The Case for the Urban Development Bank

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The Problem

There are many problems connected with public finance; not surprisingly most concern money. To paraphrase Mr. Moynihan, how long will it take the public to realize that our cities are poor because they have no money?

The Proposal

I want to discuss with you one proposal among many designed to bring more money to the states and municipalities. In the Johnson Administration we called it the Urban Development Bank, or URBANK. The present administration calls its version the Environmental Financing Authority. There are significant differences between the two, but both raise money through the sale of taxable bonds and lend to public bodies at tax-exempt rates, the difference being met through Congressional appropriations. At the heart of the Urban Development Bank, and perhaps at the periphery of the Environmental Financing Authority, is the goal of improving and expanding the existing municipal bonds market. For next to state and local taxes, the municipal bond market represents the largest source of funds for states and cities.

Financial Needs

Let us start with a brief review of financial needs, because if states and cities do not need money — or if it is available from other

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sources – there is no pressing need for a new financial institution.

We are all aware of the rapid growth of state and local expenditures, more than doubling in the past decade. The fact that state and local governments have been able to make such expenditures is a tribute to the expansibility of the three major financing devices: state and local taxes, Federal grants, and state and local borrowings. All three contributed importantly to the financing of growth.

Over the decade, state and local taxes doubled; Federal grants doubled, and by 1967 state and local new bond financing had doubled. Although there was a decline in state and local borrowings in 1969, over the decade as a whole state and local borrowing more than doubled. The question before us is will these demands for funds continue, and if so, where will the money come from?

In 1966, the Joint Economic Committee forecast public facility capital requirements in the decade 1966 - 1975, projecting a total of $328 billion.[1] This forecast represents an average annual growth rate of 10.5 percent. These estimates were considered high at the time; they will probably turn out to be low. The pressure for public expenditures is not merely a function of population but also of standards. It is this escalation of standards that will keep public expenditures hopping for some time to come. It will be expensive indeed to bring the quality of the public sector in line with the private sector – as we are seeing with the equalization of Federal-private wage scales. And it is going to put even greater pressure on state and local governments – not only for salaries. Municipal public works standards are frequently low. Can we believe, for example, that anti-pollution standards will decline? That hospital standards, that recreation standards, that public transportation standards will decline?

State & Local Taxes

With rising income levels and a continuing shift from property taxes to income taxes, tax revenues will play a major role in supporting the increase in total expenditures. The ACIR found that taking the country as a whole, most state tax systems will produce an increase in revenue roughly proportional to the percentage increase

[1] **Joint Economic Committee, "State and Local Public Facility Needs and Financing."**

in state personal income. This does not speak of municipalities, where income taxes are less popular. And it does not address the main question that demands for public services are going to outstrip increases in personal income.

Although there is wide variation in tax effort among states, California and New York, which represent close to 19 percent of the population and 22 percent of the personal income of the nation, have a tax burden (including miscellaneous charges) of close to 16 percent of personal income. What the economic limit of taxation is I hope we will not soon know. What we do know is that state and local taxes have virtually tripled since 1956 and have increased 7-fold since 1946. While Federal taxes have declined steadily as a percentage of the GNP since the early 50's, state and local taxes have increased as a percentage of the GNP. When the press discusses a tax revolt, it is a local and state tax revolt they should refer to.

In its most recent annual report, the ACIR in referring to the past decade, commented "through this period the political landscape was strewn with defeated governors, mayors and county officials who had courageously committed suicide at the polls by doing what had to be done to increase sources of revenue to meet – in part at least – escalating service demands of the citizenry." Hopefully there will continue to be courageous elected officials – and local and state tax reform will proceed. Nevertheless I suspect most elected officials will still look to every alternative and the first will be the Federal government.

Federal Assistance

Some of us, particularly those of us who have been employed at the Federal level, are less sanguine than others in anticipating financial relief from Washington. We know the pressures of the private sector. What remains for the public sector is simply not enough for all the demands made upon it. Revenue sharing, which may be an attractive mechanism for the allocation of money to cities and states, does not, of course, raise money.

The problem of raising sufficient revenues for revenue-sharing, as well as Federal needs, remains. One can seriously question the ability of the Federal government to meet its announced responsibilities at the present tax rates. For the problem of rising standards and expectations at the local level is also true at the Federal level: pro-

grams for income maintenance, medicaid and compensatory education – even the SST and inter-city rail transportation – reflect rapidly changing standards.

The national commitment to end poverty is truly a giant leap for mankind but a far more expensive one than that taken by Armstrong on the moon. Moreover, rather than reducing demands for public services, I would suggest that higher income standards will require greater public service standards, and costs, at both the Federal and local levels.

It is not the place here to enter into a detailed discussion of the military budget. One would have to be a great optimist, however, to forecast a major reversal in the absolute level of military spending for a long time to come. We will be fortunate indeed if we can keep the military budget flat from now on over any extended period of time.

Long-term planning cannot afford to count on a windfall from the defense budget. In fact, if the percentage of the GNP devoted to the military is not to rise, the Congress will have to keep a sharp lookout for the "acorn" type of military systems now being substituted for short-term reductions in operational expenditures. Such acorns which bring forth expensive military oak trees may well mortgage our natural revenue growth if we are not careful. Charles Schultze, former budget director, has written carefully on this subject and for those who still count on savings in the military budget I recommend him to you.

In short, payments to state and local governments are going to have to compete hard with Federal civilian responsibilities as well as military responsibilities.

