LEGISLATIVE RESEARCH COMMITTEE

July 27-29, 1942

Testimony of WILLIAM STANLEY PARKER

Re: Municipal Reserves.

Testimony of WILLIAM STANLEY PARKER, Boston, Consultant of the National Resources Planning Board:

MR. WEBBER: Why don't you go ahead, Mr. Parker, and tell us what you have got on your mind, because I do not know enough about it to start asking any questions.

MR. PARKER: What I wanted to have a chance to discuss with you is the question of municipal reserves for municipalities, and perhaps, before arguing the validity of the idea, I will briefly state what I know of things that happened with it in the last few years.

Up to 1937, so far as I am aware, no state legislation permitted the setting up of long term mumicipal reserves of any kind: the budget wasan annual budget and they collected each year what they needed. There were a couple of items of overlay for uncollected taxes and emergency expenditures but there was no continuing reserve that it was possible for a municipality to collect. In 1937 California set up what I think might be just about the first municipal reserve for a specific purpose. In other words, they would establish the fund as it were for a specific public work or type of public works and then they could deposit into that fund surplus of unexpended balances or what not or vote new appropriations for a public work that would be built later. In other words, it would be surplus financing for public works unstead of waiting until they needed it and issuing bonds.

At that same time, without any knowledge of that action, the State Planning Board in Massachusetts was considering the matter through its Committee on Public Works, of which I was Chairman, and in March,1938, they approved the report I developed and my committee submitted, urging the need of municipal reserves and of a long-time reserve for a rainy day, not a special reserve for a particular project but a reserve for assistance in time of financial stress. In 1939 we submitted that to the Legislature in Massachusetts in order to have it referred to the next general court, which we knew would happen to that legislation the first time it was submitted. In 1941 a good deal happened. The California legislation was somewhat revised and New York State came through with quite similar legislation. The California legislation was limited to a five-year period: the New York legislation had no limit in the time; it was legislation that permitted municipalities to set up funds either for a specific public work like a hospital or a school or a thoroughfare or for types of public legislation like sewers or schools and put funds aside for that purpose. Those funds, as in the California legislation, were considered trust funds and were administered under the laws governing trust funds and with the same penalties. In 1941 also a very conservative New York lawyer and a leader in the finance committee submitted to a conference in Connecticut a plea of which I have a copy, arguing in favor of the desirability of municipal reserves.

The Massachusetts report says any such reserves must be protected against suits. His report differs from the Massachusetts report. The Massachusetts report admits it must be done and makes the first attempt to set up the formula by which protection can be accomplished.

Also in 1941, in November, Governor McGrath of Rhode Island before a full meeting of the New England Council made a very strong appeal for both State and municipal reserves as a sound financial procedure. I have a copy of that here. Also in December, 1941, the Council of State Governments issued a report strongly favoring municipal reserves, and in 1942, a few months ago, the emergency legislature in Massachusetts substantially paralleled New York and California legislation by an emergency legislation that permits municipalities in Massachusetts to invest in defense bonds or other federal bonds to not exceeding one dollar on the tax rate or one-tenth of one per cent of the valuation for the preceding year, to be spent for public works, any kind of public works, after the war is declared over. That is temporary legislation, but it is substantially the same thing as the New York legislation except you do not have to specify a public works of any particular kind: it is a blanket investment, purely permissive legislation, and to what extent it has been taken advantage of I cannot say, and I think probably to a very slight extent, but I think in a few places. It didn't get onto the books until a week or two before most of the town meetings were held in Massachusetts and after all the town budgets and finance committee reports had been set up, so that I think it was almost too late to be very much use as yet.

In addition to these specific actions, I in my work in New England on the Public Works Program have been in all the states, meeting a good many public officials, state and local, and I think it is fair to say practically everywhere I go I have found a definite impression of interest and a lot of people have got the idea of municipal reserves, that somehow or other they ought to be permitted. Now that indicates quite a good deal of water has gone over the dam in the last four or five years in thinking in connection with municipal reserves.

