it is the only source of funds they had, it is the only way they could get big money.

But now, if they were changing it around and just letting the big concerns get the benefit of it, I share your views, that we ought to take a look at that, and see whether or not it is in the public interest, and how far it should go.

But it all goes back, in a way, to the lack of a source of funds, big money. And I think that should be considered.

Don't you think so, Mr. Goodman?

Mr. GOODMAN. I think the fund question is a vital one, Mr. Chairman, and I think you hit the nail on the head in assessing it as such. May I say, however, that what we are talking about here as an adequate budget to finance a first-class rating service would be something in the area, I suspect, of about a million dollars a year. In view of the modest requirements, I tend to the view that the involvement of the Federal Government is not necessary in terms of the financing. I believe that bond rating services should be financed by municipalities,

banks, institutional investors and municipal securities dealers. The individual subscriptions from each could be small if enough would cooperate.

Chairman PATMAN. You brought that up in your statement. I think it is a good suggestion.

Mr. GOODMAN. I hope, however, that the Federal Government will nudge those concerned to consider a proper solution to the problem in the near future.

Chairman PATMAN. Do you think the recent riots in the cities in this country hurt municipal bond sales? What do you say about that, Mr. Mayor?

Mayor HURLBERT. I really do not know.

Chairman PATMAN. What do you say, Mr. Goodman?

Mr. GOODMAN. I think they have created a major question mark in the minds of all citizens of the country, both the investing public and others. I am particularly proud that Mayor Lindsay of New York was able, through a series of carefully preplanned measures, to avert race riots. I do think it is noteworthy that despite that admirable record, there was no upgrading of New York bonds. It seems that the riots have the effect of causing increasing dubiousness as to the credit worthiness of all cities. But we do not get any gold stars or plus points for the averting of riots, because then the charge is made that if you did not have a riot this year, you may have one next year.

The rating services move so slowly. They are like the astronomer looking at distant planets through a telescope. What he sees happened years ago, but he is only recording it at this moment. Apparently we are going to have to wait a long time for the rating services to upgrade New York, despite the fact we have undertaken a whole series of measures, including higher taxation—which a lot of experts feel has put the city on a much firmer fiscal footing.

Chairman PATMAN. It is like the interest rates. It seems that everything that happens that should cause the interest rates to go down has caused them to go up. They have gone to such heights, that I think Congress has to do something about it.

I understood that there are cases where special revenue bonds or similar issues of cities may sometimes continue at the same rating when a city's general obligations are downgraded. What is the logic of this, Mr. Goodman?

Mr. GOODMAN. It is devoid of logic, Mr. Chairman. It is illogical, particularly for New York, since the taxpayers' obligation to pay real estate taxes to our city takes precedence over the obligation to pay debt service on the many billions of dollars of private mortgages held by banks, insurance companies, and other institutional investors. Yet the private debt is rated higher than the city's.

Chairman PATMAN. Fine. I think you are rendering great public service, both of you gentlemen.

Mr. Mayor, do you feel that the smaller communities are adequately served by the municipal securities market as it exists today?

Mayor HURLBERT. I would question that the smaller communities—by this I mean smaller than the 25,000——

Chairman PATMAN. Do not most of them feel that they are discriminated against?

Mayor HURLBERT. Definitely so.

Chairman PATMAN. In the securities market?

Mayor HURLBERT. Yes.

Chairman PATMAN. I understand the small-sized bond issues, say under $600,000, are not rated. That is correct, isn't it?

Mr. GOODMAN. Yes, sir.

Chairman PATMAN. Doesn't this work to the disadvantage of these bonds?

Mr. GOODMAN. Decidedly so. I think it is readily demonstrable. For example, a bank portfolio manager, in deciding which securities to purchase, does not wish to have to wrangle with his bank examiner who comes in from the Federal Reserve Board, or the FDIC, or the Comptroller of Currency. He wants to be able to show the examiner a portfolio which is clean, and which is not subject to question.

When you have an unrated bond, the unrated bond unhappily has a faint odor about it, and it places a burden of proof on the individual banker to show the examiner why it is a justifiable investment. Most banks play it safe and do not want to bother with that type of protracted explanation.

Chairman PATMAN. How many bids do you generally receive on a bond issue?

Mayor HURLBERT. Three to four.

Chairman PATMAN. Don't you feel like you should receive at least three or four, or you should look elsewhere?

Mayor HURLBERT. Yes, because this gives each one of the banks a chance to line up with different financial agencies.

Representative BROCK. Excuse me. Just at that point. Are all of your issues GO's, or do you have some revenue?

Mayor HURLBERT. No, we have no revenue bonds outstanding. They are all general obligation.

Representative BROCK. The point I was raising earlier with the chairman, about revenue bonds, was because they are restricted in the market, that you would be fortunate to get one or two bids, if you had revenue. That might have an impact upon the interest cost.

Mayor HURLBERT. Another point. This $600,000 limitation on any bond issue—I am sure our last issue was approximately $360,000. And somehow we still carried our A rating.

Now, of course, we had over the million dollars outstanding.

Chairman PATMAN. How would you resolve the problem of insufficient competition for these smaller issues? Do you have any plan on that, Mr. Mayor?

Mayor HURLBERT. Actually, I think it would go back to this question of rating. If you have a good rating, you can interest Bobbart——

Chairman PATMAN. Something like Mr. Goodman is advocating.

Mayor HURLBERT. Yes—work with your financial agencies that are involved in this, and dig them up.

Chairman PATMAN. Should State governments assist local governments with their bond issue?

Mayor HURLBERT. They do not. I mean South Dakota does not. If the Federal does not step in and help, it would seem to me like we are going to have to turn to the State—one or the other, to get our ratings, and understanding to the people that have to provide information on bond issues.

Chairman PATMAN. Would you have Federal help continue somewhat like it has been in the past or would you have it changed? If so, what changes would you make?

Mayor HURLBERT. This Federal help you are talking about, is on what?

Chairman PATMAN. On the cities of different sizes.

Mayor HURLBERT. Actually, we——

Chairman PATMAN. Including the housing and everything else that goes with the city?

Mayor HURLBERT. We have to depend more and more upon help from Federal agencies, because they are versed in municipal operations. It would be almost impossible for us to work out programs without continued help from the Federal Government agencies.

Chairman PATMAN. I understand the smaller municipalities have not made much use of the Federal credit programs like the public facilities loan programs. That was taken out of the old RFC Act pretty well.

Mayor HURLBERT. This is true.

Chairman PATMAN. Administered by the Department of Housing and Urban Development.

You see, the smaller towns have not taken advantage of that much. Do you know why?

Mayor HURLBERT. Possibly lack of understanding, fear of what it is all about.

Chairman PATMAN. Now, I would like to ask just one question of Mr. Goodman—and Mr. Brock, maybe you have more questions.

Can you explain why New York City general obligation bonds are rated "BAA" whereas the New York Transit Authority bonds, which are guaranteed by New York City, are rated "A" by Moody's and rated "AA" by Standard & Poor's?

Mr. GOODMAN. Presumably that the rating services feel that the revenues to be derived from the riding of the subways by New Yorkers are superior in financial strength to the revenues to be derived from 8 million residents of the city, and some $48.7 billion worth of real estate in the city. The logic of this conclusion eludes me as I gather it does you, Mr. Chairman.

Chairman PATMAN. Yes.

Representative Brock?

Representative BROCK. Just a couple of comments.

No. 1, I did want to mention that I was particularly interested in your three recommendations for resolution of the problem insofar as ratings are concerned. I think they are excellent.

The one question that occurred to me is: How do we begin?

I wonder if it is a function that can really be initiated here, or if it does not have to initiate with the rating services, with the cities demanding better service.

For example, the comment that the cities should share was one that interested me, Mayor Hurlbert, because when you start calculating the number of communities in this country, you spread that out across the million dollars that Mr. Goodman mentioned, you are not talking about very much money to insure that you receive adequate rating services. It would be a cheap investment on your part. I think you would probably agree with that.

Mayor HURLBERT. Sure the city of Aberdeen would jump at a chance to do something like this, so we would at least know where we are.

Representative BROCK. Your budget is $2 million a year?

Mayor HURLBERT. $2,300,000.

Representative BROCK. I think a hundred dollars or so would be a very nice investment.

Mayor HURLBERT. This could very easily be done.

Representative BROCK. Insofar as your comments go, Mr. Goodman, on industrial revenues, I share your concern, because I think there is a great deal of abuse creeping into this particular situation today.

As the chairman mentioned—not so much in the smaller businesses, but in the major blue chip companies taking advantage of this.

I do think there is something that you failed to mention.

When you talk about competition for money, Mr. Goodman—I do not know who can say just exactly how much savings are created in this country every year. I have heard figures ranging to $75 million.

Now, that is the market from which you have to draw, corporations have to draw, private individuals have to draw. Anybody who wants debt money is competing for those dollars.

When you mention that industrial revenues were pulling a billion dollars out of that market—it is true. But you also cannot ignore the fact that the Federal Government is a major competitor for debt money today.

If we meet the deficit that is projected for fiscal 1968, this Nation will have had to borrow or created $100 billion in additional debt since 1960—a hundred billion dollars in competition with New York City or Aberdeen, S. Dak.

Chairman PATMAN. May I ask you a question on that?

Are you taking into consideration the manufactured and created money, irrespective of savings?

Representative BROCK. Well, let's talk about the actual increase in debt this year, which is going to have to be borrowed in the market. That figure, according to Treasury, is $11 billion in this year alone. Now, that is $11 billion that is not available to Aberdeen or New York.

Chairman PATMAN. The point I am trying to——

Representative BROCK. It raises your interest rates.

Chairman PATMAN. Actual savings represent just a small part of the money that is in circulation in credit; isn't that correct?

Representative BROCK. They are the foundation on which you create money. You cannot create money unless savings are created.

Chairman PATMAN. Savings could be used as a reserve upon which, under the fractional reserve system, demand deposits can be created in a 10 to 1 ratio, and 33⅓ to 1 on time deposits. But there is where most of our credit and money, I think, stems from, and not from savings. And the reserves that the banks actually have—we talk about them as reserves, but they are not, they do not exist. It is a fiction.

We tend to think about the $18 billion in reserves upon which the money is created as maybe a little gold and silver and greenbacks and things like that. But it is not actually there. It is just fiction, it is just pencil marks, machine imprints.

So the point that I was trying to bring out, Mr. Brock, is that in our monetary system, the actual savings, genuine savings, represent

a very small, insignificant part of the money and credit in circulation and used as the basis of our economy.

Representative BROCK. If I recall correctly, the average American citizen in this country in 1967 will save something in the neighborhood of 7 percent of his gross personal income. Without the 7 percent that ~~was saved, you would have no additional reserves on which to make~~ your loans. You would not have the expansion factor. Because if you do not save $7 and put it into a savings account, you cannot loan $70 against the $7. You don't have the first $7. So you have to create money through savings.

Chairman PATMAN. I know there is a lot to what you say there, Mr. Brock. But don't overlook this fact. The rate the other day was raised from 4 percent to 4½ percent on what is generally referred to as the discount rate. I think the proper name for it would be the rediscount rate—of the Federal Reserve.

The way that is done—there is no actual savings involved in that at all. The Federal Reserve will buy a million dollar bond from, say, your bank in New York, and that creates a million dollars in reserves—just by reason of that million dollar bond—a U.S. Government bond. There is no savings involved in that. And upon that U.S. Government bond credit of $1 million, the banks can expand a minimum of 10 to 1—$10 million for that $1 million. And, of course, that goes out into the channels of trade and business and commerce, and helps everybody in the country. But so far as savings are concerned, not $1 of savings is involved in that.

You see, these are high-powered dollars. That is the reason I could not understand people who say that the devaluation was affecting us. We are not connected with England in our monetary matters. I don't think it should affect us in the least. But certainly the rate here, which only banks can take advantage of, should not be in competition with the 8-percent rate in England, because nobody can get this rate except the banks, and they use it for reserves, for high-powered dollars, upon which from $10 to $33 can be created for everyone.

Actual savings are wonderful, and we need them, and we want to encourage people to save money. I think we ought to talk more about thrift than extravagance. That is the reason that I opposed your lottery there in New York—not because of New York. I wasn't fighting New York, or your educational funds. I thought it was terrible that you would use a roll of the dice to get funds for education in New York—as rich as that State is—the richest State in the Union. And I just did not believe in encouraging people to gamble. I feel that we should not allow our banking institutions in New York—really this is the cause of it—to have a thrift window here, and a savings window next, and then a couple of lottery windows to sell lottery tickets; in effect, in the same banking institution, encouraging people to gamble at the same time they are encouraging them to save. I think we ought to get back to the old-fashioned way of encouraging people to save. It helps everybody and it helps the country.

So I did not have any personal feeling about the city of New York, but I could see in that entry there an opportunity for the hoodlums and the gamblers all over the Nation, all the States, to try to entice other States to legalize a lottery on the theory that that helps them in their business, the numbers racket—which is a rather profitable racket in New York; isn't it, Mr. Goodman?

Mr. GOODMAN. I believe it is.

Chairman PATMAN. And they have a better deal than the State has. You see, when the chances for winning are several times better than the State offers them—and in addition to that, the real bonus payoff is that if a person is fortunate, and he collects a hundred thousand dollars by having the right ticket, his name is not put in the newspapers. There is just nothing said about it. Of course, the obvious conclusion is that in the numbers racket, the winners do not pay income tax on their winnings, but in the legalized winning in New York, they would.

So you have every——

Representative BROCK. Which are you advocating—the payment or nonpayment of income taxes?

Chairman PATMAN. Of what kind of tax? A lottery?

Representative BROCK. Never mind.

Chairman PATMAN. What I object to there is the numbers racket is helped, and it would be helped in every State, if the hoodlums could get the lottery legalized for any purpose. And always they pick out some really good purpose, like veterans, or hospitals, or something like that, to have a lottery for. If we could get them legalized in any State, that helps the numbers racket in that State, and the hoodlums make lots of money on the numbers racket.

So we would finally get down to the question of we would be paying more attention to gambling and lotteries than we are paying attention to thrift and savings.

So I think we ought to be in favor of the latter instead of the former.

Any other questions or comments, Mr. Brock?

Representative BROCK. No, thank you.

I have enjoyed the testimony very much.

Mr. GOODMAN. Mr. Chairman, may I just ask your indulgence for one brief moment to indicate to Congressman Brock what I think represents the most concise answer I can find to the question he just raised.

Exhibit 9 of my testimony consists of two graphs, one of which projects the future volume of industrial revenue financing in 1969 to $8 billion. Now please note the graph on the left. The checkered portion of that bar in the year 1969 represents the proportion of industrial revenue issues.

Right here you have the potential danger, the really deep-seated and fundamental problem which industiral revenue bonds pose. If they ever reach the point where they comprise one-third of the total new issues being offered every year, and they very well may, in a few years, the whole structure of the municipal bond market will be endangered.

Chairman PATMAN. Yes. You both have presented some interesting information. It will be very helpful to us.

Let us say 1950, New York was paying so much in interest, a certain rate. Could you estimate in your statement to be filed along with your testimony, when you look over your transcript, how much it has cost the city of New York since that time in what may be termed excessive interest rates, that is, interest costs above what might have occurred if the 1950 rate levels were still in effect in succeeding years?

Representative BROCK. What cost to New York?

Chairman PATMAN. Interest. Interest rates were low in 1950.

Mr. GOODMAN. I would have to ask your assistance in defining excess, Mr. Chairman.

Chairman PATMAN. Anything that was higher according to rate would be excess. That is the way I would construe it.

Mr. GOODMAN. I would appreciate time to ponder that very complex question.

Chairman PATMAN. Yes, sir. If you find a better way of bringing out the point, to show the excess, it would be all right with me.

Now, some members of the committee are not here. Oftentimes they would like to ask witnesses certain questions which they propound in writing and send them to you gentlemen in advance of the time that you return your transcript. Will that be satisfactory with you?

Mr. GOODMAN. Yes, sir.

Mayor HURLBERT. Yes, Mr. Chairman.

Chairman PATMAN. Fine.

Well, thank you very much for your appearance here. You have been wonderful. I appreciate it. I know other members of the committee will. We meet tomorrow at 10 o'clock in this room, and we will have as our witnesses Mayor Travis H. Tomlinson, of Raleigh, N.C., Mayor Herbert H. Behrel, of Des Plaines, Ill., Mayor Elmer H. Dodson, of Charleston, W. Va. Those three witnesses will be here tomorrow morning. And then Thursday we have four witnesses, including Congressman Whalen, of Ohio, Dayton, Ohio, and the mayor of Dayton, Ohio, also, as well as the mayor of Salem, Oreg., and the executive director of the Ohio Municipal Advisory Council of Cleveland.

So we will have some more very able witnesses in addition to the fine witnesses we have had today.

Thank you, gentlemen, again.

(Whereupon, at 11:45 a.m. the subcommittee was recessed, to reconvene at 10 a.m., Wednesday, December 6, 1967.)

FINANCING MUNICIPAL FACILITIES

WEDNESDAY, DECEMBER 6, 1967

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC PROGRESS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room S-407, the Capitol, Hon. Wright Patman (chairman of the subcommittee) presiding.

Present: Representatives Patman and Brock; and Senator Proxmire.

Also present: John R. Stark, executive director, and Arnold H. Diamond, consulting economist.

Chairman PATMAN. The committee will please come to order.

We are honored to have with us the chairman of the Joint Economic Committee, the Honorable William Proxmire of Wisconsin. You gentlemen know him, I am sure. He will participate with us today.

Today we continue our inquiry into the problems of municipal finance. From the testimony received here yesterday, the bond rating houses are guilty of either outright fraud or shocking negligence in their rating of municipal bonds. It appears from the evidence that these ratings are not based on a genuine sound analysis of finance, but are really based on the opinions of poorly informed and poorly paid personnel who are overburdened with the task assigned them. I do not criticize the people themselves; I criticize the indifference of these bond rating institutions.

Although this strikes me as a serious indictment of their conduct, I have heard no murmur from them, nor is there any indication that they would like to testify. Let me say that our subcommittee intends to pursue this matter further. As a matter of fact, we may bring representatives of the investment banking community—some of the so-called bond houses—in as witnesses to testify as to their observations on this question of bond rating, and its effect on our communities.

Our study of last year shows clearly that the communities face heavy demands now for facilities construction, and that these will grow sharply in the 10 years ahead. At best, it will be a difficult challenge to meet these requirements. In the circumstances, it is clearly against the public interest to have outmoded and harmful practices like the current bond rating practices, standing as barriers to meeting our financial problems.

We are privileged to have with us today three outstanding mayors. Mayor Dodson has not arrived yet, but he will be here momentarily. You might say these men are in the frontline, facing the financing problems that confront most of our communities. They are Mayor

Travis H. Tomlinson, of Raleigh, N.C., Mayor Herbert H. Behrel, of Des Plaines, Ill., and Mayor Elmer H. Dodson, of Charleston, W. Va.

Mayor Tomlinson, you may begin and proceed in your own way. Do you have a prepared statement?

Mayor TOMLINSON. Yes, I do, Mr. Chairman.

Chairman PATMAN. We would be very glad to hear you, sir. You may proceed in your own way.

STATEMENT OF TRAVIS H. TOMLINSON, MAYOR OF RALEIGH, N.C.

Mayor TOMLINSON. Thank you very much, Mr. Chairman. If it is agreeable, I will simply read this statement, and then we will have a discussion if you like.

Chairman PATMAN. After the witnesses conclude, we will interrogate you gentlemen.

Mayor TOMLINSON. I am Travis H. Tomlinson, mayor of Raleigh, N.C., and chairman of the National League of Cities Revenue and Finance Committee. I am here to represent the National League of Cities which is composed of nearly 14,400 members, municipalities, large and small, in all 50 States.

I regret I was not able to appear yesterday as originally requested. Nevertheless, my purpose is to provide a general background for the other testimony you will receive in the course of these 3 days. Surely the subject matter which the committee has chosen to explore is of vital concern to all cities.

Cities rely as never before on bonded indebtedness as their major financial tool for providing needed public facilities. Many of our older and established cities are facing physical deterioration. The effects of urbanization and technological revolution and resulting demands for new and better services place added stress on the need for physical revitalization and modernization. Thus, the capital program of cities is of great importance to their future physical, social, and economic vitality. Without the ability to borrow, which, even so, I might note is often limited by archaic State constitutional or statutory provisions, cities could not stand the strain of paying for capital projects.

As an indication of the increased reliance on bonded indebtedness, cities and States in 1966 issued more than $7 billion of general obligation bonds and over $4 billion of revenue bonds. Totals for this year of both types are expected to substantially surpass the figures for the preceding year. Outstanding debt of municipalities has now reached better than $33 billion.

Of greatest significance in the municipal finance field is the tremendous surge of revenue bond issues since the late 1940's when few of these bonds were on the market. The importance of revenue bonds to cities cannot be overemphasized. Revenue bonds often provide the only practical method of financing facilities when a community is unable to commit its taxing power to debt service or where State legal limitations on general borrowing and taxing powers preclude or limit the use of GO's. Likewise, it makes good financial sense to use a revenue bond when a project can provide a source of revenue sufficient for debt service.

With the importance of municipal borrowing firmly established and with clear indications that cities will turn to borrowing even more

in the next decade, it is extremely important that the cost of borrowing not place greater financial strains on already financially depressed cities, than is necessary.

This cost of borrowing is mounting steadily. Twice in recent months, the Bond Buyer's 20-bond index reached an all time high of 4.33 percent. Some cities have been unable to sell their bonds because of excessive interest rates. Thus, every factor which bears on the ability of a city to finance its projects at lowest possible costs must come under careful scrutiny. It is extremely encouraging, therefore, that this subcommittee has chosen to examine credit problems of municipalities now.

In the remainder of my statement, I shall attempt merely to outline the problems facing cities in the context of the objectives of these hearings and thus provide a checklist with detail provided by the other witnesses.

At the heart of the problem is the municipal bond rating procedures. The National League of Cities national municipal policy [1] adopted August 2, 1967, at Boston, states that:

> Present methods of determining rating for municipal bonds by private agencies have recently come under attack as being antiquated and not a true indication of a municipality's financial stability and credit reliability. These methods, furthermore, do not provide for small cities (nor small bond issues) and in effect increase the cost of bonded indebtedness for these units.

League members considered this problem so serious that it charged the revenue and finance committee to "* * * undertake a study of municipal bond rating systems and make recommendations for improving these systems."

The basis for many of my further remarks on rating is a study prepared by the institute for Local Self Government, research arm of the California League of Cities. It is entitled "Municipal Credit Evaluation and Bond Ratings: Diagnosis, Prognosis, and Prescription for Change." I commend this to the committee as an excellent report and offer a copy for inclusion in the record.

The report concluded that the rating agencies, which are privately operated and privately financed "* * * are not able to give primary consideration to the public interest as it is involved with bond issues and municipalities and borrowing for public purposes." To quote further from this report:

> If the rating agencies are looked upon as offering final judgments, their actions become affected with the public interest and can have great effect not oly upon individual investment portfolios but upon economic development of municipalities. If the agencies label a municipal issue top grade, one can be reasonably assured that the issue will sell, and at a relatively moderate interest cost. It they give an issue a poor rating, however, that issue's chances are poorer still and taxpayer interest costs are bound to skyrocket. This is the power of rating agencies. Their responsibility lies in the prudent use of this power, through thorough investigation of all situations to insure the avoidance of mistakes that can be too costly in too many ways. But investigation costs money, and funds are apparently not readily available for the painstaking job of getting all the facts. Ratings, therefore, often become haphazard; worthy projects are bypassed, and unfortunately mistakes are all too frequently in evidence.

The question which the institute felt most needed answers were these:

1. What can be done to develop more explicit rating criteria rather

[1] Document in files of subcommittee.

than the present system in which no one, including some of the analysts involved, is quite sure what a rating is based on?

2. How can bon-rating services be adequately financed without either involving them in conflicts of interest or subjecting them to political pressure?

3. How can staffing inadequacies be overcome to deal with the gigantic statistical and analytical workloads occasioned by the elevenfold increase in municipal financing since 1946?

4. How can fact-gathering techniques be improved through the use of computer technology not now employed by any of the rating services?

5. How can a rating scale be devised which will more sensitively reflect whether a credit is improving or deteriorating, relate quality of rating to bond price, and make allowance for the fact that a short maturity of a BAA bond might be a better risk than a 30-year maturity of an AAA bond?

There is a demonstrated need for improving the rating system since so much official importance is given to its product. Whatever solution is ultimately developed must be adequately financed, adequately staffed and provided with sufficient information upon which to make its judgment. Almost certainly, as the institute concluded, this service should be taken out of the hands of the present private agencies and given to some individual agency, preferably connected neither with governmental issuers nor with the underwriting or buying public and which can devote its full energy and interests to provide complete and equitable ratings for municipalities of all sizes.

This leads to the second of the committee's interests, credit problems of small municipalities. Often the issues of small cities receive no rating because of their size or a number of other factors. The National League of Cities' Department of Urban Studies in a study it conducted for this committee entitled "Credit Problems of Small Municipalities" concluded that:

> * * * small municipalities, particularly those having less than 10,000 inhabitants, often are penalized, solely on the basis of their size, in the rate of interest they must pay. This occurs in spite of the fact that the degree of credit risk involved is not an intrinsic characteristic directly attributable to size alone.

The problems of smaller municipalities were adequately summarized in this report:

> Several interrelated factors tend to cause such discriminatory treatment. First, small municipalities market bond issues at infrequent intervals, and these issues usually involve only a limited number of bonds of relatively small total dollar amounts. However, overhead costs incurred in marketing an issue of small dollar amount is not proportionally less than the cost incurred in marketing a sizable issue. As a consequence, market costs per bond are higher for small issues, because the "spread" is greater for a small issue than it is for a large issue. Major bond buyers, such as insurance companies and commercial banks, usually prefer to purchase bond issues that are large in total dollar amounts because larger issues are generally easier to trade. Thus, bond issues of small municipalities are relatively more costly to market, and less attractive to investors, than are the issues of large municipalities. Second, large municipalities generally can provide quickly and accurately the detailed financial information needed by bond dealers and buyers for an analysis of investment possibilities. Third, small municipalities usually cannot afford to employ the experienced legal and financial advisors necessary to guide the bond issue through the intricacies of the bond market smoothly and effectively. Finally, the influential bond-rating services, that evaluate municipal fiscal responsibility, usually will not rate bonds of political subdivisions unless such units have at least a specified minimum

amount of debt outstanding. For example, Moody's has followed a policy of not rating debt of governmental subdivisions unless debt outstanding totals $600,000 or more. Standard & Poor's does not rate governmental subdivisions having less than $1,000,000 in debt outstanding. Such policies probably reflect the general lack of interest in the bond issues of small municipalities, and the difficulty in securing detailed financial data from such units. The absence of a rating tends to decrease still further bond-buying interest.

Here, again, National Municipal Policy states:

States can help improve municipal credit by—

(1) establishing standard procedures for the preparation and minimum content of official statements or prospectuses issues by municipalities when they offer to sell long-term obligations;

(2) guiding municipalities into the practice of reporting regularly on their financial condition and giving such reports adequate circulation among investor groups; and

(3) giving municipalities, particularly small ones, technical assistance in the management of the debt.

Some States already have taken action to help their cities. Ohio is one and the testimony to be presented tomorrow by Mr. Scott should be of particular interest in this respect.

I would like to state also at this time North Carolina has a local government commission, it has been in existence for some time, and we are deeply indebted as municipalities to the guidance and assistance of this organization among the municipalities in the State of North Carolina.

In conclusion, there is much at stake when we discuss the credit problems of our cities. The ability of our cities to borrow money at lowest costs spells the difference between providing or not providing public facilities and services. Higher interest rates mean fewer police and firemen, fewer classrooms, fewer hospitals, fewer water and sewer lines, fewer urban development projects. In this age of dynamically changing social and physical needs, cities must be equipped and assisted in securing the financial wherewithal needed to make the human environment a better place in which to exist and prosper. I cannot overestimate, therefore, the importance of the findings and recommendations this committee will make.

I would like, in closing, to say I urge also your consideration of the problem of higher interest rates that are coming as a result of a greater increased use of industrial bonds.

Chairman PATMAN. Thank you, sir. We appreciate your testimony.

And now we have Mayor Herbert H. Behrel, of Des Plaines, Ill. Mr. Mayor, we would be very glad to hear from you, sir. You have a prepared statement?

Mayor BEHREL. Yes, Mr. Patman, I have, and I do plan to read it.

Chairman PATMAN. That will be satisfactory, sir. We shall be glad to hear you now.

STATEMENT OF HERBERT H. BEHREL, MAYOR OF DES PLAINES, ILL.

Mayor BEHREL. It was also my privilege in 1966 to have been a member of the Revenue and Finance Committee of the National League of Cities.

What I will say here this morning is an expression of an experience of what we consider a small city in attempting to put together bond issues, and then acquire the best possible rating, and, of course, the best possible sale, net cost interest.

Thank you for inviting me to make this presentation. You understand, of course, that the opinions I express to you are based in large measure upon my personal experiences as alderman of the city of Des Plaines for 8 years, and subsequently, as mayor since 1957. During the past 3 years our city has sold three bond issues, aggregating $6,500,000, for the following purposes:

Water revenue bonds (1964)	$2,750,000
General obligation surface water drainage bonds:	
1966	2,000,000
1967	1,750,000

By way of giving you background material about Des Plaines, we were incorporated originally 110 years ago, and experienced a very moderate growth until 1950, at which time our population was about 15,000. Since that time, however, we have grown to 55,000, and from a relatively rural community, have become one of the larger suburban cities in the Chicago metropolitan area.

While to a certain extent we provide a "dormitory" for the city of Chicago, in recent years we have been benefited by the construction of 125 substantial industrial establishments, employing in excess of 16,000 persons at this time.

Our experiences in developing two substantial and diverse financings during the past 3 years will be of interest to your committee. As noted above, in November 1964, we sold $2,750,000 water revenue bonds, and in September 1966 and April 1967, we sold $2 million and $1,750,000, respectively, general obligation surface water drainage system bonds. The details of each of these bond issues are contained in the official statements and reports of sales attached hereto as exhibits.[1]

You will observe that, interestingly enough, our water revenue bonds enjoy a better rating than our general obligation bonds:

Water revenue:
- Moody: A.
- Standard & Poor: A.

General obligation:
- Moody: BAA.
- Standard & Poor: A.

This is rather an anomalous situation in that usually general obligation bonds of a given community are rated better than revenue bonds of the same community.

Upon review, however, the reasons are apparent. Our water department has been a consistently sound operation, unaffected by the activities of overlapping tax bodies. In giving consideration to our general obligation bonds, however, the relatively heavy demands upon our taxpayers for the needs of overlapping taxing bodies, particularly for our schools, have had an adverse effect upon our credit standing. Throughout these proceedings we have proceeded without State or Federal assistance in the preparation and issuance of the bonds.

You will be interested in our procedure in preparing for financings. It has been our practice to engage professional assistance of the best order for each phase of every project. These services include those of professional consulting engineers, financial consultants, attorneys, and bond counsel. Our city council, composed of 16 aldermen, with myself presiding, represent as many diverse occupations and professions. We

[1] Material referred to retained in files of subcommittee.

do not pretend to know all about each project, but rather depend upon the professional advice and guidance of specialists in each aspect of each project. We then apply our collective experiences to the recommendations submitted by our advisers and find that the best interests of our community are so served.

Upon arriving at a course of action, it has been our policy to give the program at hand utmost publicity through the several local newspapers and the "metropolitan" sections of the Chicago press. In each of our recent projects we have enjoyed the support of our community and have been able to construct the projects authorized as expeditiously as possible.

Before going to market with our bond issues, our financial consultant prepared a comprehensive official statement and such other supplementary information of interest to the municipal bond rating services and beyond the immediate data required by underwriters and investors. Meetings were arranged with representatives of the bond rating services who very kindly allotted us several hours for extensive interviews, during which time we presented the official statements, engineers' reports, 5 years of complete and detailed audits and additional material, not necessarily of a financial nature, that would aid in a subjective analysis.

I cannot emphasize too strongly the need for proper municipal recordkeeping and reporting as an aid to a proper credit presentation. In our case, we have benefited by the efforts of a highly professional accounting staff. A copy of our last annual audit report is attached as a demonstration.[1] Our experiences during the course of our interviews with the representatives of the rating agencies were illuminating in that we were well received and were given the benefit of their opinions as to the functions involved in rating bonds and how we might best meet them. It is my opinion that a rating in and of itself will not necessarily provide the lowest interest rate. Rather, sound administration and accounting practices, proper and consistent reports to the public, and particularly to the investment community, provide the means to most advantageous net interest cost to the borrower.

We cannot expect to substitute good intentions for proper administration and reporting. We feel the latter will always derive an affirmative response from the rating agencies, and particularly from the investment community.

In summary, we were a little bit disturbed in our meetings with the rating people, who apparently are the last word from which there is no recourse. When they tell you your rating is A, or BAA, that is it, there is no place else to go.

Our exhibits here will show you that in November of 1964, on the water revenue issue, we were very successful in getting a 3.5165, which is a very handsome interest rate net interest cost. By the time we went in for the storm drainage, or storm sewer bonds in April of 1966, we had a new junior college coming in our community, the park district was floating a bond issue of 1.3 million—all of these had a net effect on the opinion of the rating services as to the overlapping tax debt.

[1] Material referred to retained in committee files.

I do not know what the answer is to get around that particular feature, because certainly it is recognized that all of these taxing bodies have an effect on the total real estate tax bill that our taxpayers receive.

I hope that if there are any questions, that I will be able to answer them. It has been a pleasure to make this presentation. And certainly it is a distinct pleasure to be here.

MUNICIPAL CREDIT EVALUATION AND BOND RATINGS DIAGNOSIS, PROGNOSIS, AND PRESCRIPTION FOR CHANGE

(James F. Reilly)

(Institute for Local Self Government, Hotel Claremont Building, Berkeley, California 94705, Randy H. Hamilton, Executive Director)

THE INSTITUTE FOR LOCAL SELF GOVERNMENT

Research and Education To Promote and Strengthen the Institutions and Processs of Local Self Government

California's urban communities have entered a dynamic era of physical, social, economic, and cultural growth and change. The severe problems present a challenge and an opportunity which calls for the best in initiative, organizing ability and leadership from those of our citizens who accept responsibility for decision-making and problem-solving at the local level. The Institute's capabilities and research activities are designed to produce results keyed to practical local government operations and programs. In frequent affiliation with the League of California Cities, the Institute's research projects are broad-based and flexible to provide a bridge between the academic community and local government practitioners. Research projects are intended to result in "Designs for Action."