Municipal Bond Market

If salvation is not to come from Washington and political suicide seems to be the reward for fiscal courage, our elected official must turn to other sources: the municipal bond market is one such source; a market which provided $25 billion in 1968, $23 billion in 1969 and probably more than $25 billion in 1970. Surprisingly enough, our elected official doesn't pay a great deal of attention to this area. It is mysterious. It is controlled by bankers. It is characterized by a grade system – a single A being only third best. He pays attention only when the U.S. Treasury staff (or Wright Patman) challenges its basic tax exempt features.

It was felt that in this mysterious but important area the Urbank could make its mark. The Urbank was proposed because it was believed that a bank could make a contribution to the solution of the money problem by expanding and improving the municipal bond market. It was not designed to destroy that market. Rather, it would achieve its aim in several ways:

- by tapping new funds for municipal needs
- by increasing the competitiveness of the municipal bond market, particularly the smaller, less known communities, and
- by providing technical expertise and assistance to its clients.

Because the municipal bond market is our target for improvement, I would like to discuss some of those things that are right with it – and some of those things that are wrong with it.

What Is Right With It?

What is most right with it is that it is large. It is effective. It is established. Most communities can rely on it at a price. From a level of $5.3 billion of sales of municipal bonds in 1948-50 the market absorbed over $25 billion in sales of state and local bonds in 1968 and should exceed that total in 1970. A total of 8,000 communities should go to market this year. At the end of 1969 there were outstanding a total indebtedness of states and local governments of $123 billion. This is a lot of financing. It is equivalent to about 40 percent of the Federal debt outstanding.

What Is Wrong With It?

What, then, is wrong with it? The first thing is that, of course it is not large enough, and it could be larger. It is too dependent upon commercial banks as buyers; the maturities of its securities are too short; smaller cities are at a disadvantage; the cost of funds is too high in relation to the tax benefits given by the Treasury – and this relative cost may go even higher. Let me touch upon some of these defects.

Capacity to Serve Additional Debt

State and local governments have increased the amount of their outstanding indebtedness by seven times since World War II but,

taken collectively, their debt policy has been quite conservative and not out of line with the state and local governments' capacity to service it. The amount of receipts (exclusive of borrowings) has increased as rapidly as outstanding indebtedness and the ratio of debt to revenues has not exceeded 1.5 to 1 in any year during the past three decades.

It is interesting to point out that before World War II and back to the beginning of this century this ratio generally exceeded 2.0 to 1.0. Interest on state and local debt in recent years has absorbed roughly 3 percent of total revenues compared with an interest burden ranging from 8-9 percent of revenues in the Federal budget. Of course there can be no precise formula for determining the limit on the amount of indebtedness, particularly in the case of a sovereignty with the power to tax. A multitude of factors enters into a consideration of the amount that a municipality can prudently borrow and the amount that bankers and other investors should appropriately lend. Among them

- the level of receipts from sources other than borrowings,
- the portion of those receipts that must be used to service debt,
- the portion of those receipts that are derived from stable sources which can reasonably be expected to be sustained for an indefinite period,
- the level and terms of existing indebtedness,
- the purpose to which the proceeds of the proposed new borrowings are to be put,
- the extent to which the projects and programs financed are self-liquidating, or at least revenue producing,
- the interest rate, maturity, grace period and type of amortization schedule that would apply to any proposed new debt,
- the economic position of the borrower,
- the quality of management of the projects being financed, and the management and leadership of the community as a whole – both civic and official, and projections of population and economic growth.

If borrowings do not seem excessive in terms of the borrowers' own financial strength, one can also argue that in terms of the total public and private debt, state and local debt is not high. In 1933 it represented 10 percent of the total; in 1970 it probably represents less than 8 percent. Since the relative level of debt between the

public and private sectors is a question of great subjectivity and political bias, it can at least be said that there appears to be room for additional state and local debt if we wish to so set the priorities.

Market Relatively Narrow and Highly Variable

State and local government bonds are bought by a broad range of investors but exemption from U.S. income tax is an attraction which limits the bulk of the sales to the relatively narrow group of institutions and individuals in the upper tax brackets. At the end of 1969 three groups of investors held 89 percent of all municipal securities outstanding:

- commercial banks held 44 percent of all municipals outstanding;
- individuals held about 32 percent of all municipal bonds outstanding;
- insurance companies held 13 percent of the municipals;
- all other investors combined (mutual savings banks, private pension funds, public retirement funds, state and local governments, municipal bond investment funds, other financial institutions, business corporations and federal credit agencies) held the remaining 11 percent.

More importantly in recent years, with the exception of 1969, commercial banks have accounted for approximately two-thirds of the net purchases of municipal bonds. This compares with their purchases of about one-third of the municipal bonds issued a decade earlier.

Commercial banks thus now dominate the investment side of the municipal bond market. Such a narrow market is not as competitive, particularly for small and medium sized issues, as the broader based corporate bond market or the market for U.S. Government and World Bank bonds. A less competitive market results in higher interest rates and harder terms, and consequently reduces the total amounts that can be raised.

In addition to being relatively narrow, the municipal bond market is highly volatile. Most of the commercial banks' business comes from corporate and individual depositors who, understandably, enjoy first priority on the banks' lendable resources.