Briefly just to touch on some of the points, and then I hope you will shout questions. The idea seems to have been among legislators that they didn't trust legislators, that municipal governments could not be relied upon to expend reserves if they collected them for what they should be spent for. Nobody had attempted the somewhat complex job of laying down some kind of a formula or procedure that would protect the reserves so that they would be used for the purpose for which they were collected. It seems as if they said the municipal corporation is something different from the private corporation: it must go on a hand to mouth basis: no other type of corporation does, but a municipal corporation should. Apparently the only valid reason I have sensed is they simply didn't trust the ability of municipalities to protect the reserves for the use for which they were devised, and, so far as I am concerned, that is the only reason I have found that has motivated the general prohibition of municipal reserves. Now the general prohibition of municipal reserves seems to have acted in this financial field the way it has acted in other fields: it has brought about bootleg surpluses in many communities. I have found in New England in many communities an over-estimating of expenditures and over-estimating income in order to have some unexpended balances to tuck away somewhere. It has been by no means unconscious; it has been frankly admitted.

In Connecticut, where they have to wipe the slate clean every year, when the municipality makes up its budget it has to set off against the budget first any unexpended balances on hand and wipe the slate clean before they can fix up their tax rate and then they collect the balance, but they have no lee-way. One man told me about the way they arranged things in their estimates so that there was going to be quite a tidy sum that wouldn't be invested because they knew there was a school coming along they wanted to pay for. Municipal officials are doing that with regard to bootleg surplus as I call them which are unprotected. What I am arguing for is a protected reserve that will be used for the purpose for which it is intended.

The result is they are collecting in many communities very substantial surplusses that have no protection and can be used for anything any time. And not only do municipal officials act in this way, but State officials responsible for guiding and controling in some states the municipal financial procedure, which is done in quite a definite way in Massachusetts, even in Massachusetts we find the spectacle of the Tax Commissioner responsible for the enforcement of municipal tax legislation telling municipal officers they must not reduce the tax rates this year because they must set up a cushion against the future, which is quite illegal.

I think that this situation and the unfortunate reaction to it suggests the desirability of thinking pretty carefully as to whether a protected reserve would be advisable that would do the job that is needed and set up a reserve for a rainy day. Now it seems to me there are two kinds of reserves that are needed, the reserve for a rainy day which is to help carry normal maintenance expenses when trouble comes and the reserve that will at least permit a municipality to do surplus financing for any known need in the future instead of telling them they cannot put any money aside in their sock for that public highschool but that they must wait until they need it and then go to the bank and borrow money and pay interest on it. It seems to me it is unreasonable to tell a community that can afford to tax themselves in good times that they ~~must~~ cannot do it but must wait until bad times come and increase their public debt to get what they need. It does not seem to me reasonable. M

Now the first kind of special reserve for a future public work is instanced by New York and California legislation. It is easy to draw up; nothing very subtle about it. You have those for guidance. The other is a more difficult type of reserve to provide. In my study of public works expenditures as Chairman of the committee of the State Planning Board I was led to re-read a great many reports I had read before, some of them, and see what policies we ought to suggest with regard to public works; and I came across the situation that had develpped in the thirties with the depression, where all the municipalities were in trouble and the federal government was in trouble because all the municipalities were in trouble. After 1929 and 30, after the boom period of public construction, when the crack came the municipalities immediately pulled in their horns on public construction in order to have money enough left over for the current welfare, and I suspect that for every dollar they cut down on their public construction they acquired another dollar of welfare as a result of that operation. In that couple of years the expenditures for construction by states and municipalities shrunk two billions of dollars. At that time the construction of the federal government was about six hundred million dollars a year and the municipalities turned to the federal government to expand their construction in order to take up the two billions of slack. That was the problem that faced the federal government in the thirties, and they were just able with their extremely large public works spending to bring the total public construction up to what it had been, and all that effort was not able in any way to offset the shrinkage in private construction.