The Institute for Local Self Government is in its second decade of service as a non-profit, tax-exempt, educational and research corporation under applicable California and federal laws. As a public educational organization, its purposes are to promote and strengthen the processes and institutions of local self-government; sponsor and conduct meetings and conferences of local community leaders concerning local government problems in order to improve the quality of citizen participation in community growth and change; sponsor and conduct training courses in local self government to develop individual leadership capabilities in policy formation at the local level; acquire and disseminate educational materials to increase the knowledge and understanding of the principles of local self government; improve the capability of community leaders to participate and contribute more effectively to local self government; and, to engage in research programs related to local government public administration.

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INTRODUCTION

Municipal and quasi-municipal bond issues are now being marketed in the United States at the rate of about a billion dollars a month. Municipal borrowing costs are at an all-time high, with the rate of interest having increased by nearly 30% in the past year and the yield index reaching a peak of 4.24 percent—the highest rate in about a quarter of a century. Issues in California and New York accounted for nearly 30% of all bonds issued in 1966 by dollar volume.

Research indicates that the inadequacy of the present system for evaluating municipal credit and rating municipal bonds is a major factor in the high cost of borrowing. By mid-1967, the failures and deficiencies in the system led the New York Times to editorially conclude:

"There is a demonstrable need for more current and comprehensive rating of all municipalities, large and small. More adequate rating will not always make it easy to borrow. What money is tight and interest rates are rising, any municipality will have a hard time. But, cities should not be unduly penalized by inadequate or improper ratings."

Concurrent with the growth of municipal financing has been the development of the art of municipal credit analyses and the increasing importance of municipal bond rating agencies. Underwriting firms and many of their institutional accounts devote considerable effort to analysis of municipal credits so that they might be better able to conduct their own affairs and portfolios. But, resources available to the dealer or large institution are obviously beyond the individual and small corporate investor. The parallel growths of small investors and the number of issues results in a municipal market in which there is increased reliance on the major municipal bond rating agencies. Additionally, many banks and institutions are prohibited by regulatory authorities from buying bonds which do not fall into certain rating categories. While this is not willed by the rating agencies, it is a fact of municipal financial life. Thus, investor reliance and rules imposed upon others have given the rating agencies great power. And with power has come the responsibility for someone to administer it judiciously and primarily in the public interest.

There is no doubt that the two major private rating agencies, Moody's and Standard and Poor's, have certain deficiencies which they, themselves, recognize and acknowledge. They are, as Paul Hefferman writing in the June 5, 1967 issue of the *Bond Buyer* points out, "attempting the impossible with staffs held down both in number and in compensation by the costliness of the undertaking." They lack the manpower for searching examinations; they are frequently subjective in their decisions, and they often disagree among themselves. Yet, as the Times noted, "their obvious fallibilities have little influence on investors who treat their ratings with awesome respect that makes a great deal of difference to the municipal borrowers."

The "difference" is the higher cost which might be paid to compensate for the deficiencies of a rating system that was basically devised a half-century ago, primarily for a different purpose, and which, simply, is no longer capable of performing as the investing public and the banking community think it performs.

There is no implied criticism of the objectives of the rating agencies as such. It is the system to which the criticism is directed. The rating agencies recognize their deficiencies from the public point of view. In their own behalf they contend, quite legitimately, that their primary purpose is not to serve the public interest but to serve the private interests of their subscribers. Heffernan echoes their defense and notes that "their service is intended primarily not to aid bond dealers or bond issuers, but to aid investors."

The essence of the criticism is that because the ratings are unrealistic and not up-to-date, the bonds of certain issues sell below their true worth in the market, and municipalities, therefore, have to pay unduly high interest charges in borrowing new money. A subsidiary criticism is that the reverse might also be true and that there might be "sweetened" reports having the opposite effect. The integral point is that we have not yet developed in the United States a system of municipal credit evaluation which results in publicly accepted bond ratings prepared in an expert and knowledgeable manner by an agency whose sole purpose would be in the public interest to fashion a fair representation of municipal credit ability and bond ratings.

The three federal agencies which supervise the United States banking system and exercise broad powers over the national economy are rightly concerned about inadequacies in the present municipal bond rating system and the problems which it poses for municipalities. Governors Mitchell and Maisel of the Federal Reserve Board have said:

"The Board has a deep concern with the rating problem because of its supervisory responsibility and would have sympathy with the idea of a study by a reputable concern to gain an understanding of the problem and its broad impact on the economy."

Chairman Randall of the Federal Depositors Insurance Corporation says:

"We concur in the concern about the inadequacies of the municipal bond rating system and we are already doing some field work in the area."

First Deputy Comptroller of the Currency, Watson, and Deputy Comptroller, Park, agree with their colleagues and note:

"The Comptroller's Office has a great concern with the problem of rating municipal securities and would be interested in a study which could provide better standards of evaluation."

The disservice to the public interest under present conditions can be expressed in terms of schools unbuilt, public facilities unconstructed, or urban development retarded because of higher interest costs resulting in fewer funds available for construction. It can also be expressed in public administrative terms in a concern for the effect on the public interest of a municipal credit rating system primarily designed not for municipal securities and whose basic motive is a private interest.

In the words of Roy M. Goodman, formerly associated with Kuhn, Loeb and Company, and presently Finance Administrator of the City of New York, a nationwide study should be undertaken to find answers to five principal questions:

1. What can be done to develop more explicit rating criteria rather than the present system in which no one, including some of the analysts involved, is quite sure what a rating is based on?
2. How can bond rating services be adequately financed without either involving them in conflicts of interest or subjecting them to political pressure?
3. How can staffing inadequacies be overcome to deal with the gigantic statistical and analytical workloads occasioned by the eleven-fold increase in municipal financing since 1946?
4. How can fact-gathering techniques be improved through the use of computer technology not now employed by any of the rating services?
5. How can a rating scale be devised which will more sensitively reflect whether a credit is improving or deteriorating, relate quality of rating to bond price, and make allowance for the fact that a short maturity of a Baa bond might be a better risk than a 30-year maturity of an AAA bond?

We at the Institute for Local Self Government are grateful to Mr. James F. Reilly, a senior partner of Goodbody and Co. and perhaps the nation's leading student of the problem, for having prepared the basic manuscript for this monograph. Our publication of it is designed to stimulate debate and lend impetus to the undertaking of the nationwide study that is needed. Little is generally known about this vital aspect of public finance. Fuller understanding and dissemination of information is called for. Even the rating agencies, according to Paul Heffernan, "would welcome the entry of more rating services from any direction—private enterprise, trade-subsidized, foundation-endowed, or even tax-financed by government."

Nothing in this publication should be taken as an impugning of the policies or motives of the present rating agencies. Systems are in question, not motives. Our purpose is to strengthen the institutions and processes of local self government, included among which are those concerned with public finance and borrowing. Hopefully, from the effort will come support for the initiation of one kind of needed fiscal reform. No thoughtful observer of the municipal finance scene with whom the Institute has discussed this problem has questioned the need for an exposition of it and an advocacy of more thorough study to produce benefits for municipalities, the investing public, and the rating agencies themselves.

RHH

BERKELEY, *September 1, 1967.*

CHAPTER ONE.—WHAT'S THE PROBLEM

Almost despite the rating agencies, directives from the Office of the Comptroller of the Currency, and their subsequent administration by bank examiners, have caused an over-reliance to be placed upon rating agencies. Commercial banks, among the largest purchasers of municipal bonds, increasingly buy according to ratings, spending less time evaluating issues themselves. This has caused some embarrassment to the rating agencies, for, unwittingly, they have come to be looked upon by banks, as well as by the public at large, as "official agencies" serving a public rather than a private purpose.

But the agencies are, of course, not official. They receive no compensation from the United States Government, nor from any of the communities rated. The cost of ratings is mainly covered through subscriptions and fees paid by customers for the investment advisory and other services provided by the agencies. Naturally, their first responsibility is to clients subscribing to their services. It is not to the general investing public. A high official at Standard and Poor's has said that since the amount which can be charged against any single rating is distinctly limited, "we can only apply ourselves to those issues which are of interest to

a number of clients or subscribers." It is unfortunate that a far larger group looks to and relies upon word from rating agencies.

The power of the agencies has become great. In today's market the difference of a notch in a rating or between similar rated and unrated issues can be anywhere from 25 to 50 basis points or more. This can result in the payment of vast additional sums of money for increased interest costs spread over 20 to 25 years. But power brings with it responsibility. If the rating agencies are looked upon as offering final judgments, their actions become affected with the public interest and can have great effect not only upon individual investment portfolios but upon economic development of municipalities. If the agencies label a municipal issue top grade, one can be reasonably assured that the issue will sell, and at a relatively moderate interest cost. If they give an issue a poor rating, however, that issue's chances are poorer still and taxpayer interest costs are bound to skyrocket. This is the power of rating agencies. Their responsibility lies in the prudent use of this power, through thorough investigation of all situations to insure the avoidance of mistakes that can be too costly in too many ways. But investigation costs money, and funds are apparently not readily available for the painstaking job of getting all the facts. Ratings, therefore, often become haphazard; worthy projects are by passed, and unfortunately mistakes are all too frequently in evidence.

CHAPTER TWO.—A BRIEF DESCRIPTION OF THE RATING SYSTEM AND ITS METHODOLOGY

The art of municipal bond analysis has come a long way since the pre-depression days when a rule of thumb was the number of railroads passing through a town. In those days, seven percent debt to assessed valuation was considered satisfactory; any debt above that figure was suspect. Today, a determination of ability to pay involves analysis of a host of economic, social, political and historic factors tempered by the analyst's own subjective or even intuitive assessment.

Agency ratings are, in effect, graduated listings of bond issues categorized by investment quality. They are meant to be long-run appraisals of the intrinsic worth of bond issues and should reflect the ability of the issue to withstand default and capital losses over future long time periods.

The primary aim of the ratings is to rank issues in the order of the relative safety from default and capital losses arising therefrom. Issues with the highest rating are those on which default is adjudged least likely to occur; issues with the lowest rating are those already in default or on which default is imminent. The rating agencies do not divulge in detail the particular factors and weights used in assigning the individual ratings. However, it appears from the manual descriptions that attention is given to such factors as population, assessed valuations, per capita debt, all taxable property, current tax collections, etc. For revenue bonds, earnings coverage, lien position, capital structure and growth and stability of earnings are also included among the assessed variables.

The sytem of municipal credit analysis and bond ratings is basically an outgrowth of ratings for corporate bonds. The first corporate bond ratings appeared in 1909 when Moody's began rating railroads. In 1914, they expanded their services to cover public utilities and industrials. In 1922, Poor's began rating all industries. Standard Statistics and Fitch followed in 1924. Thus, four ratings were available for most corporate issues from 1924 through March, 1941, when Poor's was merged with Standard Statistics. Thereafter, three ratings were available. For the most part, the agencies did not assign ratings to small issues of little public interest, to private placements or situations for which sufficient information was not available.

From 1909, when Moody's Investors Service began rating corporate bonds, ratings assigned by the various independent agencies have been an important device for evaluating the quality of corporate bonds. From 1924–1935, ratings were assigned to cover 98% of the total par amount of all straight corporate bond issues outstanding. Thereafter, with the growth of private placements (not usually rated by the advisory agencies) the coverage declined. Nevertheless, as late as 1914, more than 92% of the total par amount of all issues outstanding was rated by one or more of the agencies.

Moody's began rating municipal bonds in 1919, ten years after commencing its corporate service. Its rating of municipal bond issues is in the same alphabetical symbol form (and are thought to be comparable to) as those which apply to Moody's corporate ratings. They range from Aaa—judged to be the finest quality

—through Aa, A, Baa, Caa, Ca and, finally, C issues which are never seriously expected to attain any real investment standing.

Until the Great Depression, Moody's rated most issues as Aaa or Aa. Defaults during the thirties caused Moody's to re-evaluate its standards and adopt a more conservative approach. It has been estimated that during the 1930's, approximately 2½ percent of a total of 160,000 local governmental bodies were in default on some part of their interest or principal requirement. The aggregate loss of principal sustained by bond holders was approximately $100 million, or only ⅔ of 1 percent of total public debt. Forty-eight percent of the number of defaulting issues in the 1930's were rated Aaa in 1929 and 78 percent of the defaulting issues were rated Aa or Aaa.

Moody's does not rate issues under $600,000, obligations of enterprises without established earnings records, projects under construction, or issues where current financial data are lacking. More than 16,000 public bodies are currently included in Moody's Municipal and Government Manual, although not all are rated.

The second major advisory service which rates municipal credits is Standard and Poor's Corporation, which began rating municipals in 1950. It rates issues of governmental bodies having at least $1,000,000 of debt outstanding, provided adequate information is available. Standard & Poor's also categorizes bonds into letter groupings. They are AAA (prime), AA (high grade), A (upper medium grade), BBB (medium grade), BB (lower medium grade), B, CCC and CC (speculative issues with varying degrees of risk), C, DD, and D (defaults). Because the investing public considers Standard & Poor's rating categories to be comparable to those of Moody's, Aaa is thought to be equivalent to AAA, Baa equivalent to BBB, etc.

Both Standard & Poor's and Moody's issue weekly publications with data pertaining to municipal bonds. Unlike Moody's, Standard & Poor's does not publish a comprehensive annual volume of data and ratings. Today, Standard & Poor's rates more than 7,000 issues.

Dun & Bradstreet, Inc., does not rate municipal bonds as such. For many years, however, it has issued a series of credit surveys of the major issuers of tax-secured bonds. In addition, the post-World War II growth of revenue-secured public bonds has been extensively analyzed by Dun & Bradstreet. Both tax and revenue-secured bonds are labeled either "above average," "favorable," "fair," "poor," etc., according to principal factors. For tax-secured bonds these factors include economic or social characteristics, administration, debt obligations, debt structure, bond security provisions, debt service coverage, debt history, rate structure and policy operating trends, financial conditions, economic factors and management. Numerical or alphabetical ratings are not given. It is Dun & Bradstreet's policy to provide only the fullest information possible, and allow the investor to draw his own conclusions as to the overall quality of the issuer.

Fitch Investors Service issues municipal bond ratings only on a specific request basis.

Other agencies of varying quality exist throughout the United States which either rate municipal bonds or provide detailed information on municipal credits, but each confines its activities to prescribed geographic areas. Among these agencies are the North Carolina Municipal Advisory Council, the Oklahoma Municipal Advisory Council, California Municipal Report, Ohio Municipal Advisory Council, Michigan Advisory Council, Iowa Advisory Council and the Kansas Advisory Council.

It is, of course, highly unlikely that all parties concerned with a bond will agree with the verdict of a rating agency. Issuers generally think that a rating is too low and interest costs unjustifiably high. Underwriters investigate situations themselves and commonly dispute ratings thought to be too low (and sometimes too high). The investor, once a purchase is made, only hopes the rating will not be lowered. If a rating is lowered and it is necessary to liquidate holdings before maturity, the investor might be forced to incur a loss.

So attuned are investors to ratings that almost automatically "the rating" will determine within rather broad limits the interest rate the issuer must pay on its bonds. It is hardly necessary to note that the Underwriter must keep this in mind, for clients can often cite ratings in argument against an Underwriter price. Moreover, many investors are bound by procedures and regulations which narrowly prescribe the breadth of investment possibilities. As the Underwriter is aware of these requirements, he can attempt to measure the market for a particular issue. It is only now becoming commonplace for an investment house which underwrites municipal bonds (and most which later deal in them) to

conduct some form of research into the quality of the bond and its issuer. This research may be as cursory as a quick look at a Moody's manual for verification of the taxable values behind the general obligations of a well known political subdivision, or it may be as thorough as a complete analysis of a new construction issue for which no information had been previously collected and for which no rating may be expected.

Investor preferences are usually guided by ratings. In general, the greatest demand is for issues rated "A" or better. Unrated issues seem to be preferred to those rated "Ba" or lower. Unrated issues will usually carry higher yields than comparable rated issues. An additional bonus awaits the analytical investor if he can take advantage of unrated issues or those which seem to be rated lower than justified by careful analysis. Moreover, simplicity requires that all rated bonds be assigned to only a few categories. As a result, there can be wide differences in yields available, even within each category. Yield differentials are compressed in high markets (periods of low interest rates) and spread in low markets. Bargains, therefore, become available, i.e., one can buy low-quality issues in low markets and replace them with high-quality issues when the market goes up.

The bid an underwriter submits is largely influenced by ratings. The underwriter knows that potential customers will look at the rating. While customers will be happy to buy AAA rated bonds on a Baa scale, it is virtually impossible, no matter how strongly the underwriter may protest the quality of a bond, to sell Baa rated bonds at AAA prices. Investors will simply buy something, and usually somewhere else. Similarly, investors usually prefer rated to non-rated bonds. The rating represents additional assurance. Without it, investors (and therefore underwriters) insist on a lower price. If an underwriter cannot offer a bond with a relatively attractive price and yield, an investor will again go elsewhere.

CHAPTER THREE.—RATINGS AND THE BOND MARKET'S PRINCIPAL INVESTORS—COMMERCIAL BANKS

Because the commercial banks, which as of December 31, 1966, held over $40 billion of state and local bonds in their portfolios, are a major element of the municipal bond market, it is imperative to consider the preferences of investment officers and understand the regulations which prescribe and proscribe their operations and investments and on which they are accountable by examining authorities.

National and state banks, which are members of the Federal Reserve System and Federal Deposit Insurance Corporation, must adhere to rules and regulations set forth by the Comptroller of the Currency. State banks which are not members of the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation. State banking authorities also examine banks within their states, and Federal Reserve Banks may look into the affairs of state member banks within their respective districts. Difficulties which could result from these overlapping jurisdictions are fortunately avoided by close co-operation among the several regulatory authorities.

In 1949, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Executive Committee of the National Association of Supervisors of State Banks issued a statement in which investment securities purchased by banks were divided into four categories:

"Group I Securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equvalent value.

"Group II Securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest, and unrated securities of equivaent value.

"Group III Securities are those securities in default.

"Group IV Securities are stocks."

An opinion from the Comptroller regarding ratings holds that:

"Responsibility for proper investment of bank funds rests primarily with each banks' directors and this responsibility cannot be delegated to the ratings services of others, or be considered as having been fully performed merely by ascertaining that a particular security falls within a particular rating classification.

"On the other hand, where securities are not included in one of the rating manuals, but the bank has evidence that the securities meet requirements as to marketability and are not distinctly and predominantly speculative, and the directors are satisfied that they meet the requirements of the statute and Investment Securities Regulations, this office will not take exceptions to the securities merely from the standpoint of their rating (or absence of rating) in a rating manual. In the last analysis the burden of proof of eligibility rests upon the bank and such proof of eligibility should be on file in the bank and available to the examiner.

However, it must be borne in mind that in determining the eligibility of securities not rated in one of the first brackets of recognized rating manuals, there will be a corresponding greater burden upon the bank to satisfy the examiner that the particular security is in fact eligible." [1]

In August, 1957, the Comptroller of the Currency issued a directive concerning bank investment in state and local bonds which

1. Specifies that an "investment security" must be a marketable obligation, i.e., it must be saleable under ordinary circumstances with reasonable promptness at a fair value, and there must be present one or both of the following characteristics:
   a. a public distribution of the securities must have been provided for or made in a manner to protect or insure marketability of the issue; or,
   b. other existing securities of the obligor must have such a public distribution as to protect or insure marketability of the issue under consideration;
2. Provided, however, that special revenue obligations of state or local government or of duly constituted public authorities thereof, which possess a high degree of credit soundness, so as to assure sale under ordinary circumstances, with reasonable promptness at a fair value may also be considered to constitute investment securities even though they may not meet the above distribution standards;
3. Prohibits the purchase of investment securities in which the investment characteristics are distinctly or predominantly speculative, or the purchase of securities which are in default, whether as to principal or interest;
4. Requires that all investment securities shall be supported by adequate information in the files of the bank as to their investment quality.

The Comptroller's *Digest of Opinions* states that retaining adequate financial information is just as important with respect to general obligations of municipalities even though exempt from the restrictive provisions of Revised Statute 5136. The minimum information to be retained and analyzed in support of a proper credit judgement of municipal obligations is as follows:

A. Statement of debt, including overlapping, floating and full faith and credit obligations.
B. Assessed valuation, including basis of assessment.
C. Property tax rates.
D. Tax collection record.
E. Receipts and disbursements.
F. Sinking fund operation and requirements.
G. Future debt service requirements.
H. Population.
I. Economic background.
J. Default record.
K. Per capita debt.

Revenue bonds are not treated differently from general obligations, but not more than 10% of a bank's capital and surplus can be invested in the revenue bonds of a single issuer. According to the Comptroller, revenue bonds qualify as investment securities on the basis of actual earnings records. Where no historical earnings record exists, revenue bonds are ineligible for bank portfolios.

It would obviously be impossible for bank examiners to be familiar with the many thousands of public bond issues outstanding. Consequently, despite the Comptroller's exhortations, examiners naturally rely heavily upon the opinion of rating agencies. They have no other information source to turn to.

As a matter of expediency, all public bonds rated Baa (or BBB) or higher by either Moody's or Standard & Poor's have come to be eligible for bank invest-

[1] Italics added.

ment as are all unrated, but tax-secured bonds. All bonds rated below Baa and all unrated revenue bonds are ineligible for bank investment unless the banker has a file sufficient to convince a carefully scrutinizing bank examiner. Most large banks, as well as the major insurance companies, are adequately staffed to make justifiable investment decisions independent of the rating agencies. But the smaller bank must rely upon the rating agency. In any event, experience indicates that most issues rated below Baa by both agencies are rejected out of hand for bank investment. The burden of proof is too difficult for most commercial banks to bear.

CHAPTER FOUR.—HOW DO ADVISORY AGENCIES RATE BONDS?

A former vice president of Moody's has said that "ratings are not a reflection of bond maturity or marketability except in rare cases where the combination of maturity and marketability itself has a direct bearing on the prospects of payment. Security, or safety (relative certainty of the payment of interest and principal) remains as the principal, almost the sole ingredient of the ratings."

The float of local government bonds is growing at the rate of more than $5 billion a year and is now well beyond the $100 billion mark. As Paul Heffernan relates in a mid-1967 issue of the *Bond Buyer*, "as city and state governments become more enmeshed in financial problems that defy yesterday's solutions, the investment world's spotlight is giving more play than ever to the bond rating function administered by the nation's major investment service—Moody's and Standard & Poor's."

The growing magnitude of public financing has made it impossible for the rating agencies to fully cover the entire realm of issues and issuers. Nor would they claim that their ratings and information are always absolute and accurate, or that the thousands upon thousands of issues from almost as many issuers can fit perfectly into fewer than a dozen cubbyholes. Nevertheless, one cannot overestimate the financial and investment impact that ratings exert upon all concerned with municipal credits. The public interest is vitally affected because the issuer, underwriter, investor, taxpayer and even toll payer are all in some way affected.

Agency ratings are not derived through the use of statistical formulas. Though statistics are used, great weight is given to numerous economic and non-financial factors which can affect the future performance of the bonds. Ratings are reviewed periodically and may be changed whenever the rating agency is convinced that long-term risks have either diminished or increased.

Research conducted by rating agencies and underwriters is basically the same. Each looks to the same figures and data. Admittedly, some look more closely than others, and some find what others fail to see. But the basic material is there for all. What becomes of this information distinguishes agency from underwriting research. Agencies evaluate an issue and slip it neatly into one of a dozen categories. When an "A" bond comes along, it does not matter if it is high A, low A, or middle A. It's just A. Underwriters cannot afford to be as generous. Based upon completed research, an underwriter must submit a bid for a bond issue. At competitive bidding his price must be low enough to satisfy the syndicate he represents and be sold at a profit, yet high enough to win over competing bids. The bid must be exact and, as such, represents the nearest any segment of our economy comes to the classic workings of supply and demand. The underwriter must also base his bid upon current market conditions.

As has been previously noted, Moody's does not rate bonds outstanding in amounts of less than $600,000, bonds payable solely from special benefit assessments, bonds payable from the earnings of a hospital, university or other public, non-profit institution or facility which does not have an historical earnings record, and bonds in which there is a minimum of public interest. Bonds are also not rated if sufficient information is not available. Included in this latter category are bonds of municipalities which have failed to provide current information as well as bonds which are payable from the earnings of a project which has no earnings record. This group also includes new construction projects; engineers' estimates are not considered sufficiently reliable.

Bonds are appraised according to two basic risk factors. They are:

1. The risk that bond quality will be diluted by inordinate increases in debt. In recent years, many states have come to relax or expand legal debt limits; special taxing districts and authorities are more frequently being used to finance projects beyond municipal debt limitations. Thus, Moody's has said it can only be satisfied that bond quality will not be diluted by inordinate debt increases, when

"municipal debt is modest and governmental facilities adequate for immediate and prospective needs." However, no evidence is available showing the rating agencies to be adequately staffed and equipped to perform the deep analysis required to judge each situation on its true merits.

2. *The risk that ability to meet maturing bond principal and interest may be impaired under depressed business conditions.* The investor wants assurance not only that a community is able to pay today, but also that it shall be able to meet its obligations in the future. Although debt service may be secured by law, the whole community budget structure must be sound if a high credit standing is to be provided.

An appraisal of management is included by rating agencies before a final rating is given. Management administers present-day policies and forms plans and policies which are to be followed in the future. Since management's role is that of executor of debt proceeds and developer of the economy, its capabilities must be properly judged.

A city's history of debt policy and administration is one key to credit standing. How willing is management to face its responsibilities? How aggressive and how capable? Economic development depends very much upon the governmental environment created by city managers. To maintain and improve credit, agencies look to the performance of management in attracting new business and residents and shouldering community responsibilities. Communities must not be targets for exploitation. Businesses and residents will come when a community is known to give fair, equitable property assessments, provide adequate facilities, and insure that spending (and taxing) results only after careful and complete analysis.

Moody's expects effective management to be a good public relations officer. Information provided by managers is relied upon by bondholders, and for them, by Moody's. It is apparent that Moody's appraises management by how well its reports tell its story, as well as the story itself.

Moody's, particularly, asks management to tell its story through municipal records, histories and statistics as well as all documents relating to the proposed bond issue. Questionnaires are sent to municipal authorities which request figures on assessed value of reality, personal property, net direct debt, tax collections over periods, etc. With this information, it is hoped that questions such as the following may be answered.

1. Is the population actually there, or is it only hoped for?
2. Can the total debt be supported by the present inhabitants under any foreseeable business conditions?
3. What additional financing is to be expected, either from the units under consideration or from any other unit taxing the same properties?
4. Are securities payable from unlimited taxes on all property in the community, or are there limitations which might prove troublesome at some future date?
5. Is there diversification of industry or rather a heavy dependence on a single plant or a single industry?
6. How vulnerable is the community to economic unsettlement?
7. Are there nearby towns in which the residents can find work?
8. Are industries likely to migrate and, if so, are there factors that suggest the attraction of replacements?
9. Has the attitude of the administration been pro-debtor or pro-creditor?
10. Do the laws and traditions lend themselves to debt evasion?

Because rating agency representatives have not been able to visit all of the many thousands of communities rated, these questionnaires and other information returned from the community must often form the basis for an eventual rating of that community's credit. Moreover, as the rating agencies readily admit, impressions and judgement, factors not susceptible to numerical measurement, always constitute an important part of that analysis which ultimately is transformed into a rating. The burden of proof falls upon the issuer, rather than upon the investigative process.

Chapter Five.—Some Case Studies and Other Evidence

DO RATING AGENCIES GET THE FACTS?

The rating agencies are constantly asking municipalities to supply complete and current information. In the course of one average year, Moody's received reports from over 16,000 municipalities. Ratings are not given or are withdrawn

when information supplied is not complete enough so that an evaluation can be made. But unless an agency representative visits each community personally, there can be no assurance that information supplied is complete and not biased in one way or another. The lack of any uniform procedure for financial reporting among the several states makes the task of the agencies extremely difficult. The rating agencies must rely in large measure upon fiscal officers. Two questions arise:

1. With so many thousands of reports to cover, and with apparently inadequate numbers of experienced personnel to review them, can the agencies be sure that information received is complete? Or can some information be left out and a rating still be given?
2. Can the agencies be similarly assured that information judged complete is accurate?

An indication of the answers is given by studying the situation of Peoria, Illinois. For many years, the General Obligations of Peoria had been rated Aa. Just before the city came to the market in July, 1965 to borrow $4,280,000 on serial bonds, Moody's withdrew the Aa rating. Because of insufficient credit information, no rating at all was given. After the bond sale, Moody's was asked to give a rating. On the basis of information then available, a single A was given.

But, in September, 1965, the rating was restored to Aa. New information had come to light. For almost a year, Peoria had neglected to report a 20 percent increase in taxable valuations resulting from the annexation of a high school district. Also not reported was a favorable re-statement of the City's tax collection experience. As a result of Illinois mandatory overlay of five percent to cover tax collection costs and losses, Peoria had, in fact, suffered a net loss in tax collections in only one of the prior five years. And in that year—1962–1963—the loss was related to a large reduction in assessed valuations caused by a change in the method of assessing railroads.

There is no doubt that Peoria failed to report properly. Moody's was given incorrect information and upon this information was forced to lower its rating. Perhaps Peoria will have one less school as a result of the higher interest rate A bonds must pay over Aa. Peoria will know better next time.

What this example shows is simple. Moody's had to rely upon incorrect information; it had neither the staff nor the funds to find the correct information itself. One must ask what would have happened had Peoria's information been slanted the other way; if Peoria had overstated rather than understated its values, would it have received a higher rating? Just as Moody's had relied upon incorrect, understated information, would it similarly have refused to question incorrect, overstated information?

An equitable rating can only be given after painstaking investigation. An official at Dun & Bradstreet estimated that such an investigation would cost between $1,500 and $2,000. The rating agencies simply cannot afford to pay the price. Yet someone must! High ratings for poor bonds hurt investors; low ratings for good bonds limit a community's progress. In both cases, the effects of an incorrect rating can be measured in terms of monies lost. Ratings are too vital and intimate to the public interest to be summarily granted or nonchalantly dispensed. How often has Peoria's story been repeated elsewhere? And how often have "sweetened" reports avoided detection?

TOO MANY PROJECTS ARE NOT RATED

The public welfare must be of primary importance. Thousands of bond issues are not rated each year for one reason or another, and there is a great need for something to be done about the many situations rating agencies are not able to consider. The absence of a rating has manifold effects. In most cases, only bonds rated Baa or BBB or better are immediately acceptable for investment by banks and insurance companies. The larger banks have perfected rating systems of their own, but these systems carry little weight with bank examiners. Should a bank wish to buy an unrated bond, it must show exhaustive detail of the merits of that bond. As already noted, the effort is too great to justify the expense and trouble, and banks simply "buy safe."

In such a system, it is the public and the taxpayer who suffer. The public welfare seems subordinated since the absence of a rating can usually be expected either to limit the market for the bond, and/or to raise the interest rate which must be paid. When a community is forced to offer high interest rates, the investor, of course, benefits. But the added cost to the community must cause

that unrated community to offer its residents less in the way of public improvemens. Again we say that rating agencies are not public institutions in spite of the fact that they do perform a public function. Unfortunately, the agencies have not been able to carry out this function fully. Since ratings have such great importance and exert a strong market influence, coverage must expand sufficiently so that all worthwhile municipal issues and the projects they become can have a fair chance of success.

Banks and insurance companies need more latitude than is given them by the rating systems. They are too often saddled with the unwillingness of an agency to rate a bond. The policy of the agency not to rate certain types of projects frequently causes banks to pass up issues they would normally buy.

One could not force Moody's to rate construction or other projects currently not rated, but somehow these projects should be rated. Adequate staffs would, of course, be needed. Since most figures dealing with construction projects depend on predictions of engineers, proper forecasting would be required. Moody's says it will not give a rating based upon an engineer's estimate. But all ratings are based upon predictions. There really is no difference between predicting the increased revenues occasioned when a corporate electric company is expanded to meet the needs of a growing population, and the revenues which would accrue from an electric system built in a community which previously had none. In both cases, the future must be predicted. Yet the first situation is permitted a rating while the second is not. It seems peculiar that a municipality's position can be forecast as far as 40 years into the future while the earnings of a project to be completed one year hence cannot be.

RATING AGENCIES OFTEN DISAGREE

Recently, Louisville, Kentucky announced that $8 million of revenue bonds would be brought to market. The two major rating agencies came up with completely opposite evaluations of the bonds' quality. Moody's lowered their rating from Aaa to Aa ; Standard & Poor's raised theirs from AA to AAA. Strangely, the same facts were cited by both agencies. But Moody's said that long-term earnings would decline while Standard & Poor's said future earnings would rise.

The Louisville situation is not by any means unique. Approximately 70% of all issues rated both by Moody's and Standard & Poor's have similar ratings. These situations present no difficulties. But 20% of all issues receive higher ratings from Standard & Poor's, whereas 10% of all issues are given higher ratings by Moody's.

Disagreements are not necessarily undesirable, nor should it be a hard-and-fast rule that two different organizations should not reach different conclusions based on fact. But, it is precisely in the area of fact that the rating system comes into question. Are the ratings based upon informed judgments or merely upon judgments of whatever information happens to be most readily available?

NEW YORK CITY AS A CASE STUDY

While it is not always a sound public administrative procedure to reason from the example of the "special case" New York City, it is true that what occurs there affects much of the municipal world, and that frequently patterns and trends are set with reference to its operations.

On July 19, 1965, Moody's Investors Service lowered the rating of New York City tax-secured bonds from A to Baa. Moody's cited excessive public spending as the main reason for the downgrading. The analysis stressed that while New York's assessed values had risen 52% since 1955 and net debt had risen 56%, expenditures had risen 143%. Moody's said that "the City government had tended to succumb to the pressures of special interests and minority groups . . . The increase in the expense budget is due neither to a population explosion nor to a sharp rise in the cost of living. . . . We believe that New York City's obligations are of lower medium grade quality."

