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"SOME ASPECTS OF THE PROBLEM OF ANALYSIS OF MUNICIPAL OBLIGATIONS"

Yesterday I outlined briefly some general aspects of the problem of bank investment in securities with special reference to municipals. Today's program centers around the problems of analysis of individual municipal obligations. This is a broad subject, but since it has been outlined in the memorandum, this paper will be confined to five significant aspects of the subject which I have given additional study since the preparation of the memorandum:

- (1). A proper maturity schedule;
- (2). The importance of an adequate, dependable and unified system of revenue;
- (3). The proportion of the total revenues absorbed by debt service and other fixed charges;
- (4). Tax limitations;
- (5). The contribution of agriculture to debt-paying ability.

1. A Proper Maturity Schedule. There has been a great deal of difference of opinion on what is a proper maturity schedule, although recently, I feel this issue has been somewhat clarified. There is agreement that the common practice of depending upon the market for refunding is unsatisfactory. Any unit, large or small,

is in a less vulnerable position if its budget and maturity schedule are so planned that interest and principal requirements can be met without refunding operations. Peak maturities may be a source of serious trouble. It is particularly dangerous for the smaller units which ordinarily lack the financial connections necessary for refunding in a bad market to have a large volume of maturing obligations in any one year.

Refunding in itself is not necessarily a matter of concern to the creditors, but inability to sell bonds when funds are needed to meet interest or maturing principal results either in a default or a forced refunding. If the finances of the government are not sound, refunding will be difficult. A municipality in a weak financial position will be forced to pay a high rate (in comparison with the rate paid by sounder governments) in a good market, and in a bad market will have difficulty selling its bonds under any terms. Moreover, a continuous use of refunding is expensive and ultimately results in a high debt.

Serial bonds, if carefully planned, are more satisfactory than issues which all mature at one date, because they relieve the officials of the duty of administering sinking funds. As is generally recognized, sinking funds are all too often either not maintained at all or are poorly invested, and in extreme cases insiders even use them for their own purposes. A carelessly arranged maturity schedule of serial bonds, however, may prove

as disastrous as a large maturity of term bonds. There are times when it is desirable and necessary to refund maturing serials, but it is a difficult and dangerous practice to refund them year after year.

The popular practice of leveling out maturities so that the annual debt service over a period of years is approximately equal is a dangerous one. From time to time a community finds it desirable or even necessary to issue bonds to pay for improvements or to meet emergencies. If there is not to be a more or less steady increase in the debt, it is necessary that the maturity schedule be so arranged that there is a gradual reduction in the amount of the yearly debt service. Otherwise, new bonds will increase the yearly debt service and, if this continues until refunding is necessary, pyramiding of debt will result.

Before a local government incurs an obligations, plans should be made for its retirement. Debts issued to purchase assets which depreciate should be retired at least as rapidly as the assets depreciate, with reasonable allowance for obsolescence. For instance, the annual rate of retirement of bonds issued to purchase motor vehicles with an estimated life of 5 years should be at least 20%, or better still, 25%. It is more difficult to determine how rapidly to retire debt issued to make permanent improvements, but the old rule of thumb that at least 5% should be retired each year seems reasonable. With the character of cities and neighbor-

hoods constantly shifting and the wants of the people changing, it is impossible to forecast with much accuracy the usefulness of a given project twenty years hence. Some municipalities grow so rapidly that it is necessary to install new equipment before the old is worn out; while others decline in population or fail to grow and have unused capacity. Also, most improvements need extensive repairs if they are to render satisfactory service much beyond twenty years. When debt is created to meet an operating deficit, there is no automatic guide to determine the rate of retirement, but the frequent recurrence of such emergencies as depressions and disasters suggests that debts incurred for such purposes be paid rather quickly. Communities which depend in substantial part upon wasting assets should retire their obligations even more rapidly than outlined above.

2. The Importance of an Adequate, Dependable and Unified System of Revenue. The more I study municipal bonds, the more I am impressed with the importance of an adequate and dependable source of funds, and the next revision of the memorandum will be reorganized with a view toward placing additional emphasis on this aspect of the problem. It is important that the revenue system as a whole be satisfactory. Not only should it bring in enough money to operate the government according to the accepted traditions of the community and to provide for debt service, but it should be so planned that it does not disorganize the economy as a whole.

