CHAPTER 16

Credit Problems of Small Municipalities*

THE MARKET FOR BOND ISSUES OF SMALL MUNICIPALITIES

Long-term municipal debt outstanding totals in excess of $29 billion.[1] In the 9-year period 1957–65, such debt increased by approximately $1.4 billion a year, and there is every indication that municipal debt outstanding will continue to increase at no less a rapid pace in the future.

With few exceptions, the Nation's cities, like its citizens, are compelled to borrow in order to obtain funds for the construction and acquisition of capital facilities. However, unlike private citizens who can secure loans with relative ease at fixed interest rates, small municipalities, particularly those having less than 10,000 inhabitants, often are penalized, solely on the basis of their size, in the rate of interest they must pay. This occurs in spite of the fact that the degree of credit risk involved is not an intrinsic characteristic directly attributable to size alone.

The average annual net interest costs of bonds in the A, B, and unrated categories for municipalities having less than 10,000 inhabitants and for municipalities having 10,000 to 250,000 inhabitants are compared for the 5-year period 1961–65 in table I on the following page. In each year, the average annual interest costs paid by smaller municipalities exceeded the average costs paid by the larger municipalities.[2] Application, on a monthly basis, of the Bond Buyer index to the various categories of bonds shows that the time of sale is not a significant factor contributing to the consistently lower net interest costs enjoyed by the larger municipalities. Table II shows the difference, expressed in basis points,[3] between the average annual interest costs of small- and medium-sized municipalities as a deviation from the Bond Buyer index. In each case, the adjusted interest costs for the medium-sized municipalities are less than those for the small municipalities. The difference varies from 4 to 79.9 basis points, depending upon the year and the type of bonds.

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[1] U.S. Bureau of Census, "City Government Finances in 1964–65," Governmental Finances/GF No. 5 (Washington, D.C.: U.S. Government Printing Office, 1966), p. 6. Total long-term debt outstanding for all local government units amounted to $68 billion in 1965. U.S. Bureau of the Census, "Governmental Finances in 1964–65," Governmental Finances/GF No. 6 (Washington, D.C.: U.S. Government Printing Office, 1966), p. 28.

[2] The Investment Bankers Association of America very kindly provided the raw data, on a monthly basis, for the preparation of table I. The data was converted to an annual basis because the number of issues marketed in some months provided too little material upon which to base conclusions. (See app. A at the end of this chapter for a presentation of the data on a monthly basis.)

[3] A "basis point" is one-hundredth of 1 percent of the bond yield. Each basis point constitutes $0.10 in interest per year on a $1,000 bond. On a $500,000 bond issue, maturing serially over 20 years, an increase of 25 basis points in the interest rate increases interest payments by $13,125.