Bond quality is a reflection of the combination of (a) willingness to pay, and (b) ability to pay. New York's willingness to pay its obligations has not been questioned. There are, however, those who believe that someday the City will not be able to meet its obligations. In 1933, when the City had financial difficulties, there were those, too, who said that the City was insolvent. The City weathered that storm. And today, thorough examination of New York City's financial structure reveals the following:

1. The assessed value of real property owned by the City of New York is almost double the total municipal debt. Only a modest development of some of these properties could result in the creation of enormous values;

2. Only $3.0 billion of New York's $4,875 billion debt is held by the public—the rest is held by the city itself in pension and trust funds. New York has almost $2 billion invested in itself;

3. More than 60% of New York's bonds have been issued to construct and acquire revenue-producing improvements such as parking facilities, water and sewer plants, waterfront enterprises and transit system properties. Increases in only a few of the currently subsidized rate structures on these utility enterprises could produce immense earnings to meet future needs;

4. New York's present debt structure is heavily weighted in short maturities and more than 50% of the debt is scheduled for payment by 1975. A slight lengthening of the debt to a mere 15 years average life could have resulted in a 1965–66 budget surplus compared to the $250 million deficit experienced.

5. More than 8% of New York's debt outstanding as of July 1, 1964 was paid off by July 1, 1965. This suggests an unusual ability to adequately meet debt requirements even if economic conditions in the future warrant expenditure cutbacks;

6. The ratio of debt to assessed valuation is less now than it was in 1944, or, for that matter, in 1939;

7. As of June 30, 1965, only 1.6% of all real estate taxes levied during the past five years had not been collected. New York City bonds remain as full faith and credit general obligations payable from unlimited real estate taxes levied on all taxable property within the City's boundaries.

A year after Moody's lowered New York City's credit rating, Standard & Poor's followed suit. They chose July 25, 1966, the day before New York City borrowed $112,929,000 to lower the City's credit rating from A to BBB. In so doing, Standard & Poor's according to a fair sampling of Wall Street experts, added some 10 basis points to the interest costs New York City had to bear. The rating agency, in effect, told investors that New York City's bonds were riskier than in the past.

But, Standard & Poor's also said:

". . . the city's continuing ability to meet debt service requirements is of course not questioned. Its bonds are payable from unlimited property taxes, and debt service is unhampered by rigid constitutional limitations. Net debt has increased less rapidly than estimated full property valuation, currently standing at about 8.9 percent, compared with 10.4 percent fiscal 1962. This is still a heavy load, but the rapid schedule of principal payments permit flexibility in planning future requirements as additional borrowing power is generated, within the debt limit."

While Standard & Poor's was lowering New York City's rating, Wade S. Smith, Vice President and Director of the Municipal Research Service of Dun & Bradstreet, one of the two agencies which had downgraded New York City last year, was saying how much better the city's credit looked. The New York Times reported that even Moody's, though not yet prepared to change its rating upward, was encouraged by the City's current fiscal position.

According to all the agencies, New York's credit is better today than it was a year ago for four principal reasons:

1. A policy, instituted during the Wagner Administration, to borrow to meet operating expenditures had been ended. The new administration is determined that it shall not be reinstituted.

2. The city's floating debt has been reduced by $40 million.

3. The city has, for the first time in three years, lived within the estimates of the general fund without having to borrow from reserves.

4. The city finished its 1965–1966 fiscal year without the issuance of budget notes for the first time in more than 20 years.

In Standard & Poor's *Outlook*, the following appears relative to New York City's ability to increase revenues:

"With the advent of the income levy the tax pattern is set for some time to come. Offtrack betting and the legalized lottery are possible escape hatches, but the likelihood that these will be adopted is tenuous in the existing socio-political climate. Except for these areas, virtually every known form of taxation has now been tapped."

Yet, the very next page of the Bond Outlook offers this contradiction: "Economically, New York enjoys a unique status. . . By every measure, New York's resources remain unmatched."

Standard & Poor's is unhappy that "since 1962, the share of revenues afforded by Federal grants and state aid has risen from 20.8% to 28.8%." For years, ever since Federal and State income taxes were instituted, New York City has rightly complained that its share of benefits was in no way commensurate with its payments. Now, finally, something is being done to end this inequality. An office was opened in Washington to help assure New York City its fair share of Federal disbursements.

The biggest city of all must have the biggest problems. But New York City has more than demonstrated its ability to meet its obligations. Much of the New York City experience is directly applicable to other great cities such as Boston, Los Angeles, and Detroit, which have, of late, been so rudely jostled by ratings. What needs emphasizing is the public welfare and the significance of a notch on the rating scale. How many schools would 25 less basis points have built over 20 years? This is the question of prime importance, for it once again points up the heavy responsibility carried by rating agencies.

VARIATIONS IN REPORTING PRACTICES

Minnesota municipalities have generally lower credit ratings than similar towns in neighboring states. Yet, there is no contention that Minnesota's economic condition suffers by comparison with her neighbors. The disparity seems to stem from Minnesota's state-wide practice of setting the assessed valuation of property at 8 to 10 percent of market value. It is, therefore, not uncommon to find direct and overlapping debt in excess of assessed value and total tax rates up to 300 mills or more. In contrast, assessed valuation in Wisconsin average above 90 percent of market value. Tax rates, therefore, need not exceed 50 to 60 mills. One can readily see that owners of similar homes in each state would pay nearly the same amount in taxes on their properties. Only accounting methods leading to those same figures would differ.

Studies show that of 266 Minnesota municipalities rated by Moody's 19 are classified as Aa, 109 as A, 108 as Baa, and 30 as Ba.

Wisconsin, on the other hand, has 58 municipalities rated Aa, 155 as A, and only seven rated Baa. There are no Ba ratings in the state.

In Iowa, 45 municipalities are rated as Aa, 75 are A, and 3 are Baa. Again, no Ba's at all.

In South Dakota, all municipalities are rated AA or A, and in North Dakota, 19 of 21 ratings are Aa or A. There are two Baa's.

Minnesota is clearly rated well below the norm for the region, and Moody's officials agree that assessment practices do affect the Minnesota ratings. In a study presented by Ehlers-Mann and Associates of Minneapolis, it was shown that if Minnesota corrected its valuation standards to nearly 100 percent of market value, Minnesota taxpayers could save millions of dollars in interest every year. As a result of improved ratings, one must consequently draw the conclusion that Minnesota is, to a great extent, being penalized by Moody's for the State's property assessment procedures. This is difficult to accept and somewhat adverse to the public interest. Only a little effort would allow the rating agencies to see the true picture. But, of course, with so many municipalities to rate, extra effort becomes very expensive and the agencies are loathe to spend this extra money. But, again and again, it must be said that concern here is not for private businesses whose profits rise or fall and whose accountants are trained in the fine art of "best foot forward." *Concern is for the public and its welfare. Millions of dollars in interest costs mean less profits; but to municipalities, these same millions mean fewer policemen, fewer classrooms, fewer hospital beds. A line must be drawn. Where necessary, the rating agencies must dig for the facts—too much is at stake to allow for superficial judgments. If this task is too great for the agencies (and not being "official," it indeed appears to be monumental) then they must gracefully relinquish their ill-afforded responsibilities and bless others who can do the job more thoroughly.*

THE CONFLICT OF NOMENCLATURE

It is regrettable to find that in some areas ratings seem to hinge on terminology. The agencies appear to distinguish, for example, between State general obligations and State leasehold obligations. Leaseholds are traditionally rated one notch below the credit of the lessee. Yet both have exactly the same merits and limitations. The agencies seem to hold that leaseholds only create moral obligations. The credit of leaseholds is said to be weakened by a state's immunity to suit. But are general obligations stronger credits because the legislature waives

immunity for court action if the bonds are not paid? Only if successive legislatures could be bound by the actions of earlier ones. Leaseholds, like general obligations, are only moral obligations of states. Obviously, this is not apparent to Moody's for recently $70 million County of Albany, New York bonds were issued. The proceeds will be used to construct a state office building. The bonds are secured not only by the full faith and credit of Albany County, but also by contract from the State of New York with Albany County for lease rental payments. Hence, they represent a lease obligation.

The Official Statement of the County of Albany, New York, reads:

"The Bonds will be general obligations of the County for which the faith and credit of the County will have power and will be obligated by law to levy on all taxable real property in the county such ad valorem taxes without limitations as to rate or amount as may be necessary to pay the principal of and the interest on said Bonds . . . the Bonds will also be secured by rental payments from the State in amounts sufficient to pay, when due, all installments of principal and interest on all Bonds issued by the County to finance the project. . . ."

New York State has obligated itself to full rental payment. Is this obligation not as valid as a general obligation? Moody's and Standard & Poor's feel that it is not, for both rate New York State general obligations one notch above the Albany County bond, which is secured by New York State.

This point is already labored, but how much money would have been saved for other public purposes had the agencies rated these bonds one grade higher? Was it fact or tradition which prompted the ratings these bonds received?

In the case of revenue bonds, discussion is also needed concerning the difference between a primary and secondary obligation of an obligor. Primary obligations are obligations against gross operating income, i.e., income from which operating expenses have been deducted. Secondary obligations, guaranteeing the debt of another company, however, are obligations of the guarantor first in priority with operation expenses on gross revenues.

But, for example, the Nevada Irrigation District of California is rated A by Moody's (AA by Standard & Poor's). The bonds of the Nevada Irrigation District are secured by fixed semi-annual payments equal to current debt service under contract for sale of power to the Pacific Gas and Electric Company. So long as Pacific Gas and Electric remains solvent, this contract represents a secondary obligation to Pacific Gas and Electric Company which must be paid before principal and interest on Pacific Gas and Electric's own bonds can be paid. Still, Pacific Gas and Electric Company is rated Aa by Moody's (also AA by Standard & Poor's) while the bonds it guarantees are only rated A. The same story can be told for many situations, among them the Placer County Water Agency in California. In these cases, the discrepancy in ratings by the agencies gives ample cause for discussion. There is no need for the agencies to reach identical conclusions, but their basic premises upon which ratings are based should be explored.

CONFLICT OF INTEREST

Central to the discussion is the investing public's viewing of rating agencies as "official" organizations. Though Moody's and Standard & Poor's rate municipal bonds, this service is not their primary function. Both are primarily investment advisory institutions. Unfortunately, a conflict of interest may arise when a rating agency also acts as a financial consultant to governmental bodies. Moody's is known to operate in the dual capacity of rating agency and financial consultant.

On November 10, 1964, the Florida Security Dealers Association passed a resolution which read, in part, as follows:

"The employment of . . . rating services as . . . consultant is wholly inconsistent with the exercise of unbiased and honest judgment in the valuation of municipal securities, and it is further wholly inconsistent with the accepted standards of business and finance, . . . and could result in the complete lack of confidence in the ratings of such rating services, which would not be in the best interest of municipalities and other public bodies . . ."

Moreover, since in the capacity of consultants, the ratings services "would have a confidential and fiduciary relationship . . . with municipalities . . . the issuance of ratings by such rating services in such relationship would create a serious conflict with those entitled to rely on the integrity of such ratings."

It seems fair to question a system which places a possible conflict of interest situation on equal footing with the public interest.

CHAPTER SIX.—CONCLUSIONS AND RECOMMENDATIONS

The rating agencies as they now exist are not able to give primary consideration to the public interest as it is involved with bond issues of municipalities and borrowing for public purposes. Moody's and Standard & Poor's are not official agencies and their financial support and clientele reflect this. They cannot afford to profitably employ the staffs and resources necessary to insure that public financing will always be assured to qualified borrowers at equitable interest costs. Since their private interests expectedly are paramount, there is no reason to expect that they would do so. Proper ratings, alone, will not provide that assurance. But incorrect ratings will most certainly prevent it.

A new system may well be required—adequately financed to guarantee thoroughness, independently operated to prevent obvious conflicts of interest, and nationally organized to have each issuing jurisdiction personally inspected so that communities will not be rated solely on the basis of available printed information. In so vital a matter as a municipality's credit and bond rating, information must be gathered on the spot by people who know what to look for and where to find it.

The main difficulties with the ratings today stem from the quality of information used. Often, too often, this information is erroneous or incomplete. The ratings which result from the present system are demonstrably deficient. Whereas present agencies try to simplify questionnaires to avoid costly detail, proper ratings require even greater detail—more facts, figures, anything and everything which may help to evaluate an issue in question. Factors such as a community's management, outlook, and promise should be analyzed. Only personal investigation can be used as a basis for that kind of analysis. Only by assembling and correlating all available information can an analyst properly and adequately assess the investment quality of given offering.

A new system could be organized around a central office, well-staffed to act as a sort of "editorial review board" to give final approval to all ratings recommended by a series of field offices strategically situated throughout the country. Concurrently, a network of correspondents and researchers could be established, comprised of competent people to be called upon to investigate a particular locality (usually one issuing only limited amounts of bonds). The new agency could have as its primary function the rating of bond issues, but it could also serve as a source of data for those seeking information about particular issues. In any event, its operation would be in the interests of the public and the issuers in order to provide the most complete and thorough information necessary for a true, accurate, and fair rating. The agency could have a secondary role to maintain current files which would give financial and economic pictures of political subdivisions.

The new agency would not simply be a reformed version of those in existence. It would be an expanded system, providing those increased services made necessary by the growth of municipal financing in the United States in the last two decades, which bids fair to expand at an increasing rate to the end of the century.

The information should be gathered and stored using modern EDP methods with a library of computer tapes to provide, at a moment's notice, complete histories of municipalities being examined. This service could be available to all, whether subscribers or not, at a nominal cost. The agency should properly apply other computer techniques for analyzing issues. The final rating should be expressed numerically rather than be limited to alphabetical categories. The North Carolina Municipal Council, for example, has had great success in rating bonds from 100 down (with default situations occurring at about 60). This system allows fine lines of distinction, not presently available, to be drawn.

Periodic reports should be provided covering all new issues to be sold in the immediate future. These reports would supplement a larger volume of data containing facts about all bond issues and issuing municipalities. The format should be such as to make *seriatim* changes, additions, and deletions.

While further study is necessary and is also recommended, preliminary research indicates that such a system would cost over $500,000 per year. Many will ask whether the industry can afford this system. The real question is whether it can afford to be without it, or whether or not tax support for such a system would be an investment with a potential manifold return in the form of more accurate gauges for borrowing costs. The requirements of the public interest in today's multi-billion dollar bond market make it impossible to any longer "afford" the old system.

The new agency could, in fact, be supported by subscriptions sold to dealers, private investors, insurance companies and all other institutions interested in municipal bonds. Most probably, the cost of maintaining this operation could be raised through these subscriptions.

Of course, the agency would be totally independent of all subscribers and have no connection with any issuer or underwriter. This independence would have to be firmly established at the outset. The agency would then, undoubtedly, be approved by the Comptroller of the Currency, and its ratings would be respected by bank examiners.

Many banks, insurance companies, and other financial institutions have initiated their own rating systems. In Cambridge, Massachusetts, Alan Rabinowitz and his Urban Survey Corporation are collecting essential data on all municipalities and governmental subdivisions in the United States. Once collected, this data is stored in libraries of computer tapes and is available at the press of a button. Other work designed to rate public issues better is in progress, which can easily be incorporated into the new system herein suggested.

How long would it take to make this new system operative? If a plan were put into action fairly soon, it could be established within five years.

As a first step, it is recommended that a Committee be formed representing the Investment Bankers Association, the Municipal Finance Officers Association, the National League of Cities, the National Association of Counties, the Federal Deposit Insurance Corporation and other federal agencies concerned, as well as other major interest groups. The Committee's primary goal would be the establishment of a uniform municipal finance credit analysis. One of the philanthropic foundations interested in the development of municipal finance and its relationship to the public welfare should be willing to support the nationwide study herein recommended. Development would then proceed according to the Committee's recommendations.

The rating agencies, no doubt, will be among the first to recognize the need for another opinion. The creation of any agency specifically designed to rate municipal bonds would relieve the existing agencies of a great and apparently unrewarding burden. The rating agencies operate on very limited budgets and rating is only one of numerous functions they perform. Increasing public pressure to have all issues rated causes those available resources to be spread rather thinly. A new agency would relieve that pressure and allow present agencies to concentrate only upon those bond issues which are of greatest interest to their clients. The new agency would better serve the public interest while enabling the old rating agencies to better fulfill their primary role of serving the private interests of their clients and subscribers.

The market volume necessary to fill tomorrow's needs requires new ideas and new approaches.

Finally, most students of public administration would agree that the paucity of revenue and the accompanying financial plight of cities is one of the factors inhibiting the full utilization of our system of local self government. More and more, it is becoming necessary for municipalities to turn to higher levels of government for funding sources. Reform of the rating system should result in lower interest costs and, consequently, be at least one step in the direction of providing more money to municipalities for implementation of local government programs, services, and functions.

The volume of local bond issues in California alone each year is such that a difference of only a few tenths of one percentage point results in over \$2-½ million *per year* in higher interest charges which must be paid by its local governments. This can give rise to advertisements like the July 29, 1967 one from a brokerage house with headquarters at 1 Chase Manhattan Plaza in New York:

"It is truly amazing that general obligations of our American municipalities, recognized as a class of securities second only in safety to U.S. Government bonds are obtainable at yields of 4-½% tax-free."

On the basis of research to date and the present diagnosis of the system, the Institute for Local Self Government concludes that it is time, at least, for a major study to investigate the necessity for change and devise a system to do so. The major rating agencies concur. Robert Riehle, vice president of Moody's, said in mid-May, 1967: "No one can really appreciate the size of the job we undertake. A rating, after all, is really an opinion. It would help if there were more opinions for comparison."

The inescapable conclusion is that the bond market has grown too big in volume and frequency for the present rating system to do full justice to the public interest.

CHAPTER SEVEN.—TEXAS—A POSSIBLE MODEL

In 1955, the municipal securities dealers of Texas launched the Municipal Advisory Council of Texas. Acting "boldly and without benefit of landmarks," the voluntary trade association is limited to Texas firms engaged in the business of buying and selling municipal bonds. MAC's purpose is the promotion of Texas municipal bonds and improvement of the business climate in which Texas municipal bond dealers operate. It believes that the three keys to improving municipal credit evaluation and bond ratings are: (1) better financial reporting, (2) liaison and public relations, (3) industry regulation and betterment.

Its Executive Director, W. E. "Buck" Tinsley concurs in the Institute's findings that "the main difficulties with ratings today stem from the quality of information used and that often, too often, this information is erroneous and incomplete." It is his opinion, however, that "if we correct this condition, 90% of the criticism directed at the present system of bond ratings in this country would be eliminated, and he advised the Institute by letter of August 25, 1967:

"I am of the opinion that we have no problem worthy of mention with respect to bond ratings in this state. That is not to say that all of our issuing agencies are happy; far from it. And therein lies one of the reasons for the satisfactory situation which I think we enjoy: most of our local governmental units are constantly striving for a better rating, and in their striving not only do a creditable job of debt administration but help maintain a system of reporting which puts their record before the rating agencies in intelligible form."

The Texas bond volume is not insignificant. The total outstanding now exceeds $5 billion and the annual new issue volume is about three fourths of a billion dollars. The Texas system seems to be working well and the Executive Director of the Texas Municipal League states that "we feel the Municipal Advisory Council contributes a great service toward the financial stability of our Texas cities and other units of local government." Because it offers an alternative to a publicly supported rating system solely in the public interest, a brief description of it is presented as a possible model which other states might want to consider adapting. The material which follows is extracted from a limited edition report published by MAC in 1966.

Financial Reporting Activities

Financial information on the borrower is one of the essentials of all credit. This holds true for individuals and corporations but especially for local governmental units for whose bonds a day-to-day trading market must be maintained. One of the Council's first undertakings was the acquisition of historical data files on each Texas governmental unit and certain publication rights from Texas Bond Reporter, Inc. From these there has been developed a comprehensive financial reporting system on municipal finance in Texas which has no equal in any other state. The demands of this activity accounts for about 75% of the Council's budget and the manpower of its staff.

Texas Bond Reporter is a weekly news magazine with coverage limited solely to items of interest to municipal bond dealers and those in certain fringe industries. During the ten years of its publication under the Council's banner, it has charted from week to week pertinent details in the authorization, sale, issuance and delivery of $5 billions which the local governmental units of Texas have borrowed during that period. Its "Calendar of Scheduled Bond Sales" is invaluable in the orderly marketing of bonds in the volume demanded by the present rate of economic expansion. Among its several featured sections, dealers find such vital subjects as "Scheduled Bond Elections" and "Bonds Called for Redemption."

Texas Municipal Reports is a series of individually prepared reports to cover each of the 3,000-odd units of local government in Texas which have bonds outstanding. Coverage is designed to accommodate the needs of bond dealers, bondholders, securities analysts, rating agencies, and regulatory agencies concerned with investment portfolio examination.

During the ten years since Texas Municipal Reports was established, more than 18,000 Reports have been compiled, and more than four million copies have been distributed.

At no other time and at no other place in municipal bond circles has there ever been a reporting system which has approached the record of Texas Municipal Reports in its support of Texas municipal bonds.

MAC Special Reports, a series of reports on topics of current interest to municipal bond dealers, are published intermittently under such typical titles as "Investment Policies and Procedures of the State Permanent School Fund," "Property Assessment Ratios in Texas," and "A Directory of Assumed Bonds."

Texas Legislative Report, published weekly during the sessions of the Texas Legislature, reports the introduction of each measure which is of direct professional interest to the Texas municipal bond dealer. The progress of each such bill is charted from week to week, and, upon the adjournment of the session, there is compiled and published a digest of all such bills which have become law.

Maps of the Taxing Jurisdictions of Texas is a set of individual maps of each of Texas' 254 counties on which are shown the boundaries of each unit of local government which levies ad valorem taxes.

Liaison and Public Relations [1]

The term "public relations" does not fully describe the extent of the Council's activities in this area; "liaison" more aptly describes the contact which is maintained with certain agencies of State and local government and with certain associations of local governmental officials.

Liaison between borrower and lender is always desirable. But the holders of the $5 billion of outstanding Texas municipal bonds are numbered in the tens of thousands and are generally unknown. The local governmental units of Texas which have bonds outstanding are 3,000-odd, but at least they can be identified. It is in the interest of all concerned that the Council maintain liaison with all local governmental units of the State; moreover, that in such liaison it assume the posture of the bondholder.

Industry Regulation and Betterment

In this, the least publicized facet of the Council's program, the focus of attention is on internal problems of the municipal bond industry in Texas, although the objectives would appear to be as much in the public interest as any other part of the program.

Code of Ethics and Standard Practices. The adoption of the Code was one of the first actions taken by the members of the Council after its founding. It governs the professional conduct of members and demands the highest standards of good conscience and fair dealings in all transactions as between dealers, between dealers and bond issuing agencies, and between dealers and investors.

Standards for Financial Advisory Services. The principle of awarding a contract for professional services solely upon the basis of competitive bidding is not in the public interest. This fact is well known to all professions and the communities they serve. Therefore, standards of performance for bond dealers who accept employment as financial advisors to bond issuing agencies were established by the Council in 1958 and with it a schedule of recommended minimum fees. The arrangement has proved highly satisfactory to all concerned. There is no state in the Union whose local governmental agency loans are more soundly devised and favorably presented than Texas, although fees are among the lowest of any.

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[1] The list of agencies, in addition to local government units, with which the Council is in "continual contact" is impressive. It includes:

State Government: Attorney General of Texas; Banking Department of Texas; Board of County and District Road; Indebtedness; Coordinating Board, Texas College and University System; Education Agency of Texas; State Board of Education; State Legislature; State Securities Board; State Treasurer; Teacher Retirement System of Texas; Texas Water Rights Commission; Texas Water Development Board.

Associations of Local Government Officials: American Association of School Business Officials; City Clerks and Secretaries Association of Texas; County Judges and Commissioners Association of Texas; Municipal Finance Officers Association of the United States & Canada; Texas Association of Assessing Officers; Texas Association of Junior College Board Members & Administrators; Texas Association of School Business Officials; Texas Chapter, Municipal Finance Officers Association of the U.S. & Canada; Texas City Managers Association; Texas Municipal League.

Other Groups, Professional Societies, Associations and Regulatory Agencies: American Society of Association Executives; American Waterworks Association; Investment Bankers Association of America; Committee on Valuation of Securities, National Association of Insurance Commissioners; Regional Comptroller of the Currency; Texas Bankers Association; Texas Construction Council; Texas Group, Municipal and Utilities Branch, Associated General Contractors; Texas Research League; Texas Society of Architects; Texas Society of Association Executives; Texas Society of Certified Public Accountants; Texas Society of Professional Engineers; Texas Water Conservation Association; University of Texas—Institute of Public Affairs.

In conclusion, mention should be made of the educational activities of MAC which include: (1) An *annual municipal bond forum*—a meeting place for the exchange of ideas for personnel of all levels of experience; (2) An *annual municipal secretaries conference*—primarily designed for the benefit of female personnel in the municipal securities business; (3) *reference manuals* including a 300 page "Texas Bond Man's Source Book," and instructional notebooks for its conferences; (4) *field analyst—apprentice program*—four persons with primary duties to collect and assemble financial information, providing valuable training for potential practitioners in the municipal bond field; and, (5) *tools of the trade*—for mutual convenience. MAC has devised a number of standard-form contract documents. Blank forms are stocked and available covering such things as: Financial Advisory Contract for General Obligation Bonds, Financial Advisory Contract for Revenue Bonds, Financing Agreement, Bond Purchasing Contract (Pre-election), Bond Purchasing Contract (Post-election), and Account Letter for Western Type Joint Accounts.

Chairman PATMAN. Thank you, sir. Senator Proxmire will interrogate first.

Senator PROXMIRE. Mayor Tomlinson, you represent the National League of Cities in your statement this morning?

Mayor TOMLINSON. Yes, I do.

Senator PROXMIRE. And on the basis of your experience, and that of your colleagues at the National League of Cities, did you make any finding that it would be valuable to have banks underwrite revenue bonds?

Mayor TOMLINSON. Senator Proxmire, we have a member of the staff here, and I would like to consult with him on these questions, because the responsibility as chairman of this committee has not been long upon me.

I will read the national municipal policy statement which Mr. Harkins has given me:

Cities are turning increasingly to revenue bonds to finance necessary public works. Interest charges that cities must pay for revenue financing are determined in large measure by the competition between financial institutions for their issue. Although commercial banks may deal in general obligation bonds, they are prohibited by law from underwriting revenue bonds. This restriction in competition has the effect of increasing interest costs and as a result the cost to many municipal public works has necessarily increased.

I think this answers the question.

Senator PROXMIRE. It does indeed. This is something that has concerned us a great deal. We had extensive hearings in the Senate Banking Committee on this. There are problems involved in having commercial banks underwrite revenue bonds. But we feel that safeguards can be written into the law to protect depositors and so forth. At any rate, it would substantially increase the amount of competition, and would, on the basis of the testimony I thought that we had, indicate that we could have somewhat lower interest rates.

Mayor TOMLINSON. This last sentence reflects on the attitude of the national league:

Congress should authorize commercial banks to underwrite revenue type government securities, and to compete freely with other financial institutions in these issues.

Senator PROXMIRE. Very good.

Now, one of the points that you made—you implied this, and then you stated it explicitly later—was that these private rating agencies, Standard & Poor and Moody's—and you emphasized the privately

financed—just did not seem to have the capacity to give proper attention, especially to the smaller issues, but to all the issues overall.

I was not here yesterday, but I had a chance to read the testimony of the gentleman from New York, Roy Goodman, the city's director of finance, who made a very interesting analysis and pointed out on the basis of the 12 analysts that I think Moody's has, and working an 8-hour day, a 5-day week, and the number of securities that they had to analyze, they would only have half an hour for each, and they would have to pretty much accept the information given to them, wouldn't have a chance to doublecheck it. And that in many cases this would be grossly inadequate to give any kind of a proper analysis and conclusion.

Then he also went on to say this was not a very profitable operation. Standard & Poor and Moody's are not cleaning up on this thing. Anybody else can get into it, I suppose, and would if it were profitable.

His implication and your implication is that perhaps the Federal Government ought to get into it in some way, and provide, through Federal appropriations, an agency which would have—be detached from municipalities, but be in a position to provide this kind of rating service. Nobody has come out and stated that explicitly. I can see some dangers in it, but I would like to know your reaction. Is this what you have in mind?

Mayor TOMLINSON. I think you have touched on the problem as the league sees it, and that is it is not a profit situation so far as the two rating agencies are concerned.

Some means should be provided so that there would be somebody detached from the investors, the municipalities, and the Government, perhaps—that would be set up as a separate agency to do this job.

Senator PROXMIRE. Insulating them from political pressure would be tough. I would be called upon, I am sure, if for example, Fond du Lac, or Sheboygan, or Oshkosh had their rating dropped. I might be called upon to see what I could do about it, saying "This isn't fair." And I can imagine the New York Senators being pressured on the basis of New York City's having their rating dropped—and the additional cost of some $40 million—and they might go to bat to try to get this rating raised. This is the worst thing that could happen, in my view. Once you get that political pressure by powerful Members of Congress on this kind of rating system, you might as well forget about it. It would completely destroy it. And how you would prevent that puzzles me. It might be recognized by most Members of Congress they should not touch this kind of thing. But, after all, we are all human, and this is something of the greatest importance to our municipalities. And they might feel deeply aggrieved—maybe they are wrong, maybe they are right. But, at any rate, I would suspect that once we get it away from private control, we are going to have that kind of a problem. How do we deal with it?

Mayor TOMLINSON. Well, I don't know. I think that the problem is one that would require certainly a lot of consideration by this committee, involving those people who are interested as suppliers of the funds to the muncipalities. And I think that their interest chiefly is one of cold finance. They want to know, not what the political influence happens to be, but they want to know the ability of a city to repay debt. And I think this is the thing that in the final analysis has to be

given considerable consideration over and beyond my ability as an individual to appraise just what is the best system.

We are pointing to this as an idealistic type of solution.

Mr. PROXMIRE. There has been no question raised, to my knowledge—maybe it was raised yesterday—but in the paper I read—there has been no question about the integrity of these two services, or their honesty. They seem determined to do the best job they can. The only question is whether or not they have the resources and the competence and the time to do it. And I think the fact that their integrity is unquestioned is an important element here, one that we have to keep in mind, along with the very important element of trying to get some more resources into this very very important area.

Mr. TOMLINSON. As a matter of interest on this particular point, Senator, in our own case, I asked our finance officer what his experience was—he has been with us quite a number of years—with regards to Moody's and Standard & Poor's ratings, and he said, "We have always experienced a double A rating and always had good results in marketing our bonds, and have found no particular problem." We attribute this to the existence of the local government commission, the guidance we have had, and to our bond attorneys and those others who have been a great help to us over the years. Even in the North Carolina League of Cities office, we found relatively little concern about the rating systems. Of course, there is a rating system within the State of North Carolina—this is a numerical rating system, and this rating system is highly respected by the investors. So from my own personal experience we have a little different situation than we experience on a national basis.

Senator PROXMIRE. This really comes to a head when you have your rating reduced. That is what really rubs it. At the same time this is an indication, it would seem to me, of the integrity of the rating service. It takes a lot of courage, I would think, to reduce to BAA the bonds of a great city like New York or Boston or one of these other great cities, which are so important, and which rely so heavily—you know you are going to get terrific criticism when you do it.

I ask you, Mr. Behrel, if your experience with the rating service was quite favorable on the basis of what they told you? They were willing to listen to you and hear you out, hear your case? You were well prepared. You had a relatively substantial issue—that was not a small one—this was, in two cases, over $2 million, and a substantial sum in the other.

Was your quite courteous and favorable experience—do you think that was because of the size of your issue, and also because of the perhaps unusual care, detail you went into in preparing it?

Mayor BEHREL. I do not know whether it was because of the size, Senator; but I would say this.

Of course, we made our appointments in advance, and they allocated us all the time we needed. We were well received. There were suggestions of some changes that might be made in our prospectus, and they were done, which were as helpful as we thought they could be.

I might give you one little sidelight.

At Moody's we were asked whether or not we had a building code, and, of course, we told them "Yes." The parties said, "We would like to have a copy of your building code for our file." I said, "Well, it is only

five and a half inches thick, and 546 pages. If you get a building code from everybody who comes in with a bond issue you will need a new building." He said, "You won't have to send us the building code." What he was going to do with the building code in the ratings I don't understand.

But other than that little sidelight, we always felt our treatment at both Moody's and Standard & Poor's has been fine. I have been there on two separate visits, as you can see from these issues. I might add that the $3,750,000 storm sewer bonds was one issue. We sold $2 million in 1964 at what our bond consultant felt was a very bad market in his opinion, because we had pegged out interest rate not to exceed 4½ percent, and you will note in this report that we sold at 4.49 and a fraction, because the market—that was at the time the Federal Reserve had raised the interest rate a bit, and this affects the bond market, of course. In the following spring, when we sold the $1¾ million, we received 3.70, and this, of course, reflects the market.

I am sure the small cities can do nothing about that. That market situation is something—you sell your bonds at the most advantageous time. But we did not want to delay our storm sewer project, so we took a chance on the 4.49.

Senator PROXMIRE. You did not have the same, or did you have the same feeling that Mr. Tomlinson expressed here, and was expressed by Mr. Goodman yesterday—that the bond rating agencies have inadequate resources to do the job?

Mayor BEHREL. I don't know if I can say that. Frankly, I was very impressed with my visits to both Moody's and Standard & Poor's, with the qualifications and capabilities of the gentlemen and one lady we talked to. Whether they have enough time to aline each individual issue, of course, I could not answer. But I am sure on my one issue of $3,750,000, it would take more than 30 minutes to analyze and put that together, for sure—if this is the figure of the gentleman from New York, then they do not have enough time—if his figures are correct.

Senator PROXMIRE. Do either of you gentlemen have any judgment or any notion of the cost if this were done on a full and comprehensive basis by some agency? If, for example, all municipalities that had any interest in borrowing money, even if the borrowing was $25,000 or $20,000 or some very small amount—if all of these were given a rating, and you had adequate resources and adequate personnel to do it, to check wherever it was thought necessary at first hand the information that was sent in—what would be the cost to the Federal Government? Has there been any estimate of that at all?

Mayor BEHREL. I have no thought on it.

Senator PROXMIRE. I am concerned, because once the Federal Government gets into it, you cannot draw the line—you cannot say, "We are not going to rate anything less than a million dollars or less than $800,000, as the rating services do now." We would have to rate everything. Congressmen would come in and say, "This little town is as good as New York—there is no reason to discriminate against us because we are small." You would not be able to draw the line anywhere. I am just wondering what this would mean in terms of cost to the Federal Government. Is it very great, or something pretty modest?

Mayor TOMLINSON. Mr. Harkins has had more time to study this

report, which has some comments on the question. If there is no objection, I would like to have him comment very briefly.

Chairman PATMAN. I would like the record to show that Mr. Peter Harkins, of the National League of Cities, is appearing here, accompanying Mayor Tomlinson, I believe. Mr. Harkins has been very helpful to our committee in preparing for these hearings, and we appreciate the assistance he has given us. We would be glad to hear from you, sir.

