FINANCING MUNICIPAL NEEDS

859

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH AND STABILIZATION

AND THE

SUBCOMMITTEE ON FISCAL AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
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THURSDAY, JULY 28, 1977

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THURSDAY, JULY 28, 1977

Congress of the United States, Subcommittee on Economic Growth and Stabilization and the Subcommittee on Fiscal and Intergovernmental Policy of the Joint Economic Committee,

Washington, D.C.

The subcommittees met, pursuant to notice, at 10:20 a.m., in room 6202, Dirksen Senate Office Building, Hon. Hubert H. Humphrey (cochairman of the Subcommittee on Economic Growth and Stabilization) and Hon. William S. Moorhead (cochairman of the Subcommittee on Fiscal and Intergovernmental Policy) presiding.

Present: Senators Humphrey and Javits; and Representative Moorhead.

Also present: Louis C. Krauthoff II, assistant director; Deborah Norelli and Kent H. Hughes, professional staff members; and George D. Krumbhaar, Jr., and M. Catherine Miller, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE MOORHEAD

Representative Moorhead. The joint meeting of the Subcommittee on Economic Growth and Stabilization and the Subcommittee on Fiscal and Intergovernmental Policy will come to order. Senator Humphrey is at a very important meeting of the Foreign Relations Committee and hopes to be with us momentarily, but I think in order to complete the schedule we had better get started.

The survey of the fiscal conditions of cities which the Joint Economic Committee released today contains some good news and bad news. But I am pleased that production in service expenditures, public employee layoffs, and large tax increases have tapered off. I am very concerned about the long-term effects of the reductions in capital expenditures. I do not believe this to be an isolated phenomena peculiar to fiscal year 1977.

My instinct is that this is a long-term trend which must be nipped in the bud. I see these hearings as an avenue to resolving this problem. The municipal bond market is working satisfactorily and interest rates are well below their peaks of 1975 and 1976.

The capital needs of at least some cities still pose a problem. An alternative mechanism for financing municipal needs deserves exploration. Efficient public facilities are the key to maintaining and attracting businesses and residents. Employees rightfully demand schools and parks for their children as well as decent and reasonably priced public transportation systems. Businesses must have modern, well-maintained highways and bridges, as well as efficient treatment plants to dispose of industrial waste and reliable modern sources of power. To provide for these public facility needs, the cities in turn must have a reliable source of capital and at reasonable rates. The municipal demands for capital are constantly increasing. By 1976, their long-term borrowing increased to $33.8 billion, more than 100 percent increase from the 1968 level. Municipal finance is further complicated by the variations from month to month and from year to year in the interest rates.

Between 1968 and 1976, the average interest rates for AAA-rated cities increased from 4.20 percent to 5.66 percent. For BAA-rated cities, the variation was greater. From 1968, the average interest rate for these cities was 4.88 percent compared to 7.49 percent in 1976. So far in 1977, the average interest rate for BAA cities has been 6.34 percent, as compared to 5.18 percent for AAA cities: a BAA city which sold $10 million worth of 30-year notes on May 28 of the year, would pay a 6.15 percent interest rate or a total of $18.45 million in interest charges. A AAA city, the same circumstances, would pay an interest of only 5.14 percent or $17.5 million in interest payments over the course of the loan. The BAA city would thus pay $2.7 million more in interest payments than the city which is apparently in better fiscal condition. The validity of these ratings has been subject to some informed and impressive criticism. Yet, the buyers of municipal bonds are entitled to some kind of informed judgment on the creditworthiness of the issuing local government. Here, again, is a problem that deserves further examination.

I am most anxious to explore all alternatives for meeting the need of municipalities and I am pleased to have here the views of experts on this important but very complex matter. We have six witnesses scheduled today, and I suggest that we divide into panels of three each, and in the first panel, I would call Mr. Herrington J. Bryce, vice president of Washington Operations, the Academy for Contemporary Problems, Washington, D.C., Ms. Jean M. Gray, associate professor of finance and department chairman, Department of Finance and Insurance, School of Business Administration, Rider College, Lawrenceville, N.J., and Mr. Paul R. Porter former administrator of the Marshall plan and author of "The Recovery of American Cities." Unless the witnesses have any preference, I would propose that we hear the witnesses in the order I called them. Mr. Bryce, Ms. Gray and Mr. Porter.

At this point in the hearing, without objection, I will include Senator Humphrey's opening statement in the record.

[The opening statement of Senator Humphrey follows:]

Opening Statement of Senator Humphrey

I would first like to welcome the witnesses. There are a lot of my old friends here. I'm very pleased that you have come.

We have called these hearings to begin a discussion of a vital public issue. The evidence has accumulated for many years that our municipalities are having problems in creating and maintaining the public infrastructure that provides a congenial home for economic and social activity. I don't believe that anyone in this room would dispute the proposition that a healthy national economy requires healthy local economies. But, the survey which our committee staff has just completed indicates that far too often our local economies are ailing. The survey contains bittersweet news for those of us who are concerned about city and municipal government.

Our survey found that service expenditures for all cities had increased by 5 percent. This is a decrease in real terms of over 1 percent when adjusted for inflation.

Further, while the survey revealed that discharges of public employees are no longer widespread, cities generally were not increasing their levels of employment. Total public employment for the 67 cities studied increased by 0.2 percent last year to 555,818 employees. It should be kept in mind, that without the Federal job creation programs, layoffs would probably still be widespread.

Although tax rate increases are not as frequent or as large as in past years, 21 of the 67 cities studied found it necessary to increase their taxes by a total of $182.9 million or 2.4 percent of their combined budgets.

I am disturbed by the report's finding that there has been a decrease of 5 percent in the aggregate capital budgets of these same cities while, at the same time, total capital needs have increased to $22.4 billion. That's $448 million for each of the 50 cities which estimated their capital needs for us.

Additionally, I am extremely concerned about the disparities between cities. As one would suspect, cities with high unemployment and declining populations fared significantly worse than cities with low rates of unemployment and growing populations. While I am delighted that these latter cities are enjoying good fiscal health, the plight of the other municipal governments are a continuing source of grave concern to me. The high unemployment cities with decreasing populations increased their service budgets by only 3 percent—a real reduction of 3 percent—but yet have the highest net tax increases. More significantly for our hearings today and next week, these 25 cities, 37 percent of the surveyed cities, account for 60 percent of the total capital needs of the 67 cities. Moreover, these cities have found it necessary to reduce their capital expenditures by 13 percent. As the chart indicates, the higher the unemployment level of the city surveyed, the greater the reduction in capital expenditures.

The deteriorating capital structure of many of our cities is a poorly understood, but ever more serious problem. If these reductions continue, it could spell disaster for these cities and be a crippling economic blow to the Nation. America's commerce, for example, from the farm products off Minnesota to the industrial wares of Pittsburgh, relies upon the network of local highways and bridges which connect this nation. The impact of unmet capital needs in our major cities will reach into every community in the nation.

We must also bear in mind that the deterioration of sewer systems and public transportation, for example, will not merely be a burden to the city's residents, but will further exacerbate the out-migration of urban dwellers and businesses, and thus, enhance the problems which are plaguing these communities.

We have confronted these problems before in the context of international development financing. The United States is a leading partner in international banks, assisting the development of other nations—the World Bank, the Asian Development Bank, and the inter-American Development Bank. Why can't these established principles of international financing be applied in our own nation? Why can't this assistance given to other countries to develop public facilities and an economic base, also be extended to our own cities and towns with the decline of public services and the out-migration of business?

I am suggesting that there is a need for a new institution to assist cities and municipalities with developmental and capital funding. The traditional method of allocating credit for municipal credit needs, the municipal bond market, has not proved adequate to the task. Cities are not assured of obtaining funds at reasonable rates of interest on a consistent basis. While it is true that municipal bond rates since January have been lower than at any time in recent years, cities with BAA bond ratings were still paying an average interest rate of 6.25 percent for long-term credit. Since this is an average, many municipalities are paying considerably more.

Municipal capital needs are simply too important to be left to the mercy of the mercurial bond market. The functioning of that market dictates that the cities most in need—those suffering the most severe fiscal strain—are just the municipalities which must pay the highest interest rates. While this may make banking sense, it does not make good development sense. Somehow the perspective from which we view and fund municipal development must be broadened. The consequences of a restrictive investment policy ought to be recognized and corrected. Municipalities are far too important and have needs which are too great to rely exclusively on a capital market that is narrow and constantly fluctuating. The municipal bond market is an important source of funds, but I believe very strongly that it cannot be the only source of funds.

Most of you in this room know that for the past several sessions I have introduced legislation for an institution which I think goes a long way toward giving proper recognition to the importance of public investment. The National Domestic Development Bank would provide a constant and reliable source of capital for municipal investments at reasonable interest rates. It would draw additional capital into the municipal market because investors who cannot take advantage of the tax exempt character of municipal bonds would be able to invest with the security of Federally guaranteed paper. The Bank would lend capital funds to municipal governments at rates comparable to Treasury rates and each year the Congress would appropriate any subsidy that might be necessary to match borrowing rates with lending rates. Additional tax dollars would flow to the Federal Treasury because investors would pay taxes on interest income from the Bank's bonds.

An essential part of the NDDB proposal, because it lends efficiency and rationality to financing public development, is its provision for a technical staff working at a regional level to assure that loans are sound, that investments make sense, and that the best combination of loans and subsidies is provided. It may well be that if some institution like the Bank had existed a few years ago, it would have served to hold back the forces which led to New York City's financial crisis.

In summary, I believe that the time has come for this Nation to provide a reliable, low cost source of long-term financing for municipal capital needs. I look forward to the comments of our distinguished witnesses on this subject.

But first, I understand that Congressman Moorhead and Senator Javits, who have worked extensively on these problems for many years, will make brief opening statements.

STATEMENT OF HERRINGTON J. BRYCE, VICE PRESIDENT, WASHINGTON OPERATIONS, THE ACADEMY FOR CONTEMPORARY PROBLEMS, WASHINGTON, D.C.

Mr. BRYCE. Thank you, Mr. Chairman. The remarks I wish to make are simply an attempt to outline some functions which a national development bank might perform. My views are not necessarily those which are consistent with the Academy for Contemporary Problems or with the views of its sponsors.

I believe that the fundamental role of the national development bank ought to be to increase the efficiency of the private capital market or to supplement that market but certainly not to compete with it. By that, I am suggesting that there are a great number of investments which are considered to be socially worthy, which are not likely to be financed, certainly not at the going interest rate or term.

These kinds of investments, even if the market were theoretically efficient in the general economic sense, would not be financed by the private market and a national development bank could help in being sure these investments are realized. I do hope, that the bank would not only provide guaranteed loans or direct loans, but that one of its primary functions would be to make investments attractive to private lenders.

It can do so in a number of ways. Certainly, one way would be to reduce transaction costs. Those costs can be reduced partly by working with lenders as well as borrowers to increase the quality of information that is available, and by packaging loans so as to reduce costs. I think another function which the bank could serve is the function of coordinating Federal projects and Federal funds. Now, that can occur in a number of ways. I do not believe that the only way it should occur is by being sure that projects which are proposed are consistent with comprehensive plans. Certainly, the bank could help jurisdictions to leverage the funds they receive from one Federal department, with the funds received from another or from other sources. The trick here is one of trying to coordinate and trying to integrate a set of funds so as to obtain the greatest leverage.

I would propose that a major responsibility of the bank would be one which are well-integrated rather than single small projects.

It occurs to me that one important function that this bank can serve is to reduce the risk associated with a single project. I give you an example.

It is oftentimes true that within a particular neighborhood or within a particular place, a single project will fail to be attractive to investors for any number of reasons. One possible reason is that the neighborhood itself might not be seen as one where a single investment would be profitable. But by packaging those investments, by packaging activities, the risks can be shared among a group of investors, and, therefore, reduce some of the costs and risks to an individual investor.

That example, also holds for packaging a number of issues from various jurisdictions. I am thinking in particular of many of the smaller or poorly rated or unrated jurisdictions.

Since I do wish to abide by your 5-minute rule, I shall make one more statement. I do believe that it has been generally presumed that one of the functions that a bank of this sort might perform would be to reverse the flow of capital from one region to another. I am not very sure that I have very much confidence that a single bank could or should do this.

My point simply is that the way capital flows among regions tends to be sensible, to have some sort of logic. The problem in trying to interrupt that flow oftentimes amounts to penalizing areas which have been imaginative in the way they have attracted capital or which have certain natural advantages which investors are seeking at a particular time.

The attempt to reverse the flow can be extremely costly. This leads me to the conclusion, Mr. Chairman, that any organization of the national development bank ought to be one which has a number of regional and local offices and, therefore, is responsive to local needs.

Thank you.

Representative MOORHEAD. Thank you very much, Mr. Bryce. Your prepared statement will be printed in the hearing record at this point.

[The prepared statement of Mr. Bryce follows:]

PREPARED STATEMENT OF HERRINGTON J. BRYCE

Mr. Chairman and Members of the Joint Economic Committee: I am honored to have the opportunity to appear before you. The comments I have to make are brief. They do not necessarily reflect the views of The Academy for Contemporary Problems or the organizations by which it is operated.[1]

My comments are in the form of eight items upon which I am prepared to elaborate.

One, the key role of an urban development bank ought to be to increase the efficiency or to supplement the private capital market, rather than to compete with it. This ought to be a very conscious policy. Such an institution could significantly reduce transaction costs by assisting both borrowers and lenders. Two ways of doing this are to increase the accuracy of information and to provide technical assistance. This presumes that the bank will not only make direct loans or guarantee loans, but will assist in making potential issues attractive to private lenders.

Two, such an institution could help in the coordination of a number of federal programs. The leveraging of funds is important. Thus, the bank should go beyond merely rejecting projects which conflict with regional or comprehensive planning and actually assist jurisdictions in coordinating and integrating projects and the use of federal program funds.

Three, it seems to me that the real advantage of going to a quasi-public bank with subsidies comes where there are large-scale investments to be made. One of the functions that this bank could perform is packaging, bringing together large-scale well-integrated projects.

Four, a program domain should be clearly identified—economic development, public works. But the bank should be free to use the most prudent business principles in choosing among alternative investments within this domain.

Five, one of the perceived notions of this institution is that it should reverse the regional flow of capital. There is logic to the way capital flows from one region to another. There is some sense in capital flowing into areas where there are higher expected rates of return. I would not want to see any new institution disturb the inter-regional flow that results from any number of factors, including the fact that different jurisdictions through their own initiatives have different financing arrangements, different kinds of institutions for financing long-term investments.

There is something to be said for rewarding imagination on the part of states. There is something to be said for rewarding imagination on the part of individual cities and counties. It seems to me that the structure of an urban development bank, even though it should be centralized, should also have a number of regional if not local branches which can respond to local needs as they are perceived.

Six, the bank should be aggressive in seeking investment alternatives within its domain.

Seven, the board that would direct the institution is part of the political equation to be taken into account. Decisions on the use of public capital should not only be made by bankers; the board should also include political figures and individuals who represent the public at large. I say that partly because I would hope that this institution would have more than a market function. The fact is that even if the market operated perfectly there would be a number of socially worthy investments which would not be undertaken. The interests which favor those investments should be represented on the board.

Eight, significant contributions of the bank would be the pooling of risks among jurisdictions and the reduction of transactions costs for many jurisdictions. Furthermore, to the extent that the bank concerns itself with large-scale projects which are well-integrated, it also pools the risks of each unit, reduces its transactions costs, and makes location decisions more favorable. A single firm might be unwilling or unable to borrow funds at an appropriate rate so as to locate in a neighborhood. But the packaging of several of these firms into one project could change the entire outlook.

Representative MOORHEAD. Our next witness will be Ms. Jean M. Gray.

[1] Many of the points I shall make here today are related to my views as expressed in The Brookings Institution Round Table Discussion on Urban Development Banking," on March 21, 1977, at The Brookings Institution, 1775 Massachusetts Avenue NW., Washington, D.C. That institution, of course, holds no responsibility whatsoever for these comments.

STATEMENT OF JEAN M. GRAY, ASSOCIATE PROFESSOR OF FINANCE AND CHAIRPERSON, DEPARTMENT OF FINANCE AND INSURANCE, SCHOOL OF BUSINESS ADMINISTRATION, RIDER COLLEGE, LAWRENCEVILLE, N.J.

Ms. GRAY. Thank you, Congressman Moorhead.

I am delighted to be here today and thank you very much for inviting me. The financing capability of State and local governments is something in which I have recently become interested, and I appreciate the opportunity to share some ideas with you.

First, there are the arguments that favor the bank. Many of them are familiar and I won't belabor them too long, but I think they need to be stated. The existing market for municipal securities is inefficient. It is inefficient as a subsidy to State and local governments. It is inefficient in providing financing at equivalent costs for equivalent default risks, and it is inefficient as a means of carrying out the intent of existing Federal programs to provide incentives to local governments to promote socially desirable projects.

The first inefficiency is one with which this subcommittee is very familiar. That is, that the tax revenues lost to the Federal Government exceed the interest costs saved by municipal borrowers. The difference accrues as a tax-free surplus to investors in high tax brackets.

The basic problem with the market is that there are too few investor groups and too many borrowers. The tax exemption benefit, as far as investors are concerned, applies only to three groups, commercial banks, fire and casualty companies, and individuals. If one or the other of the institutional investors moves out of the market, the rates on municipals tend to rise relative to other rates in the market, and, most particularly relative to corporate rates. Private investors enter the market and stay in so long as the institutions stay out. When the institutions come back, interest rates fall, and private investors move out of the market.

This seems to have been the typical market behavior over the past few years, but there is some question as to whether it will prevail in the future. Banks have found other tax shelters. It is as simple as that. Tax sheltering opportunities can become competitive. It may be that investment tax credits granted through leasing by commercial banks works to the disadvantage of municipal borrowers. Fire and casualty companies—which left the market in 1975—are back. But in 1974 about half their assets were in municipals, and that is about as much as they can probably take. Individuals can take up the slack, but even with tax exempt mutual funds, there is a very serious question as to how much municipal debt they will want to absorb. After all, individuals have tax shelters too in the form of pension and retirement funds.

On the supply side, there are just too many borrowers for too many purposes. One estimate suggests that there are something like 120,000 issues outstanding, issued by 34,000 government units. The figures are mind-boggling. They mean that two kinds of risks apply to borrowers in this market. One is default risk, and this has been covered many times before. The other is market risk. This is the simple proposition that with many securities of diverse maturities, diverse coupon rates, and diverse credit ratings, it may be difficult to find a market for any one issue.

Buyers become suspicious, not necessarily of the credit worthiness of the borrower, but rather of whether or not they can sell securities under tight credit conditions. In a perfectly normal reaction to higher perceived risks, they will attempt to sell municipal securities and, quite possibly, to invest in now higher yielding corporates, which can be marketed more readily in the future. This adds a risk premium: The market risk premium. When municipalities come to the market, they now have to pay a premium not only with respect to their credit worthiness, but with respect to protecting investors against the capital losses which may accrue from future sale.

There is another very good reason for establishing a domestic development bank. That is, to reduce the proliferation of Federal municipal assistance programs with special financing features that have evolved over the last couple of years. Tax-exempt issues are now available to private borrowers who invest in socially desirable projects. Federal guarantees are granted on some tax-exempt debt, but some subsidies and guarantees are given without tax exemption. In other cases government units are provided access to the Federal Financing Bank. When you put all of these together, if you are a municipal finance officer, the question might become, what is the appropriate credit assistance program to follow up for your municipality. Finding the answer may become very difficult. What the bank can do is collect all of these various programs under one umbrella. Clearly, issues that carry Federal guarantees ought to be marketed at fully taxable rates. The bank would substitute its own taxable debt issues, which would trade in broad, deep, and resilient markets, for the multitude of local issues. The investor base would be broadened because it would not be restricted to those few groups which benefit from tax-exempt investments. It should include the full spectrum of institutional investors.

I think it is very important that use of the bank be on a voluntary basis. It is quite possible that a situation would develop whereby potential borrowers might examine the private tax-exempt market and examine the terms of borrowing from the development bank and simply choose, what for them, appears to be the best financing option.

This in itself would reduce interest rate volatility in the tax-exempt market. If one market won't serve a borrower's purpose, another one will. I think that the bank will improve supply conditions in the market. It will be precisely those securities that the market currently does not want to handle, that the market discriminates against, that would find borrowing from the development bank advantageous. This would essentially leave the tax-exempt market to AAA–rated borrowers, to borrowers with large issues, and to borrowers who are in the market on a regular basis. They would find a market not cluttered by an array of small borrowers who may or may not be credit rated, and who often have high costs of flotation. The bank should improve the market overall.

I would like to make just one final point with respect to the benefits of a national domestic development bank. There has been a lot written in recent years on whether to use a Federal intermediary such as the development bank or to provide municipalities with a taxable bond option. The two schemes are comparable in several dimensions: For any given net interest cost to a municipality, both would substitute fully taxable bonds; both would increase Federal tax revenues and reduce the tax-free surplus accruing to intramarginal investors in the market; and both would provide municipalities with the option of issuing bonds in two markets. Beyond these similarities, I think the development bank has another clear advantage. It would simply be cheaper in terms of any interest subsidy which may be given. In my prepared statement, there are some tables that show the ratios of interest rates on municipal bonds with those on corporate bonds of equivalent ratings and with the interest rates on long-term Treasury bonds.

Representative MOORHEAD. Where are those tables?

Ms. GRAY. Table 3 of my prepared statement shows the ratios with Treasury securities, and appendix I of that paper the ratios for the corporates, Mr. Chairman.

Representative MOORHEAD. Thank you.

Ms. GRAY. The quarterly average ratios with the corporates run about 70 percent, 71 percent with A-rated securities. The same ratios with long-term Treasury rates and A-rated municipals, average 94 percent. Now this is not an appropriate comparison in the sense that the development bank, if it issued its own debt, would have to borrow at rates closer to those on other agency obligations. These would be higher than Treasury rates.

As a rough approximation, suppose that the ratio of, say, A-rated municipalities to agency debt would be somewhere in the neighborhood of 85 to 90 percent. If the taxable bond option was used, and let's say a 30-percent subsidy was given to the State and local governments for issuing their own securities fully taxable, the equivalent subsidy that would be necessary at the development bank would be in the neighborhood of 10 to 15 percent. Just in terms of cash outlay, this would be a considerably smaller sum. Moreover, you are dealing with only one institution in making a subsidy to the bank. Whereas, the administrative complexities of subsidizing the individual issues of some 34,000 State and local government units directly could be a little horrendous, to say the least.

I think there is another advantage to the development bank, and it is one that I have already touched upon. That is, it should improve the market. It would provide alternative financing for that mass of small or lower grade borrowers for whom the market does not really provide a viable source of funds.

The taxable bond option would leave those 220,000 issues outstanding, or, at least, would apply the subsidy to every new issue that came along. Getting many of these issues out of the tax exempt market and into the bank would be a definite advantage.

I have one doubt that should be mentioned. I had a feeling when I started looking at some of the literature in this area, that the bank is supposed to solve all the problems of the cities, social, economic, structural, whatever they may be. I would like to see the development bank kept as a fairly simple intermediary operation. It should be a specialized oranization with specialized functions. I think it can best serve the needs of the cities in this way.

In short, I believe that a national domestic development bank would smooth the flow funds to the Nation's communities and improve the overall functioning of a very important financial market.

I thank you very much.

Representative MOORHEAD. Thank you, Ms. Gray, without objecting, your prepared statement will be printed in the hearing record.

[The prepared statement of Ms. Gray follows:]

PREPARED STATEMENT OF JEAN M. GRAY

THE CASH FOR A FEDERAL INTERMEDIARY FOR STATE AND LOCAL GOVERNMENTS

The proposition that the availability of funds to states and political subdivisions could be improved by the creation of a new financial intermediary is not new.[1] Opposition to such an intermediary has already been voiced. Representatives of the securities industry oppose it on the grounds that an existing capital market would be at least partly destroyed. There is a fear that an intermediary would encourage fiscal irresponsibility. Some municipal financial officers forsee a possible loss of local autonomy and the substitution of loans by the intermediary for outright federal grants. However, there are a number of reasons that suggest that a carefully conceived National Domestic Development Bank can improve and strengthen the market for tax-exempt issues that continue to be offered; can impose reasonable credit standards on would-be borrowers; can enter into local decision-making only through negotiation of the terms of the loan; and can operate independently of other federal programs (other than guarantee programs). The Bank should not, therefore warrant opposition. The idea of a Domestic Development Bank is good one whose time may have come.

This statement will briefly review some of the reasons why financial market conditions support the establishment of a Domestic Development Bank;[2] it will suggest some of the kinds of functions that the Bank should undertake; and will indicate why the concept of a Bank is seen as more efficient than a so-called "taxable-bond option."

Municipal market conditions

On the assumption that national goals include providing assistance in allocating funds to municipalities similar to that already available to farmers and home owners, the overriding argument in favor of the establishment of a National Domestic Development Bank is that the present system for directing resources to state and local public uses is inefficient. It is inefficient as a means of subsidizing state and local financing, it is inefficient in providing financing at equivalent costs for equivalent default risks, and it is inefficient as a means of carrying out the intent of existing federal programs to provide incentives to local governments to promote socially desirable projects.

Something of the nature of these inefficiencies can be demonstrated by the data pictured in Charts I and II. Chart I shows the ratios of tax-exempt to taxable yields for new issuer of "prime" (Aaa) and "good" (A) grades of municipal and corporate bonds. Chart II shows short- and long-terms interest rate movements on prime and medium (Baa) grade municipal bonds since 1969.

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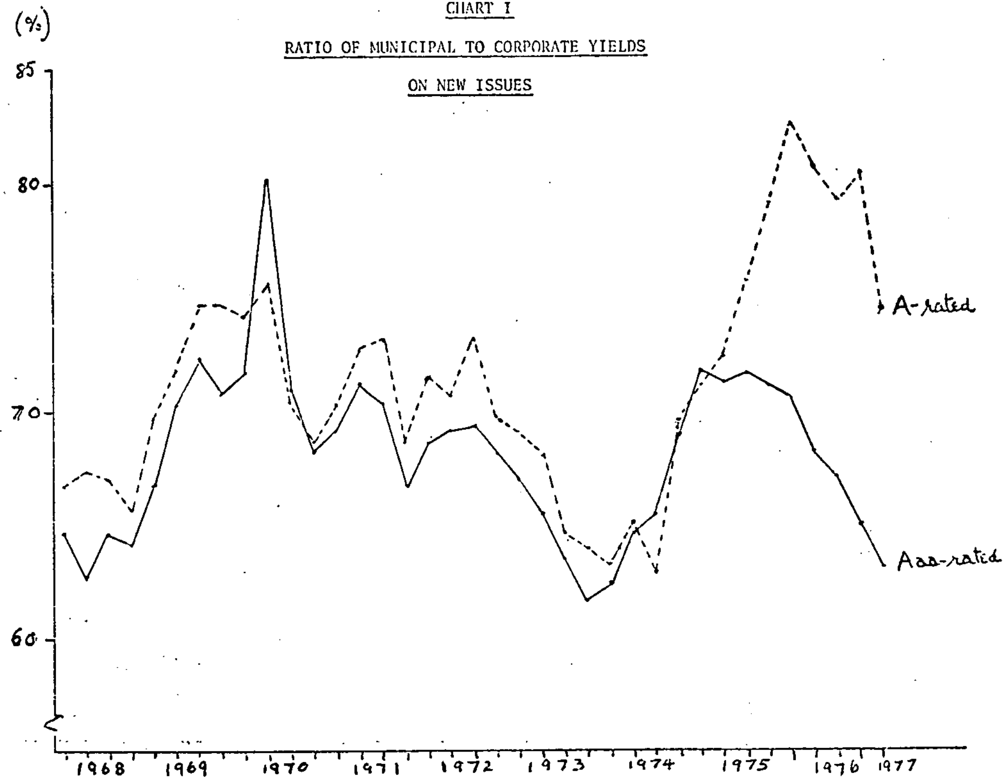
[1] An early proposal for an "Intergovernmental Loan Corporation" appears in Alvin H. Hansen and Harvey Perloff, State and Local Finance in the National Economy (W. W. Norton & Co., 1944), pp. 203–05. The "Case for an Urban Development Bank" is put by Peter Lewis in Financing State and Local Governments (Federal Reserve Bank of Boston, 1970), pp. 159–180. Proposals considered by the Congress include those of then Vice President Humphrey in 1969 for an Urban Development Bank and Senator Humphrey in 1971 for a National Domestic Development Bank.

