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Summary of Remarks

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The reasons for our study of municipal revenue bonds today are not hard to find. In the first place, it appears that we are now facing a period of marked expansion in this type of financing. Secondly, the absolute dollar amount of revenue bonds presently outstanding is not trifling, even though percentagewise the securities could scarcely be classified as important. Finally, there are a few revenue bond issues which in recent months have been exceedingly troublesome to bank examiners.

Demands for new and vastly improved community facilities are wide-spread. The range of these demands includes such old and established requirements for urban living as police and fire protection, sewer, water systems and other public utilities, schools, highways, and hospitals. Furthermore, demands are voiced for a variety of new projects generally related to transportation, for example, rehabilitation of outmoded street and elevated railways and subway systems, airports, super highways, and auto parking. Finally, an increasing amount of attention is now being devoted to community facilities for recreation, and it is only reasonable to anticipate a wide variety of relatively costly projects in this category. They will probably encompass everything from museums to amusement parks with roller coasters.

Owing to the fact that the minor subdivisions of government are for the most part loaded with debt, the financing of novel and amplified demands will be difficult. It is not surprising, therefore, to discover that municipal officials and the public generally are well disposed toward any financing which promises to avoid the retarding effects of statutory limitations on debt and at the same time to avoid increases in the regular tax bills. Revenue bond financing offers precisely these advantages.

REVIEW OF ESSENTIAL FACTS

A review of the pertinent facts confronting minor political subdivisions of government today may be illuminating. These facts highlight the financial dilemma confronting public authorities.

Deferred Maintenance. All but the most essential building maintenance and repair work was brought to a standstill during the war. The effects are obvious even to the most casual observer. Neglect in the care of public buildings is widespread and roads are in a notorious state of disrepair.

Many communities will be able to finance their rehabilitation programs in part with wartime accumulations of cash, and partly by increasing debts to prewar levels. Cash accounts grew during the war and, as compared with a few years ago, municipalities are now in a relatively strong current position. Furthermore, some of them reduced their debts during the time when the ability to spend money was circumscribed by regulations designed to prevent all expenditures unrelated to the war effort. However, cash balances and debt retirements when combined probably have only accumulated sufficiently to offset the wear and tear on physical properties.

Growth and Changes in Population. The excess of births over deaths which now accounts for an increase of more than one million annually in the population of the U. S. imposes a substantial burden on existing facilities. Changes also are occurring in the age composition of the population with the result that the proportion of old people is increasing. These factors of growth and change underlie the many new demands for facilities in such diverse fields as education, public welfare, and recreation. As a matter of fact, certain sections of the country possessing the advantage of mild winter climate are developing as areas where old people may live in retirement. Public facilities demanded in such areas differ materially from the ones required elsewhere.

Income and Living Standards. The national income practically doubled in the course of the war years and its distribution changed greatly. As a consequence many segments of the population have newly acquired financial resources with which to implement their demands for improvements in educational facilities, housing, transportation, institutional care and recreation. Erstwhile farm laborers in relatively poor agricultural regions, for example, migrated to manufacturing centers where they became semi-skilled industrial workers. Furthermore it is not reasonable to suppose that income will slump permanently to its pre-war levels. Wartime increases in the productivity of the economic system will certainly sustain a national income much larger than the one formerly prevailing in the United States.

FINANCING NEW FACILITIES

The known and anticipated requirements for community facilities obviously cannot be financed out of current income. Some of them call for such large outlays that it would be practically impossible to do so. As to the remainder, it just is not in the American tradition for citizens to tax themselves sufficiently to pay more than a very small part of the cost of improvements which they demand from their local governments, however reasonable such a course may be. Large increases in municipal debt, therefore, appear to be inescapable.

Recently there has been much discussion regarding the dollar volume of prospective municipal expenditures for capital improvements. Deferred maintenance alone might account for $2 or $3 billion. The new capital expenditures would be sufficiently difficult to estimate without the complication of rapidly rising construction costs. That complication by itself, however, may upset all current estimates.

Municipal financing today is confronted by two serious barriers. In the first place, over the years many legal limitations have been imposed upon the issuance of bonds secured by the general taxing power of the obligor. Limitations upon the issuance of these full faith and credit obligations have taken the form of such direct prohibitions as the provision that debt shall not exceed a stated percentage of the assessed value. Others are somewhat more indirect. Thus, limitations on the amount of the total tax rate, or the levy for debt service may prevent a community from collecting enough taxes to support an increase in the outstanding debt. As a result, reliance upon the traditional form of financing, namely, the issuance of full faith and credit obligations, is not too satisfactory at this time. Even with debt reductions during wartime, the fact still remains that large sections of the country are presently in debt about as much as possible under existing laws.

The active resistance of taxpayers furnishes a second important barrier to the growth of general tax supported debt. Not infrequently they will demand new facilities for their community, and at the same time be violently opposed to the tax increases needed to finance the improvements. The issuance of full faith and credit obligations means higher bills through increased tax rates or increased assessments for property subject to taxation. Neither prospect is inviting, and public officials are attracted by alternative financial devices.