Commercial banks, therefore, purchase municipal securities only

after having fulfilled their Federal and state regulatory investment requirements and after having taken care of their regular customers. Thus, the Banks' holdings of municipal paper at any particular time are limited to the amount of their residual funds that are not used to buy Federal, Federal Agency and other securities.

The wide fluctuations in demand for business and consumer credit create a wide variation in the availability of funds for the purchase of municipal paper by the dominant factor in the market. This occurred dramatically in 1969 when commercial bank net purchases of long term municipals fell from a level of $10.7 billion in the previous year to $3.9 billion. In 1969 commercial bank net purchases accounted for only about one-third of net purchases of municipals.

Overall, during the period from December, 1968 through December, 1969, sales of long-term municipals declined from $16 billion to $11 billion, a decline of 30 percent. Although the sale of short-term municipals (under one year) jumped by more than $3 billion, offsetting a good portion of this decline, the refunding problem becomes just $3 billion more severe during 1970.

Maturities and Grace Periods Too Short

One of the most important principles in financing development is that loan maturities and grace periods be appropriate to the nature of the project or program being financed and that account be taken of the debt servicing capacity of the borrower in setting such terms. It is basically unsound to finance long-term capital works with short-term loans.

Economic and social overhead development works generally are substantial, solid, permanent structures with a very long life potential. They usually have an economic life of 50 years or more if reasonably well treated and properly maintained. Obsolescence is not a serious factor in most public facilities. Consequently, the international practice in financing development works of this type is to set the final maturity of the loan at approximately the end of the economic life of the facility being financed.

Public works are usually large, sometimes complex, and generally require several years to construct. It is standard development finance practice to set the first maturity of the loan six to twelve months after a realistic estimate of the date that construction will be completed. In cases of revenue producing projects, the date of the

first maturity may be extended for a reasonable period if it is expected that there will be a further lag in the project generating income, especially for newly organized entities.

In addition, it is traditional in financing development to take account of the current and prospective economic and financial position of the borrower in determining the final maturity and grace period of the loan. Borrowers with current financial difficulties but with reasonable long-term prospects could be accorded maximum maturity and grace periods of municipal securities currently being issued but it is clear that

- maturities are frequently shorter than needed for sound municipal development financing;
- grace periods are generally non-existent;
- both maturities and, where they exist, grace periods more nearly accommodate the interests of the investors than the developmental and financial needs of the municipalities;
- laws governing municipal borrowing have been written to preserve conservative standards and, therefore, do not permit as much discretion as would be desirable;
- the municipal bond market is considerably more conservative in establishing maturities and grace periods than a development banking institution would be;
- the commercial banks, the predominant buyers and holders of municipal securities, understandably prefer shorter term maturities.

In 1965, the latest year for which data are available, only one-tenth of all municipal securities issued had a final maturity in excess of 20 years. A survey made by the Federal Reserve Board of its member banks in June 1967 indicated that only 9 percent of municipals held had a maturity of 20 years or more. More than two-thirds had a maturity of less than 10 years.

This is in sharp contrast to the extensive need for municipal development loans of 40 years or more and to the practice of the Federal government to progressively make more of its loans, many for identical or similar types of facilities, at terms of 30 to 50 years.

These longer terms would reduce the level of the annual debt service burden on the municipality per dollar borrowed, make possible substantially larger municipal borrowings and provide an incentive for municipalities to accelerate their rate of development and progress.

Cost of Money Too High

The yield on municipals is too high
- in relation to corporate bonds;
- in relation to U.S. Government securities.

The yield on state and municipal securities is too high, particularly in light of
- exemption from U.S. income taxes and, in some instances, from state income taxes on interest paid to holders of municipals;
- an excellent debt service record, with a post-war default record second only to that of the U.S. Government.

Yields averaged between 1 and 2 percent throughout World War II, progressively increased to approximately 3 percent in the late '50s, and remained between 3 and 3½ percent until the past several years when they have rapidly increased, with some issues now exceeding 7 percent. The current rate is exceedingly high, particularly since it has to be borne entirely by the states and local communities; they are unable to write off half of it through income tax deductions as corporate businesses do and they are unable to recoup a third or more through income taxes as the U.S. Government does. In one sense it can be said that the net cost of money to states and municipalities is the highest of any group of borrowers with relatively good credit records.

The cost of money to municipalities is not only very high in absolute amount but it is too high in relation to the yields on taxable securities.

Exemption from Federal income tax of interest paid to holders of municipals lowers the cost of borrowing to state and local governments, but, as we know, it does not lower the cost to the states and municipalities to the full extent of the tax exemption.

Competition for money has resulted in the states and municipalities sharing this benefit with the investors. The extent to which this exemption is shared is clearly revealed by the relationship of yields on tax exempt municipals to taxable securities. The yield of municipal securities is currently 70-75 percent of the yield of top rated corporate bonds and 80-85 percent of long-term governments, despite the substantial tax benefits that accrue to nearly all of the purchasers of municipals.

A research project carried out by Brookings Institution indicates that the average income tax rate, before the introduction of the surtax, of holders of municipal securities was 42 percent. This, therefore, means that the states and municipalities receive only about one-half of the benefit from the exemption from Federal income taxes; the investor gets the remaining one-half of the benefit. Consequently, the loss in tax revenue to the Federal Government is considerably greater than the benefit to the states and municipalities.

