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PRESENT PROBLEMS AND POSSIBLE PLIGHT OF LOCAL FINANCE

Address of C. Canby Balderston,

Vice Chairman, Board of Governors of the Federal Reserve System,

at the 51st Annual Conference of the

Municipal Finance Officers Association of the United States and Canada,

Saint Paul, Minnesota,

on Monday, June 3, 1957.

PRESENT PROBLEMS AND POSSIBLE PLIGHT OF LOCAL FINANCE

The longer the present plateau lasts with its high employment, high prosperity, and high and rising prices, the more worrisome become the problems of financing State and local governments. Mass prosperity has created for municipal finance officers an immediate but not insoluble problem. It has also brought into being a serious threat to the functioning of local governments.

The current financial problem, which doubtless explains my invitation to meet with you, is alleged to stem from so-called "tight money". Money is "tight" in the sense that the aggregate demand for money and credit is greater than the supply. Though the money supply increased last year in this country by 1 per cent and its activity (*i.e.*, demand deposit turnover) by 8 per cent, the demand for money and credit mounted still faster and pushed up the interest rate, which is the price of money. What was true of credit has been true of other commodities, particularly those in short supply, such as metals and metal products, not only in this country but in others.

To have pumped short-term bank credit into the credit supply would not have made human and material resources more plentiful, but it would certainly have boosted prices still further. This gap between our desire to spend and what we can actually produce, and between our desire for capital improvements and what we manage to save to finance these improvements creates a problem.

This problem is not unique to State and local governments. It confronts businessmen, consumers, and the Federal Government. Of the increase of $22 billion in total expenditures for gross national product last year, more than half represented price rises. In the scramble for resources to build new plants, houses, schools, and roads, demands have outrun supplies, and the prices of all of our resources have been bid up. Similarly, demands for funds to finance expenditures have outrun the available supplies of savings, and the price of long-term funds has increased for all borrowers.

As you know, interest rates on State and local securities have risen sharply. This rise is shown by Figure I. The higher costs of borrowing may have received a disproportionate share of public attention in view of the relatively small part that interest plays in total municipal and State expenditures. Figure II indicates that interest accounted for only 2 per cent of these total expenditures in the calendar year 1955, the latest year for which data are available. This percentage was less than in 1945, or in the years just prior to World War II. Interest has increased less in the past decade than have other types of expenditure. Nevertheless, most of the publicized efforts to solve the problem of inadequate resources for local government have centered on this 2 per cent rather than on the high and rising costs of the other 98 per cent. To me this approach is incorrect. The potential plight of municipal finance arises not out of increased costs of borrowing, but out of growing costs of current operations and of enlarged capital expenditures.

Perhaps only a few would argue that the problem would be solved by making credit available to meet all borrowing demands. Yet, a subtle, insidious version of this argument is gaining some measure of acceptance. This version rejects the easy availability of credit that would invite massive inflation, but suggests that we can tolerate enough credit expansion to permit a "mild" price rise of, say, 2 or 3 per cent a year. Aside from what such a national policy would do to savings in the form of pensions, insurance policies, savings bonds, and bank deposits, what would such a policy mean to the cost of carrying municipal debt? Suppose we examine this question in the abstract by considering two alternatives for the year 1965: (A) one with interest rates held at current levels of about 3-1/2 per cent, but at the expense of an annual price rise of 2-1/2 per cent; (B) another with prices held stable at current levels by monetary restraint which would increase borrowing costs to 5 per cent per annum. To make the example explicit, assume a physical volume of capital outlays roughly one-half above the present level.

Under alternative A, that of creeping inflation, the 1965 capital outlays would cost about $4 billion more in total debt service than if prices were to be prevented from rising. Under alternative B, that of stable prices, total debt service would be $2.6 billion less than under assumption A, because the higher interest rate would have been applied to a smaller base. Under these assumptions, sound money would actually save almost one-seventh of the capital budgets assumed for 1965. This comparison is shown in Figure III.