STATEMENT OF PETER HARKINS, REPRESENTING THE NATIONAL LEAGUE OF CITIES

Mr. HARKINS. Mr. Chairman, the Institute for Local Self-Government prepared a recommendation which I might note did not necessarily recommend that the Federal Government enter into the rating business. However, in estimating the cost of the system that they have proposed, which, by the way, they have suggested should receive contributions from municipalities, buyers, bond houses, and so forth——

Senator PROXMIRE. I would be concerned about that.

Mr. HARKINS. That is their recommendation, of course. They have estimated such a service to be done adequately, including the use of electronic data processing equipment, would cost something over $500,000 per year.

Senator PROXMIRE. On the basis of your own knowledge of it, would you question that? Do you think that is pretty reasonable? For a comphrehensive system? The subsidy would be less than a million dollars.

Mr. HARKINS. I think the big factor concerned here, Senator is the use of the electronic data processing equipment. For example, yesterday Mr. Goodman made a point of the fact that he could not see how, with all the comparison that must be undertaken in formulating these ratings, and all the myriad of data that has to be collected—he could not understand how this could be accomplished without the use of EDP. Yet neither of the two agencies to my knowledge make use of EDP for this particular service. I understand one of them does for other services, but not this one.

Consequently, I think if you were to introduce EDP in here, then $500,000, or perhaps something closer even to a million dollars—I am not certain—would be a fair figure for the purposes of our estimates here.

Senator PROXMIRE. At any rate, the record is pretty clear that it is unlikely, even over a period of years, even as this snowballs—and we all expect municipal borrowing to increase enormously in the next 10 years, very greatly—revenue bonds especially, but general obligation bonds, too—and many more cities than in the past will get into this situation—you still feel that a million dollars is a pretty fair estimate—maybe a little more than a million?

Mr. HARKINS. Well, I would say for now that that is a good neighborhood figure; yes. Certainly, for the immediate future.

What we are going to get into, of course, in the 1970's, as far as rating requirements are concerned, I do not think we are even quite aware of that yet. But I think right now we can talk in terms of a million dollars.

Senator PROXMIRE. You gentlemen say not necessarily the Federal Government. I was—I immediately reacted, as I am sure others might—that they rely on contributions from municipalities—if you rely on contributions and they are going to be rated, I know what political contributions do.

~~Mr. HARKINS. I think what they had in mind, of course, was more~~ of a service charge.

May I draw your attention to a copy of this report which has been offered into the record—on pages 37 through 39 the recommendation is outlined in detail and calls for a number of procedures which should be followed. Mr. Diamond has a copy which you might care to look at. This outlines and gives more detail to the general recommendations.

(See insert, p. 92 et seq., for pages mentioned.)

Senator PROXMIRE. I want to thank you gentlemen very much for an excellent presentation.

Chairman PATMAN. Thank you, Senator.

How many of these issues turn sour a year? I use the word "sour" as going bad in one form or another.

This year I believe there will be about 6,000 issues. About how many of them, according to our experience in the past, would you say will go bad during the year?

Mayor TOMLINSON. I am sorry, I cannot answer that question.

Chairman PATMAN. Would you have any information on that, Mr. Behrel?

Mayor BEHREL. No, sir: I do not.

Chairman PATMAN. What about you, Mr. Harkins?

Mr. HARKINS. I would be glad to research that for you, sir, and submit a statement on that.

Chairman PATMAN. I wish you would. That occurs to me as being a very important problem. In other words, it goes to the question of whether or not a rating is necessary.

After all, whenever you permit people to rate, as they are rating here, you, in effect, grant them privileges to cause some cities to pay more than other cities. And, in effect, it will be a discriminatory practice. If you cannot rate them accurately and precisely, you will be causing some cities to pay a higher rate of interest than others. Those that rely upon bond rating analysis probably consider these evaluations to be exactly the same. And if the numbers of defaulted issues are so small that they are insignificant, I just wonder whether or not the rating service is the right answer. I just wonder about that.

(The following material was subsequently received:)

NATIONAL LEAGUE OF CITIES,
Washington, D.C., December 18, 1967.

HON. WRIGHT PATMAN,
Chairman, Subcommittee on Economic Progress, Joint Economic Committee, New Senate Office Building, Washington, D.C.

DEAR MR. PATMAN: On December 6, 1967 during the testimony of the National League of Cities before the Subcommittee on Economic Progress, you requested information regarding the record of defaults of municipal bonds. Having had opportunity to research this question for a Senate committee earlier in the year, I should like to supply your subcommittee with the product of this research, for its consideration in its study of municipal credit problems.

In general, the record of revenue bands is far superior to that of general obligations. However, some of this must be explained by the fact that revenue bonds were not widely used prior to the 1940's. Nevertheless, as the use of revenue bonds is rapidly reaching very substantial proportions, this growth has been

marred by only a virtual handful of defaults, most of which are described later in this letter, in comparison to the G.O. record.

Most of the defaults of general obligation bonds occurred during the depression period immediately following the 1929 failure, peaking in the year 1935 when there were 3,252 defaults of municipal issues on record. Special purpose or special assessment districts led the list of defaulting units, with school districts having the least number of defaults. Up until 1941, 144 cities and towns of over 10,000 population (by 1930 census) defaulted. (Interestingly enough, most of these cities were rated AAA or AA at the time.) However, legislation by Congress and state legislatures during the 1930's for the most part, has assured us that defaults of this magnitude will not again occur.

For a more detailed account of the period up to the end of the depression years, I refer you to the "Hearings before the Committee on Banking and Currency, House of Representatives, Eighty-Eighth Congress, First Session" (1963) entitled, *Increased Flexibility for Financial Institutions.* This citation covers a portion of the statement by Mr. Alan K. Browne, Vice President, Bank of America, San Francisco, appearing on pages 460–472 (inclusive).

During World War II, the number of issues of municipal bonds was greatly reduced in order to provide more capital for the war effort, and defaults of either type bond during this period were practically nil. Following the war, bond issues began their great upward surge toward the annual issue level of today. Revenue bonds came into prominence after 1950.

In total dollar amount, the volume of defaults of both type bonds currently stands at less than one percent of total debt outstanding of State and local governments. As mentioned earlier, the number and volume of revenue bond defaults is pitifully small indeed in comparison.

The following listings represent the only clearly recorded defaults since World War II.

The most well known:

Name	Type	Amount in default (millions)
West Virginia Turnpike Commission	2 series, revenues	$133
Parkersburg, W. Va	Revenue, issued for toll bridge	6.5
Dunbar, W. Va	do	4.2
Bellevue (Nebr.) Bridge Commission	Revenue	2.8
Burt County (Nebr.) Bridge Commission	do	1.97
Chicago Calumet Skyway	do	101
North Omaha (Nebr.) Bridge Commission	do	3.45
Total		252.92

Most of the above are making payments as money becomes available. Defaults in these instances were brought about either by higher expenses than originally estimated, by lower than estimated revenues, or by a combination of both factors.

With regard to general obligation bonds, the *Bond Buyer* reports a scant few G.O. defaults on record. Most are "ancient drainage district and special assessment bonds," located mainly in Florida and Texas.

Researchers have also estimated that there may be 30 to 50 current default situations in addition to those mentioned above, most of which are extremely obscure and of little significant dollar volume. They are generally "in over-promoted resort or suburban areas and submarginal rural areas where debts are entirely out of proportion to the resources available for debt service." The *Bond Buyer* has reported the following:

Arkansas: El Dorado Industrial Development Bonds — 1964
California:
Redondo Beach Harbor Revenue Bonds — 1965
Rio Ramajo District (G.O.) — 1965
San Jacinto Winter Park Authority — 1965
Louisiana: Conshatta Industrial Development Revenues — 1962
Michigan: Muskegon Township Water District — 1965
Mississippi (all industrial development revenue situations): Baldwin, Booneville, Clarksdale, Cleveland, Coffeeville, Greenville, Greenwood, Lambert, Port Gibson, Rienze,, Tupelo — (1)

Footnote at end of table.

New Mexico: Carlsbad — 1962
North Carolina: Saluda — [1]
Pennsylvania:
  Lancaster County Natural Gas Authority — 1964
  York County Natural Gas Authority — 1964
  Chester County Natural Gas Authority — 1966
Tennessee:
  Jefferson-Coke Public Utility District — 1965
  Middle Tennessee Natural Gas Utility District — 1962
  Anderson and Campbell Counties — 1966
Vermont: Colchester Fire District No. 3 — 1965

[1] Date not supplied.

I hope this information will be of benefit to the Committee and I shall be happy to supply whatever additional information on this subject, you may require.

Sincerely yours,

PETER B. HARKINS, *Legislative Assistant.*

Chairman PATMAN. Dr. Diamond, you have done some research on that. Do you have any information on it? Just go ahead and state it if you have.

Mr. DIAMOND. In a study issued by the Joint Economic Committee, on "State and Local Public Facility Needs and Financing," in volume II, chapter 15, there is a chapter prepared by an official of Dun & Bradstreet, which is another rating service, entitled "Post-War Default Experience of Municipal Bonds."

If I might read one paragraph?

Chairman PATMAN. Go ahead.

Mr. DIAMOND (reading):

> A search of primary sources of default experience revealed that in the post-war period there have been 30 instances of failure to pay principal, interest or both when due.

Chairman PATMAN. Thirty instances—in how long a period?

Mr. DIAMOND. Over a 20-year period, which means assuming that the volume of bond sales averaged at over 5,000 long-term issues per year—over 5,000 per year times 20 years means at least 100,000 issues. And you had 30 defaults.

Chairman PATMAN. That is practically none. I just wonder if we are talking about the right thing here.

Mayor TOMLINSON. I wonder, Mr. Chairman, if I might ask if there is any indication in this report as to the possible deterioration in value, rather than the going sour—the degree of going sour that you referred to a moment ago. They sold for a par price, and then at some later time sold for less than par. This I think may be the problem.

Chairman PATMAN. Anyway, I believe you will admit that we should consider whether we are approaching this thing in the right way.

It occurs to me that we need a source of capital for cities and towns which we do not have now.

I am sure you gentlemen recall the Reconstruction Finance Corporation under Mr. Jesse Jones. He was especially kind to cities in dealing with their problems. I know that in many instances he took a whole State and refinanced all their obligations.

But we do not have the RFC any more. We do not have any source of capital—I mean in large amounts.

It occurs to me that that is a problem which we should consider here. There should be another place to go instead of being dependent upon an almost fixed market. In an investigation I have made through the committee on the House side on interlocking directorates, it was revealed that a situation has developed in this country where we do not have much of an opportunity to get funds in large amounts to carry forward needed projects in cities, counties, and States.

I know of one case where there was a steel mill that should have been constructed. Everybody agreed, except the big steel companies. They were against it, they did not want a steel mill built anywhere. A new mill would affect their freight rates about $14 a ton, so they were against it. I know the sponsors of that project and it was strictly in the public interest. They finally wound up in New York. Around that big directors' table were directors of Jones & Laughlin, Republic Steel, United States Steel, and they tried to talk them out of the project. They did not have any idea of making them a loan. And then, of course, having failed that, they went back to the insurance companies, and the insurance companies said "We cannot take on this big money"—about $75 million—"but there are several companies in New York that can take it on, so we will pick out the best one and go up and visit them."

They went up there to visit them. They had around that board of directors table representatives of all these steel companies. And they did not have a chance. Finally they went to see Mr. Roosevelt and persuaded him. It was wartime and we needed steel companies. The big steel companies were right there opposing it, but Mr. Jones and Mr. Roosevelt approved a $75 million loan, and that steel plant was established. It has been in operation over 20 years. The company itself has paid back more than $75 million in Federal income taxes. The men who work there and the jobs generated by men working in the area have paid back more than $75 million. And so that was pretty good seed-corn money. I think an illustration like that could be used all over the country.

But the point I am trying to make is that there is no source of funds any more—big money.

The Government will help little business fellows get enough money to fight among themselves, but never enough to compete with the larger businesses.

So that is kind of an unequal situation the way I see it.

These mergers are going on every day and every week. There are hundreds of good boards of directors abolished each year composed of men with knowledge, experience, and management skill who are put out of jobs. If there was a source of big money, where people who have been displaced because of mergers, or who have retired because of compulsory retirement laws at 65 had an opportunity to get funds to go into businesses that are now somewhat monopolistic, it would be a great service to the public. There would be more competition, prices would be lowered, and everybody would be helped. But there is no source of funds like that.

It is the same way right here.

I think your problem is more the lack of opportunity to get consideration from people who are not in with the establishment, so to speak, on a competitive basis. You just do not have anybody to go to. And, as you said about the ratings, there is no appeal from them.

They have complete authority, they do what they want to. They make mistakes like all other human beings, I am sure. I am not charging that they do it deliberately.

But the information we had here yesterday and the information we have received since these hearings were announced, indicates that there is something terribly wrong with the present rating system. I think that people who have been doing the rating should seek an opportunity—whether or not it is for this committee I am not saying—to get this before the public, and let the public know they are not being cheated and defrauded. But it looks to me like there is something wrong going on.

I would like to ask you just a few questions.

Would you have any State constitutional or statutory requirement that gives debt service on your bonds a priority against tax revenues?

Mayor BEHREL. Not to my knowledge.

Chairman PATMAN. What about you, Mr. Tomlinson?

Mayor TOMLINSON. Not that I recall.

Chairman PATMAN. To the best of your knowledge, has a representative of any of the bond rating services ever visited your city to learn firsthand as to its economy and financial operations? Mr. Tomlinson?

Mayor TOMLINSON. I could not answer that with authority, but it was my feeling, after talking with our finance director, that they had visited our city. Perhaps because we are a State capital.

Chairman PATMAN. What about you, Mr. Behrel?

Mayor BEHREL. I cannot answer it authoritatively, either, except I know both the Moody and Standard & Poor people have been in the Chicago metropolitan area. Whether they have ever been in the city of Des Plaines, I have no knowledge. They have never visited my office.

Senator PROXMIRE. Not in the years you have been in it?

Mayor BEHREL. I have been mayor almost 12 years. I am in my third term.

Chairman PATMAN. To what extent is your city relying on user charges to finance these public facilities?

Mayor BEHREL. User charges?

Chairman PATMAN. Yes, sir.

Mayor BEHREL. You are referring to sales tax?

Chairman PATNAM. Well, no. Water and sewer charges, things like that.

Mayor BEHREL. We have the water system only.

Chairman PATMAN. You have user charges on the water system only?

Mayor BEHREL. Yes.

Mayor TOMLINSON. In our case, all of our utility indebtedness is paid for through our water and sewer bills. The complete operation is a break-even type of program—self-supporting in its entirety; about $30 million, and I think about 60 percent of this probably is utilities.

Chairman PATMAN. Do you make use of revenue bonds to finance needed public facilities?

Mayor TOMLINSON. We had a discussion of this yesterday, and on a clear definition of revenue bonds versus the obligation of the tax dollar—I think that ours are considered a type of revenue.

Chairman PATMAN. Do you have sales taxes in your two cities?

Mayor BEHREL. We have them in Illinois; yes, sir.

Chairman PATMAN. What is your sales tax?

Mayor BEHREL. Total sales tax is 5 percent, of which the cities and villages get three-quarters of 1 percent.

Chairman PATMAN. You mean the State collects 5 percent, and gives you three-quarters of 1 percent?

Mayor BEHREL. Yes, sir.

Mayor TOMLINSON. In the case of North Carolina, Mr. Chairman, we have a 3-percent sales tax, and it all goes to the State. There is one exception to this. We had a rather extensive fight in the last legislature last time in this regard, to try to get permissive type of legislation, so that a local county unit could impose an additional 1-cent sales tax. This was defeated in the legislature. However, the city of Charlotte was able to get a local bill through. The bill passed and the city had a referendum on this within the past 60 days, and the referendum passed. So in this one exception, the city of Charlotte, N.C., does get a 1-cent sales tax.

Chairman PATMAN. The legislature in Texas has passed a law to permit any city to have a sales tax by a vote of the people. A large number of small towns and cities have adopted the sales tax. Of course, a large number of them have defeated it, too. It is left up entirely to a vote of the people.

Has your city experienced any significant out-migration of middle-income families to the suburbs?

Mayor BEHREL. Well, in my case, we are the suburbs. The migration has been from the metropolitan city to our suburb.

Chairman PATMAN. You are the beneficiary of the out-migration. How about you?

Mayor TOMLINSON. The legislature authorizes the cities of North Carolina to annex the suburbs as they find it necessary. We may have experienced some exodus, but we take care of that.

Chairman PATMAN. You can take on all the land that adjoins yours?

Mayor TOMLINSON. We have guidelines by which we have to operate. But we can annex the areas with a certain ratio of population.

Chairman PATMAN. Do you have financial consultants on the bond issues?

Mayor BEHREL. Yes, sir.

Chairman PATMAN. You do, too, Mr. Tomlinson?

Mayor TOMLINSON. We use, actually, the local government commission for this service.

Chairman PATMAN. Do you use any assistance from the State government?

Mayor TOMLINSON. The local government commission is a State organization—a State-supported program.

Chairman PATMAN. Is yours that way, Mayor Behrel?

Mayor BEHREL. No, sir; we have no State agency for this purpose.

Chairman PATMAN. Suppose you had some method of guaranteeing the bonds, either by the State or Federal Government. I have not considered this too much, and I am not saying that it should be done, but wouldn't that eliminate most of your problems? We could have a sort of FDIC for municipalities, and they would pay a certain small amount into a fund to guarantee. Then you would not have any rating

problems, and all bonds should sell at the same price. Do you think that should be considered?

Mayor BEHREL. We have two facets. We not only have the rating service, but we have the bond buyer or the bond investor. If they are going to be satisfied with the FDIC feature of protection, then I think we have a solution. But this is going to be up to the people that put up the money for the bonds when they go for sale.

Chairman PATMAN. Well, as long as they have the money in the bank to make it good, it looks to me like that ought to satisfy them. That would at least eliminate any rating, wouldn't it?

Mayor BEHREL. It sounds like it would.

Senator PROXMIRE. Would you yield at that point, Mr. Chairman?

Chairman PATMAN. Yes.

Senator PROXMIRE. Kind of a mind-stretcher. I have this jotted down. I wondered how I could phrase it without making it appear I was considering this or advocating it—which I certainly would not do without a great deal more information.

How about an insurance system like FDIC? This would not only eliminate the rating services—it would very sharply reduce your interest rates. After all, if you had something that was 100-percent guaranteed, and you knew it was good, and you pay no Federal income tax on it, what more could you ask?

Mayor TOMLINSON. I would be personally concerned with the fact that if your city had an excellent rating and, even though you eliminate the rating system, you might deteriorate this position, by allowing the fund to be responsible for the borrowing of less sound financial enterprises.

Chairman PATMAN. It does not seem to hurt the banks.

Mayor TOMLINSON. Of course, the banks are controlled more directly, perhaps, in many cases, than the State legislatures control municipalities in their respective States.

Chairman PATMAN. There would be no control the way I see it. The control would not enter into it in such a big way as long as the insurance fund was taking care of a bond that defaulted. No investor would have anything to worry about.

Mayor TOMLINSON. I merely answer that way, because I think it would require a lot of study, to be real sure you are on good, safe ground.

Senator PROXMIRE. If the chairman would yield—what you are suggesting is in effect tax exempt U.S. Government obligations?

Chairman PATMAN. Well, the tax exemption part worries me, and especially since the banks have gone into the tax-exempt bond business. They own 45 percent of all tax-exempt bonds now; they bought them on the Government's credit—and they are paying no taxes on them.

Representative BROCK. But if the Federal Government guarantees a municipal issue, which is tax exempt, then in effect it is the U.S. Government which is the primary person to be concerned with. He is the real collateral.

Senator PROXMIRE. You might have an interesting trade here. A lot of us have been concerned about the inequity of tax exempts. A fellow with $10 million can sock it all in municipal bonds, pay no Federal income tax at all, and get a return of about $400,000 a year. This is inequitable. On the other hand, if you made a little trade of providing

for guarantees, insurance, and drop your income tax exemption, you might have greater equity.

Representative BROCK. Apparently the rating of some of our municipalities is better than the Federal Government, because they pay less interest. If they paid what we are paying today at the Federal level, it would cost a great deal more money.

Chairman PATMAN. When the present rate levels become applicable clear across the board, all bond issues with the lower rate will be refunded to reflect the present rates. If we were paying these rates on the whole Federal debt now, interest payments would be $21 billion a year. We are paying $14 billion, which is $7 billion excessive. Our cost of financing or servicing the national debt is the second largest item in our budget, and it is becoming larger and larger. Interest is the first thing that has got to be paid. Then you go to the next items, like war and national security. I just wonder if interest payments reach $21 billion if there would be much left for anything else.

Representative BROCK. Could I pursue this just a minute with another question, Mr. Chairman?

We mentioned banks a minute ago. Banks, of course, in order to get FDIC backing, a guarantee of their deposits, have to accept U.S. Government audit, audit and examination.

Would this be an acceptable thing to the cities, to have the same procedure apply to all of your fiscal matters?

Mr. BEHREL. Speaking for myself and the State of Illinois, we are subject to audit by the State of Illinois at the present time. How much more stringent the U.S. Government audit would be over the State audit, I do not know. Our books are audited once a year, and have to be approved by the State auditor—our financial statements. So we have some of it already. How much more it would be under the Federal Government, I have no knowledge.

Mayor TOMLINSON. City use of Federal grant-in-aid type of programs are subjected to this now.

Representative BROCK. Of course, a general audit would be pretty expensive. I wonder not so much about the cost, but I wonder about the degree of regulation that might be involved, insofar as requiring the consistency across the Nation in certain fiscal policies, practices. I wonder if it would perhaps hamper your diversity or your ability to direct your attention to your priority areas or problems. The audit in and of itself, just by its nature, almost requires a great deal of conformity. I wonder if that would really be beneficial to you.

Mayor TOMLINSON. There are two concerns. One, of course, is incentive and the other is regulation.

Chairman PATMAN. Would you permit a comment on the FDIC?

The banks, of course, have audits by the supervisory agencies, and the supervisory agencies are hard on the banks. You have never heard any complaint by the banks for any bad treatment or rough treatment or unreasonable requirements of the banks. The banks got more out of this FDIC than just appears on the surface.

I was one of the authors of the FDIC Act. I was not spearheading it, like some were. But they got something out of it that is never mentioned, which is considerable.

You know, they were going to have to invest at least one-twelfth of 1 percent of the deposits into the fund. That was considered a burden

on the banks, and they wanted something for that. So they had written into the law a provision that hereafter it shall be unlawful to pay interest on demand deposits. And that immediately permitted them to save from $3 billion to $4 billion a year. Right now I suspect it would save $10 billion or $15 billion. I have not figured it out.

But they got pretty good compensation for that.

Of course, that provision has created quite a bad effect on our economy in another way. The banks do not have to pay interest on demand deposits, which account for about half of their deposits. Whereas the savings and loan associations, on the other hand, have to pay for all of their investments. Since they are in competition with the banks this creates a bad situation from a competitive standpoint.

I am not bringing that up here for any solution, or anything like that. But in connection with the FDIC, it is interesting to note that while we were trying to remedy one situation at the time by having no interest on demand deposits, we created another situation that has caused us trouble in subsequent years.

Representative BROCK. I think the point I was trying to make, though, Mr. Chairman, is that the monetary system of this country is highly complex. It has many components. You have banks, savings and loans, insurance companies—loan institutions of various types. And the fact that our banks are heavily regulated, as are the savings and loans for that matter——

Chairman PATMAN. I question that part of it, with all due respect.

Representative BROCK. Well, they are fairly strictly defined in their area of operation.

But I wonder if you can just say banks provide all of the monetary system, the heft of it, when you have all the other institutions which do provide the diversity that is necessary in an economy such as ours. However, in this situation, if we were to back up municipalities with a Federal guarantee, and require regulation and audit and conformity, there is no alternative to the city in this country—it is the basic structure, elementary structure of government. You don't have the alternative devices that you do in the monetary system. I wonder if we would not hamper the diversity of this Nation if we tried to make them conform too much to a pattern.

Chairman PATMAN. You say "complex," Congressman Brock. Remember, though, the banking system is not complex. The commercial banking system has the exclusive privilege of creating money under the fractional reserve system. No other financial institution has that privilege. And, furthermore, having that exclusive privilege they are the only financial institutions with which you can have a checking account. No other financial institution is allowed that privilege.

So it is not as complex as you would indicate by saying that there are so many financial institutions that it becomes such a complex question. It is not complex when you consider that only the commercial banks have these exclusive privileges—the greatest and most lucrative privileges—which are not enjoyed by the others. It does not become as complex when you consider that, I believe.

Senator PROXMIRE. I would like to ask Mr. Tomlinson, you mentioned something about the problem industrial revenue bonds raises. We have been very concerned about that in Wisconsin. A tendency for our industry to go elsewhere. We are concerned about the inequity.

And that they are working to the advantage of very big industrial companies that are in a position to move part of their operation, much better than a small business does.

The industrial revenue bond seems to give them a subsidy, inasmuch as it is exempt from Federal taxation and so forth. Do you want to comment on that a little further? You brought it up. I take it when you brought it up you were speaking with your hat as a representative of the National League of Cities. So I would be very interested in your view.

Mayor TOMLINSON. The National League of Cities is, of course, as is reflected in its policy, very concerned about this thing. I also speak with a personal interest here and a statewide interest. You know the State of North Carolina has just passed a bill authorizing the issuance of industrial bonds. We never had this sales tool before.

Senator PROXMIRE. You had your great success without it.

Mayor TOMLINSON. We think we have been very successful, and this is one of the reasons why the North Carolina League of Municipalities fought to the last dying breath to keep this bill from passing. It did pass, however, and it is before the courts. The North Carolina Supreme Court has it. No determination has been made yet by the courts.

We felt, in presenting this to the committees of the State legislature, that actually—subsidy is a word you mentioned—it is a subsidy of our strongest financial organizations within the country. It is obviously having an effect upon the interest that we are having to pay for municipal bonds right now—because the funds are going off to industrial bonds.

Senator PROXMIRE. I beg your pardon, I missed that last part of your statement.

Mayor TOMLINSON. The funds are going in the area of industrial bonds in many areas, because the industrial bond is backed by big money, it is appealing, and it is a salable product. Some of our smaller municipalities especially are suffering from this. I think in the final analysis, if we approach this thing from the standpoint of losing the tax-exempt status of municipal bonds, which we may be placing in jeopardy in trying to eliminate the industrial bonds—as the league put it—we did not need this tool. As you indicated, we were getting the industry, quality industry, and quantity of industry. But, nevertheless, I think it is perfectly normal for a salesman to try to use all the tools at his disposal in order to sell a product.

Now, with about 40 States with authority for issuing industrial bonds, then what advantage is it to any when we arrive at 50 States that have this same privilege—what advantage is it to try to sell as opposed to some other State not having the ability to use the industrial bonds?

So we opposed it. The conservation development department did a pretty good job of selling the State legislature and the bill did pass.

I mention this because I think at this point Congress is about the only place we can find relief.

Chairman PATMAN. May I comment on that, Mr. Proxmire?

Senator PROXMIRE. Yes, indeed. However, I would just like to say I think this is a most unfair kind of competiton, because it means in effect that you are enabling an industry to move in and in some cases get a free plant, get—be free from local taxes for 10 years, all kinds

of concessions. And, of course, there is no income tax paid on the funds that are required to build the plant for that industry competing with another one—even in the same State, let alone another State, that pays taxes in full.

Chairman PATMAN. I realize the weight of your argument, Senator. But there are a couple of factors I think should be considered.

Are you going to tell a city: "You can only vote bonds for certain purposes; you cannot vote them for the purpose of having anything that might be in competition with other people elsewhere?" You could not go that far. I know no one wants to go that far.

You know what is a real problem here. The cities would like to borrow money, and they would like to use part of that money to help out industry, getting industry there, maybe getting little businessmen to get together and create an industry.

Nobody would object to forming and creating an industry within their own borders, and borrowing money through bond issues. I do not think that would be objected to.

Senator PROXMIRE. Providing it is tax exempt.

Chairman PATMAN. The other cities get everything for tax-exempt purposes. Why should you deny that particular city a tax exemption? I can see where if you confine an activity to just letting some big concern—blue chip concern, as Mr. Brock often says and he is right about it—go in there and use that for a sort of a subsidy, an extra bonus or premium, I think that is bad. I don't like to see that.

But where you use tax exemption for the cities' own purposes, to generate their own businesses in their own localities, I do not see where anybody on the outside has any right to object to that.

Senator PROXMIRE. How do you define their own business?

Chairman PATMAN. There is one thing that would correct it. Have another Reconstruction Finance Corporation where, if you cannot borrow money from banks, insurance companies, or other financial institutions, and you can carry a statement that "we cannot get our money elsewhere," an institution like the RFC would be in a position to furnish the capital at reasonable rates. We do not have that today.

Senator PROXMIRE. Another simpler way to do it is eliminate tax-exempt municipal bonds, which Mr. Tomlinson does not want to do. I think the mayors are very much opposed to that. But I just cannot understand the reasoning behind an argument that says it does not make any difference provided the businesses are not too big, to provide an exemption from the Federal income tax for facilities that are going to be used for private industry, in competition with others that have to pay a tax on what they build.

Chairman PATMAN. If the Federal Government, Senator, obligated itself to pay the States, counties, cities, and political subdivisions that have these outstanding tax-exempt bonds out for 20, 30, 40 years, a substantial part of that interest as compensation for dispensing with tax-exempted bonds in the future, I think it would be a good deal. The Federal Government would profit several dollars for every one dollar that it was compelled to pay in order to make the trade good. But we cannot just arbitrarily say that there will be no more tax-exempt bonds for schools, highways, and the needed construction and uses that we must have. We will have to ease it off some way.

But the Federal Government has a great interest here.

A person who can buy $10 million of tax-exempt bonds—

Senator PROXMIRE. Four percent interest on $10 million is $400,000 a year. Four percent is no trick to get now. You do not pay any taxes at all on that fat $8,000 each and every week of personal net income. Not a penny.

Chairman PATMAN. Not only that. If a person has a family he can send his children to school, use all the facilities of the city, county, and State, without any charge of any kind, without any taxes of any kind, and not even make out a tax return. You don't even have to report these bonds on your tax return. And since that is your only income, you just make no return at all.

Mayor TOMLINSON. In this connection, if I may, Mr. Chairman, in answer to Senator Proxmire's question, I would like to ask that our staff be permitted to send a copy of the paragraphs which I will not take the time to read, 5.301, 5.302, and 5.303, from national municipal policy.

Chairman PATMAN. It may be inserted at this point in the record.

(The material for inclusion in the record, mentioned above, follows:)

NATIONAL LEAGUE OF CITIES,
Washington, D.C., December 14, 1967.

Hon. WRIGHT PATMAN,
Chairman, Subcommittee on Economic Progress, Joint Economic Committee, New Senate Office Building, Washington, D.C.

DEAR MR. PATMAN: On December 7, 1967 during the hearings of the Subcommittee on Economic Progress, Senator Proxmire requested that the policy of the National League of Cities with regard to industrial revenue bonds be submitted for review. I have therefore attached to this letter an excerpt from the 1968 National Municipal Policy of the National League of Cities which deals with the subject of industrial revenue bonds. You will note that the Policy outlines an aggressive program to be undertaken by the League in the next year to encourage the states to enact legislation which would effect stringent supervision by the states over the issuance of these bonds.

May I point out that the National League of Cities is deeply disturbed by the current trends in the market reflecting the greatly increased volume of industrial aid bonds. While the revenue and finance committee of the League is in the process of researching alternative methods of bringing this problem under control, the League does oppose any federal legislation which would tamper with the basic tax immunity of municipal obligations be they industrial aid bonds or any other type of obligation. You will also find on the attached sheet two additional Policy statements concerning the subject of tax immunity.

I shall be most happy to supply an additional information you may require on this subject.

Sincerely,

PETER B. HARKINS,
Legislative Assistant.

NATIONAL LEAGUE OF CITIES,
Washington, D.C., December 18, 1967.

Hon. WILLIAM PROXMIRE,
U.S. Senate, Washington, D.C.

DEAR SENATOR PROXMIRE: On December 7, during the Hearings of the Joint Economic Committee's Subcommittee on Economic Progress, you requested that the National League of Cities supply you and the Subcommittee with a copy of the League's Policy Statement on Industrial Revenue Bonds. You also requested an outline of action the League believes would be helpful on a Federal basis in controlling the situation. I have attached a copy of an excerpt from the League's 1968 *National Municipal Policy* on the subject.

The thrust of the Policy Statement is a call for an aggressive program by the governors and state leagues and municipalities to secure state legislation to bring the issuance of these bonds under stringent state supervision. The League is

currently making plans, in cooperation with the National Association of Counties, the National Governors Conference and the U.S. Conference of Mayors, to carry out the directive of this policy.

The League is particularly concerned with the current trends in the tax exempt market, evidenced by the greatly increased volume of industrial revenue bond issues and the soaring interest rates on all municipal obligations. Our Revenue and Finance Committee is undertaking a comprehensive study prior to the League's next Policy Convention to identify additional alternative methods of reducing the use and impact of these issues.

While a substantial number of cities recognize the problems inherent in the expanding use of industrial revenue bonds and the need for some policy reducing their use, as you recognized during the Hearings, the cities are opposed to any Federal incursion on the basic tax exempt immunity of these or any other municipal bond. We believe earnestly that there are a number of alternatives to resolve this problem without any such incursion.

The attached Policy Statement reflects some of these alternatives, and, as I suggested earlier, we are seeking to develop additional methods of control.

We believe that there are still many legitimate uses of industrial revenue bonds. We must be careful in dealing with this problem that we do not eliminate a city's valuable device to accomplish otherwise legitimate objectives. The ideal solution therefore, may rest in devising a method to reserve the ability of cities to make use of these bonds in essentially public ventures, yet, bring a halt to the current instances of the seemingly indiscriminate substitution of private for public credit where, clearly. the short-term interest of the community may be served, but where, in the long-term, the interest of both individual community and all cities may not be served by such practices. Here, of course, I am referring to, among other problems, the current situation where cities are finding themselves squeezed even further out of an already limited money market.

With regard to recommended Federal action, for the time being, the League advocates Congress' giving its advance consent to the states to join in interstate compacts which would encourage the promulgation of multi-state agreements controlling the use of industrial aid financing. We believe that the states will be much more willing to undertake a supervisory program as our policy describes if their neighbors will do likewise, thus preventing unfair advantages from arising. I am enclosing a copy of suggested Federal legislation to this effect.