[2] Many of the problems of the municipal bond market have been carefully researched elsewhere. See, for example, John Peterson, "Changing Conditions in the Market for State and Local Government Debt, A Study Prepared for the Use of the Joint Economic Committee of the Congress of the United States," April 16, 1976. The review of the problems presented in this testimony serves only as a reminder that most remain unresolved.

CHART I

RATIO OF MUNICIPAL TO CORPORATE YIELDS

ON NEW ISSUES

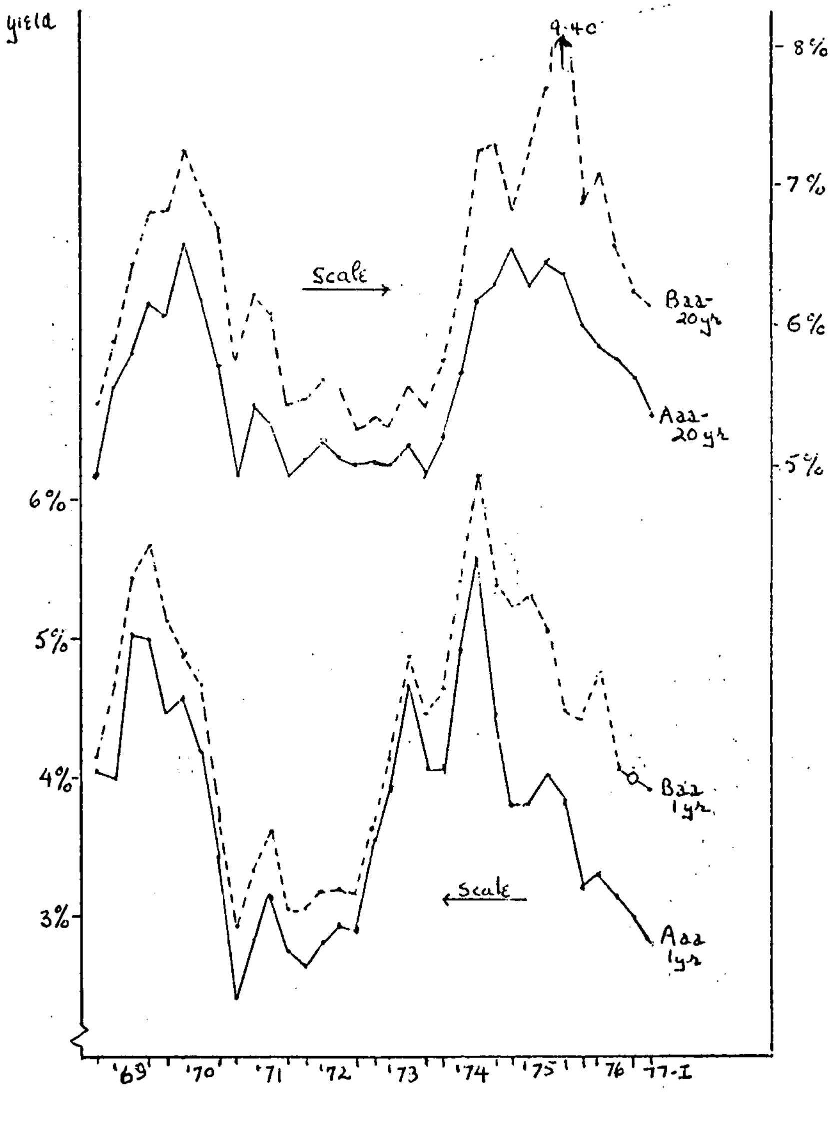


Source: See Appendix I

CHART II

SHORT- AND LONG-TERM YIELDS ON Aaa AND

Baa RATED MUNICIPAL BONDS



Source: See Appendix I

First, there is the evidence that the exemption from federal income taxes of the interest paid on municipal bonds is an inefficient and inequitable subsidy [3] to borrowing governments. It is inefficient in that the tax revenues lost to the federal government exceed the interest costs saved by municipal borrowers. The exemption is inequitable in that the difference accrues as a tax-free surplus to investors in high tax brackets. The argument is a familiar one and it has been substantiated many times by those interested in tax reform.[4] It is also supported by the high ratios in Chart I. Under a progressive tax system, the higher the ratio of yields on tax exempt securities to those on corporate securities of comparable risk, the lower is the tax rate required to induce marginal investors to enter the market and the greater is the surplus in the form of tax-free income which accrues to those in higher tax brackets.

The chart shows that the ratios on prime bonds often rise above 70 percent, and, like those on good bonds, occasionally rise above even 80 percent in response to high interest rates or unsettled market conditions, such as existed in 1976. When the ratios rise, those on lower grade bonds, usually rise relative to those on prime securities. What has been true since 1969 was also true for earlier periods.[5]

These high ratios have opened the municipals market to a much broader segment of individual investors, many with relatively modest incomes.[6] Indeed, Table I shows that in the first quarter of 1977 households accounted for more than half the net purchases of state and local securities. The advent of the tax-exempt mutual fund has further democratized the opportunities for tax-sheltered income, but only because the ratios are high enough to attract individual investors with relatively low marginal tax rates.

The high returns on tax-exempt as compared to comparable taxable securities induce individual investors into the market, but are engendered by the departure of institutional investors from it. So far as borrowers are concerned, the real problem is not so much tax exemption as the fact that so few investor groups benefit from it. In other words, the market for municipal securities is not a broadly based capital market. Traditionally, commercial banks, fire and casualty companies and individuals have accounted for about 90 percent of net purchases.[7] (Table I). When either of the institutional investors leave the market, yields on municipals rise relative to those on corporates, and individuals with lower tax rates enter the market. When institutional investors return, the ratios fall and the marginal individual investors leave. Or at least that was the scenario until 1975 and 1976. The financial crises in New York increased awareness of the inadequacies of disclosure in the underwriting requirements for state and local obligations, and growing suspicion of the reliability of ratings discouraged even individual investors. In response to high returns, some changes in tax laws, and occasionally, political pressures, state and local retirement funds, thrift institutions and life insurance companies took up the slack.

[3] Because it originates in Constitutional interpretation by the Supreme Court, some observers object to calling tax exemption a subsidy. So far as the loss of federal tax revenues is concerned it is as much a tax subsidy as an investment tax credit.

[4] David Ott and Allan H. Meltzer, "Federal Tax Treatment of State and Local Securities" (Washington, D.C.: The Brookings Institution, 1963). The U.S. Treasury estimated that for 1976 only $3.5 billion of the 4.8 billion in revenues lost to the Treasury would be passed on to state and local borrowers. "The Municipal Bond Market: Why It Needs Help." Congressional Record, December 17, 1975, S. 22558. Cited in Peterson, Changing Conditions, p. 56.

[5] Ratios on prime bonds rose to 75 percent in 1961 and those on medium grade bonds (Baa) approached 90 percent in the mid-1950's. (Peterson, Changing Conditions, p. 34 and John E. Peterson, "The Rating Game", Twentieth Century Fund, New York, 1974, p. 36).

[6] Mutual funds provide investors with greater liquidity through the redemption of shares as well as smaller minimum investments than does direct market participation.

[7] In general, commercial banks prefer shorter-term obligations. One result of their dominant position in the market for tax-exempts is that the yields on shorter-term obligations rarely, if ever, rise above those on longer-dated securities, as they do in other markets under tight credit conditions.

TABLE 1.—NET PURCHASES OF STATE AND LOCAL SECURITIES BY SECTOR

[Dollar amounts in billions]

	Households		Commercial banks		Fire and casualty insurance		Other[1]		
	Amount	Share of total (percent)	Amount	Share of total (percent)	Amount	Share of total (percent)	Amount	Share of total (percent)	Total amount
1966	$3.4	61.0	$2.4	43.0	$1.3	23.0	−$1.5	−27.0	$5.6
1967	−2.2	−28.0	9.1	1.2	1.4	18.0	−0.5	−6.0	7.8
1968	−0.7	−7.0	8.6	90.0	1.0	10.0	0.6	6.0	9.5
1969	9.1	92.0	0.6	6.0	1.2	12.0	−1.0	−10.0	9.9
1970	−0.8	−7.0	10.7	95.0	1.4	12.0	−0.1	−0.9	11.2
1971	−0.3	−1.7	12.6	72.0	3.9	22.0	1.3	7.4	17.5
1972	2.2	14.0	7.1	46.0	4.8	31.0	1.3	8.0	15.4
1973	7.2	44.0	5.7	35.0	3.5	21.0	−0.1	−0.6	16.3
1974	11.2	57.0	5.5	28.0	2.5	13.0	0.4	2.0	19.6
1975	8.7	50.0	1.7	10.0	1.8	10.0	5.1	29.0	17.3
1976	6.4	37.0	2.9	17.0	3.6	21.0	4.3	25.0	17.2
1977 (1st quarter)	7.2	51.0	0.6	4.0	4.8	34.0	1.6	11.0	14.2

[1] Includes nonfinancial corporations, thrift institutions, life insurance companies, brokers and dealers, State and local government general funds and State and local government retirement funds. All were very small participants in the market until 1975 when life insurance companies, thrift institutions and State and local government retirement funds increased their purchases substantially over earlier years. Net purchases for each were:

[In billions of dollars]

	Life insurance	Thrift institutions	State and local government retirement funds
1975	$0.8	$1.2	$1.9
1976	1.0	1.0	1.5
1977 (1st quarter)	.7	.3	

Source: Board of Governors, Federal Reserve System, Flow of Funds Accounts, 1946–75 and 1st quarter, 1977.

Prospects for a return to the traditional patterns of investment appear doubtful, as does any significant addition to demand by thrift, insurance or retirement institutions. Commercial banks have found new tax shelters and have decreased their net purchases every year since 1971.[8] Fire and casualty companies who left the market in 1974 and 1975 have returned as their profits have improved, but their liquidity requirements probably preclude a much higher share of total assets in municipals.[9] Partial exemption from federal taxes precludes much greater participation by life insurance and thrift institutions and, barring municipal rates as high as corporates, there is no logical financial reason for retirement funds to invest in tax-exempt securities. State and local governments will have to rely more heavily on individual investors to supply their increasing demand for long-term funds, and there may be some question as to the overall capacity of individual investors to absorb an increased supply of long-term tax exempt securities except at ratios that will steadily increase the tax-free surplus.[10]

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[8] See, for example, Ralph C. Kimball, "Commercial Banks, Tax Avoidance, and the Market for State and Local Debt since 1970," New England Economic Review, Federal Reserve Bank of Boston, January/February, 1977, pp. 3–21. Kimball points out an interesting facet of using tax subsidies to achieve social goals: they tend to become competitive as their number increases, and the benefits accruing to any single subsidized activity decrease. For example, municipal borrowing costs may be sacrificed to investment tax credits as bank leasing activities expand.

[9] A high of 46 percent of their total assets were invested in municipals in 1974. Fire and casualty companies need more liquidity in their investment portfolios than life insurance companies because their claims are less predictable.

[10] Life insurance, pension funds and Keogh plans already tax shelter a substantial portion of middle income long-term savings. Residual investments in municipal securities, either directly or through mutual funds, may have to compete with riskier, but potentially higher returns in equities or equity substitutes.

The market for municipal securities is a curious one in which state and local government borrowers must not only share the benefits of tax exemption with investors, but pay the high costs engendered by wide swings in investor portfolio, adjustments in a market dominated by tax considerations.

The market should also be examined in terms of its efficiency in allocating credit on the basis of equal cost for equal risk. Charts I and II show that the ratios for the two grades of bond tend to move together except when long-term interest rates are high or market conditions unsettled. Then the ratios rise for both grades of bond, but the degree by which they increase ordinarily varies inversely with the rating. The ratios rise as the interest rates paid by municipal borrowers rise relative to those paid by corporations. The market, in effect, responds to tight credit conditions by imposing an additional risk premium on the cost of municipal borrowing: one which rises as the credit rating of the borrower declines. If the assumption can be made that, in general, comparably rated municipal and corporate debt should carry equivalent default risk, the additional premium results from investors' perceptions of increased market risk. That is, the market judges the potential risks of capital loss from secondary market trading as now relatively greater on municipal than on corporate securities. Further, the risk is judged greater for lower-rated securities.

This re-pricing mechanism is efficient: borrowing costs have changed because risk perceptions have changed. However, risk perceptions have changed not because of any necessary deterioration in the borrowers ability to repay, but because the market for municipal securities is not as broad, deep and resilient as the corporate bond market. It lacks breadth because tax exemption narrowly restricts the kinds of investors attracted to the market. It lacks depth because the number and diversity of both issues and issuers restricts secondary market trading. Both factors combine to limit its resilience, that is, the quickness with which prices snap back after temporary market disruptions.

Table II demonstrates the heterogeneity of the market from the supply side. In 1976 some 5,716 government units, including states, counties, municipalities, school districts, special districts and statutory authorities, issued some $35.2 billion in long term-debt obligations for an average issue size of approximately $6.2 million.[11] However, if the 330 largest issues, totalling some $20.6 billion[12] are subtracted, the remaining 5,386 issues averaged only $2.7 million each. Most state and local government debt issues are serial: that is, they carry multiple maturities and coupon rates, so the available supply of any given component of an issue is very limited.

Further diversity among issues is created by the nature of the commitment to service the debt. General or limited tax revenues may be pledged, the obligation may be merely "moral" or it may be dependent on user charges or sales revenue. Finally, the largest and most rapidly growing category of borrower is the statutory authority. They may be spun off from both state and local governments and are used to finance public purposes that range from sports complexes to hospitals and pollution control.

The result is a secondary market in which it is virtually impossible to find continuous price quotations, regular grading, or information on changes in credit worthiness quickly and accurately for any more than a handful of securities.

The structure of the secondary market clearly influences the determination of reoffering rates in the primary markets. Even with competitive bidding, underwriters must assign spreads which cover the risks of marketing such diverse issues, and primary investors will require returns commensurate with the potential risks of capital loss from sale.[13] Uncertainty with respect to disclosure standards,[14] and questions regarding the reliability of municipal bond rating standards[15] compound the problem.

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[11] The 3,689 general obligation bonds averaged just under $5 million per issue and the 2,027 revenue bonds about $8.5 million per issue. Petersen estimated in "The Rating Game" (p. 32) that outstanding obligations included some 120,000 issues from some 34,000 government units.

[12] Derived from "Municipal Finance Statistics," The Bond Buyer, Volume 15, June, 1977, pp. 9–20.

[13] Apparently both very large and very small issues will carry higher yields than medium size issues. The market is too limited to absorb very large issues and very small issues may be unrated, locally underwritten and locally held. (American Enterprise Institute, "Proposed Alternatives to Tax-exempt State and Local Bonds," Legislative Analysis No. 3, 93rd Congress, February 14, 1973, p. 11).

[14] See Petersen, "Changing Conditions," pp. 41–46.

[15] See Petersen, "The Rating Game," especially pp. 85–117 for an analysis of the difficulties in rating municipal securities.

TABLE II.—*Municipal bond sales, 1976*

Sales by type of issues (long term):	*Billions*
States	$7.1
Counties	3.1
Municipalities	6.8
School districts	2.8
Special districts	2.7
Statutory authorities	12.7
Total	35.2

SALES BY TYPE AND NUMBER OF ISSUES

	Volume (billions)	Number of issues
Long-term:		
General obligation	18.1	3,689
Revenue	17.1	2,027
Total	35.2	5,716
Short-term	21.9	

Source: Public Securities Association, Municipal Market Developments, April 1977.

The wonder is not that investors favor shorter-term and prime-rated securities with lower relative yields, but that the premiums for raising funds at long-term for less than prime-rated borrowers have not been greater.

One reason premiums on long-term debt are not greater is that cost conscious borrowers respond to market conditions. They may delay floating issues until interest rates go down,[16] the average maturities on serial issues may be reduced, or long-term projects may be financed at short-term through the issuance of bond anticipation notes (with the expectation that the notes can be rolled over until more propitious market conditions arrive.) A rise in the use of short-term debt has been particularly pronounced since 1969. Short-term issues increased from about 50 percent of the long-term funds raised in 1968 to over 100 percent between 1969 and 1975.[17]

Unfortunately, none of these alternatives serves the public purposes for which the funds need to be raised. Facilities are either not put in place or borrowers jeopardize their liquidity and solvency by agreeing to too rapid paybacks and high debt-service costs on essentially long-lived projects. Bond anticipation notes may be a useful expedient to finance start-up costs for slow projects, but can present problems when their retirement is predicated upon the flotation of long-term debt in an unreceptive and expensive market.

Finally, the tax-exempt market is being mis-used and further segmented by a proliferation of federal assistance programs. The social intent of these programs may be laudable, but their impact on the efficient functioning of the market for state and local government debt can be pernicious. Some programs, notably housing and pollution control, provide subsidies and guarantees which funnel tax-exempt funds raised at long-term directly to private, unsecured borrowers.[18] Some provide federal guarantees for new types of tax-exempt debt.[19] Others pro-

[16] Paul F. McGouldrick and John E. Petersen, "Monetary Restraint and Capital Spending by Large State and Local Governments in 1966," Federal Reserve Bulletin, July, 1968 and "Monetary Restraint, Borrowing and Capital Spending by Small Local Governments and State Colleges," Federal Reserve Bulletin, December 1968.

[17] "Municipal Finance Statistics," 1976, p. 7.

[18] See John Peterson, "Changing Conditions," pp. 12–22 for a critique of these programs. Conservative estimates indicate that by 1980 the total tax losses since 1970 will amount to $640 million from outstanding pollution control bonds. In addition, state and local governments will be paying an additional $150 million each year in debt service costs, corporations will enjoy a total of $425 million in interest savings and investors will receive an additional $365 million in tax-sheltered income. (p. 21).

[19] For example, the Small Business Investment Act Amendments of 1975 (Public Law 94–305) authorize the Small Business Administration to guarantee tax-exempt bonds for small business pollution control. The Guaranteed Student Loan Amendments (Public Law 94–482) allow non-profit corporations to issue tax-exempt bonds to acquire student loans. (Lynda Rich. "State and Local Government Financing: Federal Guarantee and Subsidy Programs," Municipal Market Developments, October, 1976, pp. 1–2).

vide federal guarantees and subsidies for debt issued on a taxable basis,[20] and still others provide local government units with access to the Federal Financing Bank.[21]

Programs which promote the issuance of long-term tax-exempt debt by new borrowers or for new purposes raise the cost of funds to all who require access to a market in which demand is already restricted to a very narrow band of investors. Programs which guarantee the tax-exempt issues of a select group of borrowers, presumably because their access to the market is limited, discriminate against non-guaranteed borrowers of all sizes and creditworthiness. Clearly, pressure to be included in the select group will grow. Providing access to the Federal Financing Bank or a taxable-bond option simply multiplies the existing variety of municipal debt instruments.

Singly, the programs each attack some special problem. Taken together they create a plethora of credit opportunities and obligations which are likely to become competitive in their efforts to re-direct financial resources to social objectives. Finding the right credit alternative could become as complicated as finding the cheapest air fare.

The potential benefits of Federal intermediation

The inefficiencies in the operation of the tax-exempt market for state and local government obligations could be significantly reduced, if not eliminated, by the creation of an institution like a National Domestic Development Bank. As a financing alternative available to state and local governments at their discretion, it could effect improvements along the following lines.

(1) The tax equity and efficiency problem would be reduced by the substitution of a fully taxable obligation for some tax-exempt securities. The degree to which tax-free income would be reduced will depend on the relative costs of borrowing through the new intermediary as compared to the tax-exempt market, the share of municipal financing done through the intermediary and the relative returns on tax-exempt as compared to taxable securities.

(2) A single debt instrument of recognized credit standing which would trade in broader, deeper and more resilient markets would replace a heterogeneous collection of local issues.

(3) The investor base for municipal financing would be extended to all those for whom high grade, marketable securities are an attractive investment.

(4) Interest rate volatility on new issues in the tax-exempt market resulting from cyclical or other changes in investors' tax liabilities would be reduced by the availability of a taxable financing option.

(5) Supply conditions in the tax-exempt market would be improved by reducing the volume of securities traded in that market.

(6) Municipal financing cost differentials which stem from factors other than credit worthiness, such as size of issue, would be eliminated by access to the Development Bank.

(7) Specialization and economies of scale of operation which accrue to the Development Bank would result in lower flotation costs.

(8) Proliferation of various kinds of federal guarantees with and without access to tax-exempt financing would be ended. Units of government receiving federal guarantees for their debt would be required to borrow through taxable issues.

(9) State and local governments will be able to borrow at maturities which reflect the life expectancy of the asset being financed, with payments of interest and principal scheduled to coincide with anticipated cash flows. Intermediary loans could be serialized, amortized or include balloon payments.

(10) Since the loan portfolio of the intermediary would be diversified by geographic region, project purpose, terms to maturity and debt service schedules, it would be free to market its own fully collateralized obligations in denominations and at maturities which would minimize its borrowing costs. Known cash inflow from debt service payments and known loan commitments would allow the bank to shorten the average maturity of its liabilities as compared to that of its assets.

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[20] For example, the Coastal States Management Act Amendment (Public Law 94–370). (Ibid., p. 2)

[21] The Federal Water Pollution Control Act Amendment of 1976 (Public Law 84–482) enables "select" users to guarantee sewage treatment bonds through the Environmental Protection Agency and to issue the bonds directly to the Federal Financing Bank. (Ibid., p. 2)

Controversy over the establishment of a National Domestic Development Bank has centered on the scope and nature of its operations. Critics contend that, among other things, the Bank could lead to federal domination of local financial decisions; erode established private market financial relationships; destroy incentives to local governments to improve their credit standings; and, in general, lead to higher social costs and to greater misallocation of resources than prevail under the present system. Some thoughts on the characteristics and functions appropriate to a financial intermediary for state and local governments follow.

First, the institution should be free from Congressional and Executive Office control. A federally sponsored credit agency with public control and public plus participant ownership seems the ideal form of organization. However, most of the intermediary functions, and the benefits which would derive from them, could be achieved by establishing a much smaller organization within the Department of Housing and Urban Affairs or by expanding the areas of responsibility of an existing public body, such as the Advisory Commission on Intergovernmental Relations. The Advisory Commission has the appropriate public, federal, and local government representatives and, apparently, the expertise to analyze state and local problems.

Second, the scope of the intermediary's operations should be limited to providing an alternative source of long-term capital financing for state and local government units. These would include special districts and statutory authorities but should probably exclude business-for-profit operations of government units. There is a clear danger that an institution designed for a purpose as broad as assisting the nation's cities might be called upon to fund programs designed to cure all manner of social and economic ills. This could lead to the kinds of excesses associated with tax-exempt housing and pollution control bonds.[22] The problems associated with raising capital funds for the nation's cities may warrant creation of a special financial institution, but reallocation of financial resources to public purposes raises the costs of private capital formation. Private capital formation creates jobs and income for the majority of the population, including people in the cities. When public funds are re-directed to private purposes, resource misallocation does occur.

Third, all state and local governments should have equal access to Bank funding, though not necessarily at equal cost. However, the initiative to use the Bank's facilities should, with one exception, be at the discretion of the borrower. When loans are to be guaranteed by an agency of the government, such as the Government National Mortgage Association or Housing and Urban Development, the funds should be made available only on a fully taxable non-interest subsidized basis, whether this is through the Development Bank or the private market. Unsubsidized private market financing may be unlikely, but, in any event, the Treasury should not forgo tax revenues on federally guaranteed debt.

In all other cases, whether federal matching grants are involved or not, the borrowing government should be able to compare directly and quickly the general terms and services offered by the intermediary with those available from private underwriters in the tax-exempt market. High-rated borrowers with established underwriting procedures may never approach the Development Bank. Small or lower-rated borrowers may be pleased to approach the Bank directly. In other cases, putting private underwriters in direct competition with the Development Bank could have a salubrious effect on both institutions, particularly in those cases where underwriting contracts must be negotiated or only a single bid is received on an issue.[23]

The Bank would have three functions: ordinary lending, refunding, and trading in its own or tax-exempt securities in secondary markets.

The lending function requires two interdependent decisions: determination of eligibility standards and determination of the rates to be charged borrowers. Both will affect the number of kinds of borrowers the Bank will attract. If the Bank were to be financially self-sufficient, its lending rate would have to at least equal its borrowing rate. Since federally sponsored credit agency debt usually trades at rates slightly above those on U.S. Treasury obligations, there will be a few borrowers for whom the Bank has a cost advantage over the tax-exempt market. Table III provides a kind of rough benchmark for this group. It shows the ratios

[22] Petersen: "Changing Conditions," pp. 9–22.

[23] See Reuben A. Kessel, "The Economic Consequences of the Exclusion of Bank Competition from the Underwriting of Revenue Bonds, *Hearings Before the Subcommittee on Financial Institutions of the Committee on Banking and Currency*," U.S. Senate, 90th Cong., 1st sess. on S. 1306, August 1967.

of twenty-year A-rated municipal bond reoffering yields to long-term Treasury rates. A-rated securities have comprised somewhat more than one-half the new issues floated since 1973.[24] If Baa and lower- or unrated securities are added, the group makes up better than 60 percent of new issues. A-rated securities are often offered at rates very close to the prevailing market rates on long-term Treasuries and occasionally exceed them. The ratios for lower-rated or longer-dated securities would be higher. Thus, assuming credit standards appropriate to this class of borrowers, on a break-even interest rate basis, the Bank's clients would include low- and unrated borrowers much of the time and good, or, sometimes better-rated municipalities when the tax-exempt market is unreceptive to new issues.

TABLE III.—RATIOS OF 20-YR MUNICIPAL BOND REOFFERING YIELDS TO LONG-TERM U.S. TREASURY SECURITIES

[Quarterly averages]

Year: Quarter	Yield ratio	Year: Quarter	Yield ratio
1969:		1973:	
I	0.87	I	.85
II	.93	II	.82
III	.99	III	.82
IV	.99	IV	.82
1970:		1974:	
I	1.00	I	.81
II	1.02	II	.88
III	.98	III	94
IV	.98	IV	.99
1971:		1975:	
I	.93	I	1.03
II	.99	II	1.01
III	1.01	III	1.00
IV	.93	IV	1.02
1972:		1976:	
I	.93	I	.98
II	.95	II	.98
III	.96	III	.95
IV	.90	IV	.97
		1977: I	.82

Source: Public Securities Association, "Municipal Market Developments" and Board of Governors, Federal Reserve System, "Federal Reserve Bulletin."

Debt absorbed by the Bank will generate federal tax revenues. Some, if not all, of these additional revenues could be transferred from the Treasury to the Bank, enabling it to offer borrowers rates below those at which the Bank acquires funds. The size of the transfer, and whether it exceeds or falls short of new revenues collected, is a political decision. Whatever the amount, the Bank's basic lending rate should be a fixed percentage of its borrowing rate. The funds transferred from the Treasury would then be the difference in the two rates times the volume of loans in the Bank's portfolio.[25] The larger the differential between the Bank's borrowing and lending rates, the more municipalities would use the Bank and the larger would be the anual transfer from the Treasury. The transfer should be viewed as a firm commitment to return to Bank-financed municipalities some or all of the benefits previously shared with investors in the tax-exempt market. The transfer should be automatic and not subject to Congressional appropriation.[26] The amount of the transfer would vary from year to year with changes in the volume of loans in the Bank's portfolio.