No one likes to pay higher prices, of course, whether for money or for anything else. For many years, State and local governments were "preferred" borrowers, paying interest rates substantially less than others because their interest payments carried the boon of tax-exemption. And so in the early postwar years, high-grade municipal bonds yielded from 1 to 1-1/2 percentage points less than corporate issues of comparable quality. This is illustrated by Figure IV. Despite today's high tax rates, this premium is a less effective inducement than it was earlier. The scale of State and local borrowing appears to have outgrown the market that is willing to trade a substantially lower return for the tax-exemption privilege. When this borrowing demand reaches $5 to $6 billion a year, and other competitive demands are strong, municipalities must tap not only their customary market, but also attract new investors. However, the largest pool of institutional savings available for long-term investment--life insurance and pension funds--is not likely to be much attracted by tax-exemption features. State and local governments, consequently, have had increasingly to compete for funds on a straight rate basis. Since 1948 the spread between corporate and municipal bonds has tended to be smaller than in the immediate postwar years, but despite the rise in interest rates has recently remained unchanged.

By maintaining their competitive status in the money markets, State and local governments have continued to attract a large volume of long-term investment funds. It is true that last year the volume of issues floated to finance capital outlays declined somewhat, but as Figure V indicates, almost all of the decline was in long-term financing for toll roads and public housing. You will recognize that influences other than interest cost helped deflate the earlier enthusiasm for toll road projects. In the financing of public housing, the decline in bond flotations was offset by an increase in short-term financing. In 1956, long-term financing for other purposes was maintained at the large volume of the year before.

Although postponements because of market conditions have attracted much attention, little note has been taken of the successful flotation of many of the same issues when they were brought to market again. A survey made by the Investment Bankers Association indicated that about 120 issues, aggregating $175 million, were not sold on originally announced flotation dates during the third quarter of 1956. The subsequent history of these postponed issues is that by the end of that year, three-fifths of the number and two-fifths of their dollar volume had been sold, and many more were marketed later on. In some cases, the reoffering was completed at rates below those rejected earlier. By adapting terms to meet investor requirements, and by timing security flotations to the ebbs and flows of funds in capital markets, finance officers have been able to finance a large volume of municipal needs.

To secure detailed information underlying aggregate national figures for such financing, the twelve Federal Reserve Banks have recently surveyed the developments in their Districts. Some regional differences were disclosed, of course, but the reports were unanimous to the effect that where borrowers were free of arbitrary limitations on interest rates, they were able to get the financing they needed. The survey confirms the findings of earlier studies that small governmental units of respectable credit rating were, in general, not subject to discrimination in the market. Allowing for local problems not associated with monetary policy, school financing was as successful as borrowing for any other purpose. A growing awareness of the need to restrict expenditures to essentials has stripped "frills" from some projects.

Now I turn to the possible plight of the governmental units you represent. The threat to their effectiveness is deep-seated and insidious.

It is definitely more significant than the current problems of financing new projects because it has to do with 98 per cent of your total budgets. I refer to the tendency during recent times for expenditures to outrun income.

Current expenditures of State and local governments have risen greatly and have required more taxes. Returns from only certain kinds of taxes have increased automatically with the growth of the economy, and it has proved difficult to keep the tax bases current. Both population growth and population movement have aggravated the problems of some governmental units. Those with abnormal gains have faced the most severe problems, but even those areas that have suffered relative losses of population have experienced their own special difficulties.

Here are a few financial facts that concern you. State and local government purchases of our goods and services (i.e., G.N.P.) amounted to $33 billion last year, a 10 per cent rise from the previous year and two-thirds larger than the level of expenditures in 1950. These are impressive increases, and if one forgets about price-level problems, it would appear that we are making substantial progress in meeting our needs for schools, highways, and other community services. But correct the increase for rising prices, and the picture is vastly different. The contrast is shown in Figure VI. In other words, the number of dollars spent has increased substantially, but the real gain in schools, highways, and other facilities has been far less than the dollar figures appear to indicate.

The reasons for this are obvious. Figure VII illustrates the trend of prices in some areas of special relevance. Average wage payment per employee of local and State governments, still moderate, has risen two-fifths since 1950. The cost of building construction has increased over one-fourth, and highway construction costs have risen almost as much. These higher costs are embodied in the debt that has had to be incurred to finance capital improvements. In fact, a substantial share of the debt service charges paid out of tax receipts over the next 15 or 20 years will reflect the inflation of costs since Korea.