We further advocate Federal legislation to halt the so-called "double-dip" abuse, wherein a manufacturing corporation, benefiting from tax exempt financed facilities also owns the bonds which were used for the financing. This legislation is selective and does not involve the tax exemption of the bonds or their interest. I have also attached a "marked-up" version of HR 7979, introduced earlier by Mrs. Dwyer, which we support. Mrs. Dwyer has been provided with a copy of our recommended changes to her bill. I understand she has not yet re-introduced the measure.

I shall be happy to discuss this matter with you and your staff further and provide whatever additional information you may require.

Sincerely,

PETER B. HARKINS, *Legislative Assistant.*

(The following statement is excerpted from the 1968 National Municipal Policy of the National League of Cities, adopted August 2, 1967, at Boston:)

5.301 Tax Immunity of Municipal Obligations

The constitutional immunity of the states and local governments and their agencies from Federal taxation is necessary for the preservation of the form of dual sovereignty in American government. Local self-government cannot survive if the Federal government receives the power to determine local policy by penalizing certain local activities by Federal taxation while rewarding others by exemptions. The constitutional immunity of state and local activities from Federal taxation must therefore continue intact without exception. Congress must retain the statutory exemption of all state and local obligations and activities.

5.302 Tax Immunity of Interest on Municipal Obligations

The exemption of the interest on state and local government obligations from Federal taxation should not be diluted by partial "prorated" disallowance of otherwise allowable business deductions of Federal income tax payers merely because they invest in and receive interest on such state or local government

obligations. Yet such dilution occurs in the Life Insurance Company Income Tax Act of 1959 as interpreted by the United States Supreme Court in *United States v. Atlas Life Insurance Company*. The exemption of Federal obligations from state and local government taxation may not similarly be diluted by any such partial, prorated disallowance because Congress in Revised Statutes Section 3701 has forbidden the states and local governments to consider Federal obligations or the interest thereon, directly or indirectly, in the computation of state or local government taxes. The exemptions of state and local government obligations from Federal taxation should be as full as, and wholly reciprocal with, the exemption of Federal obligations from state and local government taxation.

Congress should enact legislation to conform the full and reciprocal exemption of state and local government obligations by providing that the interest thereon should not be considered, directly or indirectly, in the computation of any Federal taxes if, under Section 3701 of the Revised Statutes, the state and local governments may not similarly consider interest on United States obligations in the computations of state and local government taxes.

5.303 Municipal Bonds and Industrial Development

The unimpaired immunity of municipal bonds from Federal taxation is essential for sound local selfgovernment in our cities. However, the rapid increase of use of state and local revenue debt obligations for industrial development purposes may well result in a rise in interest rates on all municipal bonds due to the large number of such issues, the substitution of public for private credit, and the impairment of the marketability of the bonds. The effect of these developments will be to impair the effectiveness of bonded indebtedness as a financial resource to communities and to jeopardize the basic immunity of the interest on all state and local obligations. Consequently, the NLC disapproves abuses of this practice of using public credit to support private industrial development. In those States where this practice now exists or where it will be considered, we call on the Governors of each state to aggressively seek legislation to: (1) subject all industrial development bond issues to approval by a state supervising agency; (2) restrict authority to issue such bonds to local units of general government; (3) give priority to communities with chronic surplus labor, outside the area of the effective operation of conventional credit; (4) limit the total amount of such bonds which may be outstanding at any one time in the state; (5) prohibit such financing for the pirating of industrial plants by one community from another; and (6) provide machinery for informing the public as to proposed industrial development and bond projects, and to enable citizens to initiate referenda on such projects.

We urgently call on member cities and state leagues of municipalities to lend their full assistance and support to the immediate enactment of this legislation, where appropriate.

The National League of Cities should lend appropriate assistance and provide information to member cities and state leagues of municipalities in pursuit of this legislation and shall undertake a study over the next year to analyze the dimensions of the problems, to evaluate corrective measures taken, and in the process of being taken by states, and to prepare further appropriate recommendations to correct the problems associated with use of state and local bonds for industrial development purposes. The National League of Cities shall also issue, as necessary, reports to advise members of current developments in industrial bond financing and of findings and recommendations of its study.

Finally, Congress should give advance consent to interstate compacts to provide standards for the use of industrial aid financing.

H.R. ——

IN THE HOUSE OF REPRESENTATIVES

, 1967

Mr. introduced the following bill, which was referred to the Committee on

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A BILL To grant the consent of Congress to interstate compacts to limit public financing

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That:

SECTION 1. The consent of Congress is hereby given to each of the several States to enter into any agreement or compact, not in conflict with any law of the United States, with any other State or States for the purpose of providing standards for the issuance of tax exempt obligations to finance private industry, including, without limiting the generality of the foregoing, an agreement or compact to achieve the following objectives with regard to such issuance:

(a) subjecting all issues of such obligations to approval by a State supervising agency;

(b) restricting authority to issue such obligations to local units of general government and agencies of State Government;

(c) giving priority in the issuance of such obligations to communities with substantial and persistent unemployment or underemployment, and under circumstances where regular and effective operation of existing conventional credit facilities is not able to provide credit on ordinary commercial terms in adequate amounts;

(d) requiring a reasonable relationship between the volume of such obligations issued for any project and the employment needs of the community in which it is located;

(e) limiting the amount or amounts of such bonds which may be outstanding at any one time;

(f) prohibiting such financing for the pirating of industrial plants by one community from another; and

(g) providing machinery for informing the public as to proposed industrial development bond projects, and establishing procedures, whereby the electorate may have opportunity to pass on such projects to be financed by local units of general government.

SEC. 2. The right to alter, amend, or repeal this Act is expressly reserved.

[Special Note.—The "mark-up" changes shown on H.R. 7979 reflect suggestions of numerous experts who have worked on the "double-dipping" problem]

[H.R. 7979, 90th Cong., 1st sess.]

A BILL To amend the Internal Revenue Code of 1954 to deny deduction for rent, taxes, or interest incurred for the use or occupancy of an industrial plant financed by tax-exempt obligations

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

(a) DENIAL OF DEDUCTION.—Part IX of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to items not deductible) is amended by adding at the end thereof the following new section:

"SEC. 276. PAYMENTS TO ISSUER OF TAX-EXEMPT OBLIGATIONS

"(a) GENERAL RULE.—No deduction shall be allowed for any amount paid or accrued ~~(including interest on a mortgage and taxes)~~ to a State, the District of Columbia, a possession of the United States, or any political subdivision or instrumentality of any of the foregoing, relating to the use or occupancy of an industrial plant acquired, constructed, or improved ~~(in whole or in part)~~ *principally* out of the proceeds of industrial development revenue bonds, *issued to finance the acquisition, construction or improvement of the said industrial plant* if such bonds are or were at any time owned by the occupant of the industrial plant.

"(b) DEFINITIONS.—For purposes of this section—

"(1) INDUSTRIAL PLANT.—The term 'industrial plant' means any building or equipment which is used for mining, manufacturing, assembling, fabricating, ~~storing,~~ or processing articles or commodities (including any building or equipment the use of which is incidental to such manufacturing, assembling, fabricating, storing, or processing).

"(2) INDUSTRIAL DEVELOPMENT REVENUE BOND.—The term 'industrial development revenue bond' means any obligation issued (whether before or after the acquisition, construction, or improvement of an industrial plant) by a State, the District of Columbia, a possession of the United States, or any political subdivision or instrumentality of any of the foregoing, *without the pledge of the issuer's full faith and credit* to finance ~~directly or indirectly~~ the acquisition, construction, or improvement of an industrial plant.

"(3) OCCUPANT.—The term 'occupant' means—

"(A) any person in possession of the industrial plant ~~either~~ as lessee ~~or mortgagor~~ and any other person whose relationship to such person in possession would result in disallowance of losses under section 267 or 707(b) (but in applying section 267(b)(3) neither corporation need be a personal holding company), or

"(B) any corporation in possession of the industrial plant ~~either~~ as lessee ~~or mortgagor~~ which is a member of an affiliated group (as defined in section 1504, except that the phrase 'more than 50 percent' shall be substituted for the phrase 'at least 80 percent' each place it appears in section 1504(a)) and any other corporation which is a member of the same affiliated group."

(b) TECHNICAL AMENDMENT.—The table of sections for part IX of subchapter B of chapter 1 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following:

"Sec. 276. Payments to issuer of tax-exempt obligations."

(c) EFFECTIVE DATE.—The amendments made by this Act shall apply to any amount paid or accrued relating to the use or occupancy of an industrial plant acquired, constructed, or improved with the proceeds of any industrial development revenue bond issued after December 31, 1967.

Representative BROCK. May I ask one more question?

I gather that both of your cities have both general obligation and revenue bonds; is that correct?

Mayor BEHREL. That is correct.

Representative BROCK. Do you recall in issuing a general obligation how many bids you received as opposed to how many bids you received on a revenue bond? Is there a difference?

Mayor TOMLINSON. Our experiences have been that we have received around 20 bids on most all of our bonds that we call for bids.

Mayor BEHREL. We have not received that many. Generally on our revenue bonds we had eight bids in 1964. On the general obligation, storm sewer bonds, we had five in one instance and four in another.

Representative BROCK. I gathered from your statement, Mr. Behrel, that your revenue bonds were rated higher than your general obligations.

Mayor BEHREL. Yes, that was in my statement. The only reason we can find for it is the revenue bond of course in the rating service is not affected by the overlapping debt. We have the township, the county, the city, the park district, fire protection district, and you name it—we have 27 different districts—they are all a part of the real estate tax bill eventually. We have a new junior college. They came out with a $7 million issue. Moody and Standard & Poor insisted that we put that overlapping debt into our total figure, which we feel affected the rating and eventually the interest rate for the general obligation bonds in our city. This is not true with the revenue bond which is self-sustaining by the revenues of the sale of water.

Representative BROCK. Are your revenues also backed up in fact by the general obligations?

Mayor BEHREL. No, sir.

Representative BROCK. They are specific?

Mayor BEHREL. They are specific.

Mayor TOMLINSON. It it is all right, I would like Mr. Harkins to respond.

Mr. HARKINS. We at one time, sir, conducted a comparative study on this subject and found in reviewing all issues of revenue bonds, and

comparing them to the GO's in the same years that revenue bonds generally received one and a half bids less—this is an average figure obviously—than did GO bonds. The gentlemen are talking of specific situations here, of course.

Representative BROCK. There is a bill before the House Banking and Currency Committee to permit banks to participate in the underwriting of revenue bonds—not industrial—but revenue bonds. The argument has been made that their participation would broaden the base and perhaps the additional bids would result in a lowering of interest rates, because of the additional competition. I wonder if you have given any thought to this problem from your experience. Apparently in your opinion it would not have much effect.

Mr. HARKINS. Mayor Tomlinson already read into the record the National League of Cities' policy on that particular bill. We support it. We firmly believe that the added competition would indeed result in a greater number of bids.

Representative BROCK. I know the National League's position, but I gathered from your response it might not have any impact on your situation. I am talking about Raleigh, N.C., where you have a substantial number of bids.

Mayor TOMLINSON. I think—there is some confusion in my own mind as to the obligation of the tax base to repay our bonds. We have a very limited number of revenue bonds, per se, and I think they are limited to the airport authority.

While you could consider that our utility bonds are specifically revenue bonds, we are exposing the ability of the city to pay through the tax structure.

Representative BROCK. Quite often that is the case. And in effect they are almost general obligations, if not pure general obligations, whether it is a set-aside or specific revenues for that particular issue, as a prior claim. But they are backed by the full faith and credit of the city.

Mayor TOMLINSON. That is correct in our case.

Representative BROCK. One of the things that has distressed me a little bit in hearings of this type, and others that are held here in Washington, is that we sometimes, I am afraid, look at the trees to the extent that we fail to see the forest. I wonder if either one of you might comment on the general financial plight of the cities.

In my own State, and I think it is true in North Carolina, we are constitutionally prohibited from having an income tax. We are limited to sales and property taxes. We are at our constitutional maximum. We do have 1 percent additional for our cities, which we have already imposed. But we are at that constitutional limit on sales taxes. And our property taxes are to the point where if we raise them to the degree necessary to provide the kind of sewage, the kind of educational system, the kind of water system that is necessary in a growing metropolis, we might price ourselves out of the competition with Raleigh in trying to attract new industry. We have been fairly competitive in the past.

This is a problem, a dilemma that faces every city, it seems to me, whether or not there is an adequate resource base within the tax structure as it exists in the particular State.

I wonder if either of you have given—I know you have given a great deal of thought to the problem. I wonder if you have given much thought to some of the proposed solutions.

For example, there has been a great deal of interest here in Washington, some sort of revenue sharing or tax sharing or bloc grants, nonspecific grants, to the municipalities, counties and States on a flat percentage basis, in order to make the income tax available as a tax resource to your cities.

Have you addressed yourself to this, and if so, with what result?

Mayor BEHREL. Well, I can say that we have not in our city, and that it is an interesting concept that I would like to see and hear more about in the future.

We are at the top of our constitutional limit for sales tax in the State of Illinois, and obviously our real estate taxes are getting just almost out of sight. In our last legislature, there was an income tax bill presented and defeated. I am sure it is going to come up again. The implication of the income tax bill would be that it would relieve some of the real estate tax burden. But thus far it has not had the appeal of the voters—no question about that.

But this Federal grant, that you are discussing, may have some interesting ramifications. I have not heard of it before. But it would be interesting to look into, I would think.

Chairman PATMAN. Congressman Brock, wouldn't it seem a little unusual for the Federal Government to give part of the income taxes that the Federal Government collects to a State where they have expressed opposition to income taxes and prohibited them?

Representative BROCK. I think it would be—I think the reason the people in my State have consistently opposed an income tax—and it is prohibited constitutionally in Tennessee—is because the Federal Government has preempted such a large share of personal income today, that they do not feel they can take the additional burden.

The logic of the case—and I am an advocate, as you may gather, of tax sharing—is that both sales taxes and property taxes, by their nature tend to be somewhat regressive. They tend to penalize the low-income person primarily—they take a higher percentage of his income. Therefore, a State which constitutionally prohibits an income tax is in a position of being required to impose the most regressive form of taxation available. It is self-defeating in a number of ways. And I mentioned, in my own city, if it raised property taxes to the extent necessary to provide the services we really need—and there are great needs in our community—then we would lose our competitive advantage with Raleigh, Charlotte, Jacksonville, Atlanta, Birmingham, to the effect that sooner or later our industrial growth would phase off, or smooth out, and we would be hurting our tax base for the future.

So a property tax which is excessive is self-defeating.

The logic of tax sharing, Mr. Chairman, is that the income tax by its nature is probably the most equitable tax we have—it is certainly the most efficient. By allowing revenue sharing or tax sharing or bloc grants, we make that resource available to the cities, so that they can allocate it to their primary area of priority—their primary problem area—rather than being told by us what their problems are. And I think this is the reason I am very interested in it.

Mayor TOMLINSON. If I may comment on this, in North Carolina we do have an income tax on a State level. The cities are preempted as well as the counties in this area. We are vitally concerned about the increasing ad valorem costs and the burdens placed on the property owner. We are looking for all the possible areas of revenue, and we are very much interested in a tax sharing concept. And the National League of Cities has a policy on this, and revenue sharing has first priority for consideration of the revenue and financing committee in this year's study and activity. We also look to working with the Governors of the respective States, and with Members of the Congress. We feel that there is going to have to be a sharing program in order to support the needs that are very evident in the municpalities.

Representative BROCK. As you recall, the Governors unanimously, in the Governors' conference, endorsed the concept of tax sharing. I did not know that the Municipal League had taken a specific stand in the area, other than to express an interest.

Chairman PATMAN. That should not be a difficult vote for Governors, should it?

Representative BROCK. No, I do not think it would be very difficult. I do not think it should be very difficult for Members of this body, either.

Chairman PATMAN. I just wonder if it would lead to the eventual conclusion that since we are furnishing 5 percent to the States and later 10, 25, or 50, there should not be one tax authority of the Federal Government to collect all the taxes from the 50 States, and then just share the part necessary for the support of the Government.

Representative BROCK. If we could let the cities respond to the needs of their constituents in their own fashion, I think that might be something well off into the future.

Chairman PATMAN. The paramount question, I believe, is that some of us believe money should be spent for certain purposes, and some believe it should not be spent for those purposes at all.

Have you finished, Mr. Brock?

Representative BROCK. Yes.

Chairman PATMAN. And thank you, gentlemen, very much, for your appearance. You have been very helpful to us and your testimony will be valued by us.

Mayor TOMLINSON. One last point, if I may. Mr. Harkins reminded me, the municipalities and the Governors have been working together on this program and will continue to do so. I wanted to inject this in the record. It has been a pleasure for us to be here.

Chairman PATMAN. Of course, if it ever gets to the point where the Members of Congress will vote for all this money to be spent and the tax bills to pay it, it puts them in a position of taking the heat from the people, and the local people get the benefit of it, and they have no heat at all. They have not voted to provide this money, nor for the appropriations. That should be considered, too, from a practical standpoint in politics.

Representative BROCK. A very great President, a member of your own party, said, "If you cannot stand the heat, get out of the kitchen."

Chairman PATMAN. Thank you, gentlemen, very much.

Mayor BEHREL. Thank you. It has been a privilege to be here.

(Whereupon, at 11:40 a.m., the subcommittee was recessed, to reconvene at 10 a.m., Thursday, Dec. 7, 1967.)

FINANCING MUNICIPAL FACILITIES

THURSDAY, DECEMBER 7, 1967

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC PROGRESS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to recess, in room S-407, the Capitol, Hon. Wright Patman (chairman of the subcommittee) presiding.

Present: Representative Patman and Senator Proxmire.

Also present: John R. Stark, executive director, and Arnold H. Diamond, consulting economist.

Chairman PATMAN. The committee will please come to order.

Today we have a distinguished group of witnesses who are here to give us the benefit of their experience. Our first witness is my very able colleague from Dayton, Ohio, Representative Charles Whalen. We invited Mr. Whalen here because he is most knowledgeable and helpful and particularly in the area of finance.

We also have the mayor of Ohio, Mr. David Hall, accompanied by Mr. Graham Watt, the city manager, and Mr. Winton Parent, the finance director.

Later the committee will hear from Mayor Vern Miller, mayor of Salem, Oreg., accompanied by Douglas Ayres, city manager, and Duane Scott, executive director of the Ohio Municipal Advisory Council, Cleveland.

Gentlemen, I would ask you to keep your initial statements short, to give us more time for questions and answers. In addition to that, you may extend your remarks in the record if you desire to do so, and include any relevant, pertinent matter that you believe is important in the hearings.

We would be glad to have you do that.

Mr. Whalen, you may go ahead first.

STATEMENT OF HON. CHARLES W. WHALEN, JR., A REPRESENTATIVE IN CONGRESS FROM THE THIRD CONGRESSIONAL DISTRICT OF THE STATE OF OHIO

Representative WHALEN. Chairman Patman, members of the Subcommittee on Economic Progress of the Joint Economic Committee, it is an honor to be asked to appear before your subcommittee today in connection with your hearings on municipal finance. I have never served as an elected or appointed city official. Therefore, I have not been directly involved in the processes attendant to the securing of community funds. Nevertheless, as an economist and a 12-year member of the Ohio General Assembly, I am aware of many of the financial problems confronting our cities.

I. Scope

This morning, I shall address my remarks specifically to the issue delineated by the chairman in his statement of December 5; namely, "the difficulties experienced by small municipalities in marketing their bonds."[1]

II. Bond Marketing Problems

Finance officers of our Nation's smaller cities, in my opinion, face three distinct problems in their bond-placement efforts.

First, they frequently are hampered by unrealistic legal restrictions.

Second, they are at the mercy of a highly competitive money market.

Third, their communities' tax bases often bear no relationship to financial needs.

Let me analyze each of these situations briefly.

A. UNREALISTIC LEGAL RESTRICTIONS

During the depression of the 1930's 10 percent of municipal bonds outstanding—approximately $1.5 billion out of $15 billion—were in default.[2] As a result of this experience, many States imposed constitutional or statutory restrictions upon debt financing. Ohio residents, for example, adopted a constitutional amendment in the early thirties which limits to 10 mills the total taxes which can be levied against real property (assessed valuation). Any additional millage can be secured only through the vote of the electorate of a political subdivision. Additional taxes once approved, then are subjected to periodic renewals.

This simply means that finance officers must spend a great deal of their time campaigning for passage of bonds issues. Thus, in Ohio, as in other States, a city finance director, in addition to his fiscal capabilities, must possess the skill of a seasoned votegetter.

Many States, including Ohio, have established arbitrary debt ceilings (usually expressed as a percentage of total assessed property valuation). When this limitation is reached, even the most politically consummate finance director is prohibited from exercising his powers of persuasion.

It is paradoxical that local officials—those who are closest to the people—are burdened with fiscal sanctions which are not imposed upon Federal functionaries operating in Washington literally hundreds, or thousands, of miles away.

B. HIGHLY COMPETITIVE MONEY MARKET

Robert E. Weintraub, in his recent publication "Options for Meeting the Revenue Needs of City Governments," estimates "a revenue gap of $262 billion" during the next 10 years.[3] Projected expenditures

[1] Statement of Chairman Wright Patman, Joint Economic Committee, Subcommittee on Economic Progress, hearings on "Financing Municipal Facilities," Dec. 5, 6, and 7, 1967. P. 1 of proceedings, Dec. 5.

[2] James A. Maxwell, "Financing State and Local Governments." The Brookings Institution, 1965. P. 181.

[3] Robert E. Weintraub, "Options for Meeting the Revenue Needs of City Governments." Prepared for National League of Cities, TEMPO, General Electric Co. January 1967. P. 6.

during this period are $1,025 billion, while current revenue sources are expected to yield $763 billion.[4]

Of the alternative methods of closing this gap, sale of securities seems the least attractive, especially to smaller communities. Small cities not only must compete for funds against private borrowers (corporations and consumers) but also against larger, better rated municipalities. In order to attract investors, therefore, less populous cities, many of which are not rated by Moody's or Standard & Poor's, usually must offer their bonds at substantially higher rates of interest.

Under our profit system, a variation in corporate bond yields can be defended. However, it seems inequitable to the taxpayer of Coldwater, Ohio, to burden him with relatively higher interest costs merely because he happens to reside in a small community.

C. LACK OF CORRELATION BETWEEN TAX BASE AND FINANCIAL NEEDS

In 1962 over 90,000 local governmental units existed in the United States.[5] This proliferation of tax jurisdictions has distorted the correlation between revenue-producing capabilities and revenue needs.

For example, the inheritance taxes collected each year by one wealthy Ohio suburb have enabled that community to enjoy the lowest property tax rate in the State. Another small town is blessed with the presence of a huge industrial plant whose property taxes proved more than enough funds to meet this city's needs.

By the same token, many other political subdivisions lack the high-yield base which factories or high-priced residences provide. The needs of the citizens residing in these areas, however, do not differ materially from those who live in high-tax-base communities. Each of us wants a good education for our children; reasonable protection of our person and property; paved streets; adequate sanitation and recreation facilities. Regrettably those whose residences are in tax-poor districts are penalized in two ways. First, the quality of governmental services which they receive is substandard. They have poorer schools, ineffective police and fire protection, inadequate sanitation and recreation facilities. Second, in order to receive even this minimal level of service, they must bear a proportionately higher tax rate on their real property. This, in turn, crates a regressive tax structure.

III. RECOMMENDATIONS

What, if anything, can the Federal Government do to mitigate these municipal bond-financing problems?

The first—constitutional and statutory legal restrictions—does not come within the purview of Federal authorities. Hopefully, State officials will undertake (and are gradually doing so) the elimination or reduction of the archaic limitations which needlessly handicap local finance directors in their bond-disposal efforts.

As a nation, however, we are concerned about the need for a more equitable tax structure, equality of educational opportunities,

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[4] Ibid.

[5] James A. Maxwell, "Financing State and Local Governments." The Brookings Institution, 1965.

and adequate protection for all of our citizens. Thus, it is in the national interest, it seems to me, to produce an alternative revenue source which would reduce the dependence of American cities upon bond financing.

The major objective of national policy in the area of local government should not be further Federal assumption, or partial assumption, of certain responsibilities presently ascribed to our communities. Rather, the goals should be to strengthen local governments so that they are capable of assuming the increased responsibilities which the public expects of them. One means of fulfilling this objective is through some type of Federal tax-sharing program.

A Federal tax-sharing plan would offer three positive advantages to our Nation's cities.

First, it would reduce the dependence upon bond financing. Local taxpayers, in smaller communities, especially, will be relatively less burdened with costs stemming from the payment of premium interest rates.

Second, a portion of the total Federal tax rebate could be distributed on a need basis. This would provide material assistance to those who, because they reside in low tax yield communities, receive poor quality services.

Third, revenue sharing could effectively broaden local tax bases by providing an incentive to political subdivisions to establish and support certain services on an areawide basis.

Ultimate adoption of a Federal tax-sharing program, in my opinion, would strengthen both State and local governments so that they are better equipped to face the challenges of our time.

Mr. Chairman, I am pleased to be joined this morning by three distinguished representatives of the city of Dayton who are well versed in the intricacies of bond financing. I am certain the Dayton mayor, Dave Hall, city manager, Graham Watt, and finance director, Winton Parent in their testimony will make a significant contribution to your study.

Chairman PATMAN. Thank you very much, Congressman Whalen. We will be glad to hear now from Dave Hall, the mayor of Dayton, Ohio. You may proceed, sir, in your own way.

STATEMENT OF DAVE HALL, MAYOR OF DAYTON, OHIO; ACCOMPANIED BY GRAHAM WATT, CITY MANAGER, AND WINTON PARENT, FINANCE DIRECTOR

Mayor HALL. Gentlemen, my name is Dave Hall and I am mayor of the city of Dayton, Ohio. Dayton operates under the commission-manager form of government as established by its charter since 1913.

We have been invited by the National League of Cities to appear before your committee to testify on the effect of bond ratings and bonding capabilities of Dayton. So that you may know our city better, let me note a few basic characteristics.

The population of the city of Dayton reported by the 1960 census was 262,332. The present population is estimated to be over 275,000. The Dayton standard metropolitan statistical area includes Montgomery, Miami, Green, and Preble Counties encompassing an area of 1,715 square miles and a population exceeding 874,000. Dayton has 800

industrial plants distributing over 1,000 products and is widely recognized for the impressive diversity of its industrial development. The retail sales volume in Dayton for 1966 was $539,606,000 and for the Dayton standard metropolitan statistical area, total retail sales volume amounted to $1,284,499,000. Dayton is recognized as a world leader in the production of many commodities—such as refrigeration equipment, tools, business machines and computers—and as an international center in the precision industry. Wright-Patterson Air Force Base and the Defense Electronics Supply Center are two important Government installations located in our area with an employment of over 32,000, including 25,000 civilians, and an annual payroll of over $258 million. Dayton is engaged in five urban renewal projects, one of which comprises 750 acres and is one of the largest single urban renewal projects in the United States.

Pay-as-you-go funds, derived from a 1-percent municipal income tax and a real estate levy as provided by the city charter, are utilized to supplement bond funds for the financing of various projects in our capital improvement program. This program is projected for 5 years and encompasses major improvements such as parks and playgrounds, expressways, bridges, storm sewers, streets, and highways.

Dayton issues only general obligation bonds, both voted and unvoted, which are retired from property tax levies on a conservative 20-year repayment schedule. General obligation bonds also are issued for self-supporting utilities such as airport, water, and sewer facilities and, although the full faith and credit of the city is pledged, the bonds are actually retired from the revenues of each utility, thus relieving the burden on property taxpayers.

For many years Dayton has benefited from high ratings on its bond issues by the bond rating houses of Moody's Investors Service, Inc., and Standard & Poor's Corp. The rating of Dayton's bonds by Moody's was revised from BAA to A in December 1937. This rating remained in effect until November 1947 when it was improved to a rating of AA and then to the highest rating assigned by this firm of AAA in December 1953. This rating was reduced to AA for our bond sale of $5,050,000 March 13, 1963.

In connection with this 1963 sale, we requested advance ratings from both rating houses so that current ratings could be quoted in our bond prospectus to be mailed to various bond dealers, brokers, and investment firms. The lower rating first appeared in the Daily Bond Buyer of March 1, 1963, in its column, Calendar of Sealed Bid Openings. Although no notice was received from Moody's Investors Service, Inc., they later reviewed the new rating with Dayton officials. Moody's stated that "ratings are strictly an expression of opinion, and potentially there can be as many opinions regarding a specific bond issue as there are analysts who may have studied that issue." In response to our further request, we were told that there were no guidelines established to advise cities of specific actions to be taken to qualify for an improved rating. In effect, Dayton's rating was reduced as a matter of judgment and we could determine nothing about the basis for that judgment.

Dayton immediately conducted an investigation in an effort to determine the effect of this lower rating and we were informed that it probably would result in higher interest rates ranging from 5 to 10 basis

points on bids for future bond issues. Assuming an increase of only 5 basis points, this would mean an increase in interest costs of $5,250 for each $1 million of bonds sold having equal annual maturities over a period of 20 years.

Standard & Poor's Corp. has rated all our bond issues AAA, the highest issued by this firm, since March 1961. Prior to that time they assigned a rating of AA to our bonds.

Although we usually have one bond sale each year, we have prepared the following tabulation of sales held immediately after changes in our bond ratings:

	Rating		Debt payable from taxes	Total property tax valuations	Percent of debt to tax valuations
	Moody's	Standard & Poor's			
December 1937	A	(1)	$6,854,842	$326,234,490	2.10
November 1947	Aa	(1)	6,059,301	374,398,990	1.62
December 1953	Aaa	AA	16,323,013	618,836,260	2.64
March 1961	Aaa	AAA	27,703,829	853,232,170	3.25
March 1963	Aa	AAA	33,066,858	856,087,810	3.86

[1] Began rating municipalities in 1950.

We do not profess to be expert in the matter of bond ratings nor the effect of those ratings in the municipal bond market. We believe judgment in this area can best be expressed by the dealers in municipal bonds. However, in preparing this statement for your committee, we have attempted to determine expert opinion about the effect of the change in our rating from AAA to AA, by canvassing some of the more important bidders for city of Dayton bonds, both in New York and in Dayton. In each case we were informed that the change had little or no effect upon their evaluation of city of Dayton bonds as they consider them to be prime rated. Their opinions are substantiated by the following tabulation of our bond sales during the past several years which shows the volume of syndicate bids received, peaking at 18 in 1965 for a relatively low effective interest rate of 3.03 percent:

Sale date	Number of syndicate bids	Amount of sale	Effective interest rates
Nov. 16, 1960	13	$4,800,000	2.01363
Mar. 29, 1961	12	2,800,000	3.13436
Apr. 12, 1962	10	8,000,000	2.70815
Mar. 14, 1963	13	5,050,000	2.77452
Mar. 11, 1964	17	3,000,000	3.0648
Mar. 31, 1965	18	3,200,000	3.0313
Apr. 6, 1966	14	5,600,000	3.4745
Apr. 5, 1967	14	3,100,000	3.4157

Gentlemen, major cities throughout the United States are facing critical years ahead. As social problems develop, it becomes more difficult to secure public acceptance of essential tax increases and as interest rates rise your local officials will need all the help they can get. The strain on credit ratings and local debt capacity may be eased by the Federal Government assuming a greater share of the cost of programs that know no municipal boundaries—highway construction, air and water pollution control, public welfare, and airport construction are some of these areas. Such Federal aid programs should be financed

with advance grants—not reimbursements after the projects are paid for from local funds. This would eliminate the need for the city to lend its credit to finance the Federal share. Federal agencies should be authorized to withhold local income taxes from their employees as an aid to local governments and as a service to the government employees. And to a greater extent, perhaps, the Federal Government could guarantee payment of principal and interest on municipal bonds or establish an insurance fund against default as a means of increasing the attractiveness of municipal bonds and reducing the interest cost of local borrowing. Furthermore, the control of industrial aid financing may help to conserve available investor money for normal municipal borrowing, which would tend to hold down the interest cost of such debt.

To summarize, we agree with Standard & Poor's Corp., Dun & Bradstreet, and the dealers who bid on city of Dayton bonds that Dayton is a prime credit risk. We will continue our past practice of borrowing only what we need—when we need it. No city can stand still and survive. Dayton is growing and progressing. It is taking its place as one of the major cities in the United States.

May I present Mr. Graham Watt, Dayton city manager, to my left, and Mr. Parent, our finance director.

Chairman PATMAN. Do you gentlemen have statements?

Mr. WATT. No, sir. We do not. We are prepared to answer questions.

Chairman PATMAN. Would you like to file a statement for the record? You may do so, if you desire.

I want to ask you about this tax sharing.

I just wonder, Congressman, if you have two States side by side, and one has levied taxes heavily—income taxes, sales taxes, every kind of ad valorem tax, for education, schools, highway, all modern public improvements—and the State adjoining it we will say has practically the same sources of revenue but they have not gone out for taxes. They have no income tax, no sales tax, low on their ad valorem taxes. And they have not done as well as the neighboring State.

How would you evaluate the share each one received? Would you just give them indiscriminately the same proportion of the tax-sharing formula, or would you try to evaluate what they had done in the past and what they owed?

Reprsentative WHALEN. No; Mr. Chairman, I think that any tax-sharing program would have to have structured into it some test which would determine effort. And I think that criteria would have to be spelled out. Quite obviously it would be unfair, as you have implied, to provide one State with the same tax rebate as another State which has put forth a greater effort at the State level to collect taxes.

Chairman PATMAN. I just wonder how difficult the job would be to properly and fairly evaluate the two situations. And, of course, it is increased somewhat by the number of States, 50 States.

How would you do that? Would you have a board, or would you have something similar to a court of justice? Or something like the Interstate Commerce Commission—I mean——

Representative WHALEN. A number of suggestions have been made, Mr. Chairman. As you know, there are a number of bills which have been introduced in both bodies of Congress. I am not here to espouse any particular system. I am talking rather in general terms. But I would say, first, that it would be necessary to provide in the tax-sharing

system some plan whereby a judgment could be made with respect to local effort and State effort in the collection of taxes.

Second, I would recognize that this would not be an easy task. It would involve in some instances judgments which might be questioned, especially by those who receive a lesser share.

Chairman PATMAN. Then there is the question of whether or not they should be allowed to go into the courts, I assume.

Representative WHALEN. I would think any such system should have some type of appeal provision, where they could either go to the court or somebody that would be established.