Now the theory of public spending in construction is that public construction should be increased in bad times to offset shrinkage in private construction to try to offset depreciation in private enterprise. Of course in municipal construction the curve is parallel to the curve of private construction: public consttuction is increased with private construction and public construction is cut down when private construction is cut down, making the matter doubly bad in boom times and doubly bad in a depression. The countercyclical theory is valid and has been arged in all reports as the procedure for the federal government because the federal government can use income tax financing but the municipalities cannot. They have just applied the countercyclical theory to states and municipalities as well as the federal government without sensing the fact they just can't do it because the municipal taxes come from real estate and in hard times they cannot indefinitely spend money and create additional debt, especially in many cases as in the serious depression of the thirties when the tax base was pulled from under them and whatever surplus borrowing power they had had was wiped out by shrinkage in values and they had no reserve.

So it seems to me in all municipalities it should be mandatory that there be some municipal reserve. There is certain legislation aimed at requiring municipal reserves, and also in the same statute the laying down of the formula, a guiding principle of what determines how and when and to what extent that reserve should be drawn on to ease the tax difficulty in times of financial stress. With that in mind, it seemed to me it was necessary to devise a formula for such a statute that would include in the formula such indices that could be read in the municipal accounts of recent years that would determine whether or not a municipal financial situation was difficult and that formula would determine whether or not they could pull out from the reserve. In that formula asfinally developed three indices were selected. They are the ones that have been suggested and seem to relate themselves directly to local financial depression conditions, and, since that is a municipal reserve, the formula must be indexed to local conditions and not general.

The three indices we used were, first, assessed values: they move solwly in relation to depression and boom conditions; in the thirties they moved very seriously and critically on account of reaction from inflation of values that had been going on in the previous decade. If assed values stop going up they have an adverse effect: if they go down they have a double effect on the base on which taxes can be assessed. If there is a drop, the difference in assessed values multiplied by last year's tax would be a definite indication of the amount of taxes you wont be able to assess this year that could be assessed before. That will work out in a formula either to a plus or minus factor, either more taxes they can assess or less. Next is the percentage of taxes collected, which quickly reacts to depression conditions. If the percentage of taxes collected drops five per cent, then that five per cent on last year's assessed taxes represents a definite loss. Again, if the percentage drops it becomes a minus factor and if it improves it becomes a plus factor. The third factor is the trend of total expenditures for welfare, which of course is very quick to respond to depression conditions. If that increases, it is a burden on the budgêt.

Now each of these three is a plus or minus factor in the formula: the three added together will be either plus or minus. With last year's experience on the books of a community, the treasurer in half an hour could work the formula off as soon asthe books are completed. We took the average of the two preceding years for the Massachusetts formula in order to spread the thing and slow up the effect. If the net result is plus and they are better off than in the two preceding years, they can put it into reserve. The suggestion was two per cent. After the budget is figured they add two per cent to the reserve, so that they are collecting 102 per cent, and in good times they are overtaxing themselves to put something aside in the reserve.

If the formula comes out minus, it means last year to that extent the budget was $50,000 in the hole worse off than the average in the two preceding years. They are happy then if they can appropriate $50,000 out of the reserve in this next year in order to make it up and help ease the tax rate situation and make it easier for them to continue their normal expenditures in the next year without increasing the tax rate. That is the whole substance of the formula.

MR. WEBBER: Don't you have to have a starting period to get some reserve built up before you allow the first withdrawals?

MR. PARKER: That might be. We didn't put that in. If you need the money and have got it you might just as well use it because you have to take it out of taxes if you can't take it out of reserve. Obviously you can't build up a reserve on a declining trend into depression: you can only collect the reserve, accumulate it under reasonably ample times. These current times are mixed in their plusses and minuses. As you know, it is not all hay. On the other hand, many communities I have bumped into in New England have been forced and have almost plaintively stated in their financial reports that they have been forced to reduce the tax rate because they couldn't get men and materials to do ~~the~~ some work they needed and wanted to do, on account of priorities and the whole situation. That is the tendency our tax commissioners have been trying to compete with by telling them they are missing out by not building up a reserve. The Massachusetts legislature was very conservative, and there might well have been two or three times as much put in the reserve. One community like Greenfield, Mass, collected $75,000 to $100,000 on the present tax rate more than they could possibly spend on the budget. They could only put aside under Massachusetts legislation $25,000 on the basis of investing in government bonds, but they could perfectly well have afforded to put $75,000 in the reserve, and they had listed a three or four hundred thousand dollar high school to be built in three or four years, and the only thing they could do was reduce their tax.