Both the Bank's borrowing and lending rates would vary with credit conditions, but the extra volatility associated with the tax-exempt market would be eliminated. Long-term project financing might still be delayed because of cyclically high rates, but tax-exempt bond anticipation notes could be converted to taxable long-term debt at the Bank if there is a sudden decline in investor interest in the non-Bank market.

[24] Advisory Commission on Intergovernmental Relations, "Understanding the Market for State and Local Debt," Washington, D.C., May, 1976, p. 25.

[25] The Bank's loans could be made on a variable rather than a fixed interest rate basis to reflect changes in its borrowing costs.

[26] This would be similar to the automatic funding for federal interest reduction payments on a taxable bond option provided in the bill introduced by Senator Proxmire in 1972. (S. 3215, 92nd Congress). (A.E.I., p. 4).

If the Bank's role is to supplement the tax-exempt market rather than to eliminate it, the difference between the Bank's borrowing and basic lending rate might be set close to the historic mean ratio between the yields on long-term good (A) grade municipals and federally sponsored agency obligations.[27] Credit standards applied to the basic loan might reflect those currently used to assign "A" ratings. Beyond the basic rate and its associated credit standards, there might be two or three tiers of standards applicable to higher risk borrowers. Lower credit standards would require higher interest rates and more restrictive loan covenants. The risk premiums on less creditworthy borrowers could be used to build up a loan loss reserve commensurate with the overall loss experience on similar municipal debt.[28] Eligibility standards for the different classes of borrowers should be made readily available to municipal finance officers so that they can quickly determine the kinds of information needed for loan applications and have an approximate idea of the rate that they would be charged.

The co-existence of a tax-exempt market with a Domestic Development Bank would continue to proivde communities with incentives to achieve high credit ratings. Financing costs would be lowest for prime borrowers in the tax-exempt market, although it is always possible that in times of great credit stringency even these borrowers might use the Bank. Borrowers with good credit standards could examine both sources of credit and choose the one that costs less or better suits their needs. The rates charged by the Bank to less credit-worthy borrowers should be lower than those available to them in the tax-exempt market, but the premiums over the basic rate should be high enough to induce fiscal improvements. Note that the elimination of the very high tax-exempt rates will increase Treasury revenues extra-proportionally.

The volume of loans made by the Bank will vary over the credit cycle, but may also vary because of conditions specific to the tax-exempt market. It is quite possible that good- and medium-grade municipalities might borrow from both sources and might, if and when conditions change, want to convert debt from bank to tax-exempt debt or vice versa. The Bank should accommodate such refunding operations at a prescribed cost.

A final function of the Bank would be trade in its own and tax-exempt securities in secondary markets. It would trade in its own securities to equate its liabilities with its outstanding assets so that it would neither hoard nor ration funds. The Bank would trade in tax-exempt securities purely for the purpose of reducing any excessive volatility in that market. Trading in the tax-exempt secondary market might generate income for the Bank since it would tend to buy when prices were low and to sell when prices were high. Other income would be generated by earnings on the loan-loss reserves and by any fees and charges made to clients. It is possible that the Bank might develop into a provider of project-planning and financial-analysis services to state and local governments, irrespective of whether the Bank would be used as the source of funds.

As it is outlined here, a National Domestic Development Bank would assist the states and political subdivisions of the nation by increasing the efficiency of the market for their debt. Financing through the Bank would lower the costs of borrowing for some borrowers—partly by requiring lower interest rates and partly by reducing flotation costs and market risks. For borrowers in the tax-exempt market, the reduced volume of debt issued and traded should reduce yields and the stabilizing function of the Bank's trading should reduce interest rate volatility.

The alternatives: Federal intermediation or taxable bond

Two proposals have emerged as the most likely candidates for improving the access of state and local governments to long-term funds: a federally sponsored intermediary and a taxable-bond option. Under the latter scheme the Federal Government would agree to subsidize directly the interest costs of state and local obligations by between 30 and 50 percent. The higher the subsidy, the greater will be the inducement to issue taxable bonds in lieu of tax-exempts.

The two schemes are comparable in several dimensions. The two most important are their effect on the equity and efficiency problem on the volatility of

[27] A cheaper alternative would be to float the Bank's debt through the Federal Financing Bank.

[28] An initial Treasury grant or loan could fund the loss reserve in the early years of the Bank's existence. Low insurance premiums might be required of all borrowers.

the new-issues market. For equivalent net interest costs to municipalities, both will increase federal tax revenues at the expense of intramarginal lenders and both will provide municipalities with the option of issuing bonds in two markets instead of one.

Beyond these common elements, the bank has two clear advantages over a taxable bond option. It will likely be less costly to the Federal Government and it will be more effective in improving the efficiency of the market.

The larger gain lies in the size of the subsidy required to reduce municipal borrowing costs to a specified level. Under a taxable bond option, the Treasury would be committed to paying a fixed percentage of the interest cost of borrowers of all sizes and grades for whom the taxable bond option is cheaper. The Bank, on the other hand, would subsidize the same borrowers to the same degree by substituting its own credit rating and the marketability of its issues for those of the municipalities. Assuming that the market exaggerates the risk premiums on lesser-known borrowers, the subsidy paid by the Bank will be less than that paid under the taxable-bond option for equivalent issues. A simple arithmetic example will illustrate the mechanism. Let the ratio of municipal to corporate yields for a given grade be 70 percent and the ratio of tax-exempts of the same grade to agency debt be 90 percent.[29] To equate the net borrowing costs of the municipality, the Bank would absorb only ten percent of the total interest costs while the taxable bond option would require the absorption of 30 percent. The Bank, by substituting its own debt for that of ultimate borrowers, will reduce the cost of funds raised in primary markets. Only if the borrowers from the Bank have high bankruptcy rates would the Bank prove more expensive. On an administrative cost basis, the Bank need not be at a great disadvantage since the taxable-bond option would require a mechanism to distribute the payment of interest to thousands of government units who have loans outstanding.

The impact of the Bank on the efficiency of the market in which municipals compete for funds can be an equally important characteristic of the Bank alternative. The diversity and large number of diffierent small issues with the inherent instability that such a mix implies, will not be reduced by the taxable-bond option.[30] Per contra, the Bank will drastically reduce the number of issues with poor marketability. The costs of flotation are high for small borrowers in private markets and this cost would be virtually eliminated by the Bank, but not by the option. The market for the remaining tax-exempts (under the Bank alternative) would be smaller and contain only the better grade and more actively traded of bonds. This will be a more efficient source of funds for the better-rated borrowers and will be further aided by intelligent trading in the secondary market by the Bank.

In conclusion, there seems to be little doubt that the present system is inefficient. At issue is the means by which to improve its operation. This statement takes the position that a financial intermediary, like the National Domestic Development bank, is the best alternative.

The degree of subsidy to be granted under any proposal is a political decision dependent on the degree to which Congress wants to direct economic resources to local public expenditures. For any degree of subsidy, Bank financing should be more economical and should bring about some beneficial changes in the structure of the municipal bond market.

One caveat is in order here. The Bank should be a low-cost, specialized organization. It should not be involved in finding solutions to the broad economic and social problems of the nation's states, cities and towns. To do so would dissipate its savings in huge administrative expenditures.

With that qualification, a National Domestic Development Bank would, by providing a financing option, smooth the flow of funds to the nation's communities and improve the overall functioning of an important financial market.

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[29] The average ratio in Chart I for A-graded municipal and corporate new issues is 71 percent. The ratio for twenty-year A-rated municipal reoffering yields to long-term Treasury securities in Table III is 94 percent. Ratios of long-term municipals to Agency debt would be somewhat lower.

[30] Federal guarantees on taxable bonds could bring a degree of homogeniety to the market.

APPENDIX I

RATIOS OF MUNICIPAL TO CORPORATE YIELDS ON NEW ISSUES

[Quarterly averages in percent]

	Aaa	Aa	A	Baa
1968:				
I	64.7		66.7	
II	62.8		67.4	
III	64.7		67.0	
IV	64.1		65.6	
Annual average	64.1	64.5	65.6	68.4
1969:				
I	66.8		69.7	
II	70.8		71.9	
III	72.3		74.7	
IV	70.9		74.7	
Annual average	70.2	71.2	72.7	71.9
1970:				
I	71.8		74.1	
II	80.1		75.6	
III	71.0		70.4	
IV	68.2		68.6	
Annual average	72.8	72.3	72.2	69.6
1971:				
I	69.1		70.3	
II	71.3		72.6	
III	70.4		73.1	
IV	66.7		68.6	
Annual average	69.4	69.8	71.1	70.2
1972:				
I	68.7		71.5	
II	69.2		71.2	
III	69.4		73.1	
IV	68.2		69.8	
Annual average	68.8	70.3	71.4	70.0
1973:				
I	67.0		69.1	
II	65.6		68.0	
III	63.5		64.6	
IV	61.6		64.0	
Annual average	64.4	65.6	66.4	67.3
1974:				
I	62.5		63.3	
II	64.6		65.0	
III	65.5		62.9	
IV	69.0		69.6	
Annual average	67.2	65.0	66.9	(1)
1975:				
I	71.9		71.2	
II	71.4		72.5	
III	71.8		75.8	
IV	71.1		79.2	
Annual average	71.7	72.5	74.7	(1)
1976:				
I	70.6		82.7	
II	68.4		80.7	
III	67.2		79.4	
IV	65.0		80.5	
Annual average	67.8	71.7	80.8	78.5
1977: I	63.2		74.5	

[1] Insufficient observations for realistic averages to be calculated.

Note.—Annual averages only are given for Aa and Baa rated bonds for comparison. The Aa bond ratios usually follow those of Aaa bonds quite closely, as do those for Baa with A rated bonds. Ratios for A rated bonds were calculated in preference to Baa bonds because there were sufficient observations of new Baa issues.

Sources: The ratios are quarterly averages of the yields of new issues of municipal to new issues of corporate bonds of the same rating. The municipal yield series is "Municipal Bond Yield Averages (Long-term Bonds)" in Moody's Municipal and Government Manual. The corporate yields are taken from "Composite Average of Yields on Newly issued Corporate Bonds" given in Moody's Industrial Manual.

APPENDIX II

1- AND 20-YR REOFFERING YIELDS ON Aaa AND Baa RATED BONDS

[Quarterly averages in percent]

	Aaa—term to maturity		Baa—term to maturity	
	1 yr	20 yr	1 yr	20 yr
1969:				
I	4.06	4.92	4.15	5.44
II	4.00	5.55	4.66	5.87
III	5.03	5.78	5.43	6.41
IV	5.00	6.15	5.64	6.77
1970:				
I	4.47	6.10	5.13	6.83
II	4.57	6.57	4.87	7.25
III	4.21	6.17	4.67	6.88
IV	3.42	5.72	3.65	6.70
1971:				
I	2.39	4.90	2.93	5.75
II	2.85	5.41	3.35	6.22
III	3.14	5.32	3.62	6.12
IV	2.76	4.93	3.03	5.43
1972:				
I	2.64	5.02	3.02	5.48
II	2.82	5.17	3.17	5.62
III	2.95	5.06	3.22	5.52
IV	2.90	5.00	3.16	5.25
1973:				
I	3.57	5.03	3.62	5.35
II	3.95	5.00	4.13	5.26
III	4.65	5.13	5.00	5.60
IV	4.08	4.97	4.48	5.41
1974:				
I	4.10	5.21	4.67	5.75
II	4.94	5.68	5.40	6.27
III	5.61	6.16	6.16	7.25
IV	4.48	6.28	5.37	7.28
1975:				
I	3.81	6.53	5.25	6.85
II	3.82	6.28	5.28	7.29
III	4.04	6.47	5.05	7.70
IV	3.81	6.37	4.50	9.40
1976:				
I	3.20	6.00	4.43	6.87
II	3.31	5.86	5.26	7.12
III	3.13	5.75	4.09	6.58
IV	3.00	5.62	NA	6.25
1977: I	2.80	5.36	3.94	6.13

Source: Public Securities Association, Municipal Market Development, various issues.

Representative MOORHEAD. Our next witness will be Paul R. Porter.

Mr. Porter, please proceed.

STATEMENT OF PAUL R. PORTER, FORMER ADMINISTRATOR OF THE MARSHALL PLAN AND AUTHOR OF "THE RECOVERY OF AMERICAN CITIES"

Mr. PORTER. Thank you, Mr. Chairman, I offer two suggestions concerning the highly constructive proposal of Senator Humphrey for a National Domestic Development Bank.

The first is that the proposed bank should have a specific mandate to promote the recovery of cities and other distressed urban areas.

The second would increase the participation of private capital in the bank's operations.

I preface these suggestions with a short comment on population losses now occurring in most central cities—in some cases, stunning losses. They occur in small cities as well as big ones; in the Sunbelt a well as in the older industrial States.

Between 1950 and 1970, St. Louis lost more than a third of its population. Between 1970 and 1975, it lost again—this time, nearly 1 resident out of 5. In the same 5 years, Minneapolis—the city that launched a distinguished public career by once choosing as its mayor a man whose name future generations will honor in the select company of Webster and Clay—even this fair city lost 1 resident out of 7. Atlanta, Cleveland, and Detroit lost 1 of 8; Fort Worth, 1 of 11. More in this range could be cited.

Up to a point, some loss of population may be desirable in cities that have had overcrowded districts. But when losses are heavy and rapid, they erode a city's tax base faster than it can cut expenses. Residents who remain bear a larger share of municipal debt and pension obligations. Taxes must be raised or services cut, or both, so much that still more residents leave. Thus, a downward spiral is created in which population losses and rising taxes propel each other.

When I propose recovery of these and other crippled cities, I do not speak of any specific level of population. Nor do I have in mind a restoration of a past era. By recovery I mean regained capabilities: a city's capability to compete effectively with its suburbs as a place to live; a capability to sustain a high level of employment and other economic opportunities—subject, of course, to a vigorous national economy; and a capability of the city to meet its needs without permanent dependence upon a subsidy.

The proposed National Domestic Development Bank could assist the recovery of cities in two major respects. First, it could lend to local governments so that they may maintain, improve or expand basic community facilities, as contemplated in the offered bill.

The second type of assistance would be a separate operation and would go beyond the bill as drafted. It would facilitate the financing of the kind of housing which, by renovation or new construction, would enable a city to induce more people who work in the city to live in it and to contribute their local taxes to its revenues. Cities have a promising opportunity to bid for suburban-reared new families as new residents. They make a large market for housing, and they grow in number.

In this type of assistance, the National Domestic Development Bank would lend only to other banks to be chartered by it. Until a better name is found, I will call them city recovery banks. They would be privately owned, and they would compete with each other for capital and for housing projects to finance. To raise private capital, they would necessarily pay a market rate for money. By meeting standards set by the National Domestic Development Bank, they could borrow from it without interest, from funds appropriated by the Congress for that purpose.

To establish an approximate interest rate at which city recovery banks would lend to their borrowers, the National Domestic Development Bank would make its interest-free loans proportionate to the volume of private capital raised by a city recovery bank. The ratio would be a standard one for all such banks, but would vary from time to time in response to experience and prevailing economic conditions.

As a rough illustration, let us assume that at a particular time a city recovery bank would need to pay 8 percent for private money. Let us assume also that a 1 percentage point in its lending rate would cover its operating costs and profit. In this situation, a 1-to-1 ratio between public and private capital would result in a lending rate of 4-plus-1, or 5, percent. A ratio of $1 of public money to three private dollars would result in a 6-plus-1, or 7, percent rate to ultimate borrowers. Since the city recovery banks would compete, some would offer better rates than others. In slack times, an increase in the proportion of public capital would give a stimulus to housing construction.

The suggestions I have offered are necessarily abbreviated. If they interest the subcommittee, I would be pleased to help the subcommittee staff to develop them further.

Elsewhere I have discussed more fully than I can here the high risk to cities in becoming permanently dependent upon a subsidy—especially when their political influence shrinks as their population falls. The American people supported the Marshall plan because the beneficiary nations were required to use the aid they received to make aid unnecessary. Our cities have important strengths and opportunities to do the same which are not now adequately used. I believe that this Marshall plan principle must govern future aid to cities if they are to receive the broad public support they need.

Thank you.

Representative MOORHEAD. Thank you very much, Mr. Porter.

Your prepared statement, without objection, will be printed in the hearing record.

[The prepared statement of Mr. Porter follows:]

PREPARED STATEMENT OF PAUL P. PORTER

This prepared statement supplements my oral testimony in support of Senator Humphrey's proposal for a National Domestic Development Bank.

In this instance, I discuss the principles underlying my suggestion that the proposed bank should charter and make interest-free loans to private development banks which would compete with each other for access to private capital and for opportunities to finance projects appropriate to the recovery of cities and other distressed urban areas.

The first principle is that maximal use should be made of private capital markets for financing urban development or redevelopment projects.

The supply of public capital, that is, that which may be obtained by taxation, will surely fall fart short of justifiable requirements. A shortage of capital for essential purposes can be overcome, however, through the instrumentality of a "mother" bank infusing just enough public capital into a particular market to induce a flow of private capital in a desired supply which would otherwise not be forthcoming.

This would be accomplished by the mother bank making interest-free loans to its chartered banks sufficient to reduce, through competition among them, the interest rate on their loans to eligible borrowers to a level at which the borrowers could afford the financing of essential projects. The ratio of a given volume of interest-free loans to private capital mobilized by a private development bank would be standard for all such banks, but it would very from time to time in response to experience and to prevailing economic conditions.

The funds available to the National Domestic Development Bank for interest-free loans would depend upon periodic appropriations by the Congress. It follows that the Congress would retain control over the general standards governing their use.

To see how a suitable interest rate would be established, let us assume that at a particular time a private development bank would need to pay 8 percent for private money. Let us assume also that a one percentage point in its lending rate would cover its operating costs and profit.

In this situation, a one-to-one ratio of public to private capital would result in a lending rate of four-plus-one, or five, percent.

In this example chosen for greater simplicity, the ratio of public to private capital is much higher than might be expected in practice. A ratio of one public dollar to three private dollars would result in a six-plus-one, or seven percent rate to ultimate borrowers. A ratio of one to six would produce a rate of $6\frac{6}{7}\%$ before operating costs and profit. With the latter added, the presumed lending rate to ultimate borrowers would come close to the hypothetical 8% rate that the private development bank would need to pay for the private capital it obtains. But in most cases it is unlikely that the ultimate borrower could obtain money in private capital markets as cheaply as could a private development bank qualified to perform essential intermediary functions.

The ratio at which a minimal infusion of public capital may attract a sufficient supply of private capital can be known only from experience. The right ratio would also vary as economic conditions do. It may be observed, however, that the suggested instrumentality readily lends itself, in a quite simple way, to selective countercyclical action to stimulate a sluggish economy.

The second principle is that users of the National Domestic Development Bank should have a choice of financing facilities to serve their needs.

The authority of the Bank to charter and to lend to private development banks would give the Bank's users an additional facility without impairing the facility provided for in the present bill.

Income from debt financed directly by the Bank would be subject to federal taxation, and would coexist with a continuing market for tax-exempt securities. In either case there would be a federal contribution to the interest rate paid by the borrower, directly or by tax exemption.

The suggestion I have offered would provide a third option for the borrower. It has these major advantages:

First, by facilitatng a greater reliance upon private capital markets, it could multiply the supply of capital for essential urban development or redevelopment projects, as I have already noted. Prof. Jean M. Gray, in her formal statement to the Joint Economic Committee, has made a persuasive case that tax-exempt securities, because of their inherently limited market, do not provide an adequate route to private capital.

Second, access by borrowers to development banks competing among themselves for financing opportunities, and presumably located throughout the nation, would minimize delays and the risk of arbitrary judgments. Competition would elevate financial judgment in the making of a loan, rather than precedent or nationwide formulas.

Third, the parallel operations of competitive private development banks and the Bank's direct lending operations would each provide a continuing standard whereby the Congress could evaluate the effectiveness of the other.

Fourth, the proposed private development banks are readily adaptable to the financing of private projects that support a specified development or redevelopment objective.

The third principle is that the Bank should assist cities to use strengths they have to overcome their present distress and to become again places where people may prosper and live pleasantly.

A major strength of nearly all cities is the large concentration within the city of well-paying managerial, professional and other white-collar jobs. This strength has markedly increased during the overall decline of most cities. But because most cities compete ever more poorly with their suburbs as a place to live (as demonstrated by the continuing large shift of population from cities to suburbs), a high proportion of the people who hold these jobs choose not to live in the city. The comparative unsuitability of city housing is one of the major reasons why they reject the city as their home.

Cities, however, have a favorable opportunity to reverse this trend. Suburban-reared new families are steadily adding to the total number of households. They make up a large and growing market for housing which is not supplied by existing suburbs. When one or more of their members are employed in the city, cities that now experience a heavy population loss can stem the loss and rebuild an eroded tax base by inducing such families to make the city their home.

To do so, however, the city must encourage the development of a supply of housing, by renovation and new construction, which will be fully competitive with suburban housing.

The provision of such housing must be pre-eminently an undertaking by private capital. Some infusion of public capital to create housing of this kind would nonetheless be justified if demonstrably it would assist a city to use an existing strength to reverse its decline and start on the road to recovery. Private development banks of the kind I have suggested would be a suitable instrument for mobilizing the necessary private capital with a minimal infusion of public money.

An interest rate to borrowers that would be appropriate to this purpose would doubtless differ from the interest rate required for financing debt of public bodies. The two operations should therefore be conducted separately.

The fourth principle is that the Bank should facilitate and encourage a convergence of public and private investment in the development and redevelopment of urban communities.

An urban policy that neglects to establish a complementary relationship between them will hobble on one leg.

It seems probable that direct lending will predominate in the Bank's financing of undertakings by public bodies. Conversely, the proposed private development banks have a greater potential for financing such private undertakings as the construction of housing needed for a city's recovery.

In the latter case, an arrangement whereby a developer's loan could be converted into individual home mortgages for refinancing in the conventional market as completed units were sold would permit a frequent turnover of the capital of the private development banks.

The fifth principle is that subsidies to cities, including subsidies for which the Bank will be an agent, should be used by recipients to make the need for subsidies eventually unnecessary.

Only a part of the federal payments which cities receive is truly a subsidy, i.e., an unearned and non-repayable transfer of economic resources to a city from other communities. A part—indeed, a large part—of such payments is a partial return to the city of federal taxes paid by persons who live in the city. Subsidy and non-subsidy are commingled in grants, revenue sharing, and the benefits of tax-exempt debt in fluctuating proportions that are not disclosed by the accounting practices of the federal government.

Despite the difficulties in knowing at this time the magnitude of the subsidy element in such payments and benefits, there is little doubt (1) that most cities, at least, receive a net transfer of unearned and nonrepayable economic resources, (2) that their dependence upon subsidies continues to grow, (3) that the amount of federal aid to cities encounters increasing resistance in suburban and rural communities, and (4) that as cities lose population, the political influence they can exert to obtain subsidies is also shrinking. The risk to cities in becoming permanently dependent upon subsidies is extremely high.

There is no assurance that even if cities make better use of the strengths they have, they will obtain enough support from the rest of the nation to accomplish their recovery. It is, however, a fundamental human trait that self-help attracts the assistance of others more readily than does a lack of it. The American people supported the Marshall Plan because they were convinced that the recipients of their aid were using it to make future aid unnecessary.

It is in this perspective that a case can be made for a temporary subsidy for the construction of housing in the city of a kind that will enable the city to compete again with its suburbs as a place to live. In the most recent issue of "The Public Interest," Irving Welfeld argues that income assistance so that every American family may have a decent home and the production of an adequate supply of housing are distinctly separate problems, and that "the one sure way of missing both of these targets is by trying to hit both with one arrow."

Mr. Welfeld's observation is a sound one. But a further comment is needed. The location of the new construction is a matter of great importance in public policy. If the new construction creates unnecessary new suburbs, it will also cause a wasteful and inflationary diversion of capital to duplicative streets, school buildings, and networks for the collection of sewage and the distribution of water, gas, electricity, and telephone service.

On the other hand, if it takes place in a city that is losing population, it can help rebulid an eroded tax base and utilize more fully an existing infrastructure, to the benefit of both old and new residents. In a lesser degree, the whole nation would also benefit. With a strengthened tax base, the city's need for fiscal relief would decline. Shorter journeys to work would reduce the need for subsidized transportation. In short, the subsidy in this instance would be of the unusual kind that is not self-perpetuating, but instead promotes recovery. This purpose should be a test of eligibility for private projects financed by the proposed private development banks.

Representative MOORHEAD. Thank you, Mr. Porter, Mr. Bryce, and Ms. Gray for testifying today; all three of your statements were excellent.

The most basic question I will direct first to you, Mr. Porter, and then ask the other two panelists to comment.

There are those who believe it is not economical to try to interfere with the market processes which tend to attract jobs and investment and people to areas which are attractive instead of those that have chronic problems.

The people who would oppose your concept, quite frankly.

Mr. PORTER. What was your question, Congressman?

Representative MOORHEAD. There are those who argue it doesn't make good economic sense to interfere with the market processes which attract investment and jobs to cities on the rise and to try to reverse that process by giving aid to cities which are on the decline.

Mr. PORTER. Cities are in decline in some respects, but they also have some very important strengths. They have assets that are actually increasing. In the midst of overall decline, practically all cities have had an increase in the number of managerial, professional, and other white-collar jobs, which is one of their greatest assets, because if they can then attract some of the people who fill these jobs within the city and contribute their local taxes to the city's revenues, they can go a long way toward overcoming some of their more critical problems.

Representative MOORHEAD. Do any of the other panelists want to comment on that question?

Ms. GRAY. Let me make one quick response which is to say: Is it sensible then, to use federally sponsored intermediaries to support the agricultural industry with, for example, intermediate credit banks and the housing industry with home loan banks. There is, I think, a public precedent for assisting funds flows to what are considered desirable social objectives. Indeed, reversing the natural flow of economic resources from the cities is, in some purely allocational sense and some purely economic theoretic sense, a misallocation. But we misallocate or reallocate resources for social purposes on a regular basis, and I think this is no worse and probably equally as good a reallocation as we can come up with.

Representative MOORHEAD. Mr. Bryce?

Mr. BRYCE. I suppose my reaction would be that we ought not to make synonymous the notion of reversing a flow with a notion of providing assistance.

I certainly would want to see that cities which are disadvantaged be assisted. I think that it is certainly an important social function.

My concern really is not in providing that assistance; I am for that assistance, and I'm certainly for any assistance that a development bank can provide.

What concerns me, really, is whether or not the Government should not deliver policies which reverse a flow which makes sense. The flow of capital to particular areas in part reflects an expected—a higher expected rate of return.

It also reflects some major or some advantage of the income maintenance, the labor, the capital, the natural resources of that area.

I am not sure that it is wise not to take a policy that penalizes. That's why I would be concerned, when I use the words "reverse the flow."

Mr. PORTER. Mr. Chairman, may I return just one moment on this?

Representative MOORHEAD. Certainly.

Mr. PORTER. If we assume that the decline of the cities can't be reversed, then it doesn't make much sense to resist that trend. But if we assume that recovery is possible, that aid eventually can become unnecessary by the way in which they use their aid, then it does make sense to give that aid to prevent a further decline and collapse of cities.

Representative MOORHEAD. Now, from the testimony presented by our three distinguished experts, I detect a slightly different concept of the basic purpose of an urban development bank.

Mr. Bryce, you talked about the bank having a domain.