Chairman PATMAN. Now, you mentioned a while ago about 91,000 governmental taxing units. I assume, of course, you must have meant to include the Federal Government jurisdiction and those of the States, counties, and cities.

Representative WHALEN. Yes; these would be separate jurisdictions—including, incidentally, school districts. This was in 1963.

Chairman PATMAN. Ninety thousand.

Representative WHALEN. It is less than this today. This figure was in 1963.

Chairman PATMAN. I have a statement here that corroborates your statement.

Representative WHALEN. Somewhat more than 80,000 today.

Chairman PATMAN. Yes, sir. In 1967 the number is 81,304. That includes local governments—81,000 local governments: 50 State governments, one U.S. Government, 3,049 counties, 18,051 municipalities, 17,107 townships, 21,782 school districts, 23,264 special districts.

I wonder whether or not it would be rather difficult to judge the local tax effort in each case.

Representative WHALEN. Well, here again I suspect that any tax-sharing plan would be on a State basis. The State in turn would have to determine that.

Chairman PATMAN. I would assume it would have to be that way—which would not make it as difficult.

Representative WHALEN. Yet I think emphasis should be given by the States to the municipal problems.

Chairman PATMAN. Mr. Mayor, can you explain why Dayton's bond rating was lowered?

Mayor HALL. We would like to have somebody explain this to us. We do not know. And they gave us no reason for it whatsoever.

Chairman PATMAN. Did you make an effort to find out?

Mayor HALL. Yes, sir. As soon as this came out, Mr. Parent went straight to New York to find out, asked everybody the same question—What have we done wrong? And everybody said—Well, this is just a matter of judgment.

Chairman PATMAN. I would like to have your opinion on how you got consideration. How many people did you confer with, and what were their positions in the rating bureau?

Mayor HALL. Well, it was Mr. Parent that went to New York City. Maybe he can answer this better than I.

Chairman PATMAN. I would like to have him elaborate on that.

Mr. PARENT. Mr. Chairman, I had an appointment with Mr. Ellinwood, vice president in charge of the municipal branch of Moody's. Now, Moody's is the only one that has dropped our rate. Standard

& Poor in 1961 increased our rate from AA to AAA. And they have maintained that rating from that date on.

However, in the conference with Mr. Ellinwood—the conference that the mayor refers to—Mr. Ellinwood had two of his staff in with him. I do not remember their names.

Further than that, preceding our bond sale the next year, the city manager and I, who at that time was Mr. Herbert Starick, went to New York and had another conference with Mr. Ellinwood, and tried to sell him our view on the city of Dayton. We were unsuccessful.

Chairman Patman. Have you finished?

Mr. Parent. Yes, sir.

Chairman Patman. Of course, obviously you did not consult the other one, because your rating was all right with the other rating bureau.

Mr. Parent. At that time; yes. Every time I make a delivery in New York, though, I make it my business to visit both of the houses and Dun & Bradstreet.

Chairman Patman. We were told here Monday, by Mr. Goodman, of New York, who seemed to have quite a bit of knowledge of these rating organizations, that only about a dozen people, I think, had to do with the ratings in each organization, and they were fairly low-paid as salaries go. Most of them were paid around $8,000 a year. And, of course, the officials in charge were paid much more. But I was not impressed too much with the character of the review as it was described. Did you receive a favorable or unfavorable impression of the organization that was dealing with your rating?

Mr. Parent. The contact I had, Mr. Ellinwood is very knowledgeable. However, I do not know the organization of Moody's. He did refer to a committee which reviews the folders or the files on each of the cities. And what that composition is, I do not know.

Chairman Patman. Now, with regard to the officials of these rating bureaus, have they visited your city at any time to determine firsthand on the ground something about your city?

Mr. Parent. I have been finance director for 8 years, and I do not recall any of them being in my office.

Chairman Patman. You do not know of any effort being made locally to determine firsthand the situation there?

Mr. Parent. No, sir. But conceivably there could have been some field inspections without an actual desk audit.

Chairman Patman. Your city has grown tremendously, I notice, from what the mayor said. What is your unemployment rate?

Mr. Watt. Citywide, under 2 percent.

Chairman Patman. That is about as low as it has been, isn't it?

Mr. Watt. Yes. We enjoy a very favorable rate.

Chairman Patman. What is the situation of this 2 percent? Are they unqualified by training?

Mayor Hall. We have jobs for the other 2 percent, too.

Chairman Patman. If they are able and anxious and willing to work?

Mayor Hall. If they breathe, we will take them.

Chairman Patman. You get a better bond rating by reason of your lower unemployment rate. Is that one of the factors?

Mayor Hall. I would think so.

Chairman PATMAN. But Mr. Goodman had in his portfolio the other day a statement to the effect that there are about 427 factors that should be evaluated in determining the proper rating for a city. You have not seen that information, I do not suppose—because it hasn't been published yet. But you are acquainted with, I assume, the number of factors that must be considered in proper evaluation.

Mr. PARENT. I have read several articles on what is considered in ratings, and I do not recall the number you refer to.

Chairman PATMAN. Quite a large number, it seemed to me to be. Does Dayton have a sales tax?

Mr. PARENT. The State of Ohio has.

Chairman PATMAN. Do you get part of it?

Mr. PARENT. Their distribution is made through what is called the local government fund, in which we participate. It was originally enacted to create moneys for local governments, but back in——

Representative WHALEN. About 1938.

Mr. PARENT (continuing). They changed it over to be general fund money for the State, and set up the local government fund which has a flat sum appropriated each year out of the State's sales tax, and it comes back to the various 88 counties on a formula basis, and the county budget commission is charged with distributing it among the local governments on the basis of need. Need is not defined, though.

Representative WHALEN. I might add, Mr. Chairman, that in the State general assembly, this question arose—getting back to our previous discussion of effort. I know the predecessor of Mr. Parent used to appear before the State legislature, urging that a new formula be adopted, because it was his opinion that the effort of the city of Dayton and other communities in imposing a municipal income tax was rewarded by a reduction in the funds granted through the county budget commission.

Chairman PATMAN. What about an income tax? Does the State have an income tax?

Representative WHALEN. The State of Ohio does not have an income tax.

Chairman PATMAN. Now, this is a profit-sharing plan, I assume, that you have in Ohio right now, on the sales tax.

Mayor HALL. I don't understand.

Chairman PATMAN. It is allocated according to the counties?

Mr. PARENT. It is a flat allocation. It is $2 million per month for the biennium. So there is no participation in growth—excepting at the will of the legislature. They can raise that $2 million if they care to.

Chairman PATMAN. That is $2 million for all the counties per month?

Mr. PARENT. That is right. Eighty-eight counties.

Chairman PATMAN. How much would that be—what proportion would you get—in proportion to what you paid in, if you have any way of ascertaining how much you paid in?

Mr. PARENT. I cannot answer that. I do not know that.

Chairman PATMAN. They do not make any effort to determine how much each county pays in in the allocation.

Mr. PARENT. But from the statistics we gave you in our report of our retail sales, it would not take much of a guess to say we share very small proportionately.

Representative WHALEN. Mr. Chairman, if you would like, I can provide that for the record.

Chairman PATMAN. Yes. Say whether or not it is 1 percent, 5 percent, 3 percent, whatever it is.

(The information subsequently submitted for the record follows:)

The State of Ohio's Local Government Fund is allocated among local subdivisions according to the formulas set forth in Section 5739.22 of the Revised Code. Briefly, this formula distributes seventy-five percent of the total $24 million to municipal corporations in the ratio that each city's total property valuation bears to the total property valuation of all municipal corporations in the state and twenty-five percent to counties in the ratio that population of the county bears to total state population.

In the calendar year 1966 Montgomery County received $1,361,376 as its share of the Local Government Fund. In this same year, the state collected $18,864,630 in sales tax receipts from Montgomery County.

Local Government Funds received by each county from the State of Ohio are, in turn, disbursed to local subdivisions (county, municipalities, and townships) by the County Budget Commission. The Commission, composed of three elected county officials—County Prosecutor, County Auditor, and County Treasurer—distributes the funds on the basis of "need", as defined by Section 5739.23 of the Ohio Revised Code. Of the $1,361,376 in Local Government Funds received by Montgomery County in Calendar year 1966, the City of Dayton received approximately $449,254.

Chairman PATMAN. Does Dayton have revenue bonds to finance such things as water and sewer facilities?

Mr. PARENT. General obligation bonds supported by revenues.

Chairman PATMAN. Sort of a user's tax on that, I guess.

Mr. PARENT. There are service charges of water and sewer, and the airport is self-supporting in its landing fees and concessions.

Chairman PATMAN. Does the State help you in preparing your case for bond issues—if you decide to ask the people to vote bonds, do you get any help from the State?

Mr. PARENT. That would be a local matter.

Chairman PATMAN. Senator Proxmire has just come in. He is not only on this committee, the subcommittee of his committee, but he is chairman of the whole committee.

Senator Proxmire, would you like to ask these gentlemen some questions?

Senator PROXMIRE. Yes. I am delighted to see Representative Whalen here. He is a man of very sound economic judgment—he agrees with me. [Laughter.] He made a wonderful speech the other day on the floor of the House.

Representative WHALEN. Thank you very much, Senator.

Senator PROXMIRE. He also has a most charming wife who is a jogger. She jogs and interrogates for a radio station.

Well, this is an interesting argument for tax sharing.

As you know, we had hearings before Mrs. Griffiths' subcommittee on tax sharing, and had some very strong presentations in that area. And you contend this might be at least a big part of the solution to the difficulties that the municipalities are having, in borrowing money.

Representative WHALEN. I would qualify that—the use of the term "big part." I think that it certainly would reduce the dependence upon bond financing. As you suggest, I think this is perhaps one argument for a tax-sharing plan.

Senator PROXMIRE. This seems to be your principal recommendation in this situation.

Representative WHALEN. Yes. I have addressed myself to this. I have not gotten into the question, for example, of rating systems. I think that Mr. Goodman, for example, in his testimony Tuesday touched on that. I think he did a very excellent job of presenting some of the problems which confront municipalities as a result of the rating system by the various bodies.

Senator PROXMIRE. One of the difficulties on sharing is—No. 1, it looks as if it will be a long, long distance in the future, because we would presumably wait until the Federal Government is in a position, either after the Vietnam war, or maybe later than that, before we will have an amount that we can share. Furthermore, the original motion, as I recall, was that you would have an embarrassing surplus and have to do something about it. That embarrassing surplus seems to be a less realistic expectation almost every day.

Then there is another problem, and that is the argument that I think Mayor Cavanagh of Detroit made, that he thought this could be used for fiscal policy purposes, too. Heller did not take that position. That is, that the sharing could be varied in the event you are having an inflationary situation—you could reduce the amount you are sharing with the city, and in the event you have a recession or depression, perhaps you could increase it. But I take it if you are going to use it to help meet your bond payments, it has to be pretty steady, something you can count on.

Representative WHALEN. Yes. I think using it as a fiscal tool would remove somewhat the needed aspect of certitude, which I think must be met as far as the communities and the States are concerned. In other words, they must, I think, in order to plan adequately themselves—have some indication as to what amounts they would receive in each fiscal year.

Senator PROXMIRE. Now, your suggestion that the Federal Government provide part of the income tax revenue to be shared with the States as an answer to this raises another interesting question that Chairman Patman suggested yesterday, or at least suggested we might discuss yesterday. And that is the possibility of having a kind of FDIC, and it could be by the Federal Deposit Insurance Corporation, itself.

Chairman PATMAN. The mayor suggested something along that line, I believe, in his prepared statement.

Senator PROXMIRE. Insurance of local borrowing. Now, of course, this would virtually eliminate the necessity for rating on the basis of risk, because, obviously, it would take the risk out of it. Just as there is no risk in a deposit of less than $15,000 in the bank now.

Representative WHALEN. I think rating certainly is a problem. On the other hand, when communities have to go into the bond market, they still have to face the rigors of the money market. Their rate of interest may vary dependent upon the rating they receive, or perhaps receive no rating. But I think that perhaps the major problem is the rigors confronting the municipalities when they go into the bond market.

Senator PROXMIRE. There is no question. For instance, now interest rates have increased very greatly. Regardless of whether you had an absolute safe investment or not, you have to pay higher interest rates than you did some time ago. But certainly from the standpoint of discrimination between municipalities. For instance, New York has

been dropped to a BAA. I notice that Dayton was dropped by Moody's to—from AAA to AA. It apparently did not have any effect—that particular drop—but obviously a further reduction would.

This element could be eliminated by FDIC insurance. All kinds of other problems develop in connection with it. On the other hand, there ~~has not been, as far as I know, any political influence with the FDIC~~ operation.

Most people accept that—I think that was a bipartisan—Representative Patman knows much more about this than I will ever know—but it seems to me there was both Republican and Democratic enthusiastic support for that.

Chairman Patman. Oh, yes. Senator Vandenberg from Michigan was one of the strong supporters of it.

Senator Proxmire. Everybody acknowledges now that it has been a great success.

Chairman Patman. We had to stop the adjournment of Congress at one time to get that bill through. We signed a petition that we would not authorize adjournment of Congress until that bill was passed—both Democrats and Republicans.

Senator Proxmire. So this is a possibility.

Mayor Hall. It seems to me the rating is almost like a human. I invest in real estate. When I go into a bank it is what I have done before, how I have repaid my loans and things of this sort. They do not tell me how I can do better. I suppose paying back faster or slower—I do not know which they would like.

Mr. Whalen happens to be one of the directors of our home bank. I go to him every day——

Representative Whalen. You are one of our favorite borrowers, I might say.

Mayor Hall. The bank president calls me every morning and asks me how I feel.

Senator Proxmire. Maybe when you go in there, it is the color of your shirt that impresses them. That lavender is pretty impressive.

Mayor Hall. Thank you. I enjoy it, too.

Senator Proxmire. He might put your Moody rating from AAA down or up on that one. Which brings me to my last question.

I notice in your statement, Mr. Hall, that you indicated that you have been unsuccessful in finding out why your rating was dropped. What did you do? What steps did you take to find out?

Mayor Hall. Let Mr. Parent answer this, because he went to New York. I went with him once, but I think he can answer it better than I.

Mr. Parent. I have given this recitation just a minute ago.

I immediately went to New York when we heard we had been downrated to AA, and had a conference with Mr. Ellinwood and two of his staff. At that time I was told they did not have to defend their ratings, it was a matter of opinion, and I said, "You tell us where we are weak, and we will build toward strengthening that," and he said, "There is no formula for rating."

Being unsuccessful that time, before we sold——

Senator Proxmire. Did you go any further? Did you go beyond Mr. Ellinwood?

Mr. Parent. I understood Mr. Ellinwood to be the top of the municipal division in Moody's.

Senator PROXMIRE. And there was no appeal from the decision?

Mr. PARENT. I knew nowhere to go. I have talked to Wade Smith of Dun & Bradstreet.

Senator PROXMIRE. Was there any change at all you could see in your national position? After all, AA is a very respectable rating.

Mr. PARENT. Yes, it is hard to be disappointed with a double A. But we are kind of a proud people back home.

Senator PROXMIRE. I don't blame you being concerned with any diminution. But you felt there was nothing else you could do—no other recourse, no appeal.

Mr. PARENT. That is right. Mr. Ellinwood did say our file would be reviewed annually, and that perhaps the AAA rating would be returned. But so far it has not.

Senator PROXMIRE. Did they indicate just in terms so that you could make your own judgment, just what their criteria were?

Mr. PARENT. No, no indication at all. He said "Your debt is growing." He referred to an article that was out of the bond dealer in Cincinnati, White & Co. It had reference to "Annie Doesn't Live Here Any More," or some such title. The theme was that the affluent city resident was moving to the suburb, and that if you do not grow this way, you are losing your upper-class citizen.

Senator PROXMIRE. Do you have a rigidity, inability to annex?

Mr. PARENT. No. Dayton has always had an open door for annexation.

Senator PROXMIRE. There is no State law that limits you.

Mr. PARENT. No. There is a procedure, though. It is 51 percent on a petition in the area to be annexed, and then a hearing before the county commissioners, which allows pro and con arguments from the public. And finally a decision from the commission that it can be or cannot be annexed.

Senator PROXMIRE. Have you lost some of your higher income people or industries because of moving out?

Mr. PARENT. The whole area is growing. Most assuredly some of the upper echelon, if that is the word, residents of Dayton have moved out to Washington township, and Kittering. I don't know where Mr. Whalen is now. But it is only natural that as the population grows, people like a little more elbow room, and they will move out where they can get it.

Senator PROXMIRE. Have you lost any industrial plants?

Mr. PARENT. We have lost some, gained some, and some that are there have expanded.

Senator PROXMIRE. It is conceivable, then, that they might have analyzed all this, and come to the conclusion that perhaps they ought to make it AA instead of AAA because your taxable base has been somewhat decreased.

Mr. PARENT. I would presume in their mind they had good material to make the judgment on. Although we would like to know what the judgment was based on.

Senator PROXMIRE. Just one other point. The chairman was right in indicating that Moody's apparently has 12 analysts who have thousands and thousands of issues to analyze. The Goodman paper showed that they would be able to spend about half an hour per issue. And that obviously they could not come to much of an analysis of the kinds of

things you and I are discussing now, without going back to you, getting more information, and sending an independent investigator out to spend some time there.

So it would seem their conclusion would have to be based on what you told them. And unless you gave them a basis for reducing the rating, it is hard to know how they could have done it.

Mr. PARENT. I talk so fast, I doubt whether they could have absorbed it in half an hour.

Senator PROXMIRE. Thank you very much.

Chairman PATMAN. Thank you very much, gentlemen, for your appearance. We appreciate your testimony. It will be helpful to this committee.

If you gentlemen would like to remain in the audience, we would certainly be delighted to have you.

We have some other witnesses here.

We have the Honorable Vern Miller, mayor of Salem, Oreg., accompanied by Mr. Douglas Ayres. And Mr. Scott from Cleveland is here.

Will you come around to the table, Mr. Mayor, and Mr. Ayres.

We are glad to have you gentlemen.

Just take your places at the table, please.

We will insert in the record at this point a statement from the mayor of Denver, Colo., the Honorable Tom Currigan. He was unable to get here, unfortunately.

(Mayor Currigan's statement, referred to by Chairman Patman, follows:)

CITY AND COUNTY OF DENVER, COLO., *November 30, 1967*.

HON. WRIGHT PATMAN,
Chairman, Joint Economic Committee's Subcommittee on Economic Progress, House of Representatives, Washington, D.C.

DEAR CONGRESSMAN PATMAN: The National League of Cities was kind enough to invite me to testify before the Joint Economic Committee's Subcommittee on Economic Progress on December 5 or December 6 during the hearings on municipal financing problems.

My schedule prevents me from being in Washington on either date, but because the subject of the committee's hearings are so important to Denver and all cities, I am taking the liberty of sending you a prepared statement, that you may wish to include in the record.

May I thank you personally for your interest in obtaining the viewpoint of mayors on this most important subject.

Sincerely yours,

TOM CURRIGAN, *Mayor*.

STATEMENT OF THOMAS G. CURRIGAN, MAYOR OF DENVER, COLORADO

Chairman Patman, and distinguished members of the subcommittee, most cities, including the city and county of Denver, have very stringent charter and constitutional limitations on bonded indebtedness.

The city charter of Denver, under the section "Limitation of Bonded Indebtedness," provides as follows:

"A6.17 Loans and bonds authorized by ordinance, voted by taxpayers—Limitation of issue. No loan shall be made and no bonds shall be issued for any purpose, except in pursuance of an ordinance authorizing the same, which ordinance shall be irrepealable until the indebtedness therein provided for and the bonds issued in pursuance thereof shall have been fully paid.

"A6.17–1 No loan shall be created nor bonds issued unless the question of creating the same and issuing the bonds therefor shall be submitted to the vote of such of the qualified electors of the city and county of Denver as shall, in the year next preceding such election, have paid a property tax therein and a majority of those voting upon the question by ballot shall vote in favor of

creating such debt and issuing such bonds, and the interest on all such bonds shall be payable semiannually.

"A6.17–2 The city and county of Denver shall not become indebted for any purpose or in any manner, to any amount which, including existing indebtedness, shall exceed three percent (3%) of the assessed valuation of the taxable property within the city and county of Denver as shown by the last preceding assessment of the city and county of Denver; provided, however, that in case section eight (8) of article eleven (11) of the constitution of the State of Colorado shall be amended at any time in respect to indebtedness of the municipality of the city and county of Denver, then and in such case the limitation of such indebtedness of the city and county, as above referred to, shall conform to any such an amendment so as to extend the provisions of said section 250 limiting the indebtedness of the city and county of Denver, as shall by such an amendment be provided for and authorized; and provided, further, however, that in determining the limitation of the city and county's power to incur indebtedness, there shall not be included within the estimate bonds issued for the acquisition of water, light, or other public utilities, works or ways from which the city and county will derive a revenue.

"(Sec. 3, charter amendment, February 17, 1914.)

"(Nota Bene: Section 250 referred to in the above section is now section A6.17.)"

It is important to note that this section of the charter was adopted by vote of the people of Denver on February 17, 1914. At that time, assessments were made on the basis of real value of property. Now, in 1967, under state law, assessments are made on the basis of 30 percent of the estimated sale value of the property. Denver's assessed valuation, in 1967, is approximately $1.1 billion. Thus, the city's maximum debt can only be $36 million.

It is the administration's belief that this limitation, while very realistic and proper in 1914, is too restrictive now, particularly in view of the fact that, in 1914, assessment was based on real value compared to a 30 percent figure in use in 1967.

Denver presently enjoys an AA rating for sale of general obligation bonds. Unquestionably, the 3 percent charter limitation is partially responsible for this excellent rating, plus the fact that the city has never defaulted on any bonds. We do not wish to jeopardize this rating.

If the 3 percent limitation is increased, either by a vote of Denver property owners to change the charter or by vote of the electorate throughout the State to change the constitution, our AA rating might drop and the city could find itself in the position of paying higher interest rates.

Discussing this with bond brokers, a rule of thumb increase for interest is ¼ percent for each reduced rating point. For example, if our AA rating dropped to an A rating, we would experience an increase of $112,500 in interest over a 10 year period on our hospital bonds alone.

Bond brokers, under the present rating system, are guided almost solely by the ratings of individual municipalities. The real basic question, then, is how are these ratings set, by whom, and what ground rules are followed. For instance, one person may come up with a rating different than another due to his method of calculation. If ratings are established through a standardized, supervised procedure that is fair and unbiased, the broker could always rely on the rating as a guide. Municipalities would then save the expense of a detailed and comprehensive prospectus on each bond sale.

In Denver, we are limited by the constitution of the State of Colorado from entering th income tax field. Therefore, we have only two major sources of revenue—property and sales tax—that can produce a sufficient amount of money to pay off bonds of any large amount.

One alternate method of financing capital improvements other than long-term bonds is the pay-as-you-go technique. Here again, cities are restricted until they have full taxing powers with which to provide the necessary funds. Cities, of course, are hard pressed to keep pace with the ever-increasing operating cost of doing business on a day-by-day basis.

Until such time when the local government has full taxing powers and cities receive a fair portion of the revenue collected within their boundaries by the State and Federal governments, the municipalities will always be in a financial crisis.

Chairman PATMAN. We now have Dr. Vern W. Miller, mayor of Salem, Oreg. You may proceed, sir.

Mayor MILLER. Thank you, Mr. Chairman.

STATEMENT OF VERN W. MILLER, M.D., MAYOR OF SALEM, OREG.

Mayor MILLER. Mr. Chairman, Senator Proxmire, Mr. Staak and Mr. Diamond. Gentlemen, I am Dr. Vern W. Miller, of the city of Salem, Oreg., and vice president of the League of Oregon Cities, and this is Mr. Douglas Ayres, our city manager. It is a great honor to be invited to appear here, representing the smaller cities of the country. It is gratifying to me, as a citizen of this great country that you are concerned with the problems of local government, which is the base upon which our governmental structure stands. Crumbling of this base is threatened. God has placed in our hands the means of attaining heaven here, or elsewhere. The result will depend upon the use made of these powers by us. The responsibility is great. Mismanagement of our blessings will bring down upon us the fabled Four Horsemen of the Apocalypse: famine, pestilence, disease, and war; and our civilization will surely be destroyed.

That the events of recent months have amply demonstrated that our great cities are in the advance stages of a near fatal disease—namely, neglect of capital improvements in the the past and failure to match improvements with the speed of urbanization. The smaller cities are suffering from the same disease, but in most instances it is not as advanced, and preventive measure, if taken now, can prevent advancement of decay at a much less cost. In our attention to the fatal case, let us not neglect the salvageable.

THE QUALITY OF LIFE IN THE SMALLER CITIES

There is much to be said for Secretary of Agriculture Freeman's idea of deurbanization. Programs that tend to increase the concentration of people in the great cities should give way to those that will make the small cities and towns more attractive. The land of opportunity should be the open spaces, an opportunity to work and produce food, for example, since nearly half the people in the world are undernourished—not be the land with the biggest welfare check and the opportunity to produce, only, more children on ADC.

There are vast areas of this land that with water and people would be a veritable paradise. Should we then spend billions to bring water past these lands to population concentration and promote a condition already out of control? Our plea is to not neglect the smaller cities and towns in this country.

Our own city of 67,000 people—the capital city of Oregon, incorporated in 1857—is a fairly typical example. In order to maintain a reasonable environment and to prevent decay, our city must, at the minimum, spend $80 million in the next 15 years over and above the income we now can see. We are struggling with the problems of finding financing to accomplish this. The cities of our State working together are making every possible effort to get State law changes which will improve our chances.

THE SPEED AND COST OF CHANGE

Anyone who has thoughtfully toured the magnificent Smithsonian Institution down the Mall here, as I did with Mrs. Miller this summer, cannot help but be impressed with the speed of change in which

mankind is participating. Man's inventiveness grows geometrically, as do the problems arising therefrom; yet the solutions to our human and governmental difficulties seem to progress only arithmetically.

Our concern in the smaller cities is that we will not have the wherewithal to prevent our going the way of the large cities. We are genuinely concerned that the speed with which change occurs will cause our problems of pollution, congestion, crime, housing, and illness to overcome us before we are in a position even to fully recognize their extent.

We hope that our testimony will assist your studies of the needs, and financing for, public facilities in the cities of the United States.

Our joint testimony submitted herewith as a separate document covers the specifics of Salem's last 16 bond issues and the bidding for them, and also supplemental information regarding them which you specifically requested. It also contains data on indebtedness for all Oregon cities.

We also have gathered some interesting information on the rise of municipal debt in the United States and raise the question as to whether the cities are unduly mortgaging their future and abetting an inflationary spiral, due to a chronic lack of adequate current revenues devoted to capital outlay. Our statement also outlines our backlog of capital needs and the master plans from whence derived.

We go on further to make some national revenue and debt comparisons and cite what our staff feels are some factors leading to higher municipal interest rates. We point out that cities generally do not have a source of income tied directly to the growth of the economy, and we even question the long-range propriety of what appears to us to be an imbalance in the "affluent society" between the public and private sectors of the economy. We also raise questions regarding industrial tax-exempt bonds and municipal bond marketing assistance.

SPECIFIC RESPONSE

SALEM'S LAST FIVE BOND ISSUES

You have inquired of us as to the net interest cost, repayment period, dates, amount, rating and purpose of our last five bond issues. Appendix A contains that data. In summary thereof, our net interest rate has ranged from a low of 2.9559 percent in October of 1964 to a high of 4.5545 percent in September of 1966. Four issues are to be repaid in 10 years and one in 15. All are so-called double-barreled bonds, being backed both by specific revenues and the full faith and credit. Amounts ranged from $305,000 to $1,340,000. All were AA rated, and the purposes were for sewers; and street, water and sewer special assessments, or local improvement districts as they are called in some States.

Attached appendix B also contains data on an additional 11 issues sold in the period from early 1957 to October 1964, with interest rates varying between a high of 3.6 percent in May of 1959 to a low of 2.613 percent in March of 1958. Most of these were special assessment bonds, but the largest were for water supply and sewage interceptors and a treatment plant. Also included were small armory and park issues. The longest period is for 25 years, with most being for 10. They ranged from $95,600 to $4,355,000.

On all 16 issues outlined we have received from a low of two bids once, and three bids four times; to a high of 11 and eight, once each. We have attached copies of press releases by our director of finance outlining the bidding syndicates and the number of participants in each.

SUPPLEMENTAL INFORMATION ON SALEM'S ISSUE

The committee also has asked for information regarding work performed by and costs incurred in retaining financial and engineering consultants and bond counsel, on our efforts to secure more favorable ratings, information provided prospective bidders, and the extent of assistance provided us by the State or Federal Governments. Appendix D contains this information in some detail.

In summary, we have found no need for a financial consultant having, with all due respect for Representative Whalen and Mayor Hall of Dayton's fine finance director, Mr. Winton Parent, the best director of finance in the country—Mr. Robert S. Moore. He and his predecessors have always prepared our issues for market.

Equally, we have found our city attorney capable of preparing issues, approved by bond counsel at modest expense. Consulting engineers have been used only twice, and each time restricted to design and cost estimating.

Our Mr. Moore, and his predecessors, both of whom are now city managers, have actually had no particular difficulty in either securing favorable ratings for us or providing adequate information to prospective bidders. In fact, Mr. Ayres is credited with writing the only authoritative document on the marketing of municipal bonds from the municipal official's viewpoint.[1]

[1] Ayres, D. W., "Marketing Municipal Bonds"; Rept. No. 239; Management Information Service of the International City Managers' Association; Chicago; December 1963.

We have had neither State nor Federal assistance in preparation or issuance of our bonds.

DEBT OF OREGON'S CITIES

With the assistance of the staff of our League of Oregon Cities, we also wish to present data on the debt of Oregon cities, which are like the cities of most States—they are going deeper into debt all the time. Below are tables showing the indebtedness of cities in our State, all of which except one—Portland—are under 100,000 population.

Oregon cities, with a total population of approximately 1,100,000 (or 55 percent of our population) reported total indebtedness of $135,-424,763 as of July 1, 1966, according to the State treasurer. Amounts on hand at that time for debt retirement left a net indebtedness of $120,994,159. This total debt figure amounted to $126 per capita for each city resident in Oregon for city government purposes only. School and county debt are not included.

The increase of Oregon city debt is shown in the figures since 1962, below:

Date	Total indebtedness	Net indebtedness
July 1, 1962	$109,103,917	$98,236,006
July 1, 1964	117,088,951	106,305,962
July 1, 1966	135,424,763	120,994,159

The following table indicates the amount of city debt as of July 1, 1966, by function:

Function	Number of cities with debt outstanding	Amount of debt
Water	112	$50,098,103.84
Sewers and sewage treatment	117	39,640,222.70
Local improvement assessments	61	14,714,792.32
Portland harbor	1	6,789,830.24
City halls	13	2,692,339.47
Libraries	10	1,350,000.00
Streets, bridges, parking	14	1,179,598.83
Airports	6	1,132,831.00
Swimming pools	12	664,600.00
Fire equipment, fire stations	15	548,946.74
Parks and recreation	6	374,791.64
Miscellaneous	21	1,409,724.17

Distribution of cities by the number in each population category, and the ratio of net debt to true cash value of all assessed property in the city, is reported as listed below:

Population	Up to 2.99 percent	3 to 5.99 percent	6 to 8.99 percent	9 to 11.99 percent	Over 12 percent
Over 100,000	1				
25,000 to 100,000		3	1		
10,000 to 25,000	5	9	1		
5,000 to 10,000	4	10	2		
2,500 to 5,000	9	13	5	1	
1,000 to 2,500	15	15	5	5	1
500 to 1,000	18	15	6	4	3
Under 500	36	11	3	2	
Total	[1] 88	76	23	12	4

[1] 21 of Oregon's 224 cities did not report any indebtedness as of July 1, 1966, the last figures available.

It is significant to note that the single recent tax-exempt industrial bond issue of the Port of Astoria (population 10,700) in the amount of $140 million, for the benefit of the Northwest Aluminum Co. exceeds by $19 million the total net debt of all Oregon cities for all municipal purposes combined.

A Thesis Regarding the Economy

WHERE ARE THE CITIES GOING VIS-A-VIS THE ECONOMY

Now that we have responded to your specific questions in specific terms, we would like to go behind this mass of data and form some theses. The question must arise as to where the cities are going. We hope it is not to mass bankruptcy, or to a massive traffic jam to the tune of automobile stereotape decks on impossibly clogged streets; but we fear it.

Basically our thesis is that without a major revision in the Nation's spending priorities, both in the public and private sectors of the economy, that that actual and symbolic traffic jam is as inevitable as are the proverbial "death and taxes." We feel that the rapid buildup of city debt is directly correlated to the rapidity of growth and the dearth of commensurate current revenue buildup available to the cities to meet this growth. We feel this is unhealthy, both for the cities, and as is being shown, for the national economy. We would now like to explore

our thesis, and to then make some specific suggestions for the consideration of the committee and your colleagues of the House and Senate.

MUNICIPAL DEBT RISE

We know that the subcommittee is aware of the rapid buildup of municipal debt, but we wonder if you are as fully aware of some contrasts between local and Federal financing and debt once intergovernmental transfers are excluded? For example, since 1942, Federal per capita revenues have increased 655 percent as contrasted to a 620-percent increase in State and local revenues. Yet during the same quarter century Federal per capital expenditures increased only 214 percent as compared to a 622-percent State-local rise. The thing which concerns us at the local level, however, is not so much the contrast between Federal and State-local expenditures, but the way in which localities had to make up the difference between their revenues and their expenditures. These comparisons come into clearer focus when per capita debt buildup of the Federal versus State-local governmental levels are compared.

During the same 25-year period Federal per capita debt increased only 304 percent as compared to a State-local increase of 380 percent. But, astoundingly, in the 16-year period from 1950 through 1966, Federal per capita debt actually went down 3.7 percent, but State-local debt climbed 345 percent.[2]

AN UNDULY MORTGAGED FUTURE?

Honorable members of the Committee, we suggest that, due to inadequate finances with which to support capital needs of an annually recurring nature, local governments of this Nation have been forced unduly to mortgage their futures. Hardly a day goes by that financial journals don't carry news of a local bond issue for firetrucks, streets, minor public buildings, park land acquisition and development, airport construction and the like, that more properly should be financed by capital outlay expenditures from current revenues, were such revenues extant. They presently are not; thus local government can no longer live as prudent families, financing only the most major expenditures—homes—by long-term debt, but are forced to dissipate their fixed incomes on interest charges servicing long-term issues for recurring capital expenses. It appears to us that this money should more properly be channeled into current expenditure programs, because cities have to purchase a given amount of these capital items each year as does private industry, yet we must bond for them rather than charge a major portion thereof up against current revenue.