Since prices have already gone up substantially, you might ask about the effectiveness of Federal Reserve monetary policy. Has the increase in interest cost that has occurred been in vain? Perhaps the most persuasive answer is to suggest what would have been the course of events if the Federal Reserve had not curbed the expansion of the money supply, but had continued to give banks additional reserves whenever they desired them. I shudder to think of the outcome. The results of pumping new money into the economy cannot be calculated with precision, of course, but I am confident that by now we would have experienced much more serious inflation. Consequently, the 98 per cent of your budget which most concerns you would have ballooned still more.

Communities can progress only if the purchasing power of the dollar is protected. Otherwise their expenditures rise without commensurate social gains. Sound money is not and cannot be in conflict with social needs; it is essential for human progress. This explains the policy of monetary restraint pursued by the Federal Reserve since mid-1955, directed toward restraining an incipient inflation.

Local and State governments share this responsibility, and will achieve the gains they desire only if the dollar is kept stable by sound monetary and fiscal policies, combined with prudence by those who make spending decisions. The continued progress of our society and its growth in well-being thus depend upon the financial health of the nation. To that end, certain rules need to be observed:

(1) The nation's spending must not exceed what it earns through production.

(2) The nation's private investment must be broadly restricted to the savings available, and its public investment chiefly to what it is willing to pay for through taxes.

(3) Governments--State, local, and Federal--as well as private citizens must be selective and prudent in their spending choices if aggregate demand is not to press unduly upon the nation's resources. In boom times, everything that governments and private citizens desire cannot be secured right away. The effort to do so merely invites inflation--the destroyer of savings and of social progress.

In common with other Americans, you are in the midst of a battle --the battle against inflation. The Federal Reserve is, of course, at the center of that battle. Despite restrictive monetary policy, the consumer price index has just moved up again; without restraint, the rise would undoubtedly have been much greater. This continued rise emphasizes why the loss of that battle would mean much to the proverbial widows, pensioners, and others whose compensation is fixed. But following close behind in this procession are those, like your governmental units, whose costs increase faster than their incomes. In this unequal race, they can scarcely win.

Figure 1

STATE AND LOCAL BOND YIELDS

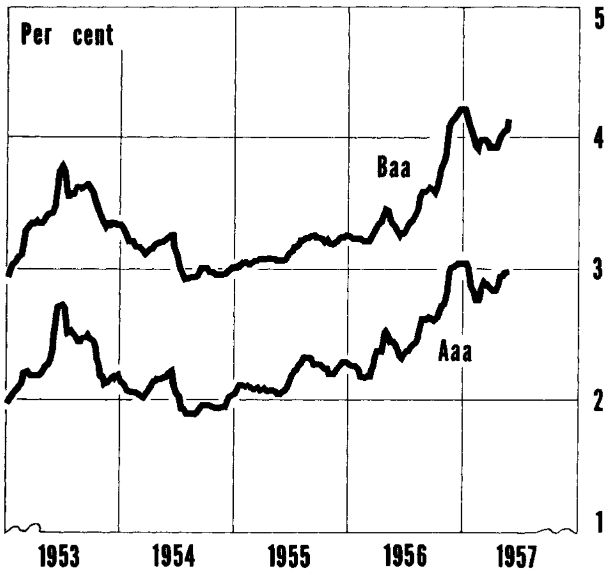

Figure 2

STATE AND LOCAL EXPENDITURES

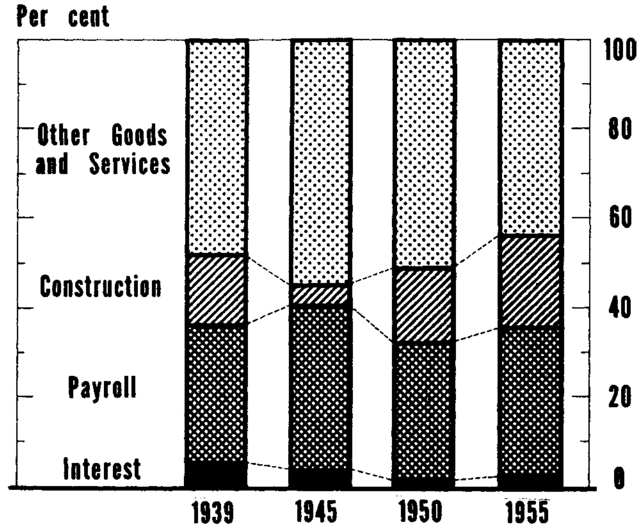

Figure 3

ALTERNATIVES

	A At present interest cost but with prices rising 2 1/2 per cent a year	B At present prices but with interest cost of 5 per cent
	Billions of dollars	
CAPITAL OUTLAYS IN 1965 physical volume one-half greater than 1956 actual	19.9	15.9
INTEREST COST OVER 30-YEAR LIFE OF SERIAL LOAN	10.5	11.9
TOTAL DEBT SERVICE	30.4	27.8
'SOUND' MONEY WOULD SAVE YOU		2.6