The yield differential between tax-exempts and taxables has narrowed – as can be expected when the municipal bond market is under great pressure. I suspect it will be under even greater pressure as governments become more sophisticated in their financial plans. For example, close to half the states currently have housing programs which finance private middle income housing by the sale of tax-exempt bonds. The largest of these programs, the N.Y. City Mitchell Lama Program had outstanding $554,000,000 in tax-exempt bonds as of April 30, 1970. The New York State Mitchell Lama Program, a separate program, had outstanding $426,000,000 in tax exempt bonds. At the moment, the totals are small due to start-up time and administrative red tape.

In several years, given the backlog of demand for middle income housing, we could see $2-3 billion in annual sales of tax-exempts for private middle income housing. This is a new demand over and above the traditional use of tax-exempt bonds, and adds to the pressure.

If one believes the pressures will continue, one must assume the yield differential will continue to narrow to the point where the states and cities will receive very little benefit from a costly tax advantage.

Penalty for Smallness

Small communities are generally penalized, solely on the basis of their size, in respect to

- their ability to utilize the money market fully and effectively
- the interest rates they have to pay for borrowed funds.

Many small and medium-sized communities do not use the facilities of the capital market. Those that do are seldom able to borrow all of the funds that they need and, in any case, they pay more for it – both directly and indirectly – than do the large municipalities.

The small and medium-sized communities frequently do not have a staff experienced in the preparation and justification of loan requests, and a market interested in providing it with funds.

A study of the National League of Cities concludes that small municipalities pay higher rates of interest, solely because of their size, despite the fact that the degree of risk involved is not an intrinsic characteristic directly attributable to size alone.

The study showed that the average annual interest cost paid by municipalities with less than 10,000 people was greater than the interest cost paid by municipalities with 10,000 to 250,000 inhabitants for each year and type of bond of a similar maturity during the five year period 1961-65.

The Issuer

In addition to the problems within the market place, there are problems which relate to the issuer. Frequently he is fearful of going to the market – he does not understand it. He is confused about the amount he should borrow – or recommend to the community. He is discouraged about interest rates. Lawyers and bankers are expensive. This lack of sophistication is a major contributor to the fact that many communities are under-borrowed.

Today's generation should not have to provide all the infrastructure for tomorrow's larger and more productive generation mortgage free. Yet this policy is behind the financial thinking of many of the leaders of our cities and states. It certainly is reflected in many obsolete debt limits and interest ceilings.

In addition to being fearful, many issuers have very poorly developed financial plans. The 1960's witnessed a great spirit of local and regional planning: mostly physical, sometimes social, rarely financial. Too often the plans were merely songs to be sung in the shower – they sounded great when the curtain was closed.

Financial planning not only opens the curtain to reality but it may, in fact, be the only practical mechanism for coordination among disparate development goals. Many of the communities have financial disciplines and skills; most do not. There is a great need for technical assistance in this area.

Municipal Bond Market – Summary

In summary, the municipal bond market is large but not large

enough; its reliance on commercial banks is dangerous; its terms are onerous. Its competitiveness is open to question. And the borrower is generally frightened of the market and can frequently use expert help in preparing financial plans and making financial decisions.

The Urban Development Bank

So the Urban Development Bank was born. Its structure is simple:

> The Urban Development Bank would be a financial institution borrowing long-term money from the taxable bond market and lending long-term money to public bodies for capital projects – at tax-exempt rates. The difference in interest received and paid would be made up by annual appropriations from the Congress. The Bank would have a technical assistance arm.

The Bank would not, I repeat, not be a Federal institution. The Federal government would own no stock. The states and cities would. Although the President of the United States would have the power to appoint the President of the Bank and a minority of the Directors, the control of the Board would be in the hands of the cities and states.

Urbank Lending Policies

The Urban Development Bank would finance those expenditures generally financed through the tax-exempt bond market. Urbank would not finance the private sector. It would finance capital expenditures of states and localities for schools, hospitals, water supply, sewers, parks, public transportation. Although not excluded, it was recommended that the Bank avoid housing – at least initially. It was felt that there were sufficient financial institutions and arrangements already active in housing. Yet it was felt that housing as part of any overall developmental package would not necessarily be excluded: A state new-town development, for example.

It was strongly urged that the specific lending priorities of the Bank be left to the discretion of the Bank's management and to its Board. Priorities change: three years ago the priority of the Bank might well have been public transportation; today it would probably be anti-pollution. Moreover priorities at the local level are not necessarily national priorities. One would hope that an effective bank – run by a Board of Directors representing various levels of

government – would indeed elevate the quality of debate on priorities and investment standards and thus set development standards for the traditional bureaucracies.

What Would the Bank Charge for Its Money?

The rate charged the municipalities would be in line with the tax-exempt municipal bond market, except that, as in the case of the World Bank, there would be one rate for all borrowers. The rate would be set high enough to limit the demand for funds to a reasonable multiple of supply. This rationing system would have the effect of encouraging application from those communities with lower than average credit.

For example, if a 7 percent rate were used today, communities such as the City of Miami and Anchorage, Alaska would probably find it attractive to borrow from the Urbank, whereas a community such as the State of Connecticut would probably prefer the existing capital market. This is oversimplified, as much could turn on maturity schedules, size of issue and other terms. Nevertheless the Bank would tend to operate among customers with less than AAA credit and with limited access to the national money market.

It is important to note that in both cases – the case where the community borrows from the Urbank and the case in which the community goes to the traditional market – interest paid on the obligation of the community would be tax-exempt. The only difference is that the creditor in one case is the Urbank and in the other, the public. There would be no prohibition, in fact, against the Urbank selling portions of its loan portfolio to the public when rates made this desirable.