AN INFLATIONARY SPIRAL?

While neither of us are economists, it seems to us that such long-term financing of ordinary annually recurring public capital needs builds an inflationary spiral into the economy. Cities thus have a vested interest in assuring that we repay our past obligations with cheaper dollars, adding pressure to further deferral of current capital financing needs, until the only alternative for the public official is an unwanted

[2] Table 580, p. 417; "Statistical Abstract of the United States, 1967"; U.S. Department of Commerce, Bureau of the Census.

bond issue, at increasing interest rates, rather than channeling these interest charges into more capital outlay.

A BACKLOG OF CAPITAL NEEDS

In our own community we are still trying to finance our ever-expanding backlog of capital needs by convincing our citizens of the need for a major new source of local revenue. But with the successful example of some of our neighbors having bonded the same expenditures we propose over 25-year periods, at nearly twice the cost, we are hard pressed to not resort to the "easy" route—bond issues. They, and now we, have fallen into the argument that "your children and grandchildren will pay for the improvement you will enjoy, and be able to pay for them with cheaper dollars."

Now don't misunderstand us, please, we do not advocate complete pay-as-you-go capital financing. We merely are questioning the long-term economic impact of "something" in the national economy which seems to effectively require cities to resort to bonding for regularly recurring annual levels of capital project needs.

Salem has only $191,000 of tax-supported debt, and we are advocating adding some $15 million to that, but we have considerably greater needs than bonds ever will meet. And that is only for city needs, and does not cover those capital requirements of other overlapping jurisdictions, such as the two counties in which Salem lies, the school district, and a score of special districts which the taxpayers of our city must finance in whole or in part, now and in the future.

MASTER-PLANNED CAPITAL OUTLAYS

Our city is one of the few, if not the only, which has essentially completed or has underway a master plan for each area of our development responsibilities—transportation, including streets and airports; parks; libraries; water and sewer; public buildings; beautification; land use and zoning; redevelopment and urban renewal; fire and police; storm drainage; and street lighting. We also have costed them out, and find that for a city of 67,000 we have backlogged and projected capital needs exceeding $80 million. By counting on maximum State and Federal matching grants-in-aid, which at present prospect is problematical at best, we can reduce our local burden to somewhat over $50 million.[3] Now, this is after eliminating even from consideration around $30 million of "needed but presently not imperative" projects, and roughly another $15 million of local urban renewal and redevelopment matching moneys. Thus, even counting on the nebulous possibilities of State and Federal assistance, and population growth to 100,000 through annexation of our unincorporated suburbs, we are faced with current capital needs of $500 per present and future man, woman, and child. Again, this does not take into consideration the capital needs of our citizens for school and county public facilities.

RESIGNATION TO DESPAIR IN THE CITIES

Based on conversations with every mayor and city manager with whom I have discussed this, I believe other cities are in no better, and

[3] "Capital Improvement Plan, City of Salem, Oreg., 1967–68"; Nov. 8, 1967.

ofttimes worse, condition than we. Were Salem's needed expenditures spread over a 15-year period, as we plan to spread some $35 million, with the balance of $15 million being bonded for 25 years, the annual per capita load during the 15-year period is brought down to around $30 per year per citizen. Yet, when debt service is included on just the $15 million, another $9 million is added, making the annual per capita cost rise nearly $3.60. Were the interest rate we will have to pay only one-half of 1 percent greater on the $15 million, another $1,125,000 would have to be paid by our citizens.[4]

While it is with trepidation that I use my own community as such a specific example, I do so to illustrate to you the frustration, and—no—almost desperation and resignation to despair, imbuing us local officials.

REVENUE AND DEBT COMPARISONS

While city government revenues have increased some 214 percent between 1955 and 1966, interest on city debts alone rose 248 percent, while outstanding debt grew only 175 percent in this 11-year period. On analysis of these figures an anomaly shows up—that of cities increasing their payoff of older debt in 1966 at a rate of nearly 2½ times greater than in 1955. Now it certainly seems to us that there is illustrated here a serious increase in reliance on debt to meet recurring city needs, while at the same time paying off of older debt which was financed at much lower interest rates. Our experience in Salem illustrates this, for since 1940 the interest rates we have paid for bonds have steadily increased, from a 1950 rate of 1.6 percent to a high in 1966 of 4.55 percent. We expect to pay as much or more on a million dollar special assessment issue we must sell early next year. And we are double A rated by Moody's.

FACTORS LEADING TO HIGHER INTEREST RATES

To the relatively unitiated on the national scene as ourselves, there appear to be several factors which have led to cities having to pay higher and higher interest rates, despite the fact that city bond interest payments are exempt from Federal, and generally State, income taxes.

First, as stated before, we believe that local governments have been forced away from financing capital outlays out of current revenues by virtue of the Federal and State governments preempting sources of revenue which tend to grow with the economy more than those left to cities. Second, the resultant public acceptance of the philosophy of paying off expensive dollars with "cheap" dollars; indeed, tacit agreement to inflation. Third, the recent rapid increase in the volume of tax-exempt industrial bonds, which soak up the traditional municipal long-term money supply. And fourth, the inability of many cities to properly structure, advertise, and market their issues, and of the rating services to adequately study the flood of bonds hitting the market. Even the rating services themselves recognize their inability to perform, a trend manifested in conflicts in ratings between themselves.[5]

If we might, we'd now like to comment on each of these reasons.

[4] Interest on $15 million calculated at 4½ percent with equal payments of combined principal and interest over 25 years.

[5] Reilly, James F., "Municipal Credit Evaluation and Bond Ratings—Diagnosis, Prognosis, and Prescription for Change"; Institute for Local Self Government; September 1967; Berkeley, Calif.; pp. 11 and 25.

NEED FOR A SOURCE OF GROWTH INCOME

We have already given some statistics and our theses regarding the capital outlay and revenue needs of cities, and the inflationary but practical pressures to resort to bonds with which to finance current and recurring capital needs. Even more basically wrong, in our opinion, however, is the need for continued overreliance on the property tax by municipal governments. Today our Nation is increasingly, and largely, composed of those either still in school or retired, thus causing ever-increasing pressure to transfer the burden of local governmental financing to the middle segment of the population which is better able to afford it. Such pressure results in the so-called property tax revolts being suffered in our own State and in numerous others, but always at the local level.

Nearly 60 percent of all the money local governments raise comes from the property tax, which has only indirect connection to ability to pay. Of major significance to the Nation's cities is the fact that nearly 80 percent of the Nation's personal income derives from other than real property.[6] Yet the cities are faced with the fact that these nonproperty tax sources have generally been preempted by the Federal and State governments, leaving little for local government but the traditional, and increasingly inequitable, property tax. Small wonder we are besieged with demands, but are rejected at the polls, when all we can do is ask for an increase in the property tax. It's analogous to cities being reliant on social security—only it requires a referendum in many places to increase municipal income, not merely the act of the representative Congress.

ADVERTISING AND AFFLUENCE

Caught between the constant outpouring of advertising of the affluent society on the one hand, and the ease with which short-term personal credit is extended on the other, it is small wonder that the individual taxpayer continues to defer his public capital needs. By law most local governments cannot advertise to compete for the consumer dollar, thus producing the imbalance in our economy of automobiles increasing much more rapidly than streets on which to move them; and the value of tobacco products shipped exceeding the total expenditures for all city police and fire protection, welfare, and parks and recreation combined.[7] In fact, advertising expenditures alone in 1965 came to within three-quarters of a billion dollars of equaling all general revenues of all cities in the Nation, for all local government service needs. More shocking, with city utilities and liquor stores eliminated, the advertising industry expended $3 billion more than the cities took in from all general revenue sources.[8]

One specific example of this unbalanced nature of our economy, which we can't help but feel will have serious implications for the economic progress of this Nation, is the contrast between the value of automobiles produced annually and the amount which we invest in highway and street construction on which to place them. In 1965 the

[6] Schultz, Glen R., "Municipal Finance Projections: Increased Volume, Higher Costs"; the Bond Buyer, May 31, 1966; p. 46.
[7] Tables 80 and 325, pp. 95 and 250, "Pocket Data Book, U.S.A. 1967"; U.S. Department of Commerce, Bureau of the Census.
[8] Tables 80 and 459, pp. 95 and 340; ibid.

value of factory sales and imports of motor vehicles was almost $23 billion. But in the same period this Nation spent only $12.3 on all of highway construction and maintenance at the State and local level. Anyone who has ever driven an auto, or attempted to do so in our cities, is not only well aware of this imbalance between the private and public sectors of our economy, but also exasperatedly aware of the terrible imbalance between Federal and State highway expenditures and the city level of street expenses; for only $1.8 billion is spent for city street construction and maintenance. Why, in the period 1950 to 1965 the value of new motor vehicles added to this Nation's streets rose 225 percent while city street expenditures for construction and maintenance were added to by only somewhat in excess of 210 percent.[9] Even worse, municipal street mileage increased only some 152 percent in the 1950–64 period.[10]

INFLATIONARY PRESSURES OF BONDING

Investors have begun to discount more and more this competition between the consumer industries and local government services within which consumer products are enjoyed, and the resultant inflationary pressures on cities to resort to longer term financing. This is illustrated by the increase of 138 points in the last 15 years in the Bond Buyer Index of 20 municipal bonds,[11] and the more than threefold increase in dollar volume of State and municipal bond offerings.[12]

INDUSTRIAL TAX-EXEMPT BONDS

A too-significant portion of this outpouring of tax exempts has been from the States allowing industrial corporations to ride the skirts of tax-exempt local governments. The Municipal Finance Officers' Association of the United States and Canada urges discontinuance of this dilution of municipal credit; the National League of Cities desires more stringent regulation of such bonds; and we personally decry such an abuse of municipal credit. Recent weeks have shown the national municipal bond market completely dominated by such subterfuge issues, literally pushing legitimate city bond interest rates to unprecedented highs. We cannot overemphasize the adverse impact of this type of issue, for to quote a municipal bond market analyst: "The best way to describe our market is that we are in psychological disarray * * * the rapid increase of industrial revenue financing is plaguing us. We expect about $1 billion of these bonds in the next 6 months." [13] Monday's Wall Street Journal brings this controversial issue into even better prespective:

> Industrial revenue bonds are being used increasingly by communities seeking to attract new industry and by companies trying to avoid the relatively high interest costs of conventional corporate debt securities. Nearly 40 states now permit the issuance of such bonds, double the number in 1960. About $1 billion of corporate municipal bonds to finance industrial construction will be sold this year, up from $1.5 million in 1956.[14]

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[9] Tables 80 and 325, pp. 95 and 250, "Pocket Data Book, U.S.A. 1967"; U.S. Department of Commerce, Bureau of the Census.
[10] Table 367. p. 279; ibid.
[11] Table 445, p. 328; ibid.
[12] Table 446, p. 329; ibid.
[13] The Wall Street Journal; Dec. 4, 1967.
[14] The Wall Street Journal; Dec. 4, 1967.

The only outcome we can see is the ultimate use of this device by all industrial and commercial corporations, with the commensurate leveling of tax-exempt and non-tax-exempt interest rates, and an accompanying drastic drop in Federal and State income tax revenues therefrom.

STATE AND FEDERAL BOND MARKETING ASSISTANCE

In our opinions the concentration of municipal finance talent and marketing efforts on these industrial bonds has detracted seriously from the more important needs of assisting cities to issue better financial data, strengthen bond sale advertising, time marketing more tightly, and broaden the market for tax exempts. For example, few States have ever considered the need for a State agency to consolidate and market small local issues.[15] Neither have we been successful in convincing you gentlemen to amend the Life Insurance Company Tax Act of 1959 to overcome the *Atlas Life Insurance Co.* Supreme Court decision, thereby broadening the market for city debt obligations. And these abuses and restrictions are continued in the fact of the authoritative prediction of a $15 billion a year municipal bond market within 10 years.[16]

[15] P. 6 ff., "Credit Problems of Small Municipalities," April 1967, National League of Cities, Washington.
[16] Schultz, op. cit., p. 46.

APPENDIX A

CITY OF SALEM, OREG.—SIGNIFICANT FACTS ON CITY'S 5 MOST RECENT BOND SALES

Description and purpose	Amount	Effective interest rate (percent)	Sale date	Bond rating	Repayment period	Number of bids received [1]
1. General obligation improvement bonds, 1967A—Assessed street, sewer, and water improvements.[2]	$1,339,000	3.3279	Mar. 1, 1967	AA	10 years—5-year call	8
2. General obligation improvement bonds, 1966A—Assessed street, sewer, and water improvements.	1,300,300	4.5545	Sept. 7, 1966	AA	10 years—3-year call	4
3. General obligation sewer bonds, 1965A—Construction of trunk sewerlines into developing areas of city.	745,000	3.21279	Oct. 13, 1965	AA	15 years—3-year call	6
4. General obligation improvement bonds, 1965A—Assessed street, sewer, and water improvements.	305,166	3.2319	do	AA	10 years—3-year call	6
5. General obligation sewer bonds, 1964A—Construction of 2 major trunk sewerlines to serve 4.4 sq. mi. recently annexed area.	500,000	2.9559	Oct. 14, 1964	AA	10 years—No call	4

[1] See attached press releases for detail on each of the bids received, names of bidders, composition of syndicates bidding and effective net interest rates bid.

[2] General obligation improvement bonds are sold in Oregon under provisions of State law which enable cities to recover costs of constructing new streets, sewers, and waterlines, costs of which are assessed against benefited properties. Property owners are assessed upon completion of project but may elect to pay in installments over a 10-year period. Installment payments are pledged to back a bond issue which also is backed by the full faith and credit of the municipality; hence bonds are sold as general obligations, enabling city to obtain cash for such construction at lower rates of interest than would be possible if only assessments were pledged to repay bonds.

Source: City recorder's files.

APPENDIX B

CITY OF SALEM, OREG.—SIGNIFICANT FACTS ON 11 ADDITIONAL CITY BOND ISSUES SOLD IN PAST 10 YEARS

Description and purpose	Amount	Effective interest rate (percent)	Sale date	Bond rating	Repayment period	Number of bids received [1]
6. General obligation improvement bonds, 1964A	$129,519	2.965	Oct. 14, 1964	AA	10 years—3-year call	4
7. General obligation improvement bonds, 1963A	126,772	2.633	May 27, 1963	AA	do	4
8. General obligation sewer bonds, 1963A—Sewage treatment plant and interceptors	4,355,000	2.899	Mar. 27, 1963	AA	23 years—15-year call	11
9. General obligation improvement bonds, 1962A	176,629	2.726	July 23, 1962	AA	10 years—3-year call	4
10. General obligation improvement bonds, 1961A	123,134	2.809	Dec. 11, 1961	(1)	do	4
11. General obligation improvement bonds, 1960A	110,896	2.925	Sept. 12, 1960	(1)	do	2
12. General obligation bonds, 1960 armory construction	175,000	3.280	June 13, 1960	AA	do	3
13. General obligation improvement bonds, 1959A	95,600	3.600	May 11, 1959	(1)	do	3
14. General obligation improvement bonds, 1958A	129,915	2.699	Mar. 24, 1958	(1)	do	3
15. General obligation bonds, 1958 park improvement	150,000	2.613	Mar. 24, 1958	(1)	10 years—no call	3
16. General obligation bonds, 1957 water transmission line	3,750,000	3.283	Mar. 5, 1957	A	25 years—10-year call	7

[1] City records do not reveal whether these smaller bond issues received a formal rating by an investor's service.

Source: City recorder's files.

APPENDIX C

CITY OF SALEM, OREG., PRESS RELEASE NO. 1, MARCH 1, 1967

The City of Salem, Oreg., received eight bids today on *$1,339,000 general obligation improvement bonds* maturing April 1, 1968 through 1977. The successful bidder was Bankers Trust Company, New York City, whose bid was at an effective interest rate of 3.32797%. A premium of $176.75 was bid. The detail of the low bid is as follows:

	Percent		*Percent*
$130,000 on Apr. 1, 1968	5.0	$135,000 on Apr. 1, 1973	3.2
$130,000 on Apr. 1, 1969	5.0	$135,000 on Apr. 1, 1974	3.25
$134,000 on Apr. 1, 1970	3.1	$135,000 on Apr. 1, 1975	3.25
$135,000 on Apr. 1, 1971	3.1	$135,000 on Apr. 1, 1976	3.3
$135,000 on Apr. 1, 1972	3.2	$135,000 on Apr. 1, 1977	3.3

Other bidders on the issue and their effective net interest bids were:

	Percent
(1) A syndicate headed by the First National Bank of Chicago and including Mercantile Trust Co. National Association, Schwabacher & Co., King, Quirk & Co	3.3394
(2) Continental Illinois National Bank & Trust Co. of Chicago	3.3485
(3) Western Security Bank, Salem, Oreg	3.3556
(4) First National City Bank, New York	3.3777
(5) A syndicate headed by the Northern Trust Co. (Chicago) and including Foster & Marshall, Inc., and the National Bank of Washington	3.4287
(6) A syndicate headed by the First National Bank of Oregon and including Merrill Lynch, Pierce, Fenner & Smith, Inc.; Pacific Northwest Co.; Blankenship, Blakely & Strand, Inc., and Rippey, Inskeep, Hess & McFall, Inc	3.4413
(7) A syndicate headed by the U.S. National Bank of Oregon and including Blyth & Co., Kalman & Co., Dominick & Dominick, Inc., and Atkinson & Co	3.4766

CITY OF SALEM, OREG., PRESS RELEASE NO. 2, SEPTEMBER 7, 1966

The City of Salem, Oreg., received four bids today on *$1,300,300.33 general obligation improvement bonds* maturing August 1, 1967 through 1976. The successful bidder was the First National Bank of Oregon whose bid was at a net interest rate of 4.5545%. The detail of the low bid is as follows:

Amount, maturity, and interest rate:	*Percent*	Amount, maturity, and interest rate—Continued	*Percent*
$130,300.33 on Aug. 1, 1967	5.0	$130,000 on Aug. 1, 1972	4.5
$130,000 on Aug. 1, 1968	5.0	$130,000 on Aug. 1, 1973	4.5
$130,000 on Aug. 1, 1969	5.0	$130,000 on Aug. 1, 1974	4.5
$130,000 on Aug. 1, 1970	4.5	$130,000 on Aug. 1, 1975	4.5
$130,000 on Aug. 1, 1971	4.5	$130,000 on Aug. 1, 1976	4.5

Other bidders on the issue were: a syndicate headed by the U.S. National Bank of Oregon and including Blyth & Co., Kalman & Co., and Atkinson & Co., (4.8181%); a syndicate headed by the Northern Trust Company of Chicago and including Foster & Marshall, Inc. (Seattle), and the National Bank of Washington, Tacoma (4.62819%); and the Continental Illinois National Bank & Trust Company of Chicago, (4.60701%).

CITY OF SALEM, OREG., PRESS RELEASE NOS. 3 AND 4, OCTOBER 13, 1965

The City of Salem, Oreg., received bids today on *$745,000 general obligation sewer bonds* maturing October 1, 1966 through 1980. The successful bidder was a syndicate headed by the First National Bank of Oregon whose bid was at a net interest rate of 3.21278%. The syndicate also included: Merrill Lynch, Pierce, Fenner & Smith, Inc.; Pacific Northwest Company; Dean Witter & Co.; June S. Jones & Co.; Charles N. Tripp Co.; Blankenship, Blakely & Strand, Inc.;

and Rippey, Inskeep, Hess & McFaul, Inc. A discount of $7,777.80 was bid on the issue with coupon interest rates as follows:

Amount, maturity, and interest rate:	Percent	Amount, maturity, and interest rate—Continued	Percent
$40,000 on Oct. 1, 1966	2.90	$50,000 on Oct. 1, 1974	3.00
$40,000 on Oct. 1, 1967	2.90	$55,000 on Oct. 1, 1975	3.00
$40,000 on Oct. 1, 1968	2.90	$55,000 on Oct. 1, 1976	3.10
$40,000 on Oct. 1, 1969	2.90	$55,000 on Oct. 1, 1977	3.10
$45,000 on Oct. 1, 1970	3.00	$60,000 on Oct. 1, 1978	3.20
$45,000 on Oct. 1, 1971	3.00	$60,000 on Oct. 1, 1979	3.20
$50,000 on Oct. 1, 1972	3.00	$60,000 on Oct. 1, 1980	3.20
$50,000 on Oct. 1, 1973	3.00		

Other bidders on the issue were: The Western Security Bank of Salem; a syndicate headed by the U.S. National Bank of Oregon and including Blyth & Co.; Kalman & Co.; and Atkinson & Co.; The First National Bank of Chicago; and a syndicate of the Northern Trust Company of Chicago and Foster & Marshall, Inc. (Seattle).

Also awarded to the same syndicate headed by the First National Bank of Oregon was a 10-year issue of *$305,166.07 street, sewer and water improvement bonds* at a net interest rate of 3.2319%.

CITY OF SALEM, OREG., PRESS RELEASE NO. 5, OCTOBER 14, 1964

The City of Salem, Oreg., received bids today on *$500,000 general obligation sewer bonds* maturing July 1, 1966 through 1975. The successful bidder was the First National Bank of Oregon & Associates whose bid was at a net interest rate of 2.9559%. A discount of $3,450 was bid on the issue with coupon interest rates as follows:

	Percent		Percent
$45,000, July 1, 1966	2½	$50,000, July 1, 1971	2.80
$45,000, July 1, 1967	2½	$55,000, July 1, 1972	2.90
$45,000, July 1, 1968	2½	$55,000, July 1, 1973	2.90
$45,000, July 1, 1969	2.70	$55, 000, July 1, 1974	3.00
$50,000, July 1, 1970	2.80	$55,000, July 1, 1975	3.00

Other bidders on the issue were the Commercial Bank of Salem, a syndicate of Blyth & Company, Kalman & Company and the Salem Branch of the U.S. National Bank of Oregon, and a syndicate of Foster & Marshall, Inc. (Seattle) and the National Bank of Washington.

Also awarded to the First National Bank of Oregon & Associates was an issue of $129,518.92 street and sewer improvement bonds at a net interest rate of 2.965%

APPENDIX D

CITY OF SALEM, OREG., SUPPLEMENTAL INFORMATION CONCERNING FIVE MOST RECENT BOND SALES

A. FINANCIAL CONSULTANTS

The City of Salem has not retained a financial consultant for any of its latest bond sales. The City has a full-time Director of Finance whose job it is to properly prepare and sell the City's bond issues.

B. BOND COUNSEL

Although the City has a full-time City Attorney who is extremely helpful to the Director of Finance in the preparation of bond issues, the necessity for a formal legal opinion on a bond issue generally dictates that a city obtain outside bond counsel. The bond counsel is an expert in the field of municipal bond law and is particularly versed in the laws of the state in which he practices. His approving opinion on a bond issue is looked to by the investment world as a guarantee that the bond issue is legally sound. The law firm of Schuler, Rankin, Myers & Walsh of Portland, Oreg., has been retained by the City of Salem for a great number of years to provide the legal opinion

for its bonds. The costs for the legal services are thought to be reasonable. Fees for the five most recent bond issues are as follows:

	Amount of bond issue and type	Sale date	Costs of legal counsel
1	$1,339,000 G.O. improvement issue	Mar. 1, 1967	$1,100
2	$1,300,300 G.O. improvement issue	Sept. 7, 1966	1,500
3	$745,000 G.O. sewer construction issue	Oct. 13, 1965	750
4	$305,166 G.O. improvement issue	Oct. 13, 1965	350
5	$500,000 G.O. sewer construction issue	Oct. 14, 1964	500

C. CONSULTING ENGINEERS

Consulting engineers have been retained to aid the City in only two bond issues in the past ten years. These issues were the $4,355,000 issue in 1963, which financed a new sewage treatment plant and the $3,750,000 issue of 1957, which financed a new water transmission line from the City's source of supply. The role of the consulting engineers was one of design and supervision of work for these projects themselves. Their role in connection with the bond issues was confined primarily to providing statistical information and total cost estimates upon which the amount of the bond issue was based.

D. OBTAINING MOST FAVORABLE BOND RATING AND LOWEST INTEREST COSTS

The City of Salem gives careful attention to the preparation and marketing of each of its bond issues. Much has been written and said about how a city can achieve the lowest possible interest on its bonds. Without going into detail, a city, generally tries to follow most of these guidelines, which are as follows:

(1) Keep the bond rating services continually informed as to the city's financial condition.
(2) Follow the legal requirements for the bond sale to the letter.
(3) Within the legal requirements, construct the bond issue (maturities, denominations, call date, interest limits, etc.) to appeal to the widest number of bidders.
(4) Time the sale, if possible, to take advantage of market conditions.
(5) Publicize the sale as widely as possible.
(6) Distribute an attractive, informational bond prospectus to a large number of potential bidders and answer any further requests for information promptly. (One copy of Salem's most recent prospectus is attached as Appendix E.)
(7) Publicize the results of the bidding.
(8) Continue to keep the investment world informed of the city's financial plans.

E. EXTENT OF STATE ASSISTANCE

The State of Oregon offers virtually no assistance to its municipal governments in the preparation and issuance of bonds.

F. EXTENT OF FEDERAL ASSISTANCE

The City of Salem has not received assistance from any federal governmental agency in the preparation or issuance of any of its bonds.

CONCLUSION AND RECOMMENDATIONS

In completing this potpourri and this tearful recitation of the continuing problems we city officials daily face, we would make to you several specific recommendations.

SPECIFIC RECOMMENDATIONS

First, develop a block grant program for sharing Federal revenues with the cities, and directly with the cities. We point out past performance of the several States and question their ability or inclina-

tion to channel such grants to the needy cities without placing undue restrictions on us, or "sopping up" the money on the way through.

Second, we would suggest some type of a federally subsidized public informational program—call it advertising if you wish—designed to acquaint the consumer with the basic fact that the local public sector of the economy must progress in harmony with the private sector or he will be unable to enjoy his private affluence due to the pollution and crowding of his environment, which will inevitably result unless such balance is upheld.

Third, we would suggest that Congress drastically limit the tax exemption privilege for public bonds used for the sole benefit of a private corporation.

Fourth, municipal officials would like to see the Congress restore the full intent of the Life Insurance Company Tax Act of 1959; permit the withholding of municipal income taxes from Federal employees pay; and permit regulated investment companies to distribute the interest on our bonds without loss of the tax exemption.

Fifth, we would suggest that the public facility loan program be properly funded so it can be utilized, and that it be expanded to financially encourage the several States to create subsidiary programs with which to assist cities to consolidate smaller municipal issues and secure better bond prices.

Finally, we would hope that you would recognize that the paucity of revenue and the accompanying financial plight of the cities is a major factor inhibiting the full utilization of our system of local self-government.[1]

Mr. Ayres now will briefly review for you, from a different angle, small-city financing problems. Thank you for permitting us to appear before you.

Chairman PATMAN. We shall be very glad to hear from Mr. Ayres. You have a very fine statement, Doctor. It will be very helpful to us. It is thought provoking, brings up the real problems that we have to face.

Mr. Ayres, you may proceed with your statement, sir.

STATEMENT OF DOUGLAS W. AYRES, CITY MANAGER OF SALEM, OREG.

Mr. AYRES. Chairman Patman, Senator Proxmire, I do not believe that you will find Salem atypical of the cities of the Nation in the approaching resignation to despair which our written statement expresses. Nor will you find Salem any different from the majority of the cities in the country under a quarter million population in the form or substance of our local government and problems.

Mayor Miller's concern is universal in the cities, even if it is not commonplace that he literally walked out of surgery to the airplane here after performing two major surgical operations yesterday morning. That deep concern is manifested by the additional fact that he has served our community more than a decade; all elected, nonpartisan and unpaid. This is an example of citizen action regarding the seriousness of the plight of our debt and obligation-ridden cities.

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[1] Reilly, op. cit., p. 40.

SALEM'S STATISTICS AND THESIS

Our thesis is that without a major revision in the Nation's spending priorities, both in the public and private sectors of the economy, that it is inevitable that the cities are doomed to a massive traffic jam on impossibly clogged streets to the tune of automobile stereotape decks. We feel, and document, that the rapid buildup of city debt is directly correlated to the rapidity of growth and the dearth of commensurate current revenue buildup available to the cities to meet this growth.

We document that in the period from 1950 through 1966 Federal per capita debt went down 3.7 percent, but State-local debt climbed 345 percent. We feel we document that the cities are having to revert to bonding in lieu of financing current needs from current revenue, and that problems with bonded debt are symptoms only, not the disease—the disease being the chronic deferral of current public capital investment in our cities due to our inadequate share of the gross national product.

This is illustrated for example, by the fact that the value of tobacco products shipped exceed the total expenditures for all city police and fire protection, welfare, and parks and recreation. Our suggestion for a national "advertising" campaign comes from the fact that in 1965, advertising industry revenues alone came to within three-quarters of a billion dollars of equaling all general revenues of all cities in the Nation, for all local government service needs. If city utilities and liquor stores are eliminated from consideration, the advertising industry expended $3 billion more than all the cities of the United States took in from all general revenue sources.

SALEM'S BONDING EXPERIENCE

Salem has sold some $13.5 million in bonds since 1957, and we are a solid AA rated by Moody's. Yet the effective interest rate we pay has risen from 1.6 percent in 1950 to 4.55 percent in September a year ago. We document that our problem is no different from any other city, but we draw the conclusion that local governments have been unduly forced to bond capital outlays that more properly should have been financed on a pay-as-you-go-basis—all by virtue of the Federal and State governments preempting sources of revenue which tend to grow with the economy more than those left to cities.

That, we think, is the real problem; not bond ratings, not underwriting practices, or even the tax exemption privilege.

CONCLUSION

I thank you, and express our joint appreciation for being invited to testify before the subcommittee. Should there be any questions, we would be pleased to attempt to answer them.

Chairman PATMAN. Thank you, sir.

(Additional material accompanying statements of Mayor Miller and Mr. Ayres is retained in subcommittee files.)

Chairman PATMAN. Mr. Scott?

Mr. SCOTT. Yes, sir.

STATEMENT OF DUANE SCOTT, EXECUTIVE DIRECTOR OF THE OHIO MUNICIPAL ADVISORY COUNCIL, CLEVELAND, OHIO

Mr. SCOTT. Mr. Chairman, I have a copy of a publication on all debt that the Ohio Municipal Advisory Council produces annually that I would like to leave with the committee.

Chairman PATMAN. Yes, it will be useful to us. We would like to have it. Do you have some copies of it?

Mr. SCOTT. I have one copy here. I can supply as many copies as you need by mail.

Chairman PATMAN. That will be fine. We will place in the record the parts we feel would be the most appropriate.

You may present your statement now, Mr. Scott.

(Material referred to is retained in the files of the subcommittee.)

Mr. SCOTT. Chairman Patman, Mr. Proxmire, and gentlemen, I am presently the director of the Ohio Municipal Advisory Council as of 2 weeks ago, which is a nonprofit organization organized by the bond dealers and investment manager concerns, organized in 1931. My previous experience has been as finance director of the city of Cuyahoga Falls, a city of 50,000, for 10 years. I am a past president of the Ohio Municipal Finance Officers Association, and I am presently a city councilman on the local level.

Generally speaking, municipalities in the State of Ohio are experiencing very little difficulty in the issuance of their obligations. It has been a long time since a properly presented bond issue has gone by the boards for want of a buyer. Most cities receive on the average of from five to 10 bids for their obligations. This excellent history of bond sales has been the dividends derived by the issuing subdivisions of Ohio for several reasons.

One, Ohio is a rich, industrial and growing State and so are most of its subdivisions. Two, the statutes allow Ohio municipalities to issue up to 6 percent par interest-bearing obligations—not limited to 4 or 5 percent as I understand cities in some other States are. Three, the State legislature has periodically taken a realistic view of debt limitations. By realistic, I mean they have not permitted an excessive amount of bonds to be issued by any subdivision, thus watering the quality of the bonds and yet they have taken the attitude that as costs rise and new facilities are needed by expanding communities, then an increase in debt limitations is also needed. Four, the permission of both the State constitution and the State statutes to issue mortgage and nonmortgage revenue bonds; and, five, having within the State statutes a uniform bond law making mandatory among other things, an approving opinion usually bond counsels on all bonds sold in the public market. We are also fortunate in the State of Ohio in having some highly respected firms in this field.

All of these factors, I believe, allow Ohio issuers flexibility in types of obligations to be issued thus allowing imagination and foresight to enter into the world of finance. The major problem of Ohio cities today is not so much capital moneys as it is in operating revenues.

This is not to say that it will always be this way. There are problems facing Ohio cities in the not too distant future that will certainly affect credit ratings and their ability to sell in the open market. The

old law of supply and demand takes hold in the money market just as it does in any other market and is one of the major problems I see on the horizon for smaller cities and cities of lesser credit ratings. The continuing increase in supply of municipal bonds is raising interest costs today and will make it more difficult for lesser credit cities and villages to find buyers for their obligations. The basic new supply of bonds marketed in Ohio are the tax-free industrial revenue bonds; $115 million worth of these bonds have been issued in the State of Ohio since May 1 of this year and there are pending at present between $25 and $30 million additional sales to be consummated within this month.

This means that in the first year, industrial revenue financing in the State of Ohio has amounted to $140 million and has been issued by only 24 subdivisions. Compare this figure to the total amount of all other types of revenue financing (including universities) of $59,500,000 for the same period. Bonds voted by all subdivisions in the State of Ohio at our recent November election only amounted to $143,888,700. Certainly, these figures show the impact on the supply by this type of bond within the State of Ohio.

At the recent Investment Bankers Association meeting held in Miami Beach, it was estimated that this type of bond has raised the cost of local government borrowing on full-faith-and-credit bonds by about one-fourth of 1 percent and has raised the cost of other local government borrowing to perhaps twice as much. It is estimated that if this type of financing continues at an annual supply of $4 billion or more, nationwide, the already increased cost could conceivably be tripled. Certainly, we have all heard the pros and cons of this type of financing and we all understand that some cities may benefit but other cities will lose, and in my opinion, all cities in the long run will lose and especially those of lesser credit ratings first by higher interest costs on all of their obligations and second by perhaps losing the tax-exempt status of municipals. What investor will want to buy a bond of small community in the State of Ohio when he can buy a 4½ percent tax-free industrial revenue bond of Middletown? Or in other words, Armco Steel.