Ms. Gray, in your prepared statement you said that the bank would have three functions: Ordinary lending, refunding, and trading in its own or tax-exempt securities and secondary markets.

And Mr. Porter, you support, as I see it, a two-purpose lending to local governments so they can maintain or pool their basic Government facilities, and then a rather massive additional housing program.

What I get from this is a difference between those who would think that cities would need assistance in what I call their ordinary financing, the most extreme case being New York City.

But it remains unclear as to whether there are going to be future New York Cities, and whether the bank is the proper vehicle for preventing that or whether the bank should be more strictly limited to the underlying economic problems of our cities. I might say that I've received indications from the Treasury Department, that their concept of a bank would focus on the more limited or structural problems underlying economic decline of the cities.

If I'm correct, there are at least slight variations between members of this panel. I would like to know what each one of you thinks the particular function of this bank should be. Should it be restricted or should it not be restricted?

Why don't we start with you, Mr. Bryce.

Mr. BRYCE. Mr. Chairman, I am for a broader use of the bank. And you are correct that I used the word "domain."

Now, I think there is one lesson we've learned from a great number of the agencies which we have created. That lesson is that they eventually are asked to become involved or become conscious of what is going on outside of their narrow financial objectives. We frequently end up requesting or mandating functions which are not strictly financial or profit maximizing. I think that is the ultimate experience of many of the financial agencies which we have created.

I'm also saying that decisions to make certain kinds of infrastructure investments are not isolated decisions. They are decisions which correlate or in fact compete with other decisions within the environment, and that's why we ended up with something called A-95 and something called comprehensive planning.

All I am saying, therefore, is that we eventually will get to the point where some nonbank functions will be imposed, and it seems to me wise to get there at the outset.

I might add that, we do ask many of the private lending institutions to become more conscious of those things which are going on around them, even though the action we request—while socially good—are against the perceived shortrun interests of these private institutions. I am thinking, for example, of savings and loan institutions with respect to redlining.

I'm also suggesting there is a vacuum. We have no institution which coordinates urban policies.

It seems to me these are all functions which the bank could undertake.

Representative MOORHEAD. Ms. Gray.

Ms. GRAY. Thank you. It is true, I do see the bank in a much narrower sense than the other members of this panel.

In other words, I see the bank as improving the present allocational system. If we can't improve that system, we probably can't improve the flow of funds to cities, and to municipalities on any broader basis.

We have, for example, a rating system where ratings are impressionistic at best, because data are not readily available. Most agencies, such as Standard & Poors, give a rating based on their best judgment, coming up with something that seems reasonable, but once an issue is rated, the rating is there forever in the sense, that there is no way in which you can really go back. You can't go back to the rating agency and say, "Gee, look, we've improved our fiscal position". The agency may rate new debt higher, but what about the old debt?

These are the ways in which the market does not work efficiently, and I think the bank, if it can improve the market, will improve the flow of funds into all kinds of capital projects within cities.

When it comes to the problem city, the default city, there is, I think, a role for a lender of last resort. I would like to see that lender of last resort. It could be established within the confines of the bank, but it must operate somewhat differently.

As an intermediary, the bank must establish credit standards. Incidentally, I don't think those standards need to be particularly restrictive. But when a community is already near default, the procedures that must be followed are different. Existing debt must be restructured. Debt service payments must be rescheduled. There may have to be loan covenants which lead to improvements in cash management.

This is a different problem and I think it could be included as a separate part of the bank, but I think it needs to operate independently of normal lending procedures.

Representative MOORHEAD. Mr. Porter.

Mr. PORTER. As I indicated in my prepared statement, I do take a broader view of the possibilities of the bank. In addition to helping communities that are unable to market securities that they need to market in order to maintain basic community facilities, or that would—could be marketed only under an exorbitant rate of interest, I think that the bank should have the objective of making it unnecessary for cities to have to go to the bank. The more a city can be aided by the bank, they should be able then to rely upon the normal functioning of the market to meet its needs.

Representative MOORHEAD. I notice one other difference in the views expressed in the panel, and that is what I'd call the structure of the bank.

As I understand it, Mr. Bryce conceives of what I'd call a central bank with branches all across the Nation.

Mr. Porter conceives of a national bank with what I'd call subsidiaries or chartered banks under it. We've also had numerous legislative proposals for regional banks that have been referred to the House Banking Finance and Urban Affairs Committee.

None of you mentioned regional banks.

Mr. Bryce, would you comment please.

Mr. BRYCE. I suppose that my preference for centralization is that in many ways I would like to see a banking system which is not too different to the way the Federal Reserve System is constructed.

I think there ought to be a lot of local initiative; certainly I indicated in my statement that I don't believe that local initiatives or local needs might be well reflected in a totally centralized system. Regional banks, which have a significant amount of autonomy may be more responsive to local needs.

But at some point there is a necessity to coordinate the entire activity and I think some centralized functions would help.

Certainly, I think a centralized system might also be helpful in terms of reducing some of the transaction costs and in very much the same way I think Ms. Gray meant when she spoke of the number of small jurisdictions which would have to receive subsidies if each one went to the market independently.

Representative MOORHEAD. Ms. Gray.

Ms. GRAY. I think there should be one intermediary debt issue. If the development bank goes to the market for funds, there should be one agency going to the market. This will provide an issue that can be broadly and deeply traded.

Beyond that, I don't think centralization has any great advantages over decentralization, except insofar as it may cut down on administrative costs.

One difference in the bank as so far proposed, or at least as I see it is that it would be lending to municipalities. That is a break with the tradition of Federal-sponsored credit agencies. Ordinarily, they lend to other financial institutions, and a program such as Mr. Porter's or what Mr. Bryce was suggesting, a group of regional banks, which would lend locally and in turn borrow from the development bank, would be perfectly consistent with the kinds of Federal-sponsored credit agencies that already exist.

Representative MOORHEAD. Mr. Porter.

Mr. PORTER. My suggestion is intended to mobilize as much private capital as possible. Therefore, the National Domestic Development Bank would be able to lend both to local governments and to banks which it would charter and which would be privately owned. They would be two separate operations. Now, it is possible that the private banks could also be used to finance basic community facilities. I have not proposed that in my statement, but it is perfectly possible that it could be adapted to that. But since I think the operations I have suggested would tap largely different capital markets, they should be conducted as two separate operations.

Representative MOORHEAD. Ms. Gray, one quick question to help me on you as an expert in the municipal field. At the present time, commercial banks can underwrite general obligations, but not so-called revenue bonds. Going back to the historical separation of commercial banking and investment banking, do you have any recommendations as to whether commercial banks should or should not be permitted to underwrite revenue-sharing bonds.

Ms. GRAY. For many purposes, it is probably a distinction without a difference. When sewer districts are formed to float revenue bond issues for basic public facilities, I can see no reason why a commercial bank should not underwrite that equally as well as a general obligation bond. When it comes to using tax exempt or any subsidized debt for building private corporate facilities, whether by revenue bonds or otherwise, I find I clearly disagree with what some consider to be an appropriate use of the exemption or the subsidy. I think it would be perfectly appropriate to let commercial banks underwrite both kinds of obligations. It would bring more competition to the market. In terms of the development bank, one thought I had was that the development bank itself would be in competition with private underwriters, that there would be communities for whom the bank was one of two possible alternatives. Individual communities might explore private underwriting and explore the development bank facilities.

Where only one bid is received on a community obligation, revenue or general obligation, the market system is not working well. There is no competition or there is very little of it. So, allowing commercial banks to underwrite revenue bonds, or putting the development bank in competition with underwriters in general may both be beneficial to the market.

Representative MOORHEAD. Senator Humphrey.

Senator HUMPHREY. Thank you, Congressman Moorhead. I apologize for not being able to be here at the opening of the hearing, but we had a meeting of the Senate Committee on Foreign Relations this morning and our subject matter was a delicate one on the sale of advanced warning aircraft, for air defense. Since I am chairman of the committee that holds those hearings, I had to be there. I have just some general questions about the possibilities of a national domestic development bank and its relationship to the financing of the State and local government needs.

Let's take a look at local government financing. I've had experience with that. There are three sources of local revenue from its tax base through franchise taxes, excise taxes, even, sometimes, local income taxes, from the sale of bonds, and by assistance from the State and Federal Government. Frequently, there is very little assistance from States, even though the cities are the creatures of the State. I noticed, for example, in the recession period, State governments were running surpluses of a half billion or a billion dollars while local governments were coming into Washington begging for help. Somehow or another, Governors and State legislators have been able to convince mayors and city council members they ought to bypass their parents, so to speak, and come to grandpa, rather than to father. Now, my first question is this. What is the average term of a municipal bond for capital improvement purposes? Do you have any information, Mr. Bryce, Ms. Gray, or Mr. Porter? Is the average term of a municipal bond 10, 15, or 20 years?

Ms. GRAY. Senator, let me try to put it into context.

The market currently is unreceptive to very long-term debts. That is, issues of 30 years are almost nonexistent. Twenty years seems to be about the longest term that is issued, but most municipal issues are serialized. That is, they are broken down into component parts. If one were to take a rough estimate of that, I would think possibly somewhere between maybe 8 and 13–14 years.

Senator HUMPHREY. I have heard 12 years.

Ms. GRAY. Twelve. I think that probably is a good estimate.

Senator HUMPHREY. It is quite obvious that you could not build any private market housing with 10- to 15-year bonds.

Ms. GRAY. No. Or——

Senator HUMPHREY. So what we have gotten ourselves into here, because of the tax exempt status of these municipal bonds, is the short-term financing of long-term projects. And one of the purposes of the National Domestic Development Bank is to provide a longer line of credit for these infrastructure, capital improvement types of loans. A line of credit that has some relationship to the service time or the effective use time of the improvement that was undertaken. And hopefully that bank could, in this way, be supplemental to the existing bond market. I have always looked upon the national development bank concept, not to supplant commercial banking, not to supplant the bond market, but to supplement it. Now, there is one other point. Most of the municipalities looks to the Federal Government for the appropriation process. And even God doesn't know what Congress is going to do in the appropriations process; when it will occur, what the amounts will be, and which of the programs that cities have been planning on will be discontinued, delayed, or modified. And to me, this process is a tremendous waste. I think Congress is guilty through its type of appropriation process of building into the governmental process incredible amounts of waste. You simply cannot plan capital improvements on an annual budget. If it is done on an annual basis it is very, very costly. When we get right down to it, it is merely a waste of the taxpayer's money. And the taxpayers are the only source of money for these purposes.

Therefore, it has been my judgment that we need some kind of financing institution that has continuity, assurance that the funds are available and would provide terms for long-term projects that seem reasonable. Now, the role of the Federal Government in this bank, as I see it, is No. 1, to purchase its stock. No. 2, possible to provide an interest subsidy for certain types of loans or credits.

I have always felt whatever the cost may be of an interest subsidy, it would be substantially less than it would be in the appropriations process. Mr. Bryce, from your experience, isn't it possible that if such a bank were established and it continued for a number of years, that it would acquire an expertise and an intimate knowledge of the socioeconomic patterns in the areas where it is serving and would thus be able to provide the kind of guidance and technical assistance as well as credit assistance that is needed by the local governments?

Mr. BRYCE. The answer to that, Senator is yes. I do think that should be one of the major functions of the bank. It is one of the reasons why I argued in my opening statement that we do need regional banks or regional branches which are very responsive to local needs. And also, I argued in my prepared statement that I would prefer to see a bank which has more than the traditional banking functions. I would prefer to see a bank which has the capacity to provide technical assistance. I prefer to see a bank which has the capacity to make issues more bankable. That is, that the bank itself might assist a jurisdiction in doing whatever is necessary so that those issues would be attractive to private lenders.

Now, I was intrigued by your opening statement partly because something went through my mind when you spoke about the State, and I wish to make a statement which I have never thought of before. About the term, about the ability of a locality to undertake important infrastructure expenditures when the terms of loans are short. I agree that that is a problem. But then I start to think about State laws as well as city charters, and I related that to your earlier statement about going back to the State. It occurred to me that many cities are forced, by local law, to undertake certain kinds of "capital" expenditures on a pay-as-you-go basis. And that perhaps one of the things we might very well want to do as we think about a national development bank, is to be concerned with the extent to which State and local laws and regulations might prohibit many of the local jurisdictions from getting full benefit from the advantages of the bank. Many of those regulations are State regulations, as you pointed out, and the cities are creatures of the State. Indeed, not only do some States require that certain localities go on a pay-as-you-go basis, but to some extent, which is a version of the same thing, of course, they prohibit them from issuing debt.

Senator HUMPHREY. So even with the bank structure, some modification of the State and local laws would be required to enable participation under the terms of the bank charter.

Mr. BRYCE. Precisely, sir.

Senator HUMPHREY. All right. Now, my interest in this bank was developed by my knowledge of the Federal Farm Credit System. It is quite obvious we never would have been able to finance the development of the cooperatives in this country, for example, out of commercial banks, so we have the bank for cooperatives, we have the intermediary bank, we also have the Federal Land Bank, which was established in the 1900's, as I recall. Now, is it not true those institutions have been financially sound, is there not a fact the Federal Land Bank today is for all practical purposes Federal only in name and it really has become private because of the earnings of the bank?

Mr. Bryce, Ms. Gray and Mr. Porter, will you please comment.

Ms. GRAY. Let me comment quickly by saying that I do see the national domestic development bank as falling into that category of federally sponsored credit agencies that is viable, long lived, and can stand as an independent institution. It is perfectly consistent with what the Federal Government has done in the past. Let me make just one other quick comment, as an instructor in finance. The first rule of finance is suitability in terms of matching the maturities of your assets and liabilities. Clearly, this has been one of the problems with the existing market. Not only could the bank arrange suitable maturities that would match the length of life of the project, but could scheduled repayments in a variety of ways. There could be amortized loans, there could be serialized loans with certain percentages of the principal repaid ever year, there could be balloon payments. If this is a long-lived project which will generate revenues or taxes only after 5, 10, or 15 years, maybe a balloon payment at the end of that period would be most suitable. Coupled with this, is the fact the development bank will hold a diversified portfolio of assets of various maturities. There will be cash inflow to the bank from interest payments and repayment of debt. This gives the bank freedom to tap the market at those maturities in which it can most cheaply and easily raise funds.

Senator HUMPHREY. One of the things that has always intrigued me about governmental finance is the manner in which the Federal Reserve Board works to take care of its own. The Federal Reserve Board lends money to its member banks at appreciably lower rates of interest than anybody can borrow from any bank or than any bank can get money from anybody else. And they do it all in the name of saying that this is the way that we keep our banking structure viable. Now, I am for banks. I think you have to have them and I want them sound because I lived through a period in time as a young man when I saw my family's assets liquidated with bank foreclosures. I grew up in South Dakota. We never had a bank in South Dakota where I lived that had its doors open after 1927. First time I saw a bank that was operative was after Franklin Roosevelt had the bank moratorium and they reopened some of the banks. We went for years without banks. But the Federal Reserve now tells me if they see a bank in trouble, they bail it out. And I have often wondered how the Federal Reserve Bank of the United States is able to loan money to its banks at around 5 percent and yet the same Government bank is not able to loan money to our cities in which the banks are located. Let us not forget that the Federal Reserve Bank is a Government bank. They don't think so, but they are. How come we have not been able to loan money from some form of Government bank to provide the resources or the infrastructure or the facilities of the capital outlays that are necessary for maintaining the municipality?

This is a question that has its own answer. The truth is, the Federal Reserve Bank can loan money to a constituent bank at very low rates of interest, and still seem to do right well. I mean, the Federal Reserve does quite well in making money. There is no reason at all why Congress could not establish another Bank, as it did the Federal Reserve, that could have interest rates that are comparable to the rates the Federal Reserve Board charges to its own banks. That is my own argument for the National Domestic Development Bank.

I constantly hear people who say, "Well, you know the interest rates are still very high, Senator." And I recognize that they have gone up over the years. It is intriguing to me, however, how the Federal Reserve has been able to keep down the interest rates to its customers, its constituents and yet has not been able to find any way we can keep down the interest rates to other customers that are public. In fact, the banks that the Federal Reserve loans money to are private. Private banks. They get a better deal than any business could. And, of course, that is all in the name of monetary policy which, incidentally, I have not yet been able to unravel. Now, after you have listened to my prejudices, which I peddle regularly in this subcommittee, I want to ask you, Ms. Gray, about a statement of yours. In a letter to the editor of the New York Times this past winter, January of 1977, you stated that a National Domestic Development Bank would be well-suited to assist State and local governments. You stated then this bank should serve as a stick, not a crutch. Now, tell me what you mean.

Ms. GRAY. What I mean by that, well, let's see if I can translate those into terms of credit standards.

The bank would have to have the power and authority, at least in some cases, of imposing loan covenants on the governments with which it is doing business. It should not provide an openended subsidy. If I have a fear about this bank, it is that the bank could become a dumping ground for every favored Federal assistance hobbyhorse that can be dreamed up. And I think that is exceedingly dangerous.

Senator HUMPHREY. May I say I used to have that fear.

However, I don't know of any federally established financial institution, the Farmer's Home Administration, the farm land, Federal Land Bank, Home Farm Credit Administration, Bank for cooperatives—I don't know a one of them that hasn't made money, including the RFC.

As an old friend of mine says, it is hard to lose money in banking because you have a clicker that is the interest and it goes click, click, click, click, 24 hours a day.

Ms. GRAY. It is quite possible that there could be, for example, a basic lending rate which is lower than the rate at which the bank borrows. Let's not forget, Treasury revenues will be increased. Actually, there hasn't been too much on this this morning. The discussion is going in other directions. Clearly this bank is selling fully taxable bonds. There is a saving to the Treasury. This could be returned to the bank.

I would like to see a firm and continuing commitment for the Treasury to return to the bank some of the benefits that the municipalities are currently sharing with those who invest in their securities.

This gets called a subsidy. It really ought not to be called a subsidy, or it doesn't necessarily have to be a subsidy. The transfer could be anywhere from zero to the entire interest cost. Where the transfer is cut off is a political question.

But within that structure, I would like to to see a basic rate, and I would also like to see some penalty rates, call them insurance premiums or whatever. They would apply to municipalities whose credit standards are not as good as they ought to be. There ought to be some scope to provide price incentives for improving your credit standing.

I think the bank, interestingly enough, can do this better than the private market because, if a community is financing in the bank and it does improve its credit worthiness, the bank could automatically reduce the interest required on all of the outstanding debt the bank is holding.

Senator HUMPHREY. Yes, yes.

Ms. GRAY. In other words, this is a nice carrot.

Senator HUMPHREY. With a stick, too.

Ms. GRAY. With a stick, because conversely, if the community is misusing the bank in some way, extending its debt beyond its ultimate capacity to repay, or engage in careless financial management, I think the bank should have the equal authority to say, "You are not minding your fiscal business. We will now impose a penalty rate on you."

The penalty premiums can go into a loan loss reserve. The reserve would have to be funded by some kind of a Treasury transfer initially, but could be built up by the premium charges. The actual default experience on municipal securities of all ratings is remarkably low. As a consequence, loan loss reserves that would cover probable defaults could be built up very quickly.

Senator HUMPHREY. One of the reasons I have been interested in the bank is pretty much what you are saying. I don't want anyone to look at the bank as a sort of an escape hatch where the politicians like myself and others can just say, "Well, go over there, the bank will take care of you." I think it has to be a bank. I think it has to look at what the assets and the liabilities are.

I think it has to look at whether it has all the facilities of a bank for the losses that it may incur, and I think it also ought to be able to work with the local municipal or local governmental officers on the type of financing that meets their needs.

That is what a bank can do, just as it does commercially today. When you go to a commercial bank today, they have several ways to advise you on the best way to finance your enterprise and what the terms ought to be. And they can give you a good deal of guidance.

Good commercial banks today do that. Particularly, I know this is true in the rural areas where we have a good deal of rural financing. State and national banks that do a lot of financing in the rural communities are doing an extraordinarily good job, not just of loaning money, but of providing guidance, expertise, technical assistance, and computer services.

I want my position clear. This is to be a bank, just like we have got a World Bank. We have an Interamerican Development Bank that runs a banking system. And we have an Asian Development Bank that runs a banking system.

These banks are able to be much more precise and efficient in dealing with their potential borrowers than somebody with political inclinations from the State Department or an AID administration.

I think the bank has to be depoliticized as much as possible. It has to be set up as an entity to itself. We have done that with the VA, for example, and, again, I say we have surely been able to do it with the Federal Land Bank.

I remember when I first came to Congress, we had a production credit administration, PCA. This was federally financed in the beginning. They are all owned by the farmers today, every one of them. They paid a little fee on each loan, and pretty soon that fee had built up. Today, the whole PCA structure is farmer owned. There is no Federal money in it at all. Similarly with the Federal Land Bank, the Federal money has been retired. So once a charter is established, if your charter is right, it seems to me you don't have to worry about it becoming a dumping ground for just what you might call fiscal trash.

Mr. Bryce, I had another item here. One of the purposes that was outlined in a domestic development bank was not only to help the public sector, but also the private sector. And there are those that believe that it is not economical to try to interefere with the market processes which tend to attract jobs and development to areas which are attractive instead of those with chronic problems.

As you know, the concept that we have advanced on the National Domestic Development Bank would permit loans to be made, both to private and nonprofit public enterprises to stimulate the economy, to meet structural problems in industrial and employment.

Mr. Bryce, do you feel that is an appropriate function for this bank, or is that something we ought to avoid?

Mr. BRYCE. May I respond first to your earlier statement, Senator, about the bank being a bank. I agree that attracts me. I might suggest that there might be even an extension of it, and that is that in any year, the bank has to make choices among alternative investment opportunities; and the choices among those opportunities which confront the bank should also be based upon very strict business principles, and that is that the bank ought not to be choosing those projects which do not have a very high rating in terms of its credit worthiness.

So, even though the bank is to provide—there is no inconsistency, but the bank does a social good at the same time that it operates or chooses among investment alternatives on very sensible, very prudent business principles.

With respect to the second question, which relates to making investment to private or nonprofit organizations, that does not bother me as long as it could be shown that those organizations or those private institutions are able to obtain loans through the private market.

There must be a test. I don't know what the test would be, but some sort of proof that those individuals having gone to the private market and for whatever reason were rejected.

Then the second state of the proof has got to be that even though they were rejected, should this bank, the National Development Bank, fund them. I am thinking in a sense of as far as home administration loans with respect to housing.

It is not necessarily true that the fact that a person cannot get a private—a loan in the private market, should make that person not a good credit risk. That is just not necessarily true.

My response to you, then, would sufficiently be, I would be less opposed to private individuals or nonprofit corporations getting funds as long as it can be shown that they have, in fact, confronted the private market and could not obtain loans.

But the products for which they are seeking loans remain projects which are credit worthy.

Senator HUMPHREY. There would have to be some kind of certification to make that judgment, wouldn't there?

Mr. BRYCE. Yes, sir.

Senator HUMPHREY. Does anyone else want to comment on that?

Ms. GRAY. I get suspicious of it. I am not sure where you do draw the line.

Senator HUMPHREY. It is difficult.

Ms. GRAY. In this sense, if this is a specialist bank for State and local governments, maybe—my feeling is that it should be restricted to those purposes. There are other programs to promote development and to combat unemployment.

There is a Small Business Administration. There is a Department of Housing and Urban Development. These programs, if they affect private industry, can better be handled through existing Government organizations. Leave the bank a specialized institution.

I get a little concerned with any form of subsidy to State and local governments, when the funds are intended for profit making organizations.

Senator HUMPHREY. Those are the tough ones.

Senator JAVITS. I apologize to the witnesses, but I think my example will bear me out. We are unbelievably torn apart.

Ms. Gray, in your prepared statement, where you said the tax equity inefficiency problem would be reduced by the substitution of a fully taxable obligation for some tax expenditures, I asked my people how you bridge the gap of a constitutional exemption for municipalities, et cetera, and their answer is that a fully taxable obligation of the National Development Bank should be inserted there. Tax exempts would be taken in by issuing tax tables.

That makes a lot of sense and is a big inducement to the United States, because, otherwise, we couldn't get past the subsidy for taxable obligations. People around here won't vote for it. But they may very well go for the flexibility of this administration. The reason they won't go for it is because not every municipality is entitled to the same break and the same subsidy at the same interest rate.

But this way they may go for it and that is a very strong point for the Domestic Development Bank.

I thank you, very strongly.

It is very necessary that this be held as an objective. This bank can do what otherwise we might do by law. But we have never been able to get these laws passed.

Senator HUMPHREY. That is right.

Ms. GRAY. May I supplement that with one additional statement. If it is the communities which now pay the highest rates that will use the bank, then, we are taking out of the market precisely those securities on which tax exemption results in the largest proportionate gain in the form of tax-free income to investors.

I think this is a very important step.

Senator HUMPHREY. I want to include in the record a letter that we have from the city of Alexandria, Va., from the city manager, Mr. Douglas Harmon. Mr. Harmon points out that several weeks prior to the city's bond sale on March 3, 1977, representatives of the city met with staff members of the bond rating houses.

During the course of these meetings, some time was devoted to discussing and answering questions concerning socioeconomic characteristics of the city, that is, median family income, unemployment rates, percentage of households below the poverty level, et cetera.

The letter continues, "we were specifically asked whether the city planned any increase in the number of public housing units." While it is probably impossible to precisely estimate how much weight is given to the socioeconomic data and trends in assigning bond ratings, it is clear that such factors do affect bond rating.

This is understandable since bond ratings are not sufficiently a a measure of the risk of default; ratings are used as a measure of anticipated future performance of the bond in the secondary market.

It appears that bond ratings both influence and are influenced by the secondary market performance, that the secondary market reflects the opinions of investors as to the general "image" of the city and the "image" of a city is affected by such factors as the amount of poverty, unemployment, and public housing. While only relatively few cities may have socioeconomic problems to agree that a default on bond payments is at all likely, it appears that much smaller problems can affect the image of the city, its bond rating and the cost it must pay to borrow money.

The point of this letter is not to criticize or suggest solutions, but to illustrate an additional cost for cities in which a significant portion of the population is poor.

While the costs of health care, social service, police and education for low-income persons have been pointed out in many reports, we are not aware of any studies which highlight the additional hidden cost for borrowing money. This is not an insignificant cost.

Recently, the difference between an A-rated bond and a BAA bond has approximated 90 basis points in net interest cost for a 20-year serial bond issue. Thus a city with a BAA rating can expect to pay about $94,500 more in interest costs for each $1 million borrowed over the life of such a bond issue.

This situation is another element in the continuing dilemma faced by cities with significant concentrations of poverty in trying to meet their obligations and responsibilities.

The letter points up one of the additional problems that cities are having today, and a problem which I think a domestic development bank would be better able to handle than the current bond market.

[The letter follows:]

CITY OF ALEXANDRIA, VA.,
July 26, 1977.

HON. HUBERT H. HUMPHREY,
Chairman, Subcommittee on Economic Stabilization, Joint Economic Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: Some time ago, Councilwoman Beverly Beidler discussed with Carla Cohen, a staff member of the Banking, Currency and Housing Committee, an event which occurred immediately prior to the most recent bond issue of the City of Alexandria. The staff of the Joint Economic Committee suggested we advise you of this event.

Several weeks prior to the City's bond sale on March 3, 1977, representatives of the City met with staff members of the bond rating houses. During the course of these meetings, some time was devoted to discussing and answering questions concerning socio-economic characteristics of the City; i.e. median family income, unemployment rates, percentage of the households below the poverty level, etc. We were specifically asked whether the City planned any increase in the number of public housing units.