When evaluating the effect of a given tax upon business, the amount of other taxes paid by the same taxpayers must also be considered. A large number of miscellaneous taxes are very annoying and may in the long run have a more adverse effect upon business than if an equal amount of revenue were collected by fewer taxes which have some rationality. In this connection it should not be forgotten that high taxes are a brake on business, although if such services as schools, roads, police and fire protection are excellent, a high tax rate will not retard the economy of a community as much as the combination of high taxes and poor services. If the credit of a unit is to be maintained at a high level, it must be conserved. The debt of the unit should, of course, be maintained well below the legal limit, but more important it should be maintained below the maximum which the community can support. In other words, the debt should not be so high that an increase necessitated by an emergency will force the burden of taxes resulting from the increased debt service to a point regarded as excessive.

In studying sources of revenue, the importance of tax collections can hardly be overstressed. Current and past property tax collections should be studied with a view toward estimating the probable ability of the unit to levy and collect adequate taxes in the future. Grants-in-aid and other miscellaneous

sources of revenue should be scrutinized to see whether or not they are likely to continue.

3. The Proportion of Total Revenues Absorbed by Debt Service and other Fixed Charges. More attention should be given to the proportion of the total revenue absorbed by debt service. Investors are quite properly cautious when the payment of interest and principal will consume a large proportion of the total revenue. It is inconceivable that those charged with the responsibilities of government will continue debt service for any length of time if it means drastic curtailment of such items as relief, schools, and fire protection.

In this connection, consideration should also be given to the proportion of the total budget consumed by other fixed overhead expenses, sometimes referred to as mandatory expenditures. Governmental units tend to acquire expenditures which, for one reason or another, cannot be reduced by local officials. Some of these have a basis in law, others in controls of the higher levels of Government, while other expenditures become so well established and supported by organized pressure groups, that reductions are not politically feasible. The salaries of certain Government officials, such as judges, mayors, members of the council, etc., are almost always fixed by constitution, law or by charter provisions. Continuing appropriations, and requirements for debt service tend to increase, while Civil Service regulations and

pension plans make reductions in personnel difficult. The public usually thinks of controls of expenditures by the higher levels of Government as a means of reducing expenses, but in practice the increased standards of such items as relief and schools set by the supervising agencies more often result in higher expenditures. In any case, it becomes more difficult to make adjustment downward.

Whatever may be the advantages from some points of view of the assurance that certain items in the budget will not be reduced, the fact remains that these mandatory expenditures add an element of rigidity to the budget which may become serious. If a large proportion of the total budget consists of items which can be reduced only with extreme difficulty, a decline in tax collections will precipitate a financial crisis.

4. Tax Limitations. Still another factor which tends to undermine credit is various types of tax limitations. In recent years there has been a great deal of political pressure for tax limitations on general property, and several states have already enacted laws or constitutional amendments limiting in one way or another the tax which can be levied. These laws and proposals differ so widely that the effect of each upon the bondholders must be considered separately. Except insofar as the power to borrow is also restricted, limitations on the power to tax weaken the position of the creditors. In recognition of this, proponents of such laws ordinarily advocate exceptions to the limitation on tax rate in favor of taxes for debt service. On superficial

examination these exceptions sometimes appear adequate to protect the interests of the creditors, but it seems incredible in cases where the debt is high that the government as a long-run policy will levy heavy taxes for debt service while drastically curtailing the appropriations for such items as schools, police, fire protection, and relief. If tax limitation laws are not carefully drawn and strictly enforced, the attempts of the local administrations to avoid the intent of the law will result in the development of a number of unsound financial policies. If assessments are not also regulated, hard-pressed local governments are apt to find the temptation to over-assess irresistible, and if debt service is exempted from the maximum tax rate, subdivisions are tempted to run current deficits as long as the markets will absorb either the short term obligations or the funding bonds later issued. Also, as the pressure on the treasury becomes greater, there is a tendency to resort to any or all replacement taxes suggested, with the result that there is less and less rationality to the revenue system as a whole. In cases where the units have limited power to tax, but there is no overall limitation, the intent of the law can be avoided by the creation of special districts. The necessity for such subterfuges makes anything approaching long run financial planning impossible.