This is an important distinction from certain alternative schemes which would require two distinct sets of local securities – taxable and non-taxable. The structure of the Urbank leaves untouched the tax-exempt status of the borrower and his debt.

Urbank Borrowing Costs

Where would the Bank gets its money? The Bank would borrow money from the public on a taxable basis, paying the going rate. An agreement would be entered into with the Treasury which would provide that the Treasury would come to the aid of the Bank in case

of need – which precedent we have in the Fannie Mae situation and which is regarded by the public investor as an "unofficial" guaranty of the U.S. Government. In today's market this might require a rate of 8½ percent for long bonds.

Now a cost of 8½ percent and a charge of 7 percent means a loss of 1½ percent. This difference would be borne by the Treasury through annual appropriations. It has been argued that such appropriations would not cost the U.S. Treasury anything as the tax bite on the interest on the Urbank bonds would be more than enough to cover differential. The specific Urbank legislation sets a maximum interest subsidy equal to one-third the cost of borrowed money. Calculations indicate the average tax "loss" on the existing municipal bonds is in excess of 40 percent.

If the Urbank paid out $85,000,000 interest on $1,000,000,000 of borrowings, the maximum Treasury contributions would roughly be $28,000,000. Assuming an average 40 percent tax bite on the $85,000,000 interest paid, revenue collections would total $34 million – a theoretical gain to the Treasury of $6 million.

Operating costs of the Urbank would be covered by banking fees and other advisory fees. These should not exceed those normally paid by municipalities to their private bankers.

Management

Who would run the Bank? The Bank would be run by its management staff reporting to a Board of Directors. The current accounting principles of the U.S. Bureau of Budget require that if the Federal government owns shares of a corporation, the expenditures or loans of that institution become part of the U.S. budget.

This is fortunate for the theory of new federalism because those who conceived the Urbank felt that such an institution could make a major contribution to inter-governmental relations provided it were not Federal. An essential ingredient of the Urbank is, in fact, that the states and cities would own shares of the Urbank, would elect a majority of the Board of Directors and would be independent of the Federal bureaucracies.

As part of this strategy to keep the Urbank independent, there was also created the possibility of a special class of stock to be owned by private corporations and financial institutions. The Board of Directors would, according to the legislative proposal, have consisted

of 17 members. The President of the Bank, who would serve as Chairman, and six other members of the Board were to be appointed by the President of the United States with the advice and consent of the Senate.

No more than three of these Presidentially appointed Directors could be employees of the Federal government. The other three Presidentially appointed Directors would be prominent community leaders, professionals, academicians. States, which would own Class A shares, would elect four directors; cities, which would own Class B shares, would elect four directors, and the private sector shareholders would elect two directors.

Ownership of shares would be through purchase and would entitle the shareholder to vote for directors. Borrowers would not have to be members. It is believed, however, that most states would join.

Technical Assistance and Advice

In addition to its financing capabilities the Bank would provide technical assistance to communities. This would include technical assistance in the preparation of development programs, financial planning and administration. This might also include certain investment banking functions. For example, a large city might require $200 million for a public transportation project. The Urbank might take $50 million of the loan for its own account and help the city place the balance with traditional lending institutions.

Urbank Summary

That in brief is a description of the Bank: A bank which would borrow money in the taxable market, lend money in the tax-exempt market, make up the difference through contributions from the Treasury, be guided in its lending policies by the majority of whose directors would represent states and municipalities.

Those of us who worked on the Urbank proposal believed it would have the potentiality to

- tap a broader and larger capital market than is currently available to cities and states,
- provide longer term financing,
- reduce the cost of municipal borrowing,

– add a competitive element to the existing municipal bond market,
– act as a catalyst for sound development and financial planning,
– develop an able group of technicians specializing in urban development,
– provide a framework for discussions among various levels of government on common problems,
– provide a more businesslike image in urban development.

If only a few of these potentials were met, the Urbank would justify its existence many times over.

Environmental Financing Authority

The Nixon proposal which was submitted to the Congress this past February calls for the establishment of an Environmental Financing Authority. The Environmental Financing Authority or EFA appears to be a cut-down version of the URBANK Bill. It may be useful however to outline the differences in order to highlight some of the issues.

First, EFA is a Federal instrumentality. The Urbank is not a Federal entity. Unlike the Urbank, EFA has no state and local representation on it; it is directed by the Secretary of the Treasury with only Federal officials and employees on the Board.

Secondly, EFA is restricted in its lending to the construction of waste treatment works – and, more specifically, only to finance the local share of those projects funded by Interior Department grants. Thus in the EFA proposal, the Urbank becomes a rather automatic device to ease the way for Federal grants. Little or nothing is left of the concept that Urbank could begin to break ground in setting development standards, criteria and local priorities. In the EFA proposal, the Federal government has settled upon one priority, that of waste treatment works. What I suspect will happen is that we shall discover new priorities and have a series of Financing Authorities – for health facilities, mass transit, schools, etc.

It is unfortunate that the concept of building an institution was dropped; creativity, leadership and coordination are desperately needed in development programs. Money, of course, is a great inspirer and coordinator, and an independent non-Federal institution – with money – would be in an enviable position to stimulate those creative functions.