While it is probably impossible to precisely estimate how much weight is given to socio-economic data and trends in assigning bond ratings, it is clear that such factors do affect bond rating. This is understandable since bond ratings are not simply a measure of the risk of default—ratings are used as a measure of anticipated future performance of the bond in the secondary market. It appears that bond ratings both influence and are influenced by secondary market performance, that the secondary market reflects the opinions of investors as to the general "image" of a city, and the "image" of a city is affected by such factors as the amount of poverty, unemployment, public housing, etc. While only relatively few cities may have socio-economic problems to a degree that a default on bond payments is at all likely, it appears that much smaller problems can affect the "image" of a city, its bond rating, and the cost it must pay to borrow money.

The point of this letter is not to criticize bond ratings or to suggest solutions, but to illustrate an additional cost for cities in which a significant portion of the population is poor. While the costs of health care, social service, police, and education for low income persons have been pointed out in many reports, we are not aware of any studies which highlight the additional "hidden cost" for borrowing money. This is not an insignificant cost. Recently, the difference between an "A" rated bond and a "BAA" bond has approximated 90 basis points in net interest cost for a 20-year, serial bond issue. Thus, a city with a "BAA" rating could expect to pay about $94,500 more in interest costs for each $1 million borrowed over the life of such a bond issue.

This situation is another element in the continuing dilemma faced by cities with significant concentrations of poverty in trying to meet their obligations and responsibilities.

Sincerely,

DOUGLAS HARMAN,
City Manager.

Senator HUMPHREY. I would like to make it clear, however, that as a former mayor, I support the municipal bond market.

As the mayor of Minneapolis, I knew that if the bonds were nontaxable, we got a lower interest rate.

So I support municipal bonds. I just think they are inadequate, and it is my judgment that this is one of the real problems today in financing cities. The cost of municipal development and municipal rehabilitation and municipal facilities have been so aggravated that the traditional methods of financing the cities no longer are adequate, they just won't work.

We have a whole new arithmetic in this country and don't know how to handle it. It is an entirely different ballgame A sewer plant that could have been built for, $5 million, 20 years ago, now costs $30 million.

The costs are incredible and the problem is that mayors cannot continue to raise the property tax without having a revolution on their hands.

So we are doing without necessary facilities. At the same time the Federal Government with all its different rules and regulations demands that streets be fixed up, sewers be constructed, pollution be eliminated and the poor mayor says, "Where is the money coming from?" And, then, the Federal Government says, "That is your problem, you figure that out."

It even was that way when I was mayor in 1949, and it has gotten worse. So I have a great sympathy for the local government organizations.

Thank you, very much, Mr. Bryce, Ms. Gray, and Mr. Porter.

Mr. Porter, nice to see you again. You did a fine job for our country as Administrator of the Marshall plan, by the way. We honor you. If everything works as well as the Marshall plan did, we would have no trouble.

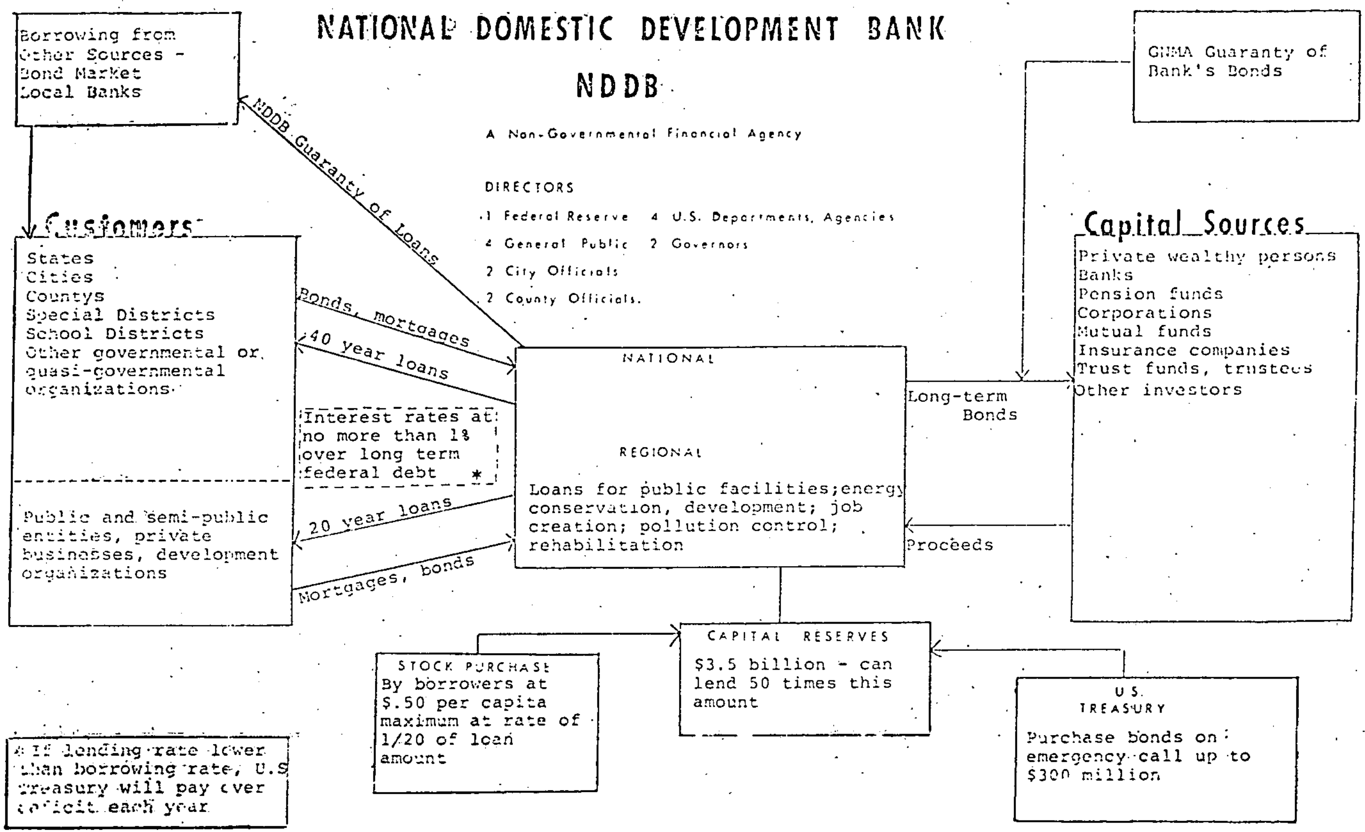
Well, I do want to say one of the reasons the Marshall plan worked is because we made a long-term commitment. And we planned both here and with the recipient countries, and they knew that the money could be relied upon.

If there were no plans, no long term commitment, they would still be trying to crawl out from under the rubble at Stuttgart.

The next group of witnesses that we have is Mr. Charles Haar, professor at Harvard Law School, Mr. Richard Nathan, senior fellow, Brookings Institution, and George Peterson, director of public finance at the Urban Institute.

We will insert in the record a chart of the National Domestic Development Bank. The chart shows the flow of capital resources, the structure, the potential customers, et cetera, along with a section-by-section summary of the National Domestic Development Bank, and also some of the purposes which the bank would fulfill in a very concise, abbreviated form.

[The chart follows:]



NATIONAL DOMESTIC DEVELOPMENT BANK
NDDB
A Non-Governmental Financial Agency
DIRECTORS
1 Federal Reserve
4 U.S. Departments, Agencies
4 General Public
2 Governors
2 City Officials
2 County Officials.
Borrowing from Other Sources - Bond Market Local Banks
NDDB Guaranty of Loans
GNMA Guaranty of Bank's Bonds
Customers
States
Cities
Countys
Special Districts
School Districts
Other governmental or quasi-governmental organizations
Public and semi-public entities, private businesses, development organizations
Bonds, mortgages
40 year loans
Interest rates at no more than 1% over long term federal debt *
20 year loans
Mortgages, bonds
NATIONAL
REGIONAL
Loans for public facilities; energy conservation, development; job creation; pollution control; rehabilitation
Long-term Bonds
Proceeds
Capital Sources
Private wealthy persons
Banks
Pension funds
Corporations
Mutual funds
Insurance companies
Trust funds, trustees
Other investors
CAPITAL RESERVES
$3.5 billion - can lend 50 times this amount
STOCK PURCHASE
By borrowers at $.50 per capita maximum at rate of 1/20 of loan amount
U.S. TREASURY
Purchase bonds on emergency call up to $300 million
* If lending rate lower than borrowing rate, U.S Treasury will pay over deficit each year

Senator HUMPHREY. Now, our first witness will be Mr. Haar, and we'll go from Mr. Haar to Mr. Nathan to Mr. Peterson.

Senator JAVITS. If I have to leave, you'll understand, we're in a big crisis here about a foreign policy matter. Thank you.

Senator HUMPHREY. Please proceed, Mr. Haar.

STATEMENT OF CHARLES M. HAAR, PROFESSOR, HARVARD LAW SCHOOL, CAMBRIDGE, MASS.

Mr. HAAR. Thank you very much, Mr. Chairman.

It is a great pleasure to be here and to testify on such an important subject. I'll be brief, not only because of the foreign, but because of the domestic crises, and will simply outline a few points and then we can get together on a panel discussion.

Rather than a formal statement, I was jotting down earlier some of the salient points for a development bank of this sort. And it seems to me there were seven or eight points that would encompass the major areas of concern.

First, we're talking about making the capital investment market more efficient. And here we come to the role of the bank as a packager dealing with long-term planning; in fact, dealing with the whole question of fiscal and financial planning that so strangely for a long time was absent from State and local governmental budgets and from government financing.

The second point follows from the capital investment one, which is looking at the problem more from the point of view of the supply of funds. This is to make the municipal bond market a more efficient, more effective market. Among other matters, this means making the bond market less dependent on commercial banks.

As the chairman has said, this is a very volatile source, the commercial banks. In 1 year they went as customers from a little over $2 billion worth of municipal bonds to over $8 billion, and then they dropped again down to $1 billion. They have other sources of lending that are more attractive to them—consumer and business and export loans—and the municipal market, depending as it does so heavily on the commercial banks, is highly vulnerable to the cyclical movements.

Not only the commercial banks as a group, but the investment is concentrated in the very large banks, since nearly half of the bond inventory of the banks is held by less than 100 banks.

And then we come to the third point—tax reform.

I was interested to note that in the latest market research survey when everyone has his and her own special perquisites that need to be protected and guarded—although others regard one person's vested right as a loophole—most seem to agree that this item of municipal exemptions from tax should be removed. Now——

Senator HUMPHREY. Except me.

Mr. HAAR. Mayors and Governors would hardly agree with that.

The effort here to move into tax reform and to institutionalize a subsidy for taxable bonds within the bank seems to me to be the most promising outlet for achieving reform in fact, for permitting flexibility, and for finding acceptance among public officials of a new, untried financial mechanism.

The fourth item about the bank, as has been brought out, is that it is a bank. Simpleminded as this may sound, it would mean that it is not a substitute for subsidy or for grants.

Nor do I think it ought to be a bank of last resort, either. It ought to be a bank that is hardnosed, businesslike, and efficient.

I know that one of the witnesses in the earlier panel talked about loans for jobs and for economic development. That might be a proper function of the bank, but only if it did it vis-a-vis the local or State governments.

That is, if a local or State government tells the bank that one of its high priorities is job development or a loan for an industrial park, let's say, then I think that would be an appropriate thing for the bank to make a loan to the government for. If the city or State has said this is our priority, and the only way it seems to me they can say it and mean it, that this is a priority, is by going on the hook for it. So, in other words, it is the city or the government that ought to borrow.

And, for instance, you might expect a 30-percent loss in these kinds of loans. Well, the city or State ought to make up that loss, but the loan to it should be a bankable loan. You should make up the loss by using other subsidies or block grant or some other technique it wants to employ.

In other words, the bank should not be confused with subsidy operations.

Indeed, I think as you begin to look at the political forces—which Congressmen have been known to do from time to time—that range around this bank, you will find that people are agreed on the need for the bank, but they all have different images of it, often different images which either frighten them or lead them to raise unanswerable questions.

Now, one factor—why I think it has to be businesslike—is that the mayors, like Mayor Gibson of Newark who did come out for the bank, are really worried whether the bank will turn out to be the substitute for a grant. Will we end up with our present grants being taken away and instead we'll be receiving loans?

If that's the case, no, thank you. I think you have to keep it businesslike, not only from the point of view of its solidity and incentives to be a lobby for urban affairs and for its impact on the Federal budget, but also from the point of view of the city itself. It should be kept as a bank.

When I talk about institutionalizing the whole operation, this conceives of the bank, too, as a chance for wrapping around these different strands, and becoming a lobbyist for the city. For we do not have effective pressure groups for cities at this time.

I know Senator Javits has tried most effectively to help New York, to help other cities, and it is a great difficulty the way the Congress especially is constituted.

It is a difficult matter for cities to get their particular needs across to the Nation as a whole. And if the bank, much the way as the World Bank——

Senator Javits. Professor Haar, the International Monetary Fund which was conditional, would be a big thing.

Mr. HAAR. That would be a very proper analogy. If this kind of bank would testify as to the needs for certain cities, before it could make certain loans, and specifies conditions and needs, that would be a very effective leader for centering public attention on the needs of the cities.

Again, my sixth point—I'm coming to a close—it can lead the private banks into city pastures. A Good Housekeeping Seal of Approval from this bank will in turn be an incentive and a link for the Chase and the First National City and the First National of Boston, much the way approval by the World Bank bring this type of consortium together.

Banks lend to countries where they haven't had a chance to do the economic investigation, but are satisfied with the financial analysis of the economic experts of the World Bank, I think you'd develop this kind of function from this bank.

I think, too, the bank is important for federalism, for the relationship of State, local, and national interests. It should be a cooperative bank, owned by its members the way the chairman emphasized the farm banks and how they're owned by the members. This institution should be run by the States and cities.

This is crucial, as you know, not only to get it off the Federal budget—which is the whole purpose here in many ways—but also because Washington simply can't run this kind of program.

It has to be priorities set by localities. A bank can act as a screen. If we didn't have this, we might as well throw the whole program of the Treasury and let them write the checks.

And that's why also I think in addition to being a bank, if I may say so, it ought to have redtape. Strange as it is to laud so unpopular a cause. There's nothing wrong with redtape—in a sense of inducing efficiency. That's one of the problems people have with a new institution, but I think criteria and standards should be turned around as an advantage.

And finally, I come to my last point, which is professionalization of municipal finance.

The bank can introduce quality into the whole arena of State and local government financing. We really have no criteria at this time in this country for urban development lending. Not only can the bank help cities put their houses in financial order, but cities can rearrange themselves.

We know the trouble New York City has been having vis-a-vis the Treasury. Each side is pushing and pulling. It is like the inevitable mother-in-law, son-in-law relationship, the relationship between a lender and a borrower.

But in this particular case, you need an honest broker, and a place where you can put the house in financial order and develop professional criteria, which can then in addition to money, make quality, and the institutionalization of standards. This is essential because the taxpayers, all of us, are looking for efficiency and prudence in the handling of money matters in these long-term investments, as the chairman so properly stressed. Again, this is much the way that the World Bank has professionalized development lending, for we really don't know today whether a city should lend for a port, park, a police headquarters, and under what standards and conditions.

It is from this sort of financial mechanism that this kind of standard can begin to evolve. So it is the institutional approach that I am stressing.

Thank you very much.

Senator HUMPHREY. Thank you very much, Mr. Haar.

[The prepared statement of Mr. Haar follows:]

PREPARED STATEMENT OF CHARLES M. HAAR

BANK OF THE CITIES AND STATES

A Step Forward in Creative Federalism Addressing the Critical Financial Needs of our Growing Communities, Large and Small.

BANK'S PURPOSE

To provide additional capital to hard-pressed State and local governments for a wide variety of public works and community facilities, including land acquisition.

To reduce interest cost to such governments.

To provide technical assistance to borrowers, particularly financial management and planning.

BANK ORGANIZATION AND MANAGEMENT

Shares owned by State and local governments.

A majority of Directors (8 out of 15) to be elected by State and local governments.

The President of the Bank and the remaining members of the Board to be appointed by the President of the United States with the advice and consent of the Senate.

BANK'S FINANCES

Money will be raised primarily by selling Bank bonds to the public—bonds will have a Treasury backstop or indirect guarantee.

$10 billion authorized over a 5-year period.

Bonds will be taxable.

FEDERAL FINANCIAL ROLE

Treasury backstop on bonds issued by Bank.

Annual payment to the Bank covering the difference in cost of money to the Bank and interest charged to borrowers.

A BANK FOR THE CITIES AND STATES A NEW STEP FORWARD IN CREATIVE FEDERALISM ADDRESSING THE CRITICAL FINANCIAL NEEDS OF OUR GROWING COMMUNITIES

(1) What is being proposed?

The establishment of a Bank for the Cities and States to provide long-term development loans as well as technical assistance to State and local governments.

(2) Who will own the Bank?

Shares of the Bank will be offered to State and local governments who shall then become eligible for loans. The Federal Government will own no shares.

(3) Who will manage the Bank?

The President of the Bank and 15 Board of Directors will direct the Bank. A majority of the Board of Directors will be elected by the shareholders (8), the balance including the Bank President will be appointed by the President of the U.S., with advice and consent of the Senate.

(4) How will the Bank raise funds?

In addition to the sale of shares, the bonds of the Bank will be sold to the public—up to a total of $10 billion over a 5-year period.

(5) What will the Bank lend for—and to whom?

The Bank will lend to State and local governments and their agencies for public works and community facilities, open space and land acquisition, new towns, and for all those facilities which enable communities to prosper and grow.

(6) Upon what terms will the Bank lend?

The Bank will lend for periods up to 40 years at competitive rates of interest.

(7) What will be the Federal role?

The Congress will be asked to provide an annual payment to make up the difference between the cost of money to the Bank and interest received from borrowers. In addition, the Secretary of the Treasury will have authority to purchase bonds of the Bank which authority will provide an indirect guarantee of the bonds of the Bank.

(8) What is the budgetary cost of the Bank?

The annual payments to the Bank to provide the interest differential will be a budgetary cost. This will be fully offset by revenues to be received on interest paid by the Bank to the investing public.

(9) Will the Bank have a technical assistance arm?

Yes. The Bank may act as financial adviser and consultant to communities which request such assistance.

(10) Why do we need a Bank for the States and Cities?

At present, sources of financing available to local and State governments are strained; local taxes, conventional borrowing and Federal sources are all under great pressure. The Bank will not only expand existing sources of funds, but by its presence and leadership will make existing sources more efficient and effective.

I. PROPOSAL

To establish a Bank of the Cities and States to provide long-term capital development funds and technical assistance to States and local governments.

To be authorized by an Act of Congress, the shares of the Bank will not be owned by the Federal Government but will be owned by the States and local governments, who shall direct the affairs of the Bank.

Patterned after the successful World Bank, the Bank of the Cities and States is designed to make existing institutions more effective by providing money and leadership in a critical area of public finance.

II. HOW THE BANK WOULD FUNCTION

Established by an Act of Congress, the Bank would be authorized to borrow money from the public at taxable rates of interest and to lend money to its members at lower tax exempt rates. The "loss" would be made up by annual appropriations from the Treasury. The "loss" would be fully offset by revenues received by the U.S. Treasury from income taxes paid by the holders of the Bank's bonds.

The Bank would have access to a limited line of credit from the Treasury, in case of need, much as Fannie Mae has. This would constitute an indirect federal guarantee of the Bonds of the Bank, and would enable the Bank to borrow money in the private sector.

A total of $10 billion woudl be authorized over a 5-year period.

Membership in the Bank will be limited to States and local governments. Inasmuch as the federal government will own no shares, the operations of the Bank would not be included in the federal budget.

Initially, the Board of the Bank and its President would be appointed by the President of the United States. Subsequently, a majority of the Board would be elected by its members; viz., cities and states. The President of the Bank would be a professional manager of high quality and experience who would report to the Board. The President of the United States would continue to appoint a minority of the members of the Board to represent the federal interest.

Application for loans would be made by members. Loans will be made for all types of capital projects, including public works, community facilities, and open space projects. Loans would be approved if, in the judgment of management, they could be repaid, and if, further, the applicant could demonstrate that funds on similar terms could not be obtained elsewhere. In certain instances, the Bank will be the sole lender to a project. In other instances, particularly when the amounts are large, the Bank will join with private banks in providing needed funds.

III. THE NEED

Our States and local governments need both money and management: money to provide for those capital outlays necessary for a growing population and to rebuild and maintain the physical plant we have already achieved; management to ensure the efficient expenditure of those funds.

In the past two decades, capital outlays for States and local governments have risen 10-fold. It is estimated that such outlays will exceed $50 billion this year. The amounts are climbing and are outpacing the ability of existing sources of funds to supply them.

Cities and States currently rely on three sources of funds: federal grants, including revenue sharing; State and local taxes and the muncipal bond market. Each source is severely strained by the demands placed on it.

The Bank for the Cities and States is designed to expand and make more productive one segment of financing: the municipal bond market.

IV. THE MUNICIPAL BOND MARKET

The municipal bond market is large and growing. Outstanding indebtedness currently in the hands of banks, insurance companies and individuals, now exceeds $200 billion, double the amount outstanding 10 years ago.

The size and rate of growth of the municipal bond market attests to its strength. However, there are serious defects in that market which have been observed for years, and which in recent times, have become more visible and dangerous. Among them are:

(1) Overdependence upon commercial banks for funds.

(2) An unhealthy bias toward short-term indebtedness and to instability in times of credit stringency.

(3) High interest rates in relationship to the tax exempt advantage.

(4) Small town borrowers are at a disadvantage in the marketplace.

(5) Inadequate rating systems to provide investors with objective standards.

In addition to the defects of the municipal bond market itself, there is a weakness in the operations of municipal finance which the municipal bond market was never intended to cure: that of inadequate financial training and expertise, both in the private sector and the public sector.

V. FINANCIAL EXPERTISE

Each year States and Cities are coping with increasingly complex questions of economic growth, tax policy and financial planning. The banking community can address in a sophisticated manner such questions as to whom to sell bonds, the proper rate of interest, how many bonds can be sold, but it is generally not equipped to assist State and local officials on such questions as

(*a*) when to increase debt,

(*b*) when to increase (reduce) taxes,

(*c*) how much is too much borrowing in terms of the long run interests of the community,

(*d*) what to do about a declining tax base,

(*e*) for what purposes should money be borrowed?

The growing myth that a balanced budget is itself sufficient to ensure financial health will prove to be costly if the underlying economic strengths and weaknesses of a community are not considered and corrective measures not taken.

In short, financial expertise is complex. In a banking operation, almost every transaction has a qualitative aspect. One important purpose of the Bank for the Cities and States is to improve professionalism at every level of municipal finance.

VI. THE ROLE OF THE BANK IN MEETING THE NEEDS:

By size of authorization, the Bank is limited to a program to expand (not replace) the existing municipal bond market. A $10-billion authorization over a 5-year period represents only 5 percent of the presently outstanding municipal bond market. Yet, properly handled, the operation of the Bank would not only inject new, needed money into Cities and States, but would:

Reduce the market's dependence upon commercial banks.

Lengthen maturities of State and local indebtedness.

Lower interest rates.

Improve access of unsophisticated borrowers, particularly smaller communities, to capital markets.

Improve investor confidence by providing necessary leadership.

In matters of technical assistance, the Bank's operations would provide (*a*) an important source of professional guidance, and (*b*) an important training ground for future leaders in public finance.

VII. SUMMARY

A Bank for the Cities and States, owned and directed by the Cities and States, can be a major step in expanding and making more effective one critical source of financing for Cities and States. The Bank will not cost the federal government any money.

The Bank places responsibility and accountability upon the shoulders of State and local government and not upon the federal government. The Federal Government plays a supportive, but background role.

The Bank demonstrates the federal commitment to helping those that help themselves.

VIII. SUPPLEMENTAL MATERIAL

Some examples of the kind of creative leadership the Bank can give:

(1) A large mid-western city wishes to borrow $100 million on a long-term basis for the revitalization and expansion of its transportation network. The city requests assistance from the Bank which sends a study team to analyze the technical and economic feasibility of the project, as well as the need. The study reviews the capacity of the city to service such debt in light of other demands on its resources. The study team recommends certain modifications in the scope of the project and the proposed fare schedule. The Bank agrees to lend the city $50 million on a long-term basis, if the city is able to raise an additional $50 million. On the basis of the Bank's professional study and willingness to commit $50 million, the city asks its investment bankers to place the $50 million balance.

(2) A medium-sized city in the Northeast with a falling tax base is advised by its bankers that it can raise $7 million for a capital improvement program for schools at 7¾ percent. These would be general obligation bonds. The city asks the Bank for its opinion. The Bank reviews the proposal with city officials. The Bank concludes that the new facilities are not high priority, but that a program of middle income housing designed to retain clerical employees in the center city is more important. With city officials, a housing program involving State and federal assistance is prepared. The Bank may or may not be asked to participate. It should be remarked that if the Bank were a federal agency, the city applicant (*a*) would be concerned that its disclosures would backfire, and (*b*) would be suspicious of the advice. Inasmuch as the Bank is owned by borrower-members, these concerns would be lessened.

(3) A small rural town finds itself unable to cope with the development requirements of a new automobile assembly plant; housing is needed, schools, sewers, transportation, roads. The Bank is asked to assist. The Bank prepared a financial plan and uses its good offices to assist the town in recruiting professional personnel. The Bank does this for a fee. The fee is paid from tax advances made by the owner of the new plant. The Bank absorbs 75 percent of the first issue of $10 million. The investment bankers (with the help of the Bank) place the balance.

(4) A large city with an eroding tax base wishes to build a large sports arena as a cost of $75 million. The Bank is asked to participate and declines. The city places the bonds elsewhere (or fails to place the bonds).

(5) A Western state wishes to establish a new town in a formerly rural area because of large underground steam power potentials being exploited by a large utility. The total cost of the planned new town (public facilities) is estimated at $100,000,000 over 5 years. The state has created a development authority and is willing to commit $25 million loan to the project. After review, the Bank believes that the project is sound and agrees to commit $25 million in a long-term loan, provided (*a*) the state's funds go into the project first, and (*b*) private funds of $50 million go into the project pari passu with the Bank. In order to raise $50 million in funds from the public, the utility agrees to provide $10 million to the new town in providing the initial water and sewer facilities. After further analysis, a staged development is accepted which allows the first phase of the project to be accomplished with minimal sale of bonds to the public.

These are hypothetical examples of what an effective professional institution can do. Analogous precedents can all be found in the experience of the World Bank.

Senator HUMPHREY. Mr. Nathan, we surely thank you for your presence here today. I know you've put a lot of time into this over at Brookings.

Go ahead, sir.

STATEMENT OF RICHARD P. NATHAN, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C., ACCOMPANIED BY PAUL R. DOMMEL AND JAMES W. FOSSETT

Mr. NATHAN. We're very pleased to be here as members of the Monitoring Studies Group at Brookings. We believe that one of the most important next steps for urban policy is the idea that this hearing focuses on, and that you have particularly stressed over the years, and that is the development of a long-term financial mechanism on the order of a National Domestic Development Bank.

Prof. Paul R. Dommel of Holy Cross College, who's here with me today, and James W. Fossett of the Brookings Institution staff coauthored this testimony. The testimony is long; what I would like to do is go through and indicate what it covers, and——

Senator HUMPHREY. You know, the full text will be made a part of the record. That goes for all of our witnesses today, automatically.

Mr. NATHAN. That will help.

What I'd like to do is indicate the points that we think are particularly important in the material we've gone through in preparation for this hearing. The testimony covers three main subjects:

First, it reviews recent trends in Federal aid for cities and defines the need for a development financing mechanism similar to that under consideration today.

Second, the testimony outlines some of the ways in which the cities most in need of support from a National Domestic Development Bank might be identified.

In the third part of our testimony, we present our views on some of the main issues that need to be taken into account in the design of such a bank.