Unattractive Alternatives. The bond of the special taxing district created to avoid legal debt limits and the special assessment bond have been the most commonly used alternatives to the issuance of full faith and credit obligations when public authorities are casting about for an expedient means of financing. Disorder and confusion in municipal finance have resulted frequently from the establishment of numerous special taxing districts in the same geographical area. Special assessment bonds were used in many sections of the country to finance public improvements during the 1920's. In some measure their current disrepute can be traced to the fact that they were used by real estate speculators to facilitate the construction of streets, sidewalks, sewers and other public works necessary to the promotion of their subdivisions. Thus, the speculators were able to turn a form of public credit to private advantage. Generally speaking, the record of these issues is poor.

Many of the projects currently proposed as municipal ventures to be financed through the issuance of revenue bonds might as well be conducted as private business enterprises. In some instances, for example, water or sewer projects, the appropriate governmental subdivision would be obliged to grant a franchise to the private firm undertaking the project. It is an odd commentary on current trends in public opinion that the spokesmen for private enterprise seldom refer to this obvious direction for expanding the area served by business. In part, no doubt, private enterprise is reluctant to enter fields which require public franchise because this carries with it the problems of regulation. Public officials, on the other hand, are not even likely to consider the enfranchisement of private establishments as an alternative for public enterprise. Finally, it should be noted that the historical record of private companies in furnishing many of these services has been subject to serious criticism.

Attractiveness of Revenue Bonds. A good historical background is an absolute prerequisite for the development of any vogue in securities. For example, the great expansion in issues to finance inland waterways followed the marvelous earnings record of the Erie Canal during its early years. Likewise, one may refer to a notable record of revenue bonds in connection with the financing of water companies. The amount of financing involved is not especially great, but the long and stable history is sufficient to justify at least for sales purposes the satisfactory character of revenue bond issues.

Not only do revenue bonds have a good record in financing water companies, but there are conspicuous successes in other fields. For example, the Los Angeles Department of Water and Power now financed entirely by the use of revenue bonds illustrates the use of this type of security in connection with the financing of an electric as well as a water utility. Here the Power Department alone has assets of over one-fourth of a billion of dollars. The Utility Plant stands on the books at about $227 million with a debt in the form of revenue bonds outstanding of about $110 million. This department of the property grosses about $40 million annually. Salesmen may readily enliven their arguments for revenue bonds with references to this wealth of historical facts.

Eluding Legal Snares. Constitutional and statutory limitations on the creation of debt and tax rates frequently can be completely eluded by the issuance of revenue bonds. To the harrassed public officials who are seeking a means for financing public facilities, this feature of the revenue bond is little short of a God-send. At times, to be sure, the courts have refused to consider revenue bonds as debt which is outside of statutory limitations. However, the barriers imposed by adverse court decisions have been surmounted in many instances by the evolution of statutory and case law.

Demands for services and facilities now confronting public authorities in many instances are scarcely within the scope of traditional public activities. Recreational projects, auto parking facilities, and a host of others of similar character may be cited as illustrations. Rather than incur the risk of having their authority called into question, public officials are disposed to establish such projects as quasi-public agencies separate and distinct from the historical governmental units and to rely on the revenue bond as a financing device.

Theoretical Justifications. There was a time when the political scientists were greatly exercised regarding the evils of overlapping governmental units e.g. special taxing districts and their concomitant debts. Some little progress, let us hope, has been made in cleaning up situations of this character. Thus far, however, little complaint has been voiced about the possible overlapping of debt which results when quasi-public corporations are formed. and revenue bonds are issued. As a matter of fact, there is a fair amount of so-called informed discussion about the advantages of the quasi-public corporations financed by revenue bonds because, it is argued, they can relate the cost of their services more directly to the beneficiaries than a governmental unit financing itself through the issuance of full faith and credit bonds.

When a measurable service or product such as electrical energy or water is involved, the cost of service may be readily charged to the beneficiaries. Unquestionably the revenue bond is quite well adapted in these circumstances. However, the problem becomes progressively more difficult when the financing involves facilities whose services are very general and diffused in character.

The financing of urban transportation facilities would appear at first thought to be an instance wherein the cost of the service could be readily related to the beneficiaries. However, upon further consideration, the problem of determining the real beneficiaries becomes well-nigh baffling. For example, to what extent do car riders benefit from improvements in the transportation facilities as compared with fortunately situated land owners?

Revenue Bonds and New Types of Governmental Activities. Bearing in mind that income from revenue bonds issued by subdivisions of a State government enjoys the benefits of exemption from Federal income taxes, this type of financing obviously provides capital at relatively low cost. Funds can now be obtained at rates averaging 1% to 2% per annum as compared with 2% to 4% for comparable securities without tax exemption. Quasi-public enterprises also enjoy other tax advantages. For example, the Federal corporate tax does not apply to these agencies. Very frequently the local governmental authorities accord certain exemptions from taxes, or at best, require only relatively small payments in lieu of taxes. As a result, public officials are encouraged to undertake excursions into realms of activity which could hardly be justified on strictly business considerations. This factor in itself may account for very considerable expansion in the volume of revenue bond financing.