Figure 4

YIELD SPREADS

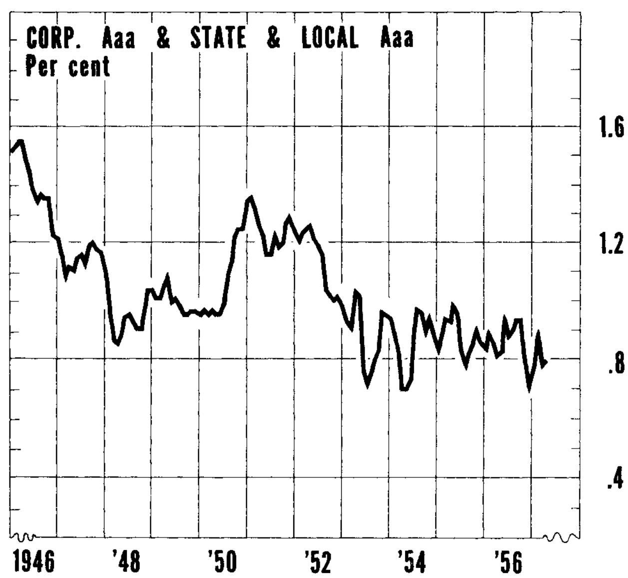

Figure 5

MUNICIPAL SECURITY ISSUES

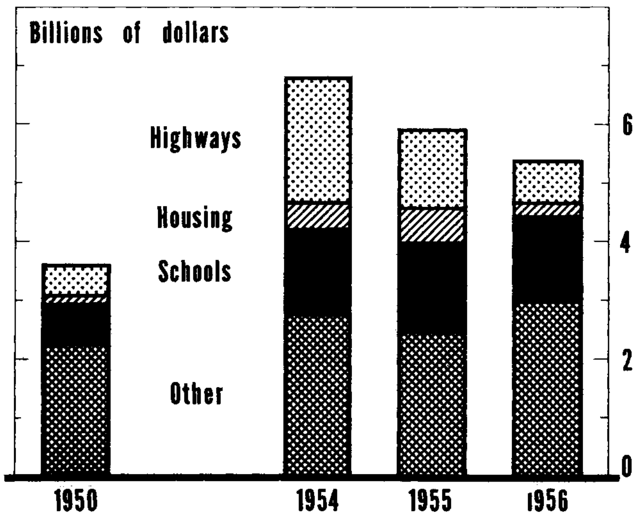

Figure 6

STATE AND LOCAL GOVERNMENT

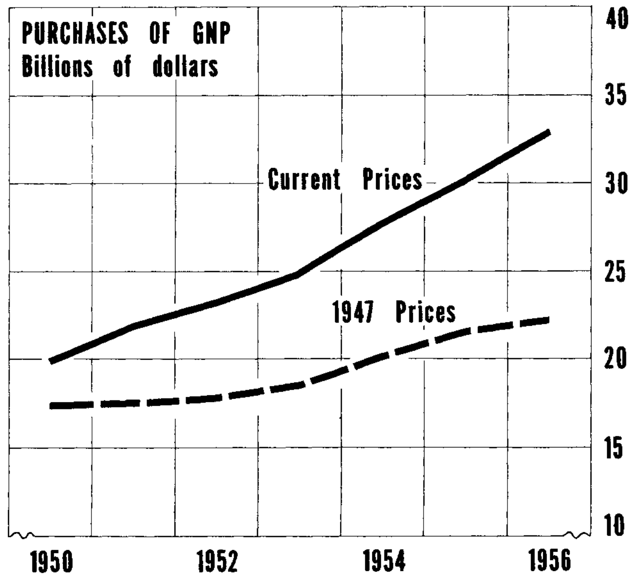

Figure 7

STATE AND LOCAL COSTS