SERIAL PAYMENT PLAN FAVORED

Expert in Municipal Finance Cites Strong Arguments Against Sinking Fund Method

Strongly favoring the serial payment plan for municipal financing, Mr. Howard F. Beebe writes in the Trust Company's Magazine, saying that he may not be charged with having arrived at this opinion without having given due consideration to the sinking fund method. Mr. Beebe, who is manager of the municipal department of Harris, Forbes and Company, and was one of the committee of three bankers appointed to make recommendations to the finance committee of the New York State constitutional convention, makes the following statement: Given a mathematically correct annual or semi-annual appropriation, invest it promptly with the periodical increment at the exact percentage which the municipality paid for the money borrowed by the issuance of bonds, there is no advantage in the serial payment, the results being exactly the same. So much for the theory, which for many practical reasons cannot be worked out to that end.

Investment of Sinking Funds.

Assuming that a city sells an issue of 50-year 4½ per cent. bonds on a 4¼ per cent. basis, it will be necessary that each annual payment to the sinking fund be received promptly when due and with interest on the accumulated sinking fund for the previous year be invested on the day it is received at 4¼ per cent. to attain the result of paying off the same issue of bonds by the serial method. Furthermore, unless the securities in which the accumulated funds are invested are of as high grade as the issue to be retired, there is the element of risk, however small, to be considered. That the investment of a sinking fund in the manner described above could not be accomplished year after year will be readily acknowledged by any one familiar with such matters.

It may be argued by some that the return on such a sinking fund might be above 4¼ per cent. and thereby benefit the city. This, of course, is possible, but the probabilities are that it would be at a lesser rate. What actually happens in a large majority of cases is that the annual payments are delayed, that they lie uninvested (except at a comparatively low rate of interest), in the local bank depositories for some time. And, furthermore, through an attempt to get as large a return as possible securities are often purchased which are of a grade inferior to the bonds which the fund is to ultimately pay off; or that there may be no question as to the safety of the moneys, the investments are sometimes made in such a materially higher grade of bonds as to preclude the possibility of realizing as high a net return as the bond issue itself cost the municipality. When a bond issue matures it is necessary that the sinking fund, for this purpose, in its entirety shall be in cash. It is, of course, impossible to arrange each investment to mature at the exact time the money is needed to pay off the maturing bonds, so that often, as pointed out above, the money lies in the bank for a considerable period at a nominal rate of interest.

Inexperience of Municipal Officials.

Unfortunately there is still another phase of this subject which must be considered: Municipal officials, as a class —due to their lack of previous training and inexperience— cannot be commended for either their intelligence in the handling of financial matters of importance or their fidelity to their duties. I can without difficulty recall many municipalities which to-day have large amounts of sinking fund moneys in their local banks drawing low rates of interest which could and should be invested in bonds of their own issues to much better advantage. Local brokers, friendly to politicians in office, are frequently known to have the "ability" to sell to their local sinking funds bonds at relatively higher prices than reputable investment dealers are able to sell the same securities.

On the other hand, assuming the same issue of bonds to have been arranged to mature in fifty annual instalments, the results would be quite different. The annual amount appropriated would have to be in the hands of the proper officials promptly to meet the maturing bonds each year when presented for payment. By making the amount maturing each year increase proportionately as the interest charge decreases, the burden upon the taxpayer may be so regulated that his tax to pay for each issue of bonds is uniform throughout its life. There is no chance that moneys will be improperly or unprofitably employed, as in effect each year's payment is immediately invested at the net rate that the issue bore when put out. Furthermore, the necessity of a careful audit of sinking fund moneys at frequent intervals is done away with because the non-payment of any part of the maturing interest or principal would immediately call forth inquiry which would correct any irregularities before they could assume serious proportions.

Statutory Control of Municipal Financing.

It is not so many years ago that municipal financing was on such an unscientific basis that money borrowed by means of long-time bond issues was expended on short-lived improvements, or even given to railroads as "bonuses" to induce them to build through certain areas, and no provision whatever was made for the ultimate payment of the debt. With the increase in scope of municipal functions came much larger debts in proportion to the taxable values in many communities, and it became apparent that some businesslike scheme for paying such debts would have to be adopted. Newly created States, profiting by the experiences of their older sister States, made due provision in their constitutions and by legislative acts to properly control the issuance of and arrange for the payment of the bonds issued by the various political sub-divisions. The New England States, with all their reputed conservatism, have been very slow to remedy some very glaring weaknesses in their financial structures. Massachusetts alone has any comprehensive plan for the proper control of her municipal financing, and that State's present admirable laws were only adopted about two years ago when it had become apparent that drastic reforms would have to be promptly made. Within the past year a prominent banker in one of the larger cities in Connecticut told the writer that the officials of his city had refunded the entire amount of a maturing issue of bonds despite the fact that the sinking fund accumulated to retire that particular issue amounted to a substantial portion of the whole. When asked for an explanation the officials naively stated that they expected to need that particular sinking fund money for another purpose and so had not applied it upon the payment of the maturing debt. It is needless to say those officials now know better how to conduct that city's financial affairs and the money is still in the sinking fund to be used only for the payment of maturing indebtedness. No one will deny that some radical change in the laws of that State is advisable to make such official laxity impossible.

Recognize Changing Conditions.

New York, New Jersey and Pennsylvania were among the first of the older States to recognize changing conditions and to provide conservative constitutional and legislative measures to require that each issue of bonds should be paid in full as it matured, and while the sinking fund method of payment is permitted for most of the political sub-divisions, there has been for years a growing practice of voluntarily using the serial payment plan.

The Constitutional Convention, now in session in New York State, is one of the most efficient bodies of men ever gathered together for such a purpose, and the committees appointed for the purpose of dealing with the financial provisions of the constitution have gone about their work in a most gratifying manner. The State debt has been created by long-time straight maturity bonds, and that no lack of provision for the payment of the same has existed is attested by the fact that careful estimates place the excess sinking funds on hand at this time at $29,000,000. Mr. Henry L. Stimson as chairman of the committee on which he is serving has just offered for adoption a plan to properly adjust the sinking funds on the existing debt, to safeguard the investment of the funds, and to require that any new bond issues shall mature serially and have a life not to exceed the usefulness of the improvements to be installed with their proceeds. This last provision is one which Massachusetts made in her financial reform and is the "last word" in public finance; its wisdom cannot be successfully challenged. The committee dealing with the constitutional changes affecting the financing of the subdivisions of the State has also been giving careful thought to these problems, and I believe its finished work will show equally satisfactory results.