5. The Contribution of Agriculture to Debt-Paying Ability.

This is an important but difficult topic for me to discuss with you;

important because a large number of your communities are rural, and because it should be made clear to all that our Corporation does not subscribe to the common doctrine that obligations of agricultural communities are more risky than those issued by industrial communities; difficult because you all know more about agriculture in this area than I can ever hope to learn. I have, therefore, chosen to read to you some paragraphs which I prepared recently for a more general use:

Agriculture is an important source of income which should receive serious consideration when evaluating the economic background of a unit. In some political subdivisions agriculture is the primary or only source of income, and in a vastly larger number, an important contributing source; while all but a few of the cities depend in part at least upon the surrounding agricultural area as a source of customers. A combination of a prosperous industry and a stable agriculture provides an excellent economic background and even an entirely agricultural background under certain circumstances can be satisfactory.

An agricultural community with fertile soil and a favorable climate is, of course, in a better position to service a high debt than one with a large percentage of untillable and barren soil or other handicaps. Distance from markets and lack of suitable transportation facilities are also limiting factors in some areas. If assessments are properly made, these adverse factors will be reflected in the assessed value of the land, so that the same percentage of debt will be approximately an equal burden in all lo-

calities. Discrepancies in assessments, however, are so common that it is always safer to investigate these factors.

Agriculture is subject to a great variety of hazards. There is the risk of crop failure, due among other things to lack of sufficient rainfall, insects, floods, and frost, while soil erosion and depletion have adversely affected some areas and threaten the prosperity of others. New crops and new varieties which are constantly being brought to the market materially influence the prospects of some regions. New varieties sometimes make possible the production of a crop in an area where it was previously unprofitable. Such shifts are apt to result in reduced incomes in other communities since the new varieties usually produce higher yields and hence lower prices, at least for the old varieties. Changes in the foreign market have adversely affected many sections in the last two decades. On the whole a diversified agricultural system, makes for a more satisfactory economic background than an economy centered around one crop. Rural areas, like cities, sometimes suffer from booms and during such a period the temptation to go more deeply into debt for new improvements is great. Another situation which should be watched is one where the income of the community has declined to such an extent that farmers can no longer support the standard of living they previously enjoyed.

A trip through an agricultural region in the growing season is an excellent method of obtaining supplementary information

about its debt paying ability. It is ordinarily possible on such a trip to get a rather accurate impression of the productivity of the land by the appearance of the crops. The methods of tillage indicate much as to the progressiveness of the area, and since people in agricultural sections typically know one another's business, a relatively few questions placed judiciously will bring out information as to the principal source of cash income and whether or not large outlays are necessary for fertilizers or other expenses, and, most important of all, if this season is typical. A knowledge of local tradition is very helpful in judging the prosperity of the area. In the middle west, for instance, where farmers often spend a considerable part of their income on improvements, the general appearance of the countryside tells an important story about income. If the buildings are large, it indicates that at one time at least income was good, and if the buildings and fences are still in good repair, it indicates that the present income is satisfactory. Such general impressions should, of course, be checked against statistics of production and income.

Although the farmer and villager have typically been independent personalities and self-reliant, a rural community tends to more of a homogenous unit than an urban center with its many diversions and numerous cross currents of conflicting interests. Citizens in the country take a greater personal interest

in good government, at least economical government, than do city residents. This seems to be due in part at least to the fact that a larger percentage of the people in rural sections participate directly in the government by holding office. Almost everyone knows most of the officials and is well acquainted with at least some of them. For the most part the community leaders in rural sections regard the credit of their county or town, and especially their school district, as a matter of honor. Recently, however, important shifts in the view point of rural people have taken place. Relief has become respectable. Federal benefits are now an accepted source of income, and subsidies given farm debt are becoming more obvious. These and other developments will doubtless alter the viewpoint towards government debt, although it is too early to tell whether or not this will materially affect the will to pay local debts.

Conclusion. Before turning the meeting over to Mr. Wayne, I wish to emphasize the importance of considering the problem as a whole. It was necessary in the preparation of the memorandum to outline the factors which we regard as important and discuss some of them in considerable detail. The danger in this approach is that we will see the trees but not the woods. As we look back on actual cases of default, we find that they usually have been preceded by a combination of unfortunate circumstances. I doubt the wisdom of making an opinion long by the

inclusion of a discussion of factors which appear in the case under consideration to be of minor importance. On the other hand, factors which would ordinarily be dismissed as being relatively insignificant, should be treated in detail if they seem to have important bearing on the ability of the unit to pay its debts. However, mention should always be made of such items as size of debt, sources and dependability of revenue, and the economy of the unit.