Referring briefly to the first part of our testimony, two main themes emerge:

The 1978 Federal budget provides an unprecedented and, we believe, largely unrecognized level of support for cities experiencing what we in our research have defined as significant or serious urban "hardship" conditions.

The level of this increase, Mr. Chairman, we think, needs to be looked at very carefully in the current economic and fiscal policy setting.

Senator HUMPHREY. Do you have any idea of the total amount provided for the cities?

Mr. NATHAN. We've written a chapter in the new Brookings budget book for fiscal 1978; it is on the order of $10 billion of new and additional grants to local governments, most of which or a good part of which is targeted on what we've defined as hardship cities.

The cities that we've been concerned about from the point of view of national urban policy are being significantly affected by these budget changes, and——

Senator HUMPHREY. That's $10 billion in new funding. That's over and above what it's been in the past?

Mr. NATHAN. Above what they've previously been receiving. All of the money in the economic stimulus package; that is, the public works money, the public jobs money, and countercyclical revenue sharing, with the exception of the State part of the latter, almost all of that money is for local government. A very small portion goes to States.

Senator HUMPHREY. Yes.

Mr. NATHAN. The second point we highlight in the first part of our testimony is that the form in which this aid is provided makes it inappropriate as a source of financing for large, long-term developing projects, designed to broaden the local tax base and create new and permanent jobs in sizable numbers, which, of course, is the purpose of the bank.

As an indication of the magnitude of current Federal grants to cities, we provide in table 1 of the prepared statement a set of estimates of Federal grants to be received in 1978 for 15 large cities.

These 15 cities were selected to concentrate on what we've defined as urban hardship conditions, and at the same time to include some better-off cities for comparative purposes, for example, Phoenix, Dallas, Houston, Los Angeles, and Denver.

The 15 cities, all of which are above 350,000 in population, are ranked in the table according to what we define as their degree of urban hardship or urban need so that St. Louis, with the highest urban conditions index ranking, is at the top of the first column in table 1, and at the other end of the table, the bottom entry is Phoenix with the lowest, or you might say best urban conditions ranking.

The figures shown in these columns, particularly columns 2 and 5 of this table, are as I indicated earlier, public service employment allocations, the second-round planning targets under the new public works program, estimates of the countercyclical revenue-sharing allocations, and finally the allocations under the House formula for the community development block grant program.

While it must be emphasized that these are allocations rather than outlays, it should be noted that cities will be in a position to commit up to these levels in fiscal year 1978 and may, if they're energetic in spending these moneys, spend the full amount this year. We therefore feel these data represent a reasonable statement of Federal grant flows.

Table 2 of the prepared statement, I think, is the most important new data in this testimony. It compares the allocations just described to the payments to these same 15 local governments in 1975 fiscal year which is the last year for which census data are available.

Senator HUMPHREY. 1975?

Mr. NATHAN. It compares 1975 to 1978. So it shows the growth over a 3-year period. What we've found is that the average rate of increase in Federal payments over these 3 years is 135 percent, or twice the rate of growth in all Federal grants in aid to States and localities during this period.

Increases in Federal support, moreover, are largest for Newark, St. Louis, and Buffalo, which our prior research has identified as the three most distressed urban areas among the 15 selected.

Senator HUMPHREY. You don't include Cleveland there?

Mr. NATHAN. Cleveland has a very large increase in table 2, 131 percent, but it is not as large as three other cities.

Senator HUMPHREY. But you say projected budget growth, is that the city budget? Are the estimated total grants both State and Federal?

Mr. NATHAN. Just Federal. All Federal grants.

Senator HUMPHREY. Good. Thank you very much.

Mr. NATHAN. Using this projection method, Federal aid to Newark increased fourfold over this 3-year period. Federal aid for St. Louis increased by 2½ times, for Buffalo by 154.2 percent.

The next point, I think, is a particularly important one. When the Congress turns next year to the question of whether and when to allow the economic stimulus package to turn off, you will face conditions in which such a decision could cause a precipitous drop in the funds available to some of the Nation's most troubled big city governments.

Frankly, Senator, we were particularly anxious to put these figures together for the committee, because we think that's a very important point.

Senator HUMPHREY. Right.

Mr. NATHAN. Our prepared statement also discusses the city of Cleveland as a specific case that is a good illustration of what is happening to America's cities under Federal grant programs right now. If you look at table 2, it indicates that the city of Cleveland is projected to receive approximately $110 million in Federal aid allocations, which are treated separately in the city budget.

This amount of Federal aid is equivalent to 90 percent of Cleveland's 1977 general fund expenditures, again if you leave out Federal aid.

So these infusions of aid, targeted in many cases where they ought to go to the cities with the deepest needs, are going to be very significant for these cities.

Our second conclusion about the Federal aid picture for cities is less optimistic. In spite of this increase in Federal grants, many cities will find it difficult to use these funds to address longer term problems of tax-base deterioration and job loss. The bulk of Federal funds is targeted toward support of city operating budgets, as in the case of the public service employment of countercyclical revenue-sharing program, and will be used to fund shorter term capital projects, primarily from applications already on file under the local public works program.

The rest of this section of our prepared statement, Mr. Chairman, discusses reasons why we think domestic development bank makes sense in relation to what's been happening to the community development block grant program.

The prepared statement also stresses the need to target development funds on areas of urban need, and then in the final section, the way in which we think a domestic development bank might work. Five principles are cited:

1. The importance of targeting.
2. The importance of large projects.
3. The importance of public-private cooperation.
4. The need to rely on State governments and regional combinations of governments for smaller projects.
5. The point that a new institution would bring fresh energy to the solution of urban development projects.

The last section of our testimony discusses the way a major projects window might work to provide funds for large development projects in the most needy cities. We think there should be specific tests written into the law to define what kind of cities and what kind of projects should be eligible for assistance in this "major projects assistance." Congressional intent in this respect should be clear. We suggest in our testimony a number of ways in which such specific tests of admission might be devised.

Mr. Chairman, that gives you some of the highlights of what's in this testimony.

Senator HUMPHREY. That's excellent testimony. We're indebted to you and your associates for your splendid documentation. We'll come back to it.

[The prepared statement of Messrs. Nathan, Dommel, and Fossett follows:]

PREPARED STATEMENT OF RICHARD P. NATHAN, PAUL R. DOMMEL, AND JAMES W. FOSSETT *

TARGETING DEVELOPMENT FUNDS ON URBAN HARDSHIP

This testimony covers three main subjects—first, it reviews recent trends in Federal aid for cities and defines the need for a development financing mechanism similar to that under discussion today; second, it outlines some of the ways in which the cities most in need of support from a National Development Bank might be defined, and third, it prescribes our views on some of the main issues that need to be taken into account in the design of such a Bank.

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Two main themes emerge in the first part of our testimony. First, the 1978 Federal budget provides an unprecedented—and largely unrecognized—level of support for cities experiencing what we define as significant urban "hardship" conditions. Second, the form in which this aid is provided makes it inappropriate as a source of financing for large, long-term development projects designed to broaden the local tax base and create new and permanent jobs in sizeable numbers.

Federal aid for cities on a sharp upswing

Partly by accident and partly by design, the Federal Government will be spending unprecedented amounts of money in "hardship" cities in fiscal year 1978. The Carter Administration's budget revisions proposed approximately $82 billion in Federal aid to states and localities in fiscal year 1978, a 15 percent increase over the Ford Administration's initial budget for 1978. The biggest increases are in programs that assist local governments, especially those designed to aid the Nation's economic recovery—Public Service Employment, Local Public Works, and Counter-cyclical Revenue Sharing. Congress has completed action on these programs and the allocation of funds has begun; $1 billion has also been appropriated for a major youth employment effort, along with additional new funds for the expansion of other employment programs. The major increases in funding under these employment programs, which are focused on unemployed and disadvantaged persons, together with the targeting of funds under the Local Public Works and Community Development Block Grant programs, result in major increases in the amount of Federal support for cities. While all major cities receive sizeable increases, cities which are experiencing particularly severe problems will be the primary beneficiaries of this increased Federal spending.

Data for fifteen large cities

An indication of the magnitude of Federal support to cities is provided in Table 1, which presents estimates of Federal grants to fifteen cities in FY 1978. These cities cited here were selected to concentrate on urban hardship areas, and at the same time to include some better off cities for comparative purposes, e.g. Phoenix,

*The authors are staff members of the Monitoring Studies Group of the Brookings Institution which is currently studying the General Revenue Sharing, Community Development Block Grant, and Public Service Employment programs. The findings and views stated here are the authors'; they do not represent the views of other staff members, or the officers and Trustees of the Brookings Institution.

Dallas, Houston, Los Angeles and Denver. The fifteen cities, all above 350,000 population, are ranked in Table 1 according to their composite "urban conditions index" ranking (discussed below), with St. Louis having the highest—worst—index rating and Phoenix the lowest—best—rating.

The figures shown in columns 2–5 of Table 1 are for Public Service Employment allocations, second-round planning targets under the new Local Public Works program, estimates of Counter-cyclical Revenue Sharing allocations, and allocations under the House formula for the Community Development Block Grant Program. These data are allocations rather than projected outlays or drawdown rates, hence they may overstate the amount of funding that will show up on city books from these programs in 1978. We have assumed that other grants received by these cities have remained level—in effect, that the cities studied have received no increases in other Federal aids since the adoption of general revenue sharing. While it must be emphasized that these data are allocations rather than outlays, it should be noted that cities will be in a position to commit funds up to these levels in 1978, and may, if energetic spending practices are pursued, spend the full amount in fiscal 1978. We therefore feel that these represent a reasonable statement of Federal grant flows.

TABLE 1.—ESTIMATED FEDERAL GRANTS TO 15 CITIES, FISCAL YEAR 1978

[Dollar amounts in thousands]

City	"Urban conditions index"	Public service employment allocation	Local public works, round II planning targets	Counter-cyclical revenue sharing (estimate)	Total stimulus	CDBG allocations, House formula	Other grants	Total grants
St. Louis	351	$20,607	$15,514	$5,265	$41,386	$32,983	$35,131	$109,500
Newark	321	23,226	14,516	5,248	43,990	16,978	17,160	78,128
Buffalo	292	22,281	13,495	3,122	38,898	21,928	20,121	80,947
Cleveland	291	21,988	9,551	3,411	34,950	35,334	40,097	110,381
Boston	257	27,607	15,963	4,112	47,682	25,235	47,969	120,885
Baltimore	226	31,275	19,574	8,094	58,943	28,564	93,887	181,394
Philadelphia	216	54,899	54,734	16,772	126,405	63,852	137,877	328,134
Detroit	201	50,313	26,805	13,683	90,801	57,778	162,563	311,142
Chicago	201	88,782	37,483	12,123	138,388	116,800	52,538	407,726
Atlanta	118	23,177	7,205	1,427	31,809	14,125	13,060	58,994
Denver	106	12,055	8,527	1,706	22,288	11,572	30,287	64,147
Los Angeles	74	101,019	45,794	8,476	155,289	51,010	95,513	301,812
Dallas	39	10,477	0	0	10,477	15,223	16,465	42,165
Houston	37	21,341	8,650	864	30,855	23,674	31,866	86,395
Phoenix	20	28,940	15,335	1,299	45,574	10,031	15,306	70,911

Sources: PSE: DOL allocation estimates for 1978. Baltimore and Cleveland allocations based on estimated allocations as if separate prime sponsor. LPW: Planning Targets for Applicants and Areas Under Public Works Employment Act of 1977 (EDA, June 9, 1977). CCRS: Estimated based on assumption of share of payment period 5 remaining constant in periods 6–9. Period 6–9 payment totals contained in CBO cost estimate accompanying House Committee Report on Intergovernmental Antirecession Act of 1977 (Rept. 95–277; May 9, 1977). Local shares computed from ORS Antirecession Fiscal Assistance to State and Local Governments; Quarter 5 (July 8, 1977). CDBG: HUD estimates for allocations under House formula. Other grants: Average of Federal revenues received in 1972–73 and 1973–74 as reported in Bureau of Census City Government Finances in 1972–73 and City Government Finances in 1973–74, table 7. See discussion in footnote 1, pp. 3 and 6 of this testimony.

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[1] The figures reported in Table 2 for "Other grants" are average of revenues received from the Federal government in 1972–73 and 1973–74 as reported in Census publications. These figures include receipts from programs folded into CETA and CDBG; however, it should be noted that these folded-in programs continued in some cases to pay out substantial sums. For example, payments continued, largely under "Urgent Needs" (primarily urban renewal) provisions of the CD legislation, for the programs folded-in to CDBG, *in addition* to the new CDBG payments. According to the OMB February budget revisions, outlays for these folded-in programs amounted to $1.45 billion in FY 1976 and were estimated to be $1.16 billion for FY 1977. The impact of some folded-in programs being included in the 1972–74 base is further diluted by growth in other grants which occurred during this period and by the fact that we have made no attempt to adjust these projections for inflation. For seven cities whose 1977 budget documents contain detailed Federal aid estimates, our estimate of "Other grants" are approximately equivalent to their projected Federal assistance (excluding the ESP and CDBG programs listed separately here) or understate the amounts that cities expected to receive. For one city (Atlanta), the projections made by the city were smaller than this Census-derived proxy number. In this case, the "Other grants" figure has been reduced to reflect city estimates.

Rates of Increase Average 135 percent 1975–78

Table 2 compares these 1978 allocations to payments to these same governments during 1974–75, the latest year for which Census data are available. The average rate of increase in Federal payments over these three years is 135 percent—or over twice the rate of growth in all Federal grants-in-aid to States and localities during this period. This compares with a GNP of 27.3 percent and an inflation rate for state and local purchases of 24.9 percent between the first quarter of 1974 and the last quarter of 1976. Increases in Federal support are largest in Newark, St. Louis, and Buffalo, which our prior reesarch has identified as the three most distressed urban areas among the fifteen cities selected. Using this projection method, Federal aid to Newark increased four-fold over the past three years, two and one-half times for St. Louis and by 154.2 percent for Buffalo. The immediate policy implications are clear. When the Congress turns next year to the question of whether and when to allow the Economic Stimulus Package to turn off, you will face conditions in which such a decision could cause a precipitous drop in the funds available to some of the nation's most troubled big city governments.

TABLE 2.—COMPARATIVE GROWTH OF FEDERAL GRANTS AND PROJECTIONS OF LOCAL EXPENDITURES 1975–78

[Dollar amounts in thousands]

City	"Urban conditions index"	Projected budget growth (percent)	Estimated total grants 1978	Grants from Federal Government 1974–75	Percent increase
St. Louis	351	33.0	$109,500	$31,483	247.8
Newark	321	50.1	78,128	15,624	400.0
Buffalo	292	31.5	80,947	31,844	154.2
Cleveland	291	21.3	110,381	47,733	131.2
Boston	257	42.6	120,885	66,782	81.0
Baltimore	226	26.1	181,394	108,015	67.9
Philadelphia	216	42.9	328,134	130,820	150.8
Detroit	201	38.1	311,142	166,183	87.2
Chicago	201	29.1	407,726	166,129	145.4
Atlanta	118	49.8	58,994	38,548	53.0
Denver	106	60.9	64,167	49,519	29.6
Los Angeles	74	44.7	301,812	115,052	162.3
Dallas	39	80.1	42,165	24,292	73.6
Houston	37	55.8	86,395	45,869	88.4
Phoenix	20	67.8	70,911	36,556	94.0

Note.—We wish to acknowledge assistance in the collection and evaluation of grant and budget data from Charles F. Adams, Jr., and Arthur A. Morton.

Sources: Estimated Total Grants: See table 1. 1974–75 grants: Bureau of Census, City Government Finances in 1974–75, table 7. Projected budget growth: Average annual growth from 1970–71 to 1974–75 in direct general expenditure for operation, and interest on general debt and net long term general debt retired and payments to own retirement system, as reported in Bureau of Census, City Government Finances, selected years, tables 5 and 7.

The increase in Federal grants shown in Table 2 outstrips, by a considerable margin, the growth in municipal expenditures during this same period. While it is not clear yet what exactly happened to the finances of these cities between 1975 and 1978, we can safely say that this growth in Federal support is substantially greater than even the most liberal assumptions about city budget growth. The second column of Table 2, for example, indicates projected increases in city operating budgets for 1975–78 if they had continued to expand at the same rate during this period as during the preceding five years. For all but two cities, the growth in Federal grants exceeds this projected growth in expenditures. Stated another way, the relative importance of Federal aid in the budgets of many of the larger and distressed cities of the nation has risen substantially in the past three years.

Cleveland, A Good Example

The city of Cleveland provides a good illustration of what has been happening. The 1977 appropriations ordinance provides for total expenditures of $349 million. Of this total, approximately $200 million is appropriated for either debt service or from "operating funds" of activities that are generally self-supporting—the operation of city utilities, parking lots and the public auditorium. The city's general fund appropriation is $122 million, representing an increase of 2.3 percent over 1976 and of 15.6 percent over 1975. Reference to Table 2 indicates that the city is projected to receive approximately $110 million in Federal aid allocations which are treated separately in the City budget. This amount of assistance is equivalent to 90 percent of Cleveland's 1977 General Fund expenditures in 1978, again exclusive of Federal aid.

But Aid Won't Get at Long-Term Development Needs

Our second conclusion about the Federal aid picture for cities in 1978 is less optimistic. In spite of this increase in Federal assistance, many cities will find it difficult to use these funds to address longer-term problems of tax base deterioration and job loss. The bulk of Federal funds are targeted towards support of city operating budgets, as in the case of Public Service Employment or Counter-cyclical Revenue Sharing, or will be used to fund shorter-term capital projects primarily from applications already on file, as under the Local Public Works program.

CDBG Not Suited to Meet Long-Term Capital Needs

The primary source of Federal support for a city wishing to try to finance major redevelopment is the Community Development Block Grant (CDBG) program, which we have concluded is largely inappropriate for large, long-term capital development purposes. The findings of our monitoring study for the first two years of local experience under this block grant for community development indicate that it has been largely used for the continuation of urban renewal projects and other activities under the "folded-in" categorical programs; neighborhood conservation; or for general development activities, such as the construction of public facilities or the repair of streets.[2] Most of the activities supported with CDBG funds have been small in scale and short-term in financing. Relatively little attempt has been made, either directly or indirectly through the leveraging of private funds, to support major long-term redevelopment activities. Table 3 indicates the incidence of leveraging through the first two years for the sixty-two jurisdictions in the Brookings sample for the monitoring study of the CDBG program. As is obvious from the table, most attempts at leveraging were directed at housing rehabilitation, rather than industrial or commercial development. Furthermore, the total amount of funds devoted to the attraction of private capital has been relatively limited to date.

TABLE 3.—USE OF CDBG FUNDS FOR LEVERAGING BY BROOKINGS SAMPLE JURISDICTIONS, 1ST 2 PROGRAM YEARS

Time period	Program category of leveraging projects for sample units		
	Housing rehabilitation	Commercial assistance	Industrial development
Attempted both years	23	10	4
1st yr only	2	1	2
2d yr only	10	7	2
No attempt	27	44	54
Total units	62	62	62

Source: Field research data.

There are two primary reasons that account for this minimal use of CDBG funds for major redevelopment purposes and limit its potential for such uses in the future. Funds come only one year at a time. Jurisdictions can only assume that funds will be available for the length of the program's appropriation. Thus, there is uncertainty associated with future funding, an uncertainty that may be increased by HUD's recently announced intention of tying CDBG funding more closely to the provision of low- and moderate-income housing, a goal which many support and which Secretary Harris has announced she will press.

The second factor underlying this short-term bias under CDBG is political: the mandates of local politics in many cities dictate that funds be spread more or less evenly among all claimants. Our preliminary results from the first two years of CDBG, for example, suggest that program benefits are becoming dispersed both geographically and economically; concentration of funding on one particular function or area is apparently becoming increasingly difficult.

[2] Richard P. Nathan, Paul R. Dommel, Sarah F. Liebschutz, Milton Morris and Associates "*Block Grants for Community Development*" (U.S. Department of Housing and Urban Development, 1977), Chapter 7.

The combination of these two factors create considerable incentives for cities to utilize CDBG funds for short-term, geographically dispersed projects. Assembling the amount of funding required to finance site acquisition, relocation, clearance, and infrastructure development for a large commercial or residential project is extremely difficult, if not impossible, in the face of these conditions and incentives.

The CDBG renewal legislation currently being considered by a conference committee contains a number of features which may make longer-term redevelopment somewhat easier in the larger cities. A number of big cities confronting substantial urban "hardship" conditions will be receiving significant increases in funding under the "dual formula" contained in both House and Senate bills. In addition, the elimination of the "full faith and credit" and grant reservation requirements under Section 108 of the act (authorizing loan guarantees for land acquisition) should make the use of this guarantee authority more practical. Both the House and Senate bills authorize "Action" grants for urban development explicitly targeted at providing funds for the front-end investment necessary to attract private development.

While these changes will make the financing of major projects with CDBG funds easier, we do not feel that they are of sufficient scale to permit reliance on CDBG as the major instrument through which the Federal government assists large long-term urban redevelopment. Both the House and Senate bills contain limitations on the level of borrowing that can be guaranteed for land acquisition under Section 108 and require that recipients pledge future grants as security against repayment; the Senate version contains the further proviso that these loans be repaid in six years. Likewise, the new "Action" grants appear to be intended for use as a supplement to enable communities to resolve particular problems rather than as a general resource for large long-term redevelopment projects.

A major conclusion of our urban research has been that Federal policies and programs should target urban assistance to the neediest communities. Likewise, one of the central purposes of this testimony is to urge that a National Development Bank have a significant portion of its programs targeted to needy cities. Our research, and the research of others, gives us confidence that these communities can be identified on a basis that makes such targeting possible.

The evolution of the Community Development Block Grant demonstrates this point. As first enacted, the CRBG program had a decided spreading effect. The formula entitlement system provided funds to nearly 600 jurisdictions; discretionery grants added several thousand additional recipients.

As already indicated, an important change that will target CDBG funds according to need is now working its way through Congress. This is the adoption of a "dual formula" system which directs more funds to older, declining cities. This targeting concept warrants further elaboration in connection with the development of specifications for a National Domestic Bank.

Targeting Urban Aid

Cities with problems cut across simple distinctions based on size, region, or that between central cities and suburbs. We have identified three factors as indicators of urban problems—(1) socioeconomic; (2) the age of a city; and (3) the growth or decline of its population. In our study of the CDBG program we used three factors in a composite index to measure urban conditions and compare central cities and large suburban cities (i.e. those over 50,000 population)—a total of 489 cities.[3] These same factors are incorporated in the revised CDBG allocation system now in a House-Senate conference.

For a socio-economic indicator, we use poverty. Poverty-impacted communities tend to spend a higher proportion of their budgets on services for the poor while deriving relatively fewer tax dollars from this group.

For community age, we use an age-of-housing factor which is a proxy for the age of the city and thus an indirect measure of overall physical development needs.

Population growth or decline is also a critical dimension of community need. Declining cities are found in all regions but disproportionately in the Northeast and North Central regions. They also tend to have slower rates of growth of their fiscal resource base as shown in Table 4.

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[3] Urban conditions index $= \dfrac{\dfrac{\text{Percent pre–1939 housing}}{\text{Mean percent pre–1939 housing}} \times \dfrac{\text{Percent poverty}}{\text{Mean percent poverty}}}{\dfrac{100 + \text{rate of population change}}{100 + \text{median rate of population change}}}$

TABLE 4.—CHARACTERISTICS OF CITIES ABOVE 50,000 GAINING AND LOSING POPULATION, 1960–70

Population change, 1960–70	Population change, 1960–70 (percent)	Black population, 1970 (percent)	Per capita income		Median house value	
			Amount, 1970	Percent change, 1960–70	Amount, 1970 (thousands)	Percent change, 1960–70
Population loss (n=150)	−6.7	17.3	$3,062	57.0	$15.9	32.5
Population gain (n=339)	20.5	10.2	3,354	61.7	18.8	38.2

Sources: Calculated from U.S. Bureau of the Census, County and City Data Book, 1962 (Government Printing Office, 1962), and County and City Data Book, 1972 (Government Printing Office, 1973).

Composite Urban Conditions Index

Of the 489 cities ranked with this three-factor index, 40 percent are above the mean—have an index rating of 100 or greater. There are varying degrees of hardship among these cities. In our analyses we have focused on the 123 cities 50 percent or more above the mean. These 123 cities represent 25 percent of all cities studied. Of these 123 cities, a disproportionate number are in the Northeast and Mid-West. Two-thirds of the cities with an index above 150 are in this Northeast Quadrant. It is also important to note that eleven suburban cities are among these 123 top cities on the index.

In terms of size, the incidence of hardship is greatest among the very largest cities. While 25 percent of all cities above 50,000 population are found at the higher level, 45 percent of the cities above 500,000 population are in this group. At the same time, it should be noted that fifteen of the nation's largest cities do not fall into this higher index group. Table 5 shows forty-four cities with populations of 100,000 or more in 1970 that are among the 123 upper-scale cities.