Nevertheless, the EFA is a step forward, a recognition that the municipal bond market is strained and that the Federal goals are furthered by relieving some of that pressure.

EFA should, however, and may one day, be more.

Inflation, Credit Programs and the Federal Budget

At a time when the Federal government is fighting inflation something must be said about creating a credit program outside the budget. As I understand it, neither the operation of EFA nor the operation of Urbank would be included in the Federal budget.

I believe the case for the Urbank being outside the Federal budget is clearer than that of EFA. The budget concepts recommended to President Johnson three years ago by Treasury Secretary Kennedy and current Budget Director Mayo would regard the Urbank as a non-Federal institution, and as such its operations would be excluded from the budget. Because the shares of EFA are to be owned by the U.S. Government, under the existing budget concept the EFA would normally be treated as a Federal entity and its loans would be considered as direct Federal loans. I am curious to see how the new budget team explains its way out of this one.

Despite my personal curiosity, I am sympathetic with the problems of budget treatment of loans, interest subsidies and guarantee programs. There are many of these and they are growing. Programs such as the Section 236 interest subsidy program for middle income housing clearly have an economic impact far above the subsidy or they would not have been proposed. Such programs have a complicated relationship to the budget. Generally the expenditure budget is an allocation device, concerned with the allocation of tax collections. Credit assistance programs, however, tap pools of money not directly under Federal control – such as mortgage money. The tax exemption privilege is also a credit assistance device and hence the attempt – if not to put the value of this subsidy in the budget – at least to calculate it publicly. Subsidies to the Urbank consitute a kind of Federal allocation of private pools of capital, an incentive to shift private capital to state and local purposes from Federal or private purposes.

The subsidy itself is, of course, under control of the Congress. The economic impact is estimable or will be in time. The credit authorities still set the overall credit policy for the country and there is no reason for the Congress and the Administration not to attempt

to shift allocations between the public and private sectors within that credit framework. This in itself is not inflationary.

The debate over the allocation of national resources between the public and private sectors will be a continuing one. The capital market is not immune from a conscious effort to shift financial resources to the public sector. The Urbank and EFA are part of this strategy.

TABLE I

COMPARISON OF BEFORE–TAX YIELDS ON LONG–TERM AAA MUNICIPALS AND LONG–TERM U.S. GOVERNMENT BONDS

YEAR	YIELD ON AAA MUNICIPALS (%)	YIELD ON GOVERN–MENT BONDS (%)	YIELD ON MUNICIPALS / YIELD ON GOVT. BONDS
1960	3.26	4.01	.81
1961	3.27	3.90	.84
1962	3.03	3.95	.77
1963	3.06	4.00	.77
1964	3.09	4.15	.74
1965	3.16	4.21	.75
1966	3.67	4.66	.79
1967	3.74	4.85	.77
1968	4.20	5.25	.80
1969	5.45	6.10	.89
1970 (May)	6.24	7.20	.87

Source: Federal Reserve Bulletin, May 1970

TABLE II

VOLUME OF STATE AND MUNICIPAL BORROWING 1950 - 1969
(billions of dollars)

YEAR	LONG–TERM ISSUES	SHORT–TERM ISSUES	ALL ISSUES
1950	3.7	1.6	5.3
1951	3.3	1.6	4.9
1952	4.4	2.0	6.4
1953	5.6	2.7	8.3
1954	7.0	3.3	10.3
1955	6.0	2.6	8.6
1956	5.4	2.7	8.1
1957	7.0	3.2	10.2
1958	7.4	3.9	11.3
1959	7.7	4.2	11.9
1960	7.2	4.0	11.2
1961	8.4	4.5	12.9
1962	8.5	4.8	13.3
1963	10.1	5.5	15.6
1964	10.5	5.4	15.9
1965	11.1	6.5	17.6
1966	11.1	6.5	17.6
1967	14.3	8.0	22.3
1968	16.4	8.6	25.0
1969	11.4	12.0	23.4

Source: The Bond Buyer, 1970

TABLE III

OWNERSHIP OF STATE AND MUNICIPAL SECURITIES

PERCENTAGE DISTRIBUTION

Year	Individuals	Comm. Banks	Ins. Comps.	All Others (see note)
1959	39.74	27.46	15.35	17.45
1960	40.96	25.30	16.72	17.02
1961	39.47	26.22	17.57	16.74
1962	38.33	28.96	17.10	15.61
1963	36.90	32.48	16.88	13.85
1964	36.91	34.50	16.43	12.16
1965	36.29	36.90	15.32	11.49
1966	36.45	38.45	13.74	11.35
1967	35.12	40.25	13.68	10.94
1968	32.29	43.50	13.60	10.62
1969	31.55	44.15	13.06	11.24

Note: includes state and local funds, corporation funds, savings and loan associations, corporate pension trust funds, mutual savings banks, and U.S. Government investment accounts.

Source: The Bond Buyer, 1970

DISCUSSION

HENRY WALLICH

It is a privilege to have the last scheduled word at a conference like this one. The honor is partly offset, however, by the disadvantage that almost everything one intended to say has already been said. Of the very few things that have not been said, some are enshrined in Peter Lewis' excellent paper, and unfortunately he skipped those. I will have to comment on these non-remarks of his, or remarks that he did not make very explicit.

The tenor of my comments will be to think small. Peter Lewis thought big. He has in mind a large, new organization – Urbank. I shall say a few words in defense of little EFA (Environmental Financing Authority), which would be a small organization. I have no great enthusiasm for coming to the rescue of EFA, however. There is a difference of size, but both outfits are essentially similar and capable of mischief. I shall explain why I think so.