That is the story in a nutshell. I have attempted to outline the general idea of the Massachusetts bill which is the only one I know that has a reserve for a rainy day, except this statement of Governor McGrath. The Massachusetts report in 1938, which I am responsible for, as far as I know is the only example of where an actual attempt has been made with a definite formula to do the job.

MR. WEBBER: As I follow your discussion, if I get it, you recommend going beyond the permissive statute and making it a mandatory reserve system on the formula?

MR. PARKER: I do. In the first place it will be all right as far as any individual community that does it under permissive legislation, it will help that community within its own limits, but that community just by doing it itself will not be spared the repercussions of depression conditions in the country as a whole, and the only way you can get the cumulative value of a financially should municipal procedure in this country would be by making it nationally in all the states a mandatory procedure. That is the only way to protect the national budget as I see it. The difficulty is that in the past ten years everybody has been worried about the increase in the federal government, they have been looking at the federal government and they have not been looking at the reason for it which was the unsound local municipal financial condition which imposed that two billion dollar depression item in construction alone caused by the municipal financial condition, and if in any depression we have got to look forward to that same result, to the unsecurity in this large field of municipal finance and the whole problem of depression has got to be passed onto the federal budget, it seems to me there is a very serious weakness in the whole economic situation.

MR. WEBBER: Let me ask you this, Mr. Parker: You are working for a United States government agency?

MR. PARKER: This is incidental to my work because my work is to assist states and municipalities in all the states to set up long-range capital budgets, long-range financial programs. This is looked upon by the National Resources as an important matter to be given very careful consideration and study in all the states. It is related to my principal subject, which is to assist in setting up a long-range program.

MR. WEBBER: What is the National Resources -- a branch of the Treasury?

MR. PARKER: The National Resources Planning Board is a planning agency attached to the executive offices of the President.

MR. HILDRETH: That is the one headed by Victor Cutter?

MR. PARKER: Mr. Cutter is the head of the regional office and Frederick Delano of the national. I work through Mr. Cutter on the National Resources Planning Board. This matter is before a similar committee to this: the Statute Revision Committee in Connecticut, and I have been invited to take it up with them and I hope I will be able to do so at some meeting before long. I am trying to get it considered in Massachusetts, but there is no recess committee, apparently, authorized to take up this kind of matter unless the Governor directs it to somebody. In Manchester I talked with the Bank Management Conference. I think Governor Blood put through the first long-range State capital budget in the country last year.

CHAIRMAN DOW: Supposing this were permissible legislation or mandatory legislation and I was one of the assessors in one of these Maine towns, wouldn't it be possible for me to so monkey with the three factors so I could escape the law?

MR. PARKER: That has been asked by a great many, and I suggested they try it, and they agree they don't see how it could be done. The only thing you could do would be to pull yourself down in the mire, because your experience that year relates to two preceding years and it has got to get progressively worse.

CHAIRMAN DOW: Your answer would be they might for a while but eventually it would catch up?

MR. PARKER: You would catch up with yourself pretty quickly.

(Off record)

MR. WEBBER: As a practical matter, the only thing I have been able to think of that might occur in a state like Maine where local self-government is clung to with such strength, a mandatory provision might not be taken too kindly even if we might all agree it was the best thing.

MR. PARKER: As a matter of fact, out west to make it mandatory would need changes in some of the state constitutions. It may be a matter of popular sentiment in some of the eastern states. I have been told by legislative counsel and the Attorney General in Massachusetts it would not require any chance in Massachusetts to make it mandatory. I think Massachusetts goes further than many states in the matter of control of municipal finance: I think it has a very elaborate and definite control. The Tax Commissioner is telling them they must keep their tax rate up, but he admits that doesn't control -- that is his own judgment.