TABLE 5.—CHARACTERISTICS OF 44 CITIES WITH POPULATIONS ABOVE 100,000 FOUND MORE THAN 50 PERCENT ABOVE THE MEAN OF THE COMPOSITE URBAN CONDITIONS INDEX

	"Urban conditions index"	Population 1970	Region	Percent pre-1939 housing 1970	Percent poverty 1970	Percent population change		Percent nonwhite and Spanish 1970
						1960–70	1970–73	
St. Louis, Mo	351	622,236	NEQ	73.9	19.7	−17.0	−10.9	42.3
Providence, R.I	333	179,116	NEQ	80.7	17.8	−13.7	−5.1	10.8
Camden, N.J	333	102,551	NEQ	70.0	20.8	−12.5	−2.5	46.4
Newark, N.J	321	381,930	NEQ	68.4	22.1	−5.7	−4.6	62.2
Buffalo, N.Y	292	462,768	NEQ	85.7	14.8	−13.1	−8.1	21.9
Cleveland, Ohio	291	750,879	NEQ	73.3	17.0	−14.3	−9.7	40.9
Trenton, N.J	288	104,786	NEQ	81.0	16.3	−8.2	Same	40.7
New Orleans, La	274	593,471	S	49.4	26.2	−5.4	−2.6	49.8
Pittsburgh, Pa	260	520,117	NEQ	74.4	15.0	−13.9	−8.1	20.8
Savannah, Ga	260	118,349	S	39.9	25.8	−20.7	−10.9	46.6
Chattanooga, Tenn	257	119,082	S	48.3	24.5	−7.8	+41.0	36.0
Boston, Mass	257	641,071	NEQ	77.2	15.3	−8.1	Same	20.8
New Haven, Conn	252	137,707	NEQ	69.2	16.5	−9.4	−4.5	30.7
New Bedford, Mass	246	102,477	NEQ	80.8	15.1	−.7	−.7	4.8
Paterson, N.J	228	144,824	NEQ	70.5	16.3	.8	−1.3	35.7
Cincinnati, Ohio	226	452,524	NEQ	59.3	17.1	−10.2	−5.6	28.7
Jersey City, N.J	226	260,545	NEQ	78.9	13.5	−5.7	−3.2	28.2
Baltimore, Md	224	905,787	S	60.0	18.0	−3.5	−3.1	47.9
Hartford, Conn	223	158,017	NEQ	67.0	16.2	−2.6	−5.9	36.6
Albany, N.Y	221	115,781	NEQ	74.7	13.2	−10.7	−3.4	12.5
Youngstown, Ohio	220	140,909	NEQ	67.4	13.8	−15.5	−5.0	28.3
Cambridge, Mass	219	100,361	NQR	79.7	12.8	−6.8	−1.8	10.5
Birmingham, Ala	218	300,910	S	42.7	22.5	−11.7	−2.7	42.6
Philadelphia, Pa	216	1,950,098	NEQ	69.5	15.1	−2.6	−4.2	35.6
Scranton, Pa	213	102,696	NEQ	86.6	11.4	−7.1	−3.3	1.0
Syracuse, N.Y	210	197,297	NEQ	70.8	13.5	−8.7	−6.4	12.2
Rochester, N.Y	205	296,233	NEQ	79.5	12.0	−7.0	−6.5	19.2
Chicago, Ill	201	3,369,357	NEQ	66.5	14.3	−5.1	−5.2	41.5
Detroit, Mich	201	1,513,601	NEQ	61.8	14.7	−9.4	−8.0	46.2
Berkeley, Calif	197	116,716	W	57.1	18.1	4.9	−3.4	37.0
Louisville, Ky	195	361,958	S	53.2	17.0	−7.4	−7.1	24.4
San Francisco, Calif	188	715,674	W	66.9	13.6	−3.3	−4.0	42.6

TABLE 5.—CHARACTERISTICS OF 44 CITIES WITH POPULATIONS ABOVE 100,000 FOUND MORE THAN 50 PERCENT ABOVE THE MEAN OF THE COMPOSITE URBAN CONDITIONS INDEX—Continued

	"Urban conditions index"	Population 1970	Region	Percent pre-1939 housing 1970	Percent poverty 1970	Percent population change— 1960–70	Percent population change— 1970–73	Percent nonwhite and Spanish 1970
New York City	180	7,895,563	NEQ	62.1	14.7	1.5	−2.9	33.3
Duluth, Minn	176	100,578	NEQ	72.6	11.4	−5.9	−2.9	1.5
Oakland, Calif	176	361,561	W	53.3	16.2	−1.6	−3.4	50.6
Minneapolis, Minn	174	434,400	NEQ	68.1	11.5	−10.0	−12.2	7.2
Springfield, Mass	170	163,905	NEQ	64.4	12.4	−6.1	+3.2	16.1
Canton, Ohio	167	110,053	NEQ	66.2	12.2	−3.1	−3.2	14.2
Erie, Pa	158	129,231	NEQ	66.8	11.0	−6.7	+.3	6.8
Worcester, Mass	156	176,572	NEQ	74.4	9.9	−5.4	−1.3	3.3
Washington, D.C	155	756,510	S	47.0	16.3	−1.0	−3.0	74.3
Salt Lake City, Utah	155	175,885	W	52.1	13.8	−7.2	−1.1	9.6
Spokane, Wash	154	170,516	W	53.6	13.5	−6.1	+1.6	3.8
Dayton, Ohio	154	243,601	NEQ	52.1	13.7	−7.4	−12.3	31.9

Sources: Calculated from: 1960 and 1979 population data from U.S. Bureau of the Census, County and City Data Book 1972, table 6, (Washington, D.C., 1972) and County and City Data Book 1962, table 6 (Washington, D.C., 1962), 1973 population data from U.S. Department of the Treasury, Office of Revenue Sharing, General Revenue Sharing Fund Data, Elements, Entitlement Period 6 (Washington, D.C., 1976).

To summarize, this composite "urban conditions index" shows that urban problems cut across regions, although the concentration of distressed cities is in the Northeast and Mid-West. Central cities are in greater distress than suburban cities, but some suburbs also face difficult problems, e.g. Camden, New Jersey (index rating 333). Finally, a high proportion of the very large cities are found at the upper end of the index but there are also a number of large Sunbelt cities that are relatively well off, as shown in Table 6.

TABLE 6.—SELECTED SUNBELT CITIES WITH POPULATIONS ABOVE 100,000 FOUND BELOW THE MEAN OF THE COMPOSITE URBAN CONDITIONS INDEX [1]

	Urban Conditions Index	Population 1970	Region
El Paso, Tex	79	322,261	S
Memphis, Tenn	75	623,530	S
Los Angeles, Calif	74	2,809,596	W
Fort Worth, Tex	64	393,476	S
Jacksonville, Fla	60	528,865	S
Sacramento, Calif	58	257,105	W
Tulsa, Okla	49	330,350	S
Raleigh, N.C	48	123,793	S
Greensboro, N.C	40	144,076	S
San Diego, Calif	39	697,027	W
Dallas, Tex	39	844,401	S
Houston, Tex	37	1,232,802	S
Phoenix, Ariz	20	581,562	W
San Jose, Calif	10	445,779	W
Anaheim, Calif	4	166,408	W

[1] The 15 cities listed represent only a portion of cities over 100,000 population whose index fall below the mean. There are a total of 78 such cities.

Source: Calculated from: 1960 and 1970 population data from U.S. Bureau of the Census, County and City Data Book 1972, table 6 (Washington, D.C., 1972) and County and City Data Book 1962, table 6 (Washington, D.C., 1962).

Other Characteristics of Hardship Cities

As stated earlier, the characteristics used to classify cities on this index are poverty, age of housing, and population change. There are also important related characteristics. For both income and housing values, the cities higher on the index tend to have a lower per-unit resource base, and the gap between those higher and lower on the scale is growing, particularly in housing values upon which the local property tax is based.

Per Capita Income

In 1970, the 123 cities 50 percent or more above the index mean had a per capita income level $529 below the rest of the cities and a 3.7 percentage point slower rate of income growth between 1960 and 1970 as shown in Table 7.

TABLE 7.—PER CAPITA INCOME AND MEDIAN HOUSING VALUES FOR 123 CITIES 50 PERCENT OR MORE ABOVE THE HARDSHIP INDEX AND FOR 366 CITIES BELOW THAT LEVEL

City category	Median house value (thousands) 1960	Median house value (thousands) 1970	Percent increase 1960–70	Per capita income 1960	Per capita income 1970	Percent increase, 1960–70
Index ranking above 150 (n=123)	11.2	14.7	31.2	$1,825	$2,869	57.2
Index ranking below 150 (n=366)	13.7	19.5	42.3	2,112	3,398	60.9

Source: Calculated from 1960 and 1970 data from U.S. Bureau of the Census, County and City Data Book 1972, table 6 (Washington, D.C., 1972) and County and City Data Book 1962, table 6 (Washington, D.C., 1962).

Housing Value

The differential for housing values in Table 7 is even greater. The absolute difference in the median housing value for 1970 was $4,800; between 1960 and 1970 housing values in the top 123 cities grew at a rate 11 percentage points slower than the values in the other 366 cities studied. Thus, in terms of two important resource bases—income and housing values—the cities with the higher index rankings (i.e. most adverse) tend also to have a lower per-unit tax base, and furthermore that base is growing at a much slower rate than that of the better off cities.

Local Spending

When one applies these two resource base indicators against expenditure patterns, the situation is much the same. Table 8 compares spending on common municipal functions between the two groups, using Census of Governments data for 1962 and 1972.

TABLE 8.—COMPARISON OF PER CAPITA SPENDING ON COMMON MUNICIPAL FUNCTIONS, 1962–72

City	1962	1972	Percent Increase
Index ranking above 150 (n=123)	$67.16	$141.27	103
Index ranking below 150 (n=366)	68.18	133.63	96

Source: Calculated from U.S. Bureau of the Census, 1972 Census of Governments, "Finances of Municipalities and Township Governments," vol. 4, No. 4, table 22 (Washington, D.C., 1972); 1962 Census of Governments, vol. 4, table 22 (Washington, D.C., 1962).

As shown in Table 8, the cities at the upper part of the hardship scale, in the aggregate, had slightly lower per capita expenditures in 1962, but the situation was signficantly reversed in 1972. The per capita expenditures of the less well off cities went up at a rate 7 percentage points faster than the spending of the other cities. In part, these greater per capita expenditures are a reflection of decreasing population. Thus, while the declining cities at the upper end of the hardship scale tend to have a lower per unit resource base, they tend to have greater per capita common function expenditures and they have collectively experienced a faster per capita rate of growth of spending.

City-Suburb Disparities

We have also done a second and related index based on socio-economic indicators that measures *disparities* between central central cities and their surrounding suburbs.[4] Using this central city-suburb disparities index, cities rating

[4] "Understanding Central City Hardship", *Political Science Quarterly*, Vol. 21, no. 1, Spring 1976, pp. 47–62. The six factors used in this analysis were unemployment, dependency, education, income, crowded housing and poverty. Dependency is persons less than eighteen or over sixty-four years of age as a percentage of total population; education is the percentage of persons twenty-five years of gae or more with less than twelfth-grade education; crowded housing is the perentage of occupied housing with more than one person per room; poverty is the percentage of families below 125 percent of the low-income level. The ratios for each indicator were mathematically standardized to avoid giving undue weight to any of the six factors. The mathematical equations used for the analysis and standardizing the data are presented on pp. 61–62 of the article cited.

100 in the terms shown in Table 9 have essentially the same socioeconomic conditions as their suburbs. *Cities over 100 are worse off than their suburbs.* Of the fifty-five large central cities with significant suburban populations examined forty-three had index rankings greater than 100, two were at 100, ten were below 100, meaning that in these latter cases the central city was *better off* than its suburbs. There were fourteen cities over 200, representing what can be considered significant socio-economic disparites between the central city and its suburbs. Of these fourteen "worst off" cities, eleven are in the Northeast quadrant with only Baltimore, Atlanta and Richmond outside this region. Conversely, of the ten central cities found to be better off than their suburbs (index under 100), all were in the Sunbelt — South and West — except Omaha.

Putting together both the composite "urban conditions index" and this socioeconomic disparities index, we find *a striking convergence.* Of the fourteen "worst off" cities on the socioeconomic disparities index, nine also have a composite urban conditions rating above 200 (100 percent above the mean). See Table 9. On the other hand, of the ten "best" cities on the disparities index, seven have an urban conditions rating of less than 100. Only one of the ten is significantly above the mean. In sum, there is substantial overlap of both inner-city hardship, as measured by the composite urban conditions index, and central-urban disparity.

TABLE 9.—INDEX OF CENTRAL CITY HARDSHIP RELATIVE TO BALANCE OF SMSA FOR CITIES WITH A DISPARITY RATING OVER 200 AND UNDER 100

Central city	City-suburban disparity index	Urban Conditions Index	Population 1970	Region
Over 200:				
Newark	422	321	381,930	NEQ
Cleveland	331	291	750,879	NEQ
Hartford	317	223	158,017	NEQ
Baltimore	256	224	905,787	S
Chicago	245	201	3,369,357	NEQ
St. Louis	231	351	622,236	NEQ
Atlanta	226	118	497,421	S
Rochester	215	205	296,233	NEQ
Gary	213	132	175,415	NEQ
Dayton	211	154	243,601	NEQ
New York	211	180	7,895,563	NEQ
Detroit	210	201	1,513,601	NEQ
Richmond	209	137	249,431	S
Philadelphia	205	216	1,950,098	NEQ
Under 100:				
Omaha	98	83	346,929	NEQ
Dallas	97	38	844,401	S
Houston	93	36	1,232,802	S
Phoenix	85	19	581,562	W
Norfolk	82	104	307,951	S
Salt Lake City	80	155	175,885	W
San Diego	77	39	697,027	W
Seattle	67	100	530,831	W
Ft. Lauderdale	64	10	139,590	S
Greensboro, N.C.	43	40	144,076	S

Sources: Disparity index calculated from data in U.S. Bureau of the Census, County and City Data Book, 1972 (Washington, D.C., 1972), tables 2, 3, and 6.

III

The material presented in Parts I and II of this testimony lead us to make a number of suggestions about the design of a National Development Bank. Most such proposals involve sets of functions grouped together, and frequently described in terms of the "windows" that would be established as part of this new financing mechanism.[5] While we do not intend this list to be exhaustive, there are a number of possible windows which we think could be established as part of a new Domestic Development Bank:

(1) A Major Projects Window which would particularly deal with the long-term development needs of large urban areas with hardship conditions as identified in the analysis above.

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[5] A recent Round Table discussion on the subject of "Urban Development Bank" held at Brookings on March 21, 1977 revealed both a high level of uncertainty and difference of opinion as to the role such a new financing institution should play. "Round Table Discussion on Urban Development Banking," Transcript (Brookings, March 1977 ; processed).

(2) A General Support Window which would make loans to State and local governments on a broader basis than the current market for municipal bonds. The Bank (through the Treasury) would sell taxable bonds and then re-lend to States and localities at an interest rate equal to or somewhat below the tax-exempt rate. This would not eliminate the right of State and local governments to sell tax-exempt bonds.

(3) A Housing Support Window to make loans to State and local housing authorities.

(4) A Rural Financing Window which would assist State and regional institutions that would, in turn, provide financial assistance for rural development projects.

(5) A Small Projects Financing Window which, also working through the States, would assist local communities and private developers in small communities and for small projects than would be eligible for assistance at the Major Projects Window.

A Multi-faceted Approach

This kind of a multi-faceted approach would in our view involve various kinds of assistance—direct subsidies in some cases, but not in others—and would operate on a basis that would assist both local governments (for infrastructure and related purposes) and private developers, especially private developers involved in hybrid public-private development undertakings.

At the recent Brookings Round Table conference on urban development banking, developer James Rouse stressed the need for assistance for large projects.

"It is much more in the national interest to plan on a community scale rather than a subdivision scale.

"This is not possible with the mechanisms available in the United States today, either private or public. The quantity of money required and the length of time over with it must remain invested, and the return and the risk, which is a hangover from the recession and the failure of Title VII, is such that the big financial institutions, big insurance companies and funds, are not going to put $150 million into a single project. The quantity of money is greater than that community, however good the prospect, is going to be able to find."

Rouse said this was particularly needed in large, older cities.

"In general we have not been able to do what the older city requires, which is also to develop on a community scale rather than on an urban renewal project scale. Thus, we have not been able to deal with the essential problems of the inner city, with the systems by which people live. This calls for the integration of the things that people do in such a way that a real community emerges."

Another participant, Patrick Henry of the Cleveland Foundation, provided a useful illustration. Explaining the overall Cleveland situation, he said, "Cleveland is now demolishing more than 2,000 dwelling units a year. In 1974, 1975 and 1976 there were less than 100 new building-permit applications for one and two-family houses. The housing stock is almost entirely frame.

"There are 150,000 or more jobs downtown. With such an economic base, it is not a city that is about to shut down. However, the housing opportunities are getting farther and farther away and becoming more and more expensive."

Henry also described the large University Circle area (near Case-Western Reserve) where a major project is being planned.

"The area just off the University Circle area is bottoming out. Real estate is 'coming on line,' as everyone says in this business. However, we do not have a land acquisition mechanism for intervening at this time to create what the developers keep telling me they want, i.e. a friendly development climate . . . This must include a will to control property and property uses before you ask the developer to come in."

Another participant, Warren Lindquist, stressed packaging and banking functions.

"The Bank could act as a packager to see to it that other existing programs are included in the overall financing package that would ultimately be developed.

I would also like to make it clear that we are talking about a development bank, and not a bail-out bank. This is a Bank to encourage and accomplish development. In this connection, development can mean rebuilding within the city to the extent that we have obsolete areas in the city and obsolete structures that would not support the kind of activities that will have to be established to regenerate the cities.

Principles

The principles that we see as involved in the design suggestions here for a Domestic Development Bank are:

(1) Targeting assistance (i.e. the largest direct subsidies) on the most needy areas.

(2) Stressing large projects, which presently cannot be undertaken and which have two main facets;

(a) they create jobs

(b) they improve the local tax base.

(3) Promoting public-private cooperation.

(4) Relying on State governments (and regional combinations of governments) for smaller projects.

(5) Setting up a new institution which would bring fresh energy to the solution of development problems.

The Major Projects Window

The Major Projects Window is most related to the research we have been doing on urban problems and programs. We have several suggestions as to how this section of a National Development Bank could operate.

In order to have and follow clear Congressional intent, we believe there should be specific tests of admission for the areas and projects that can be assisted at the Major Projects Window. Three tests we suggest relate to: (1) type of jurisdiction, (2) size of project and (3) the needs of the community. In regard to type of jurisdiction, a jurisdiction to be eligible might, for example, have to be classified as a central city of a Standard Metropolitan Statistical Area (SMA), or, if it is not a central city, have a population of 50,000 or more.

We also think it would be possible to devise a relative-size test. This could be along the lines of saying that the projected full cost of a Major Project (or small group of projects) would have to have a total cost greater than 2 percent of the annual spending (both operating and capital) of the jurisdiction in which it is located.

The third test suggested relates to economic and social conditions. We believe it is possible now to use available indices of the social and economic conditions of large local governments to identify communities which have a high level of socio-economic need. Table 5 uses such an index to classify urban conditions. We do not suggest that this is the specific index that should be used, rather that a satisfactory measure along these lines could be developed.

In every case we envision that there would have to be carefully defined discretion to the Directors of the Bank. However, we do not think it would be wise to give the Bank full discretion on Major Projects lending. These policy questions—namely who should benefit, how much, and why?—are policy issues that ought to be determined in the legislative process.

Once a jurisdiction and/or project passes the tests of admission, we envision that the Bank would scrutinize these projects and determine their "bankability". They would not necessarily be funded once admitted, but they could not be funded unless admitted.

We also see considerable merit in the proposition embodied in the Humphrey proposal for a Domestic Development Bank—namely the idea that it should be a new and independent entity rather than being assigned as a function to an existing institution, such as the Federal Financing Bank or one of the affected Cabinet departments. It is our opinion that having a new institution would give prominence to this function and bring new energy to bear in government for its successful implementation.

Senator HUMPHREY. Mr. Peterson, thank you very much for your willingness to join us today. Please proceed.

STATEMENT OF GEORGE E. PETERSON, DIRECTOR, PUBLIC FINANCE PROGRAMS, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. PETERSON. Thank you, Mr. Chairman.

I want to thank you for the opportunity to present my statement on the capital needs of the cities. I will focus my remarks on public sector capital investment, the investment that local governments carry out in basic public facilities.

Let me first try to place recent State and local investment trends in perspective.

Over the last decade and more, State and local capital formation has fallen steadily in relation to other types of State and local spending.

During the years 1960 to 1965, capital expenditures by State and local governments averaged about 29 percent of their budgets. That proportion fell to 15 percent, approximately half, in 1976, and was even lower in the first quarter and first half of 1977.

Although the recent decline was greatly exacerbated by cyclical factors, the overall direction since 1965 has been steadily downward.

In constant dollars, State and local governments spent approximately 13 percent less on capital items in 1976 than they did in 1965. There are several reasons for this decline in investment activity, but the shift in the structure of Federal aid programs has contributed greatly to the relative decline in State and local capital investment.

Until the last 2 years, growth in Federal assistance for current operating programs far outpaced the growth in Federal aid for local capital development. Again, some reference figures may be illustrative. Ten years ago, 45 percent of Federal grants were being used for capital development, and were tied specifically to capital investment by the recipients.

By 1973, the proportion of Federal aid tied to capital spending had fallen to less than one-fifth of Federal grants.

The second major trend I wanted to call your attention to is the extreme cyclical fluctuation in capital spending. Since World War II, capital spending has been by far the most cyclical element in State and local budget patterns.

During a budget squeeze, the most easily postponable expenditure item is capital outlays. Spending on new projects or on the repair and upgrading of older facilities can be cut back without discernable consequences in the short run.

Administratively and politically it may be far easier to cancel a construction project than to lay off permanent public sector employees.

In table 2 in my prepared statement, I have figures showing that between 1974 and the first quarter of 1977, the value of construction put in place by State and local governments declined by almost one-fourth in current dollars and by more than one-third in real terms.

And one lesson to be learned from the repeated cycles since World War II is the great lag with which State and local capital investment follows the cycle. It requires several months for deteriorating economic conditions to be reflected in the loss of surplus reserves by State and local governments, and several months after that to affect future construction plans, and several months more to actually change spending patterns. So it is only with a lag of 1½ years or more that capital spending declines. Capital outlays similarly lag on the upturn.

One practical consequence is that Federal emergency public works programs, even if put into operation on a timely basis, tend to stimulate State and local capital spending during the recovery stage of the cycle. When the programs themselves are not put into operation until the bottom of the cycle, their impact on capital spending may come too late.

The third general pattern is that there has been a very uneven distribution of the consequences of the cutback in capital budget resources. The cutback has hit hardest in the older urban areas, and it has hit hardest in areas presently suffering from high unemployment rates. Running parallel to that has been a disproportionate impact against the preservation and maintenance of capital.

The studies we are conducting at the Urban Institute show that repair and maintenance are the first items to be cut back and the ones that are cut back the most. Especially in older cities, repair and maintenance spending has been reduced more than total budget expenditures and more than total capital outlays.

We have found city after city where repaving cycles for streets have been stretched out from 5 to 7 years, and from 7 to 9 years. EPA did a study of water treatment plants and found they're operating at only slightly more than 50 percent of their rated efficiency often because of maintenance failures.

In New York City the old West Side Highway is now inoperative due to the fact that bridges weren't maintained for decades. A major highway system is now totally inoperative and will have to be replaced by a new one.

The pattern of deferred maintenance and replacement can be detected elsewhere in less dramatic fashion.

So in my opinion, one of the most hidden and serious consequences of the current fiscal crunch that cities are experiencing has been the deferred maintenance, the failure to undertake repairs and replacement investment on a timely schedule.

It is a liability we're building up for the future and will be most evident a decade from now, rather than currently when we're making the decisions that affect it.

In considering whether a development bank is the best vehicle for assisting local governments in their investment needs, we have, however, to ask the question, is access to capital markets a significant impediment to local public investment at present? And is such a bank desirable?

My own view is that access to the market is a relatively unimportant factor in depressing investment currently. The primary casual factor working on governments is a perhaps prudent reluctance on their part to go deeper into debt.

The fiscal difficulties of recent years have brought home to governments the risks of maintaining high debt levels.

In many cases, their unfunded pension liabilities are several times larger than the indebtedness they have in the form of bonds outstanding.

Many States have reacted to the fiscal crisis by imposing new laws that would limit local ability to issue debt.

Not only do these high debt levels expose the governments to greater financial risk, but they impose on future generations of taxpayers the burden of redeeming part of the cost of providing public services to today's citizens.

This leads me to a series of conclusions:

First, that public investment in the capital structure of the older cities should be a No. 1 priority, both of State and local governments and the Federal Government in providing external support.

Second, within the capital formation needs, I would place at the top of the list the maintenance and repair of existing structures.

The one significant advantage that older cities have in competing with newer and more rapidly growing regions of the country is their inherited stock of public capital. We must keep it in good working order.

Thirdly, in any Federal program, the emphasis must be on a revised structure of Federal grants and aid. We need to give more attention to subsidizing the cost of basic capital infrastructure and investment by local governments, rather than simply making it cheaper or easier for governments to borrow.

In my judgment, the fundamental need is not to make borrowing easier, but to reduce the cost local governments face by introducing an explicit Federal subsidy for several of these programs.

The role of expanded borrowing authority of a bank should be a supplementary one: to make certain that there is the borrowing capacity to take advantage of the local matching requirements of Federal grant programs.

Let me call your attention to two or three mechanisms I find encouraging in that regard that have emerged in the last year or two. One is the revised program currently in the Conference Committee as far as the operation of the community development block grants is concerned.

The revised provisions make it much easier for local governments to use their block grant funds to finance longer term capital investment projects.

For the first time, it would be explicitly authorized for local governments to issue as much as $3½ billion of long-term debt to complement the use of Federal grants and aid in stimulating local development projects. That kind of linkage between grants programs on the one hand and expanded borrowing capacity on the other, with a Federal guarantee, is a very promising mechanism for assisting cities.

Secondly, at the State and local government level, we have a number of vehicles that are currently operating in quasi-banking fashion. State housing finance agencies have sprung up from nothing in the early 1970's to the point where they're issuing $3 to $4 billion of bonds annually.

Running comparable to that is the use by many individual cities of grant moneys and tax moneys to form revolving loan funds for rehabilitation of private housing and the upgrading of their older facilities.

We have similar programs in the hospital area where hospital agencies are borrowing $2 to $3 billion a year to finance hospital construction.

I think that we do have models we can look to, models that are working successfully at the local and State level. Perhaps the first priority we should think about is expanding on them, tying their operation more to Federal grants so as to get the double clout of aid assistance and in expanding borrowing potential.

My final observation is that, as has been pointed out by others, what is needed overall from the Federal Government is an indication of a long-term commitment to the investment needs of the cities. Whichever vehicle seems to be most successful in expressing that commitment, I would support.

It may very well be that creation of a development bank communicates that commitment for longer term support of capital needs more successfully than other instruments.

I would emphasize, however, that the magnitude of the investment problems in the city, the magnitude of the needs for repair maintenance, and upgrading of structures will require an expanded subsidy program, and that any financial vehicle that relies primarily on borrowing, on loans, should not be viewed as a substitute either for existing grant programs or for expanded Federal capital assistance.

Senator HUMPHREY. Thank you, Mr. Peterson.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF GEORGE L. PETERSON

Mr. Chairman, I want to thank you and the other members of the Joint Economic Committee for the opportunity to present my views on the need for Federal policy to encourage capital investment in older urban areas.

I intend to focus my remarks on the capital needs of municipal governments themselves, although this question is closely linked to the testimony you have heard on the need to stimulate private investment.

I. TRENDS IN PUBLIC SECTOR INVESTMENT

1. Over the last decade, capital investment by state and local governments has declined steadily in relation to other types of spending, and has even declined in constant dollars, after correction for inflation.

The declining share of capital formation in State and local budgets has been perhaps the most pronounced trend in State and local financing over the last decade. During the years 1960–65, gross capital formation by State and local governments—spending on construction, repairs, and acquisition of equipment—averaged about 29 percent of their total spending. That proportion fell to 15 percent by 1976, and was even lower in the first half of 1977. Although the recent decline was greatly exacerbated by cyclical factors, the overall direction since 1965 has been steadily downward.

In constant dollars, State and local governments spent approximately 13 percent less for capital items in 1976 than they did in 1965.

There are several causes for this decline in investment, not all of which should be signals for alarm. National population growth has slowed, and national enrollment in public schools is on the decline. These trends are most sharply delineated in the nation's older cities. Investment in streets and highways, traditionally the sector's biggest user of capital, has stabilized as the interstate highway system nears completion.

The line between "public" and "private" investment in national accounts is also an unstable one. In recent years some investment that previously would have been classified as "public" has shifted into the private category. For example, the construction of internal streets and water and sewer networks in new subdivisions is now generally the responsibility of private developers. In several of the country's most rapidly growing areas, it is customary to require private developers to build schools, install public parks and playgrounds, and even equip fire stations, as part of the condition of subdivision approval. Although these facilities typically are turned over to public authorities upon completion, and thus belong to the public sector, the capital costs are identified as private capital investment. In case studies we have conducted at The Urban Institute we have found that in rapidly growing communities in the South and Southwest 40 to 50 percent of all public use investment is carried out by private developers.

A more recently emergent trend is the use of state financing authorities to borrow on the tax exempt market to finance the construction of subsidized housing or hospitals, or to finance private firms' pollution control investment. These activities have been judged to have a public purpose, but the assets that are formed typically are owned by the private sector. Borrowing for these uses totaled approximately $4½ billion in the first half of 1977.

Despite these qualifying elements, the fact remains that over the last decade capital investment by State and local governments has fallen steadily and sharply relative to the rest of their spending. One of the primary reasons for this trend has been the shift in emphasis of Federal aid programs. Until the last 2 years, growth in Federal assistance for welfare-related current services had far outpaced growth in assistance for local capital development. In 1965, 45 percent of Federal grants to the State and local sector were specifically tied to capital development; by 1973, this proportion had fallen to 20 percent.