Peter Lewis, in his excellent paper, starts out with some large numbers. I would like to bring those down to smaller dimensions. This has to do with the size of the tax-exempt market, which he states in gross terms – that is, before amortization. So stated it does look indeed like a $25 billion operation. In net terms, as Peter undoubtedly knows, it has been less than $10 billion in the last couple of years. As a resource to states and municipalities, therefore, it ranks well below Federal grant programs, which now are running in excess of $25 billion a year.

To say a few words about a side of the municipal bond market which Peter did not touch upon much, I think we have a very interesting lesson here on the effects of specialization, either in lending or in borrowing.

State and local authorities are specialized borrowers in that they appeal principally to commercial banks and secondarily to upper-bracket individuals. We have another example of relationship – the savings and loan and the housing industries. While the housing industry is not a very specialized borrower, it does rely heavily upon

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a specialized lender, the savings and loan associations.

The two sectors, state and local authorities and housing, that rely in some way on specialized borrowing and lending, have done worst in the recent tight period. That, I think, is a lesson. When the Commission on Financial Structure and Regulation examines the experience, I hope that record will weigh. We need more diversified credit institutions.

Next, I would like to say a word about the calculations put forward with respect to costs and benefits of the existing tax-exempt bonds. It is very difficult, as you probably know, to figure out what the true cost to the Treasury of tax exemption on municipal bonds is. It is generally stated to be in the range of 40-50 percent of the interest paid. This, however, depends on the assumption that Stan Surrey's proposal prevails and all tax-exempt bonds are eventually eliminated. In that case, even top-bracket taxpayers lose their bonds, and that is where the biggest revenue loss is. If only a portion of these bonds is eliminated, for instance by a Urbank-type device, then it will be lower bracket taxpayers who will be holding taxable securities instead of tax exempts. The loss to the Treasury in that range is much less, and consequently the gain from ending part of the tax exemption is also less.

I might add that the top bracket taxpayers whose marginal rate enters into these calculations may get tax-exempt interest not only in their marginal income bracket, but in their lower brackets too, in which case again the loss to the Treasury is less.

At the same time, a special hidden cost is imposed on holders who have a large part of their assets in tax exempts, in the form of inadequate diversification of their portfolios. The consequences of inadequate diversification have become apparent in the tremendous losses suffered by municipal bondholders in recent years.

There are also some misconceptions about the interest costs of competing borrowers. For instance, I see in the literature that it is widely believed that the Treasury recoups something like 30 percent of the interest it pays. That is thinking big.

If you think small, you will remember that if the Treasury did not issue a particular security because it did not have a need for the money, then somebody else would be presumably selling a security – at full employment the total amount of borrowing must be constant. The Treasury would get tax revenue from the interest paid on that alternative security. So the Treasury really recoups nothing unless

you assume that Treasury borrowing increases the GNP.

The same applies to the statement that corporations save 50 percent of interest because it is taken off taxes. Once more, that is thinking big. Thinking small, I am unable to understand corporate treasurers who say that. They never seem to say that wages likewise are 50 percent tax deductible. Of course, that is as true or as false as it is with respect to interest. If you regard the tax deductibility of interest as a kind of subsidy, you must spread it over all corporate expenditures equally. Very little of it will be applicable to interest, and most of it will be applicable to wages. I think it is a wrong way of viewing the tax anyway, but if one wants to do it, one must allocate it in proportion, and in that case the share of interest that is offset by the corporate income tax becomes quite small.

Let me now turn to Urbank, and first focus on some of the improvements that presumably, if created, it would introduce into the municipal market. I do not quite understand why Peter Lewis says that Urbank would improve the market, because essentially it seems to me that it would substitute for part of the market. Now it is true, theoretically, that Urbank would have been authorized to sell some of the securities, or all, that it acquired. We have had a good deal of experience with asset sales by the Federal Government, and they are not one of the happier parts of the budgetary process.

But consider the prospect. Here is an agency that ostensibly is outside the budget. It could sell assets. It has no particular reason for doing so. It can equally well sell its own securities, and is really geared to do that. My initial conclusion is that this institution will do little if any selling. It will increase the total amount of credit available to state and local borrowers, but it will not broaden the tax-exempt bond market as such. What it presumably will do is help small and high-risk borrowers. This is probably a very desirable activity.

There are something like 80,000 issuers of municipal bonds, I am told. Only 20,000 of these have ratings, the rest apparently are too small or too unknown to merit even a rating. They cannot easily go to the market. Many fortunately are taken care of by their local bank. Many small municipalities, I am told, enjoy lower interest costs than some of the large. But clearly for the average small municipality, the situation is not ideal.

If Urbank were to be injected into this picture, it presumably would do as the World Bank does and lend to everybody at the same

rate. This means to eliminate the risk premium. It is not very clear to me how far that is a desirable feature. After all, the risk premium paid by the small, unknown, high-risk borrower is quite possibly, so to say, "deserved." A good borrower probably can drive a good bargain with the local bank if not with the market. If it is a high-risk borrower, he should be penalized by paying a higher rate. If we do not do that, we penalize in effect the responsible borrower who does not get the preference in the market that he deserves.