Another one of the areas that I see rapidly pushing Ohio cities in their debt limitations is the fact that the cost of construction is increasing more rapidly than the valuations of the issuing subdivisions. In the State of Ohio all of the debt limitations (of which there are three), are imposed upon Ohio cities and villages based upon assessed valuations. In my own hometown of Cuyahoga Falls, construction costs have risen 15 to 20 percent in the past year while the valuation of our city has increased only about 1 percent. Thus, our debt limitations have not grown at an equal pace to the rising costs of construction.

Along the same line, the type of improvements that cities find themselves constructing today are air and water pollution facilities, sewage disposal facilities, water treatment facilities and so forth. This type of construction, very much needed, is, however, expensive. So here again we are facing our debt limitations. Certainly, the interest costs which approached the 6-percent level last year and are on the rise again, will preclude many lesser credits from issuance of their obligations unless somehow this trend is reversed.

In Ohio we are fortunate to have the 6-percent limitation on the coupon rate for the issuance of bonds. I understand that there are States where this rate has been set at 5 and even 4 percent. In these

States I can see where they have problems today in selling in a market where the average yield on a triple "A" rated bond is about 4 percent and "AA" or lesser bonds are over 4 percent, more nearly 4.5 percent.

There are areas at present in the State of Ohio where some subdivisions are finding it difficult to finance needed improvements. Although I have made no study as to all cities and/or villages faced with this problem. I can cite one example within rich and industrial Cuyahoga County. This is Westlake City with a population of 14,500 an area of 16.5 square miles, an assessed valuation of $54 million, existing debt of only $463,000, but with a need for trunk and main interceptor sewers that are estimated to cost $12 to $16 million. This cost is equal to 30 percent of the city's present total assessed valuation.

Some other communities have for years, as a matter of course, dumped raw sewage into the local river. Recent State law passed during the last session of the legislature prohibits this type of dumping and so these cities will of necessity be faced with a terrific problem of constructing sewage disposal systems. It is quite conceivable that due to the low tax valuation of these cities, they will be unable to issue (due to limitations imposed by the statutes) general obligations bonds.

They may also be unable to issue revenue bonds due to the low population, the high cost of construction, and exorbitant public utility rates; therefore, these cities must of necessity look to the State and/or Federal Government for aid. Here, too, lies a credit problem, one of importance to large cities and extremely important to small ones. Federal and State grants given to municipalities on a reimbursable basis is causing at present and will continue to cause, unless rules or laws are changed, much dilemma on the parts of the municipalities. There are several cities in the State of Ohio, which are building new airport facilities along with the Federal Government on a reimbursement basis. The city awards contracts for the full cost of the improvement but only finances its portion of the cost. Cities now term this type of financing "net financing."

If they would finance the total costs of the project they would then, in fact, be paying interest on the Federal Government's share or, in other words, be loaning their limited city credit to the Federal Government. As the construction progresses and the city pays under its contract to the construction company, it periodically sends documents to the Federal Government for reimbursement.

If there is any lag in either the city's supplying their reimbursement forms or in the Federal Government's payments, it is quite possible the city finds itself without funds to pay the contractor, or it may of necessity have to overdraft the fund, thus using treasury funds or moneys of other city agencies to offset the overdraft.

Smaller cities with less overall moneys will find this situation impossible. Larger cities like Cincinnati find it most difficult. I hope that in the not too distant future some method of reimbursement based on estimates with the Federal Government withholding 10 or 15 percent until after audit can be arrived at. In actuality, through this procedure of reimbursement to the local government, the local government is lending its money or credit to the Federal Government and I do not believe this was the reasoning behind these original Federal Government grants.

This briefly discusses some of the problems faced by the cities in the State of Ohio in issuing their bonds. You asked in your letter that I also remark on the importance of bond ratings on the borrowing costs of municipalities in our State. Bond rating certainly plays a major role in setting interest costs; however, almost two-thirds of all issuing subdivisions in Ohio are unrated by the major rating firms. As of January 1 of this year, there were 1,595 taxing subdivisions with outstanding debt of one class or another. Of these subdivisions, only 420 were rated by Standard & Poor and 507 by Moody. Standard & Poor has set a $1 million minimum per each class of debt for rating purposes. Moody's minimum for this same purpose is $600,000.

This is due primarily to the almost impossible job of rating every bond issue in the United States and the fact that there is no widespread interest in the smaller issues. Of those Ohio bonds rated by Moody, all but 5 or 99 percent are in the upper four classes and 78 percent of all Ohio bonds rated by Moody's are rated "A" or above; 100 percent of all bonds rated in Ohio by Standard & Poor are in the upper four classes and 75 percent of these bonds are "A" rated or above.

To my knowledge, other than the four major cities reduced in ratings, only one smaller subdivision and its school district were reduced in recent years and they are the city and school district of Coshocton, Ohio. The rating was reduced from an "AA" to "A" by Moody.

I cannot tell you just what effect this reduction has had on the issuance of their obligation. Certainly it has had some, but to describe it in a dollar and cents figure is virtually impossible. I have tried to compare their sales of 1964 with the market in the State of Ohio at that time along with their later sales compared to the same market and I can come to no concrete decision.

The brokers inform me that in today's market the difference between ratings is at least one-eighth of 1 percent which amounts to $1.25 per $1,000 outstanding per year in added interest costs. In checking some of the major cities that have had their interest rates dropped, I find that it hurt them to some extent but that they themselves cannot put an exact amount to this reduction.

The circumstances on a bond issue of the same community sold at different times are very seldom comparable. The city of Cincinnati believes after their studies that the drop in rating cost them someplace between 5 and 10 basis points, or not quite one-eighth of 1 percent. If the change between rating is one-eighth of 1 percent or $1.25 per $1,000 per year, then the total increased cost of issuance to any city would depend upon the number of bonds issued and the length of the time they are outstanding. On a $1 million, 20-year issue, interest cost would increase $13,000 to $14,000 over the life of the bonds with a one-rating drop.

Bond ratings alone do not set the price bid or the coupon rate. The length of debt, the maturity schedule, the frequency of issuance, the availability of supply of all bonds, and the number of sales on that particular day all have a bearing on the price bid. There are over 1,000 subdivisions in the State of Ohio alone with outstanding debt that are unrated by any major rating firm and yet they are able to sell their securities at interest rates favorable with the rated security.

We in our firm like to feel that we play a major role in finding buyers for these unrated securities by putting the available facts and figures before most of the municipal dealers in Ohio. In checking with these bond dealers we find that they rely quite heavily upon the information supplied by our firm in the bidding of unrated bonds.

We also find that the major rating companies use the information provided by us to help set the ratings on all bonds in Ohio. There are only five other firms to my knowledge in the United States performing this same service. Certainly smaller communities in those States without similar agencies must of necessity present a better prospectus and more information to prospective bond dealers than the unrated municipalities of the State of Ohio.

In conclusion, bonds ratings are not the major problem facing Ohio subdivisions. Their problems are ones of increased supply of municipal securities, the increased interest rates partially caused by this supply, the ever-rising costs of construction, the entering into new fields of improvements such as urban renewal and pollution problems, and the never-ending plague of inadequate operating revenues.

Chairman PATMAN. Thank you, sir.

Senator Proxmire, you are recognized to ask any questions you desire to ask.

Senator PROXMIRE. I would like to ask both Dr. Miller and Mr. Scott—because both you gentlemen put emphasis on this in your statements—to document a little bit further your contention that the tax exemption for publicly issued municipal bonds used by private corporations has a perverse or adverse effect on the ability of municipalities to borrow. And I think Mr. Scott said in his judgment it increased the interest rate by a quarter of 1 percent. This is, I think, very interesting to me, because I have had a long, strong bias against this what I think is a misuse.

Mayor MILLER. Senator, I do not claim to be an expert in this field. But I would say that we feel that this is a perversion of the traditional function of municipal bonding, and it is unfair for one city to preempt this practice and the others not. It is the position of the National League of Cities, after much discussion, that this is wrong.

Now, from a pure economic basis——

Senator PROXMIRE. Let me ask you about the National League of Cities. Is it your recollection that this was a pretty overwhelming view, or was it the bare majority?

Mr. MILLER. It caused considerable discussion. But I think, to those of the like mind that we are, it is not a satisfactory practice.

May I refer to Mr. Ayres who, on an economic basis is much more informed than I.

Would you make some remarks, Mr. Ayres, on this.

Mr. AYRES. In our testimony we say: "It is significant to note that a recent tax-exempt industrial bond issue of the Port of Astoria, Oreg. (population 10,700), is the amount of $140 million for the benefit of the Northwest Aluminum Co. exceeds by $19 million the total net debt of all Oregon cities for all municipal purposes combined."

I would also go——

Senator PROXMIRE. That is an astonishing figure. That is in your documentation?

Mr. AYRES. Yes, sir—in one bond issue.

Senator PROXMIRE. I want to study that.

Chairman PATMAN. That is a part of your record here. Of course, we will insert the entire record in the proceedings.

Mr. AYRES. I also would quote from Monday's Wall Street Journal, which says, "Industrial revenue bonds are being used increasingly by communities seeking to attract new industry and by companies trying to avoid the relatively high interest cost of conventional corporate debt securities. Nearly 40 States now permit the issuance of such bonds, double the number in 1960. About $1 billion of corporate municipal bonds to finance industrial construction will be sold this year, up from one and a half million dollars in 1956."

We say the only outcome that we—this is opinion, but I think it is fairly universal—the only outcome we can see is the ultimate use of this device by all industrial and commercial corporations with a commensurate level of tax-exempt and non-tax-exempt interest rates, and an accompanying drastic drop in Federal and State income tax revenues from bond sources.

Senator PROXMIRE. What proportion of tax-exempts are now for the purpose of private financing?

Mr. AYRES. I do not know exactly. But I know that——

Chairman PATMAN. About 14 percent.

Mr. AYRES. It has caused a glut on the market in the last several months.

Senator PROXMIRE. I understand it is $1 billion out of $14 billion of bonds sold in 1967.

Mr. SCOTT. I do not know what the national figures are. But I do know the State of Ohio just started in this industrial revenue financing May 1, and we have already issued $140 million worth. And certainly there are only so many buyers of this type of security, there is only so much money in the market. And if we are going to double the supply or triple the supply of bonds in the market, the small city in particular, and those with lesser credit ratings, are the ones that are going to be hurt in the long run.

Senator PROXMIRE. This is very very helpful. It has concerned a lot of us in the Congress for a long time—the inequity of the tax exempts. It completely eliminates the progressiveness of the income tax structure. It is an inviting tax loophole. I suppose if I had $20 million or $30 million I would put a lot of money into tax exempts. On the other hand, it has been counterbalanced by the recognition that the cities and States need this kind of tax exemption if they are going to have any chance to get capital on a reasonable basis. But there is no excuse for permitting this perversion of letting this be used to finance industry.

Mr. SCOTT. Well, one of the things——

Senator PROXMIRE. Furthermore, I think it constitutes a threat to the continuation of tax exempts, because it is so glaringly unfair.

Mr. SCOTT. Sooner or later something is going to happen along this line, and if the tax exemption is taken off this type of revenue financing which cities are now in, what is there to prevent it from being taken off water and sewer facilities and so forth. And I think this is the beginning of cities losing their tax-exempt status. If we have to go into the open market and compete directly with General Motors or some of the larger corporations of this country, I am sure that the

investor is going to buy General Motors rather than some community with 5,000 people.

Senator PROXMIRE. What you say about the growth in Ohio is very alarming. Once this thing begins to grow, it just has to snowball. The competitive forces will require it to snowball; if my competitor is able to operate this way with tax-exempt securities financing the construction of his plant and land and site and so forth, I am going to have to do that. And, of course, on the basis of competition for funds, you are just going to have an uncontrollable situation, unless you draw the line.

Mr. SCOTT. In our own community we are building an expressway. We are 50,000. We are building an expressway through the town that connects the city of Akron with the city of Cleveland. We are paying our share of this constructiton, which is luckily only 5 percent, with the Federal and State participation. But we are going through the only industrial area we have in town, and our town is 2 percent industrial. We are eliminating some of the biggest industries. We do not have space for these industries to relocate within our corporate boundaries, so the communities surrounding us, through the use of industrial revenue bonds, are stealing industry from us, and we are building the facility to help serve them.

I can see some unfairness here.

Mr. AYRES. It has taken some other interesting twists. A few years ago the city of Wichita built a Macy's store with this type of bond. They enticed Macy's into Wichita by this method. And there are other interesting facets of it at the local level. This Port of Astoria $140 million issue, was by virtue of a State legislative act permitting the issuance of this type of bond without a referendum, by port districts. Also at the same time the legislature relaxed the requirement of what is a port district, to where it does not have to be on the ocean or river. Now, everybody in the State is very eagerly going around lining up to try to create port districts, regardless—they have no assets, nothing. As a matter of fact, there is one near us where the promoter of the port district just happens to own a significant piece of acreage which he wishes to create as a port district, so he can sell his acreage to the port district, so they can say "We have an industrial tax-exempt piece of property here that we can issue a bond issue, tax-exempt, and bring in industry."

Mayor MILLER. We are not averse to industry in the Northwest. But we think this device is not in the interests of municipalities.

Senator PROXMIRE. I wonder if the National League of Cities, or if you gentlemen know of any way that you could provide for the committee, or at least for me, the specific recommendation. Is there any resolution which specified the kind of legislation that you think would be most helpful on a Federal basis to eliminate the competition, so we would have something to work on?

Mr. AYRES. There was a committee formed to study this, and I am sure that the league staff could respond to this. Mr. Peter Harkins of NLC is here.

Senator PROXMIRE. Fine. Now, I would like to ask Dr. Miller—I agree with the chairman, you made a brilliant statement.

Mayor MILLER. Thank you very much.

Senator PROXMIRE. I am concerned, as he is, and as all of us are, about sharing the Federal tax revenues or block grants. There is some tendency, and I think it is a wholesome, although conservative tendency, to feel if public officials have the responsibility of imposing a tax, tough and difficult as that may be, they may not be responsible in spending the money that they get. My argument is that perhaps it would be better if the Federal Government would provide tax areas which you would be free to tax without simply making a gift, either of the Federal income tax or a block grant.

You see, we have the feeling that it is unpopular to tax. We do not like to tax. If we do the taxing here in Congress, and you fellows do the spending, there are several problems that arise, including Governors running against Senators that make it embarrassing. But there is also a basic notion of local fiscal responsibility, too.

Mayor MILLER. Well, I would respond to that, Senator, by saying that we have made some comments in the body of the statement. But I would respond to it by saying, as Mr. Ayres indicated, it seemed to us that the problems of local government largely stems from our inability to retain sufficient portions of the funds taken from our citizens, for all tax purposes, in order to get the essential capital outlays to maintain a decent environment.

Senator PROXMIRE. Supposing there were a limitation of some kind, or an area in which you would be allowed to increase or impose an income tax, a corporation income tax, within certain limits—be free to do so—but you would have to take the responsibility and the onus for imposing it.

Mayor MILLER. Yes. I would—my own philosophy is that block grants, money from the Federal Government, a greater proportion of the amount of funds leaving our community could return—and I would indicate that I believe there are certain restrictions. But there are areas in all of our communities alluded to by the other gentlemen who have appeared here that cross boundary regions, they are regional in nature. And it is my personal belief that moneys from the Federal Government in this type of thing should be tied to taking off the backs of the local communities the responsibilities. OK—water pollution, sewers. Pollution is a national problem, really. Also air pollution—and some of the areas of traffic. If we could get these problems off our backs—and such programs would not be too difficult to regulate. I heard the chairman inquiring of the previous delegation about the mechanics. The mechanics are difficult, and I claim to be no expert in this. But if it was simplified in these areas, if we could be relieved of these responsibilities on the part of local government, it would be of great help. I would not personally like to see the Federal Government involved with the provision of police protection and fire protection and the ordinary day to day governmental services.

I think that should be the responsibility of the local government.

But there are these other areas, the largeness of them are overwhelming the country. Little cities as well as large.

Senator PROXMIRE. I see your point. All I am saying is if you have unrestricted tax sharing, on the basis of some of the formulas I have seen—in the first place, you have a disparity between those that need it and those that get it. If you share the taxes on the basis of where

the taxes came from, the richest cities and suburbs are going to get it most.

Mayor MILLER. What is unfair about that?

Senator PROXMIRE. They need it least.

Mayor MILLER. In most instances they do not. But I think if it was ~~kept to~~——

Senator PROXMIRE. We have a sharing system of State taxes in Wisconsin, in which some of our rich suburbs impose a far lighter property tax than the poorer cities. They get such a big share of the State income tax, so that they have no real problem compared to a city of which they are the suburb, which has tremendous problems.

Mayor MILLER. I may be visionary. But I believe if sufficient funds came back to the local communities to do a better job of controlling our environment, we will say, which in my humble opinion is one of the major factors facing the country—this would not be too difficult. It would need to be regional in nature. It would not be too difficult to regulate from the standpoint of this governmental agency wasting it and getting more than he needed. I cannot completely answer your question. But I believe if these types of environmental things were taken off the back of local government, the day-to-day problems could be better handled, and I believe the program could be better administered, or easier to administer, and it would be to the greatest benefit of the country.

Senator PROXMIRE. The other kind of thing I have in mind—we had a mayor of North Carolina as a witness—he said his city has the authority by State law, apparently, to annex with very little restriction. So they do not have to worry about industry leaving them, and being left with a situation where their responsibilities are very great and their tax sources are diminishing.

Mayor MILLER. We are not that fortunate.

Senator PROXMIRE. If we could somehow work that out, this would be very helpful, providing the Federal Government is not moving in on your own tax sources, and taking away from you the opportunity to secure adequate tax revenues.

Mayor MILLER. I alluded to the statement that we are working very hard to get the State law changes that would help us solve some of the problems, and one of these is the State law change in the area of boundaries, and the annexation problem. And this is rather universal, too.

Mr. AYRES. We have some opinions—that in actuality there is much municipal and Federal money literally wasted by virtue of cutthroat competition between jurisdictions, by virtue of the extremely unrealistic State annexation laws—let's call them jurisdictional boundary realinements, or alinements. And that there are grants and bond issues and there are operating levies that contain grave amounts of wasted public moneys because of this, to the point where it is, in my opinion at least, a national problem of major proportions.

On this tax sharing thing, I think that we have got one example to look at, and that is the offset of the inheritance tax—if the State has it, there is a direct offset against the Federal tax. I think this type of thing could very easily work at the local level. I am sure there are citizens who would have no hesitancy at all—for instance if the telephone tax were opted by the Federal Government to be

dropped the cities would pick it up. I see no hesitation at all on the part of our people that they would pick it up.

Senator PROXMIRE. That has a lot of merit. A lot of people like it. My only protest against it is once again there is no discipline. After all, if you are going to pay a 50 percent corporation income tax to the Federal Government anyway and the locality has the right to take 5 percent of that, and you still have no restraint on irresponsible spending.

Now, Dr. Miller has made a very strong case for more spending in the environmental area, and I think he is absolutely right. But I am arguing that we should, everywhere we possibly can, tie in this discipline, so that there is some restraint. And the only kind of effective restraint is that when people spend money, they have to raise taxes to do it.

Mr. AYRES. I believe that your problem is one of a combination of jurisdiction and financing, and in that we are like most cities. We are 67,000, but we ought to be a hundred thousand—were we to have our community of interest within our jurisdictional boundaries. This constant literal bickering back and forth and scrabbling to annex a couple of pieces of property in order to get them sewers, in order to get sewers and water beyond that point, detracts from our total problem of operating revenues being sufficient. Our problem is capital outlay—fire trucks, fire stations, street widening, parking. And I think we are one of the few if not the only city in the country that has actually physically master-planned and cataloged, and have voluminously listed, right down to the last traffic signal and the last street widening, and costed them out, exactly what our backlog is. It is $8 million, plus $15 million urban renewal and redevelopment, plus another $30 to $40 million of projects we just dropped because they were nice, but not yet imperative.

By doing this planning, our people, we think, know that we are certainly going to call on them some time to vote on this money need, but the property tax is the problem. It is akin to social security; we are on a fixed income. And this is our problem—getting tied into the economy, through either a sales tax or income tax or something that does grow with the economy, rather than continuing on the property tax as do, of course, many cities. Oregon is the originator of the petition, referendum and the recall. But this referendum bit is a tough one to go against. Everything has got to go to the people for a vote—and getting them willing to forgo their stereo tape deck in their automobil so they can have some place to drive it, rather than being locked into a traffic jam, is tough. Thus our suggestion about advertising.

suggestion about advertising.

Mayor MILLER. We are in great trouble in our little town. I do not know whether this is appropriate or not, but this concerns me. We are in competition with the schools. And Lord knows the schools need the money. And the city needs the money. We are in competition with the schools in the property tax area to a considerable extent and we do not get as much as the schools in our town. But the people are beginning—I know our citizens realize the need, but they are beginning to say "No."

Senator PROXMIRE. Well, they are in our State, too.

Mayor Miller. This concerns us greatly. Our school system is an essential.

Senator Proxmire. I would like to ask Mr. Scott—you say that two-thirds of your subdivisions issuing obligations in Ohio are unrated?

~~Mr. Scott. Unrated by the major firms; yes, sir.~~

Senator Proxmire. What does this mean in terms of volume? I take it it would be maybe 20 percent of the volume?

Mr. Scott. Certainly—it would be a guess at 20 percent. Certainly our major cities are all rated, and our major cities are the ones, when they issue a bond issue for the same purpose it is a lot more money.

Senator Proxmire. What is the size of the city normally that is unrated?

Mr. Scott. Well, again it is not really tied to size.

Senator Proxmire. I know. But by and large——

Mr. Scott. You take a rich community that does not go into bonding, and goes on a pay-as-you-go program, if they do not have $600,000 outstanding debt, they are unrated.

Senator Proxmire. What effect, in your view, does the lack of rating have on interest rates?

Mr. Scott. Well, again, as I said here, in the State of Ohio we do present information to the bond dealers through the Bond Dealers Association of which I am the director.

But in some cases I can see if your bond was unrated, and you are a very poor quality city, you might be better off to be unrated.

In other cases, if you are a high-quality city, and you are still unrated, it might hurt you on interest rates.

Senator Proxmire. Within those broad limitations, can you make any conclusion at all—of the cost or being unrated one-half of 1 percent?

Mr. Scott. I would say you are close. If you look at any sales around the State of Ohio, which we keep up on, you will find the spread between the large city rated and the unrated city usually are not much more than a half to three-quarters of 1 percent from one limit to the other, in a given 2-week period.

Senator Proxmire. This brings me to the last question. I am getting more and more interested, as the hearings go on, in the possibility of providing some kind of legislation that would enable the FDIC or some other agency—maybe FDIC—to provide a system of insurance for obligations of municipalities. It has been so successful for the banks. It would have its own self-financing, so it would not cost the taxpayer a nickel. And it would eliminate this whole rating discrimination and provide equity for municipalities that are not rated, most of whom would be in that category.

Mr. Scott. I think it would help the rating end of it. But certainly when you talk to a broker who is bidding on these bonds, he will bid a different price for even an "A" rated bond.

Senator Proxmire. It would not equalize it. But it would eliminate one great area of doubt. Certainly many people who now would be hesitant to put their money in anything that is not rated, would be much more likely to feel that they would be willing to invest if it was all insured. And if at the same time we could take out these General

Motors and other big competitors getting in under the tent, the perversion of tax exempts——

Mr. SCOTT. I can see some merit in it. Coming cold, at this time, I would have to give it a great deal of thought. I do not know what the final ramifications of such a thing would be.

Senator PROXMIRE. I understand that all public housing bonds are guaranteed, and they have a triple "A" rating. I hate to think what they might have without that guarantee.

Mr. AYRES. Those of us who have struggled to meet the conservative, and I think proper factors of Moody's and Standard & Poor's would not like that too much.

Senator PROXMIRE. I understand that. But, of course, the FDIC has very important standards. They do not permit a bank to do anything they want to. They did in the twenties and thirties. They would have standards they would insist on. You would have to meet—Chairman Patman pointed out yesterday an almost insignificant fraction of municipal bonds have been in default at any time in the last 20 years, so the insurance cost, like bank insurance, could be very low.

Mr. AYRES. Although it is dangerous to generalize from a single specific, Salem had an issue which we really marketed. At the time I was director of finance. We went at it and really did everything that was proper, and consequently we got a 2.899 percent rate on $4,355,000 double "A" rated issue, 23 years, with a 15-year call in inverse order. It was almost 9 months before any municipal issue of any size at all broke our rate, and that was a triple "A" North Carolina issue that was smaller than ours. And we worked at it. And I think that—at least in my opinion—this thing of rating is overrated. You hear the classic example in the West, anyway—"What is your rate, our rate is double "A." In Las Vegas—Las Vegas evidently is notoriously bad, although I have not firsthand knowledge. A good friend of mine, who is a former city manager of Las Vegas, always said their rating was "BAD."

Mayor MILLER. I would not like you to make reference to any of our sister cities in the West. But I would like to say this strikes me a little bit. Maybe this takes away the incentive that you mentioned with regard to another matter, and that we would be a little inclined to not be just leveled to the average.

I would agree with Mr. Scott it may have some advantage. But we would be a little bit inclined to want to look at it a little while—mainly on this incentive basis. We work our tails off to try to get a good rating, and someone else does not care, and they are all the same.

Senator PROXMIRE. You can make the same argument in a bank. Why have FDIC insurance? It means from the standpoint of a banker, the ones who have been conservative and carefully lose some of their appeal, as compared to their competitors. The answer to that, of course, is you are concerned with the depositors, and you are concerned here with getting a rate as low as possible for the taxpayers in the localities. And this would help.

Mayor MILLER. If it will really affect the market.

Mr. AYRES. I was at one time the city manager of a city that had defaulted in the depression, and was hired specifically to get them out of an impending default at the time I was hired in 1960. It is not a pleasant situation in which to find oneself. So that for some of the

smaller communities, or those who have not been so frugal with their resources in the past, it would probably be a good thing. We would hope maybe if this is ultimately developed, there would be some type of rating within it. I have talked with Mr. David Ellinwood, of Moody's, who is an exceptionally fine gentleman. His problem is the massive issues and limited staff. So that maybe it is a Federal problem that some type of Federal rating within a guarantee may be appropriate.

Chairman PATMAN. Senator, I wish you would give further consideration to these tax-exempt bonds—you have always given lots of thought to them, I know.

One time I had some experts from the Treasury Department before a committee that I was chairman of. I asked Under Secretary Bell of the Treasury, and he told me there was about one-eight of 1 percent difference, at that time, in what the people received from a tax-exempt bond as compared to a non-tax-exempt. It was very low. Over the years I think you will find it very low.

Now, here is the reason that means so much to our economy.

We make municipal bonds nontaxable, because we want to help the localities, we want to build schools, help them build the things they need, and make the interest rate attractive. But they have not been getting such an attractive rate. And think what it means to the income of the Nation. It would really be better in a way if the Federal Government paid a substantial part of all the interest on these municipal bonds, and have them taxable—they would make so much money that way.

You see, the amount that you would collect would be enormous. Practically every person in the country is in some political subdivision where they have municipal bonds. Well, now, that person there says, "Well, I get a low rate because of tax exemption." What he may overlook is the fact that it costs him more in the income tax that he pays.

Senator PROXMIRE. Well, I agree with you wholeheartedly on the validity of tax exemption for municipalities. I think they ought to have it. I do not agree that this should be extended to industry.

Chairman PATMAN. I want to get rid of it.

Senator PROXMIRE. There is a clear inequity when somebody with a lot of money can completely avoid any income taxes at all by socking all his money away in a profit enterprise, hiding a municipal exemption. We pointed out the other day, you put $10 million—which a number of people have in this country—in municipals with a 4-percent return and you do not pay any income tax on $400,000 of annual income. Eight thousand dollars a week and you do not pay a nickel of income tax.

Chairman PATMAN. And you do not make any report to the Government.

Senator PROXMIRE. That is right. And this is growing by leaps and bounds because of the extension to the industrial bonds.

Chairman PATMAN. I notice Mr. Scott said they were very fortunate in Ohio because the rate was 6 percent.

Mr. SCOTT. The limit.

Chairman PATMAN. You meant the fact that you could get money that way when others could not.

But at the same time you must realize that the principal buyers of these tax-exempt bonds now are commercial banks, and the commercial banks manufacture the money to buy these bonds, create it on the books of the banks, out of thin air. It is on the credit of the Nation. And buying things that the Nation does not get any taxes from. And they are buying over 75 percent of these tax exempts in recent months, from which the Government gets no revenue.

It is ironical that the person who owns these bonds probably thinks he is doing very well on them. But the people who have voted the bonds are paying the equivalent of about 12 percent interest on them—considering the fact that the principal buyers, the commercial banks, are up in the 48-percent tax bracket. On this basis, they are getting as much as 12 percent in some instances. That is pretty high.

Of course, I see your point—if you did not have this high rate, you just could not get the money. To that extent you are correct.

But I would like to get rid of these tax-exempt bonds some way. I do not think they fit into an economy where you depend upon a graduated income tax as a principal source of revenue. That represents a principal loophole in our tax laws.

It does not conform to the right standards. We are permitting people to have the special privilege of tremendous loopholes in the tax laws. It is a diversion; it is a loophole. It is not tax evasion. People have a right to plead any deduction that they want, if it is within the law, and nobody should citicize them for it. But it is tax avoidance. Tax evasion, of course, is the bad word, but tax avoidance is a good word. People are entitled to avoid taxes if they can. But this is really tax avoidance at its worst, I think.

Mr. SCOTT. Mr. Patman, may I ask a question—in this line of thinking here that has come up, certainly among the committee, of guaranteeing the bond.

Has the thinking gone far enough to come up with—what would you do with a city that defaults, even with the Federal Government backing? The Federal Government is protecting the holder of the bond. But what would you do to the city?

Chairman PATMAN. Well, that has not been thought through. I am sure it could be worked out.

Mr. SCOTT. There ought to be some penalty there.

Chairman PATMAN. The amount you would have to pay in assessment to cover defaults would be practically nothing.

You know, we brought out yesterday, I believe—Dr. Diamond, you stated the facts about defaults.

Mr. DIAMOND. According to a Dun & Bradstreet study, published in the "Committee Report on State and Local Public Facility Needs and Financing," there was some 30 defaults in the postwar period. Over a 20-year period, there were well over a hundred thousand long-term bond issues sold.

Chairman PATMAN. How many defaults in the number?

Mr. DIAMOND. Thirty altogether.

Chairman PATMAN. And how many thousand?

Mr. DIAMOND. Over a hundred thousand bond issues.

Chairman PATMAN. And only 3-day defaults. Of course, you would have to consider the size of the default. But obviously it was a very small number.

Mr. AYRES. As I mentioned earlier, I had the unfortunate and interesting experience at the time of being employed as a city manager in a city that had in technical default a bond issue of $7 million, and was hired with the specific instructions of the city council and Chase Manhattan Bank to get them out of it. The city council at that time was not sure they really wanted to get out of it. It took me some time to talk them out of saying "Just give them the water system."

So this thing of default and receivership is a very real thing that will come about, and what I would wonder is since there are marginal situations, in revenue issues particularly—another one was the Kansas City parking facility which at one time was on the ragged edge—if you had this type of insurance, there might be some governing bodies, particularly revenue agencies that were single-purpose districts in effect, that might say "Why fight it, just give it to them." And in this instance, "them" would be a Federal corporation, which would be putting you in a position of being a receiver to operate a local government. And having been in that type of situation, where you have to increase revenues and reduce expenditures, it is not an easy thing to do—although in the particular instance to which I refer, I did it. But it was sure sweat, blood and tears.

Chairman PATMAN. I have a way that I would advocate having another RFC, Reconstruction Finance Corporation, to keep the interest rates down. The interest rates were kept down to 2 and 2½ percent during RFC days, on all municipal bonds. Jesse Jones would pick them up very quickly in States and political subdivisions where people were not getting a square deal. That would be one way. But there is no source of big money any more. It is just not here. And that is one of the main evils. Small businessmen can get small loans to fight among themselves, but they cannot get enough to go into competition with big business. That would help the consumer, if they were to. But there is no source of big funds any more.

Mr. AYRES. This is the thing that is hurting the normal municipal traditional functions, with these industrial tax exempts; $140 million in Oregon, of course, is a national issue. But it sops up the money supply. Our director of finance right now is worrying through another million-dollar bond issue we have to sell within the next several months. And he says the market now is either bad or worse. We need the money, we have to go to market. What we fear is that the court cases on this $140 million issue will be resolved, and they will go into the market just about the same time we have to, and it will give Oregon a black eye generally, and the market specifically.

Chairman PATMAN. That is correct.

Now, the reason I do not look with favor on the industrial revenue bonds being bought by commercial banks is that mortgage money is not easy to get now, as you gentlemen know. Not only is the interest rate high, but the points are terrible; they are horrible, the amounts people have to pay as "points." And the more opportunities people

have to invest money—and particularly banks, to monetize any debt, including industrial revenue bonds—the harder it is for the person who wants a mortgage at a reasonable rate of interest to build a home. It makes it harder on him.

Now, if we had a way of making a certain part of available funds go into homebuilding, I think it would be fine. But the more opportunities you give for people just to monetize debt, the less opportunity people will have to build homes at reasonable rates of interest, because they are all in a sense competitive.

Mr. AYRES. This is one of our thrusts. There is something, it seems to us, in the national economy that is tending to force the municipalities into long-term debt for what 15 to 25 years ago was considered normal operating capital expenditure. Fire trucks; for instance, in Raleigh, N.C., which issued bonds to buy fire trucks. This was literally unheard of not too many years ago.

Chairman PATMAN. Thank you, gentlemen, very much for your appearance and testimony. You have been very helpful. We will have a hiatus in the studies for a few months. We will resume them again after the next Congress convenes. Under the Constitution, a new Congress convenes January 3 at noon every year. That is after the lameduck session. And our Congress, this Congress, the first session of the 90th Congress, will end January 3, at noon, unless we pass a resolution to adjourn, which we expect to do by the end of next week—I hope we do. We will also pass a resolution—we cannot extend this Congress, but extend the commencement of the next session. We expect not to meet until about the 15th of January, which gives us a couple of weeks out in the next year. But after the new Congress comes back, we are going to resume the studies, and we would appreciate any additional information you gentlemen have in mind.

Mayor MILLER. Thank you very much, Mr. Chairman, for your consideration to all of us.

Chairman PATMAN. Again, gentlemen, thank you very much.

The subcommittee will stand in recess, subject to the call of the Chair.

(Whereupon, at 12:05 p.m., the subcommittee was adjourned, to reconvene subject to the call of the Chair.)

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