MR. WEBBER: To show you the amount of control your municipal groups have in this state, if I am correctly informed the municipal audit control was emasculated recently by municipal pressure groups, and there was a difference of opinion as to whether that was a forward-looking step. They do exert quite an influence.

MR. PARKER: I think that is a factor that has got to be taken into consideration. You were asking me whether I was in favor of permissive or mandatory legislation. As I said, from the point of view of the possibility of getting an improved municipal financial condition it would warrant mandatory legislation in my opinion, but I am perfectly aware in many states it might not be possible at first.

MR. WEBBER: Plus some education.

MR. PARKER: Plus education. The fundamental principle in the Massachusetts rpport was the need of stabilizing municipal expenditures in order to stabilize a very large stratum of public expenditures in the country, which is a stabilizing force in depression times. At the present time they will go haywire parallel to the trend of private enterprise and that just means that the trend in public expenditures tends to make things worse. To my mind it is inevitable as a practical matter to get the countercyclical theory adopted in municipalities, to spend more in depression times and less in boom times. The stabilized trend is something a municipal official can think of, especially if you adopt a six-year program, laying out a very long-range program. That will tend to do what they all want to do, that is stabilizing the tax rate, no matter where it is. They are all perfectly satisified if they can keep twenty-five or twenty-six, what they had before, and the only way they can do it is by a long-range program. If they can think in terms of keeping their expenditures moving along their normal trend practically the same year after year, they have got to have some financial reserves to be able to do it in bad times because everywhere they have to pull in their horns.

CHAIRMAN DOW: You are talking of a tax rate of 25 or 26: that sounds new to us in the State of Maine: we haven't had it for a long time.

MR. WEBBER: Does this plan propose to include control of investments in the reserve fund?

MR. PARKER: I haven't touched on that. I will be glad to. The concept in the Massachusetts report is this: Each municipality will set up a credit reserve account in their budget into which this money to be collected out of the tax rate will be placed. If that community issues new bonds for public works or public expenditures of any kind they can absorb some of these bonds into the reserve to the extent that the annual contribution is available: in other words, they can hold their own bonds, and instead of selling them to the public sell them temporarily to their reserve. If they have no such bonds or if they haven't got enough, then the state credit reserve is set up, administered by the treasurer, and the money is paid by the communities to that state fund in exchange for state certificates, perhaps at a small rate of interest, but that is not important, and the State Treasurer invests those funds in state issues or approved municipal issues in the state or federal issues. The Assistant Secretary of State has given this idea his endorsement and has written me he feels probably some Federal Discount Bank, perhaps an RFC type of operation might be needed to take up these reserves in times when they had to be liquid for use, in order to make sure the thing would never be frozen.

But that is the principle of the investment that has been laid down, and it has been approved by the bankers I have talked with. It would have no adverse effect on municipal bond markets so far as I can see, and business men and others I have talked to have taken no exception to that. It simply means if bonds are put into the local reserve account they would not be cancelled: they would collect interest, and, later, if and when they needed to pull out the reserve they could market some of these bonds in the open market.

MR. WEBBER: What would be the harm, Mr. Parker, instead of having the State clearing it, if the State simply set limitations as to what they could invest and allow them to invest directly in municipals and states themselves?

MR. PARKER: The only thing I feel, thinking of it in terms of a general municipal adventure, the average confidence of the municipal finance officer might be felt to be less dependable in the insurance and protection and administration of these funds than if they were kept and administered by the State in a larger unit which by its very importance would demand care and supervision that would insure their protection.

CHAIRMAN DOW: Has anybody any questions? If not, thank you very much. I guess we understand the proposition, unless there is something you wish to add.

MR. PARKER: No. Perhaps I should just turn over to you here the series of statements. That is a brief outline of the two types of reserves and appended to it is a copy of the report of the Massachusetts Board, the printed document at the end, which goes into the details of reserve for a rainy day, and the formula is all explained in detail. The whole story is in that.

I think you might find this of interest: it is a copy of the report of the Council of State Governments in December, 1941, which definitely favors the municipal reserve.   (Reports filed with committee)