The risk premium consists of two components. First, there is the actuarial probability of default. That somebody has to bear, whether the private bank or Urbank; it must be deducted from the nominal rate of return in order to arrive at the net or expected rate of return. I do not see that it is fair to forgive the weak, high-risk borrower that share of the risk premium. There is a second component of the risk premium that is usually charged by the private market for bearing the risk.

In other words, even though the investor does not expect a loss beyond the actuarial expectation, there is an additional premium because the market is a risk averter and wants positive compensation for bearing risk.

This second part of the risk premium, quite legitimately, Urbank could eliminate. There is nothing in the laws to say that Urbank needs to be a risk averter. It can be a risk neutral, as intermediaries theoretically are supposed to be, although I very much doubt that they are. Here is a legitimate area for, as it is sometimes called, socializing risk.

Let me now come to the main difference that I have with Peter Lewis. You will have seen that so far we really have no very great differences. But at this point, I suspect, I will incur not only his displeasure but also that of Mr. Levitt. I question the advisability of these proliferating Government-assisted credit programs. These are "off-balance sheet," or rather off-budget financing, techniques that have been developed in recent years to get money spent without showing it in the Federal budget.

This has several bad effects. One is that, properly stated, the Federal budget is running a bigger deficit than appears. A second is that demands are escalated in the capital market and are helping to drive interest rates sky high. We must not fool ourselves. It is not only inflation that accounts for 10 percent on an A-rated utility bond. It is the increase in demand by parties that previously did not

borrow, or did not borrow so much. This occurs in the face of changes in our tax system that have reduced the flow of saving.

We have shifted our tax system from growth as a principal objective to equity. We tax the rich and the corporations, we untax the poor. That is fine socially, but it has a negative impact on savings.

Let me describe briefly how these Government-assisted credit programs shape up at the present time. In fiscal year '70, they increased – I am speaking of the net amount outstanding – by $15 billion. In fiscal '71, they are scheduled to increase by almost $21 billion. Now that is not an equivalent increase in aggregate demand, because many of the things that are done via these credit programs would be done anyway. For instance, FHA and VA guarantees, in many cases, just make cheaper some expenditure that the homeowner unassisted would finance a little more expensively.

But an increasing proportion of the programs, and virtually all the newer programs – mostly in the housing area, but also other agencies – represent almost 100 percent incremental aggregate demand. A fair guess seems to be that of this nearly $21 billion additional expenditures, something like one-half to three-quarters incremental.

If, therefore, you want to know what the "true" budget deficit now is, one way of arriving at it is to add these amounts back into the budget. You then arrive, of course, at a very large deficit, $15 billion or more. If you want to be fair to the Federal Government and say, "Let us not look at the current deficit, let us look at the 'full employment surplus,' " that is now estimated in the range of a $5-10 billion surplus. When you take off possibly $15 billion of off-budget expenditures through the Federally-assisted credit programs, you arrive at a startling full-employment deficit.

All this is a tremendous drain on the capital markets. Here is Uncle Sam giving everybody hunting licenses in the capital market, in effect, and assuming apparently that this will increase the amount of game. It leads one to think that economics is probably an older profession than one realizes. We seem to be the lineal descendants of the alchemists who thought that they could turn lead into gold. We are trying to turn paper into resources. I prefer to think small, and to conclude that we have limited resources. By issuing these hunting licenses we are not really increasing the amount of capital available.

If we continue down this road, the result is foreseeable. Everybody will end up with a Federal guarantee and quite possibly with a Federal tax exemption on his borrowing. At the beginning of

World War II we had priority allocations for defense producers, and by the time everybody had a AAA priority certificate, everybody was right back where he started. The same could happen in the capital markets. This is the direction – fortunately only the direction – in which we are moving. That is why I am skeptical of every additional step taken in that direction. Urbank would be a very large step; EFA a small step. One has to accept the realities of the situation, but the smaller the step, the better I like it.

What is the really sensible solution? It is not to help people to borrow more. Subject to corrections of some inequities in the capital markets – and there I do not preclude action in the tax-exempt area, either by changing the law, or by giving some kind of a subsidy to weak borrowers – the main prescription at this time is to form more capital by saving more.

In the private sector, we ought to re-orient our tax incentives for households and corporations. Since I do not expect another major tax reform very soon, I would hope at least that when the Congress gets to estate and gift taxes, which might be this year or next, what is done will not all be done in a way that further reduces the supply of savings. Estate and gift taxes, as you know, are paid mostly out of savings and not out of consumption.

As far as the Federal Government is concerned, I think we ought to run surpluses, as Mr. Levitt said. I wonder whether he feels the same as I do about the probability of the Federal Government doing that. If one is skeptical, perhaps a better solution is to rebudget some of those off-budget expenditures. In that way, funds could be absorbed that might otherwise be given away in tax reductions or used for additional expenditures.

For state and local authorities, I do not share the view that the burden should be shifted to future generations. This is what General Eisenhower used to warn against. He wanted to repay Federal debt because he did not want to burden his grandchildren. On various occasions his economic advisors felt that they had to tell him you could not shift the burden to your grandchildren, subject to certain special considerations.

Now our states and municipalities are trying to do just that – shift the burden forward. It cannot be done in a meaningful sense. Any one unit of course can do it; as a nation, as an economy, we cannot. The best way to respond under those conditions is to increase our own supply of saving. Fortunately, everybody who does that will

immediately benefit by having more resources. I would advise the respective authorities to move in that direction before increases in interest rates compel them to do it.