Table 1 illustrates some of these trends. Besides the steady decline in capital investment totals, one can see the sharply rising ratio of tax exempt borrowing to total sectoral capital investment. Historically, between one-third and one-half of State and local government capital investment was financed by long term bond issues, and the aggregate ratio of debt issues to capital expenditures reflected this fact. As the next to last line of the table shows, this historical relation has fragmented in the past 3 or 4 years, as tax exempt debt issuance has climbed to new highs, despite stagnant levels of capital formation. The explanation for this trend lies primarily in the use of public borrowing authority to finance private investment. (During the first half of 1977 the volume of long term tax exempt debt issued actually exceeded State and local capital formation—though debt issues were distorted by a considerable degree of refunding of existing debt.)

In the aggregate, the crowding of the tax exempt market by borrowing for private and quasi-private purposes stands to drive up the interest rates paid for traditional municipal borrowing and to jeopardize municipal access to the bond market during periods of severe credit crunches.

TABLE 1.—STATE AND LOCAL CAPITAL EXPENDITURE AND FINANCING TRENDS

[Dollars in billions]

	1960	1965	1970	1973	1976 [1]
Gross capital formation (current dollars)	$14.3	$21.4	$29.8	$34.7	$37.9
Gross capital formation (1973 dollars)	$22.7	$32.5	$36.4	$34.7	$28.2
Gross capital formation as percent of State-local spending	28.9	28.7	22.4	20.8	14.9
Long-term bond issues (current dollars)	$7.2	$11.1	$17.8	$23.0	$33.7
Tax-exempt bond issues as percent of State-local capital formation	50.2	51.8	59.5	66.3	88.9
Percent of State-local capital formation financed by long-term debt	37.1	35.0	51.0	45.0	NA

[1] Author's estimates of gross capital formation.

2. Since World War II, capital spending has been by far the most cyclical element in State and local budgets

During a budget squeeze, the most easily postponable expenditure item is capital outlays. Capital spending on new projects or on the repair and upgrading of older facilities can often be cut back without discernible consequences in the short run. Administratively and politically, it may be far easier to cancel a construction project than to lay off permanent public sector employees.

These facts have made public capital spending especially vulnerable to fluctuations in the economic cycle and to pressure on state-local budgets. The collapse in capital expenditures has been particularly dramatic during the most recent economic downturn—but this merely continues a cyclical pattern that has persisted over the last quarter century.

Table 2 illustrates the sharp reduction in State-local capital expenditures since 1974. Between 1974 and the first quarter of 1977, the annual value of construction put in place declined by almost 24 percent in current dollars, and by almost 36 percent in real terms.

TABLE 2.—VALUE OF STATE AND LOCAL CONSTRUCTION PUT IN PLACE

[Dollars in millions]

Year	Current dollars	1974 dollars
1974	$33,045	$33,045
1976	$29,941	$26,052
Percent change from 1974	−9.4	−21.2
Annual rate, 1st quarter 1977	$25,151	$21,220
Percent change from 1974	−23.9	−35.8

Note.—"Construction put in place" excludes acquisition of machinery and equipment, included in table 1 under "Gross capital formation."

Source: Bureau of the Census, Value of New Construction Put in Place, April 1977; 1976 and 1977 spending deflated by Department of Commerce Composite Construction Price Index.

One characteristic of the cyclical behavior of public capital spending is that it lags the principal turning points in the national economy. A deterioration in private sector economic activity is reflected with several months' delay in the surplus position of state and local governments. Only after their surpluses have eroded and current budget imbalances have emerged do local governments begin to make significant reductions in capital spending plans, which take several more months to be implemented. In the most recent cycle, state and local capital outlays begin to turn downward in the second half of 1975, after the bottom of the recessionary cycle was reached. The bottom of the State-local investment cycle probably was touched in the first quarter of 1977. Recovering local revenues, reinforced by emergency injections of capital funds from the Federal Public Works Employment Act, appear to have turned around the investment curve. We can anticipate steadily accelerating capital investment over coming quarters.

At this point, then, design of a Domestic Development Bank should be concerned with longer term financing and capital needs, rather than anti-cyclical ones.

3. *The steepest cutbacks in capital spending have been experienced by older cities suffering from both secular decline in private sector economic activity and from special cyclical vulnerability*

The study prepared by the Joint Economic Committee staff and released in conjunction with this hearing demonstrates clearly the unequal impact of capital expenditure reductions. These have been stiffest in cities suffering from long term population losses and high unemployment rates. Such cities have received the most severe jolts to their overall financial position, and this is reflected with special clarity in their capital-spending patterns. Some recovery is inevitable with the revival of economic activity, but the longer term prospects for these cities' fiscal position is not encouraging.

4. *The long term decline in public capital investment in older cities, compounded by the cyclical decline of the last two years, has accelerated the deterioration of the cities' basic capital infrastructure*

Perhaps the most precious inheritance that the cities possess, at least economically, is their network of functioning road and sewer systems, their schools and public buildings, and their vast investments in water distribution and water treatment facilities, hospitals and publicly-owned or subsidized housing.

This capital stock is old. Sometimes the sewer and water distribution systems in the larger cities of the Northeast are a century old, or even older. Most of the mass transit systems in the country were installed before or near the turn of the century. As a result, a great deal of spending is needed to keep the inherited capital stock in good working order. Repair, maintenance, rehabilitation, and upgrading of older facilities are a much more important part of the total investment picture in the older cities than elsewhere in the country.

Repair and maintenance investment also appears to be the first capital item to be reduced in periods of budgetary pressure. Unfortunately, few cities in the country keep adequate records either of the condition of their capital stock or of of the frequency of their repair and maintenance cycles. Interviews with local road and engineering departments, however, reveal that it has become common for cities to stretch out their road repaving cycles from five to seven and seven to nine years, or even longer. Painting and upkeep of schools have been postponed. Surveys by the Environmental Protection Agency indicate that municipal water treatment plants, on average, are operating at only slightly more than 50 percent of their rated efficiency, often because of maintenance failures.

Although the failure to repaint bridges on a regular schedule or the failure to prevent rusting of the tidal gates of a sewer discharge system may seem inconsequential repairs, which can be omitted without serious consequences, the cumulative effect of deferred repair and maintenance can be of great importance to a city's functioning. Perhaps the most spectacular example in recent years of infrastructure decay was the structural collapse of the elevated West Side Highway in New York City, largely attributable to the lack of painting and preventive maintenance. The old West Side Highway, now inoperative, is to be replaced by a new route costing in the neighborhood of $2.5 billion to construct. The pattern of deferred maintenance and replacement can be detected elsewhere in less dramatic fashion. A detailed look at New York City's budget shows that repair and maintenance staffs, for example in the Department of Water Resources, have borne a steeply disproportionate share of the city's total budget reduction.

Continued deferral of maintenance, repairs and ordinary replacement investment threatens to eliminate the one significant economic advantage that older cities possess in their competition with newer regions of the country—a complete, functioning system of capital infrastructure. Although the cities' capital assets, valued on an original cost basis, will continue to represent a large repository of social wealth, and although the physical extent of the capital network will continue to be impressive, unless the capital facilities are maintained in good working order, the cities will lose the economic advantages they should confer. As we have had occasion to observe once more from the difficulties of Consolidated Edison in New York, it is inherently more costly to carry out major repairs on capital networks that are buried underground in high density neighborhoods in constant use. If the capital infrastructure of the cities is allowed to deteriorate to the point where major system-wide repairs are needed on all networks, it will simply become cheaper to build new replacement capital at other locations than to repair the capital network where it now is located.

A national strategy to preserve and strengthen the economic position of the cities therefore should give priority to maintenance of the inherited capital stock.

II. OVERCOMING OBSTACLES TO FURTHER CAPITAL INVESTMENT

Is Access to Capital Markets a Significant Impediment to Local Public Investment?—Most proposals to establish a domestic development bank assume, implicitly or explicitly, that traditional lending markets are unable (or the lenders unwilling) to meet the financing needs of the targeted investors at reasonable interest rates. The impression is created that imperfections on the supply side of financial markets prevent investment from taking place.

I believe this is an erroneous view of the effective constraints, certainly for state and local governments. It is true that during the second half of 1975 and the first half of 1976, when the tax exempt market was in substantial disarray, many communities were shut out of the market or forced to pay exceedingly high interest rates.

The traditional tax exempt market has now recovered its equilibrium. Borrowing during the first half of 1977 was at an all-time high—up more than 40 percent from the preceding year. Tax exempt interest rates have hovered between 5.6 and 5.7 percent on the Bond Buyer index, and their relation to taxable interest rates compares very favorably with the past.

The years 1975–76 were exceptional ones for almost all areas of State and local finance. Largely as a result of the municipal bond market's difficulties, disclosure about State and local finances to potential buyers of debt has improved immeasurably, promising to stabilize the market's operation. It would be unfair in the extreme to extrapolate from the experience of 1975, when New York City's apparently imminent bankruptcy paralyzed many Government and financial operations, to a general conclusion about the inability of the tax exempt market to supply state and local governments' capital needs.

The principal obstacle, today, to heavier borrowing is a prudent hesitancy on the part of State and local governments to incur more debt.

The fiscal difficulties of recent years have brought home to government the risks of maintaining high debt levels. Moreover, local governments have begun to discover that, in many cases, their unfunded pension liabilities represent considerably larger amounts of indebtedness than their bonds outstanding. Not only do these high debt levels expose the governments to greater financial risk, but they impose on future generations of taxpayers the burden of redeeming part of the cost of providing public services to today's citizens. When it is known that future taxpayers will be fewer in number and poorer in relative income than current taxpayers, as is true in many of the hardest pressed cities, restraint in shifting debt burdens to the future is to be applauded.

Except for a very few cities, lack of access in capital markets is not presently a binding constraint on local investment behavior.

Linking of Federal Support for Borrowing with Grants-in-Aid for Local Capital Development.—Any significant stimulus to local capital formation should begin with the structuring of federal aid programs to encourage greater capital investment. Federal grant assistance lowers the cost to local governments of carrying out capital projects; it does not merely make it possible for government units to borrow larger sums. If, as I believe, basic capital investment is a priority need for the cities and for other parts of the country, the design of Federal grants-in-aid should reflect this priority, reversing part of the past decade's trend toward Federal support for operating expenditures.

Federal facilitation of local borrowing for development purposes has a role to play in supplementing federal grants-in-aid for capital projects. But the primary institutional requirement is for a more productive linkage of aid and loan assistance. A development bank is one possible vehicle for assuring this linkage, but Congress and the administration have explored other alternatives as well. Let me cite three examples.

1. The new community development block grant provisions, now in conference, would for the first time explicitly permit the use of CDBG monies for citywide development projects, including projects designed to stimulate private sector development. In addition to this expanded authoritization for applying aid entitlements, the legislation would permit local governmental units or their designated public agencies to issue federally guaranteed loans to generate investment in community development. As the legislative wording presently stands, communities would be able to issue guaranteed debt in amounts up to three times their block grant entitlements, or a nationwide total of $3.5 billion.

This legislation, if passed, would insure communities' access to bond markets for development purposes, while at the same time significantly defraying local project costs through the use of block grant monies. Moreover, the program has the very desirable feature of insulating the existing tax exempt market from a new source of competition for loanable funds. It is proposed that the guaranteed loans be fully taxable, with a federal subsidy equal to 30 percent of interest costs to compensate for the loss of tax exemption.

This arrangement incorporates the essentials of a development bank, without the need to establish a new administrative mechanism at the federal level.

2. Under the Water Pollution Control Act, municipalities unable to tap the tax exempt market on their own for the 25 percent local share of water treatment plant and related investment costs may call upon federal guarantees for their borrowing. To date, this provision has served as a standby guarantee, since no local governmental unit has found itself foreclosed from the ordinary tax exempt market. To the extent that concern about credit restrictions clouds the future, however, this Federal guarantee of access removes one of the uncertainties (at least for water pollution control investment) motivating the creation of a domestic development bank.

I might add that the cities have a large stake in the authorized uses of Federal aid under amendments to the Water Pollution Control Act. The Administration has recommended that repair and upgrading of existing sewer systems be excluded as an authorized use—a change that would work precisely contrary to what in my opinion should be the Federal investment priority, namely preservation in good working order of the inherited stock of urban capital.

3. The House Commerce Committee recently has approved Federal aid of $900 million over 3 years to upgrade existing schools and hospitals to energy efficient standards. Parallel subsidies for reducing energy consumption in other public buildings and public operating facilities are certain to be proposed.

This program affords a third opportunity to link Federal grants-in-aid for specific capital investment programs with expanded borrowing guarantees or subsidies. The retro-fitting of the older urban capital stock, private as well as public, to new energy standards will be a massive undertaking, requiring large amounts of capital investment. Federal support for expanded borrowing authority to complement Federal grants-in-aid would bring the investment objectives closer to realization. Again the most important part of the investment stimulus comes from the combined power of Federal regulation regarding energy standards and Federal grants-in-aid to subsidize the capital costs of compliance. Facilitation of local access to borrowed capital would supplement these programs, by insuring that exclusion from traditional debt markets would not become a binding constraint on local investment at some future date.

In summary, it is my belief that we have already begun to adopt the essential content of a domestic development bank. A policy to encourage local capital development would:

Tie expanded borrowing authority to Federal grants-in-aid which lower the cost of development projects, as well as make loans more readily available.

Restrict Federal assistance to designated areas of Federal investment priority.

Preserve as much local initiative as possible in project formulation.

These objectives are best achieved, I believe, by building on the de facto banking arrangements written into Federal aid programs, such as the Community Development Block Grant. There may be a residual need for a new national banking institution, to tie together the currently disparate Federal loan programs, to symbolize the Government's commitment to urban investment, not to serve as the vehicle for upgrading professional standards in appraising urban investment possibilities, but we should ask such an institution to begin by integrating existing Federal efforts, not by launching an entirely new development program.

Senator HUMPHREY. Do I correctly understand that just in your most recent commentary there that whatever we do in terms of a longer term capital structure, such as a development bank that it is supplemental to what we presently have, that it should not be looked upon to supplant the existing structure of grants and aids and technical assistance and so forth that the Federal and State Governments have?

Mr. PETERSON. The answer is yes. Also, in designing our new programs for the next 10 years, I think we can't avoid the need for a stronger Federal hand in subsidizing investment.

Senator HUMPHREY. Your statement clearly points out that capital outlays have been suffering in the cities over a long period of time.

Mr. PETERSON. That is true. At least in the last 12 years, and unfortunately it seems to be accelerating on a long-term basis.

Senator HUMPHREY. In other words, what we're doing is using up our inheritance of the fiscal structure of the city, without adequate amounts for replacement and modernization as the city gets older.

Mr. PETERSON. We're bequeathing a debt to our sons and daughters.

Senator HUMPHREY. We are prone to do that. I serve on the National Committee on Agriculture and Forestry. I told my sons one day that my generation has robbed them of 15 years of forests, because we've been penny-pinching around here thinking it would cost too much to plant trees, and now we are 15 years behind in forestry.

I had a chance to change that last year. I introduced a bill that compels the Government of the United States to have long-term forestry programs and provides the money to back it up. Hopefully, this will insure that in due time we will be able to catch up.

But we're prone to do this on all matters.

Mr. PETERSON. May I make one remark? I think there is a good analogy here. You can only allow inherited capital to deteriorate to a certain extent before it ceases to be an efficiently replaceable resource. The one advantage the cities have, as I tried to point out in my testimony, is that they possess several billion dollars worth of investment in past capital.

That confers a unique advantage on them, if that capital is maintained in working order. But once deterioration sets in, so that your sewer systems, road networks and other facilities are deteriorating, you throw away the advantage the cities have. There may be simply no good economic reason, as opposed to a social reason, for going back and investing in the cities rather than building the same capital new elsewhere.

Senator HUMPHREY. The big problem we face at the municipal level is the tax base, both in terms of its content and its extent. Most of our core cities have tried to live off their tax base and at the same time provide services for anybody that happens to drop in from Mars, the Moon, London, or wherever else it may be.

"Come on over, folks, use our streets, use our parks, and clutter up our streets and fill up the garbage cans, do whatever you wish, boys, and we'll try to pay for it out of this little limited tax base."

There's one of two choices:

They can spread the tax base to include the metropolitan area. The surrounding areas start having convulsions the minute you mention that.

Or we can come up with a program of Federal and State subsidy. Isn't that about right?

Mr. PETERSON. Yes, sir.

Senator HUMPHREY. I tell you, it was bad enough to be the mayor of a city 25 years ago. The person that takes on that job now is either a masochist or some kind of sadist, or is just one of God's good people that wants to give his life for the common cause, the good of the land, because it's nothing but a headache; particularly in the older cities of the Northeast.

I have said to our Minnesota State Legislature in my appearances with them, and I work closely with some of our younger legislators—I said:

> Look, every problem we have in Minneapolis and St. Paul, which is a community of about a million people in the metropolitan area, and 750,000 people in the immediate two cities, every problem we have today is still manageable if you keep at it. You just give it 5 years of neglect, though, and it will be totally unmanageable. You'll be in a position in which you'll never catch up.

And that's when it gets costly. It is just like taking care of your health.

It is very hard to take care of it after you've lost it. What you really need to do is find a friendly mortician, see if you can get a deal. There isn't much else left.

Mr. Haar, you served in our Government here and served well. I'm very happy to see you, sir.

Your testimony supports the concept of some form of a bank for long-term financial requirements of our cities; is that correct?

Mr. HAAR. That is absolutely so, yes.

Senator HUMPHREY. You feel that we've arrived at a point where this is the most responsible and feasible method that we would have of meeting the capital needs?

Mr. HAAR. I think it does. It puts into a setting, into a context, the various answers coming at the problem from different parts of the interest groups. A bank puts together the need of the local governments for access to efficient and economic financing.

I just want to refer briefly to Mr. Peterson's testimony about housing finance agencies. I was recently chairing our commission to look into our State housing finance agency. They've been in terrible difficulty in terms of financing. And the access problem, the domination by a few commercial banks—a whole system, which is a seat-of-the-pants operation by a few private organizations—leads me to conclude there must be some better way. We need to fashion a broader, more effective market for these bonds.

Of course, one of the promising alternatives, is to get away from the tax-exempt field which limits the potential number of purchasers. And the bank thereby does both tax reform and also widens the market, widens the access, widens the supply, and gives you different people other than those who are simply looking for tax advantages. It gives you all the pension funds, for instance, all the known sources of investment and thereby deals with the crucial question of shrinkage in demand.

It seems to me, too, and it is most appropriate you're holding hearings on it today, is that we really don't have professionalism in the field of public finance. You need a critical mass of people who are doing it day-to-day, who learn all the intricacies of finance and budget, experts and professional people. That's an important thing that has to be realized here—an ability to begin to look at priorities, to begin to say, for example, that deferred maintenance is not always a sensible policy.

You need some long-range planning, as you so well summarized at the beginning.

What does a city have? It has its tax base, its borrowing, and the ability to get back some of the tax dollars from the Federal and State governments. Those are its financial sources.

How do you do a budget for local governments the way General Motors does it? Some of our metropolitan areas are larger than General Motors, yet they don't have any financial planning. It is the bank which, hopefully, will develop the technical expertise, the staff, working together with local people, because it is a cooperative bank. It isn't Washington. It isn't HUD saying: "You got to do it this way."

Senator HUMPHREY. That's something that we commented on earlier today with the other witnesses.

Municipal bond rates, Mr. Haar, I gather, have been coming down since the high levels since a few years ago. Can we assume the worst is over in the municipal bond market and that it will be adequate to meet our city needs?

Mr. HAAR. It's safe to assume we're going to have cycles. We can assume, projecting from the past, what the future is. We can assume more droughts. If things get a little hot, the Federal Reserve Board tightens. There will be an increase in rates.

I think we can assume, too, they might go a little lower, too. One thing we cannot assume is that bond rates will be stabilized. What we do know is that when the cycle gets tight, it is the municipals that will be hardest hit. They're the last in line on the credit market and the first to go.

And, therefore, they're the most vulnerable to any increase in rates.

Senator HUMPHREY. And isn't it fair to say even if the market does stabilize and interest rates are down for a considerable period of time, there still is an inadequate amount of money for the kind of capital outlays that are necessary for the modernization, the repair, the rehabilitation, and the development of our cities?

Mr. HAAR. You've made that case very well.

For instance, in Massachusetts, at the crisis of 1974, we went to 9½ percent tax-exempt, and that's a 30-year bond, and can't be refinanced for a long time.

So even though interest on tax exempts has gone down to 5 point something, the taxpayers are paying every year, 9½ percent on that $500 million issue that came out of that crunch.

Senator HUMPHREY. Mr. Haar, I think it was Ms. Gray that suggested that we establish one, could be put in HUD or an Advisory Council on Intergovernmental Relations. What do you think? Should it be independent, out from under the agencies, have a status of its own, or should it be incorporated into the agency?

Mr. HAAR. I would rely on your judgment. As Vice President, you were in charge of many of these coordinations and dealing with many of the interrelated problems, cutting across EPA, Commerce, HUD, Treasure, and so on.

My own sense of it is that it ought to be independent. It ought to be something like the World Bank, and removed from politics, so far as possible. The bank ought to attract people of great stature, like Mr. Black, and start on an independent basis as an independent force. But I would be most interested in your appraisal.

Senator HUMPHREY. That is my judgment. And otherwise I'm afraid it gets tangled up into the existing programs, which in their own right are meritorious. I want to see a bank that develops its own expertise that operates to a large degree on banking principles, that is not a political entity. This bank should be able to look at the needs of the community and assess them individually, because every city and every loan has a character of its own.

You just can't generalize either the loan or the communities. There's no way to generalize. Each one of them has to be looked upon as a separate operation.

Mr. HAAR. You want to get away from a Federal department. You want to make it a cooperative bank of the States and cities—it is not a Federal creature. You may have to do it in terms of the budgetary impact as well.

Senator HUMPHREY. Mr. Nathan, I think you've heard people say that cities are not really in need of long-term capital financing, that if they get specific solutions to some of their immediate problems, like job creation, for example, that sufficient revenue will be generated and all will be well.

Now, there are those that sincerely believe that the present economic recovery and the kind of growth we're having will result in such an influx of revenue that the municipalities will be able to really undertake the long-term projects that they need.

What's your judgment?

Mr. NATHAN. That isn't what we would predict. Just as you've stated in your perceptive questioning on these issues, it is the older cities that are losing population that have the deepest and most serious problems. It is those cities in which deteriorated older capital structures and infrastructure are most in need of both repair and replacement. That is why we particularly stress that there needs to be, in a Domestic National Development Bank, what we've referred to as a major projects window for large development projects, which today can't be undertaken.

We recently had a roundtable discussion on this subject at Brookings and particlarly talked about the university circle project in Cleveland, which is one that holds much promise, but can't now be undertaken.

We think that in a way, to sort of dramatize what your question gets at, and I agree with the views you have expressed, that we've got to reinvent urban renewal on a sufficiently large scale to do the important things that now can't be done in the places with the greatest needs.

Aiding these older and delinquent cities should be one of the most important functions of a bank in a professional and institutionalized way, as has been suggested.

Senator HUMPHREY. I just hope that we'll be very careful that we don't use the words "urban renewal" too often. That has a bad connotation. In many ways the problem there was that it was undercapitalized to really do the job. We got started and had the old buildings torn down, but we didn't have the juice to start up the new, you know.

Mr. NATHAN. I think I wasn't selective enough, No. 1. And, No. 2, it tended to go to the point where you cleared the land and not to the point where you then developed new structures.

Your own city, which I have visited several times this year, still has large tracts of urban renewal land which aren't developed. The bank offers a capability to be more selective and to follow through. While I realize that the past is not something a lot of people want to bring back up in terms of programs that we've discarded, I think it is these bigger projects that can't be done now that demonstrate why the bank is the missing piece for current urban policy.

Senator HUMPHREY. Because of my interest in the Domestic Development Bank, I couldn't help but feel the other day that when our good friend and distinguished American, Vernon Jordan, was speaking as he did, that the problem is not that we haven't done a good deal. I think your testimony shows a tremendous increase in the amount of funds that are available for the cities.

But we haven't really assessed the dimension of the problem as it relates to the degree of the funding that comes to the cities. There's no doubt that much more comes. A good deal of it, however, is for short-term use, to provide for current operating budgets, to deal with the immediate problem of unemployment and the immediate problem of deterioration. Cities just can never get ahead and proceed on a planned basis for rehabilitation, reconstruction, and redesign.

I feel there is a desperate need in this country for the enunciation and the articulation of a national urban policy. Just as we have a national agricultural policy.

We know what that policy is. We know what it is in terms of production, we know what we mean in terms of land ownership. We go a long ways. We have a farm credit system. We have a storage system. We have a price support system. We have an export system. We, in an essentially urban, Congress, believe it or not, have come closer to designing a national rural policy, including the National Rural Development Act, which I sponsored and with Senator Talmadge spent 2 years holding field hearings. The result is that today we have a mechanism for rural America that we can put to work: Farmers Home Administration, Production Credit, Bank for Cooperatives, and the Federal Land Bank.

When it comes to capitalization and financing, disaster loans, crop insurance, farm price supports, storage for means of absorbing surpluses and finding usable means of disposal and proper use, we have a policy.

We've designed one. Even when prices get bad and go down, farmers still know that there are places they can go, that there are responses that are readily available.

For example, right now, under both the House and the Senate farm bills, you can get a $2 crop loan on your corn. The farmers don't have to wonder. They don't have to come knocking at the door to say, "Can you help me? We're in trouble." We have a system. When it comes to the urban areas however, its in pieces. There are the community development block grants, there are HUD programs and there are EDA programs, et cetera. But no one has put it together, so you can see a design. I think that people that live in our urban centers today, particularly mayors, and the councilmen and the city administrators and supervisors, whatever their title may be, they're not quite sure that they've got a mix here, a compound that meets their needs.

There are some needs that are met, some that are not. Essentially what we've got here today is an ad hoc prophylactic treatment of problems that really has almost terminal qualities to them.

We really are just patching over all the time. In some cities, it's different, however.

We really should not generalize. Kansas City is a good example. If I may say so, in my own city of Minneapolis, there's been a tremendous change for the good. But we're not old cities, like some cities are, and we haven't had the ups and downs in the economy like some cities have had. So the revenue base has not been so distorted.

But I happen to believe that the new form of racism in this country is the discrimination against our cities; I mean, the failure to deal with our cities now, on a basis that's more than just palliative.

Our cities have become home to the poor, many of the lower income working class, the minorities, the disabled, and the handicapped. They tend to group there and there are reasons for it.

Why? The hospitals they need are there; the transportation, as inadequate as it is, is there, as is much of the low-cost public housing. So it's been like a magnet to attract that particular group of our citizens. But then the deterioration process sets in, the next thing you know, we're all in trouble.

I want to ask Mr. Peterson if you have any further comment.

Mr. PETERSON. I've had the opportunity to express my views. Thank you.

Senator HUMPHREY. You've been very, very helpful, as usual. In these hearings, we just hit the tip of the iceberg, so to speak. We just touch it. But we're going to hold some more hearings on this topic. This is the beginning of a series of hearings.

Congressman Moorhead, who has been the cutting edge on this, and I are trying to generate some interest in the development of the kind of financial institutions that can give us the base for a national urban development policy. I think that we're going to have to be innovative. I want to say, Mr. Nathan, your analysis in Brookings is exceedingly helpful.

Mr. Haar, and you, Mr. Peterson, you've just added to our knowledge here.

Now, here's what we will do with the information you've given us. We will summarize these hearings. We will pass them around to our constitutents. The Joint Economic Committee has a newsletter that goes to every Member of the Congress, in addition to being broadly circulated throughout the country. We try to develop a public opinion here.

And to get something changed around this place, well, I'll tell you, you have to live as long as Methuselah, you have to have the faith of Moses, and the genius and wisdom of Solomon, and the prophetic vision of Isaiah.

Then you've got to be damned mean besides; otherwise, it won't happen.

Thank you.

[Whereupon, at 1 p.m., the subcommittees adjourned, subject to the call of the chair.]

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