INVESTMENT QUALITY OF REVENUE BONDS

From the foregoing discussion it appears quite obvious that investors may very well be confronted with a rather wide variety of offerings involving revenue bonds covering many new situations during the next few years. They will be obliged to form judgments regarding the merits of these offerings.

Admittedly, a thorough consideration of security analysis techniques as applied to revenue bonds is quite beyond the scope of the present discussion. However, it clearly is relevant at this juncture to trace in rough outline the framework of analysis for these issues.

Nature of the Enterprise. No one would expect a municipality to finance the construction of a poorhouse by the flotation of revenue bonds, although there has been talk of an attempt to accomplish this bizarre result. The income, if any, could scarcely be depended upon to service the debt. On the other hand, certain types of service, for example, the production and distribution of electric energy furnish a good illustration of an activity which has been demonstrated clearly to be suited for revenue bond financing. This type of financing is workable if market analysis reveals that customers will buy the service at reasonable prices which, in turn, provide satisfactory margins over costs. Few will argue that revenue bond financing is appropriate for enterprises requiring support from the general taxing powers of the state.

Organization, Administration and Management. Like any other form of enterprise, the one financed through the issuance of revenue bonds ultimately will depend for its success upon the character of its organization, the quality of the administration and the ability and integrity of persons in managerial positions. Difficult though the appraisal of organizational structure, administration and management is for private enterprise, the problem is even more trying when a quasi-public agency is involved.

The statute books are full of devices and plans calculated to lift the administration of a quasi-public entity above the controversies of day to day politics by organizational devices, such as bipartisan boards of control and long or overlapping terms of office for directors. Some of these are successful; others are not. The best ones are calculated to attract and hold men of eminence and ability in the administrative and managerial positions.

Prospective Revenues and Expenses. Ultimately, revenue bond financing depends for success upon the margin of revenues over expenditures. Revenues can only be estimated by analyzing the market situation and interpreting these estimates in view of their reasonableness. Past experience and technological knowledge can be used to buttress the estimates of expenditure to some extent but ultimately they are matters of judgment. Revenue bond financing is indicated only when a comparison of estimated revenues and expenditures reveals an adequate margin of protection for service on the debt.

Payout Plan. Capitalization presents the sorest problem in the financing of quasi-public enterprise. Many of the ventures likely to be financed by revenue bonds in the course of the next few years will be new and untried. Unless these enterprises receive financial assistance in the form of capital advances from other sources, investors in the revenue bonds will be called upon to furnish every cent of capital. Given just a little bit of adversity, ventures so financed are almost certain to have trouble.

The soundness of the capital structure for a public enterprise financed through the issuance of revenue bonds is reflected in the adequacy of its payout plan. This plan should provide for the retirement of debt at a rate which is reasonable in view of the facilities it employs and the prospective operating margins over a reasonable period of time. Failure to present such a plan is a good indication that the venture is not established on solid ground.

Adequacy of Periodic Reports. The analysis of revenue bonds like that of any other investment is a continuing process which can only be undertaken if a system of adequate periodic financial reports is furnished to the public. An adequate reporting system will include a detailed statement of revenues and information regarding the various categories of expenses as well as a comprehensive balance sheet. Furthermore, the reports will be prepared by competent accountants.

Standards of Investment Quality. With respect to revenue bonds, the importance of the operating record cannot be over-emphasized. Quasi-public enterprises obtaining all or practically all of their capital through the issuance of revenue bonds afford the investor no protection against losses in bad times. The securities issued by such enterprises obviously are unsuited for bank investment, irrespective of their attractiveness as speculations. However, they may become suited to the needs of a bank portfolio after the completion of a probationary period during which stability of earnings has been demonstrated and they have accumulated reserves which will afford the bondholders some protection when current operations are unprofitable.

SUMMARY AND CONCLUSIONS

A very substantial increase in the amount of debt outstanding for State and local subdivisions of government is now in prospect. There is good reason to believe that a considerable part of this increase will take the form of revenue bonds.

The analysis of revenue bonds presents a number of very nasty problems. In some respects, these enterprises should be analyzed as private businesses. This calls for an appraisal of revenues and expenses both historically and prospectively. Furthermore, it is a fact that revenue bonds are not always confined to the financing of well established public enterprises with accumulated surpluses to protect the bondholders against losses in bad times. Investors will be well advised to eliminate from the bank investment category, revenue bond issues for new and untried ventures, as well as the ones that fail to develop a creditable operating record over a period of three to five years and to accumulate a surplus of earnings to bolster the bondholders' margin of protection against default.