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Highlights



Study of 1977 Municipal Bonds Shows Rural Issues Sold Well

Patrick J. Sullivan*

Long-term bonds of rural governments compete favorably in the municipal bond market. Despite disadvantages associated with selling relatively small issues, the interest rate on nonmetro debt issued in 1977 nearly equalled the rate on metro debt. Nonetheless, many rural governments incur unnecessarily high interest costs.

Rural Bond Sales

The financial press describes most municipal bond issues sold through traditional marketing channels. Bond sales reported in the press are generally believed to account for most of the dollar volume of local government borrowing.

*The author is an Economist with the State and Local Government Program Area, Economic Development Division.

A total of 5,031 local government bond issues, valued at \$32.7 billion, were reported in the financial press in 1977 and were recorded in the Public Securities Association long-term municipal bond file. Nonmetro governments accounted for 1,894 of these issues, which were valued at \$6.9 billion.

To focus on the basic differences between metro and nonmetro bonds, this analysis excludes two classes of nonmetro bond issues. One class consists of bonds sold by the city of Valdez, Alaska, to finance the construction of oil pipeline terminals in its harbor. Because of their large size and the nature of the facility being built, these bonds had little in common with other local government issues.

The other class of bonds excluded consists of issues sold to refinance existing municipal bonds. Such refunding bonds typically comprise a small portion of government borrowing, but in 1977 their volume was unusually large following the market's recovery from the record high interest rates charged after New York City's financial problems.

The remaining new capital issues constitute 61 percent of the long-term debt issued by nonmetro governments

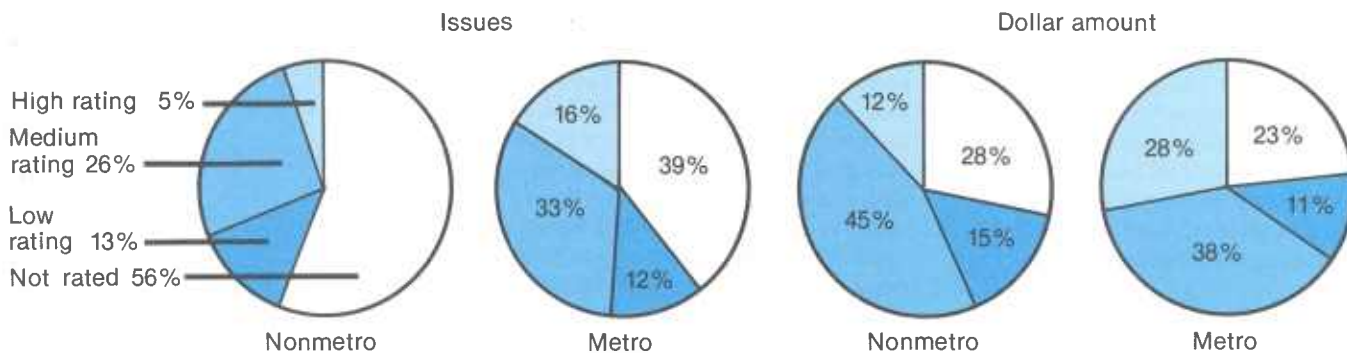
in 1977. The cost of selling these bonds varied considerably from government to government and from bond issue to bond issue. Although out-of-pocket costs for printing, advertising, and marketing a bond issue can be considerable, the major cost associated with selling bonds—and the only one examined here—is the interest paid during the life of the bonds.

The interest rate for rural government bond issues varied from 2.7 to 9.5 percent in 1977. The overall interest rate of 5.74 percent on rural issues was remarkably close to the 5.71 percent paid on bonds sold by metro governments, in spite of the less favorable characteristics of many rural government bonds.

Rural Bond Characteristics

The cost of borrowing money is largely a function of how it is borrowed. Characteristics of a local government bond issue and how that issue is marketed help determine the interest cost underwriters and investors demand in return for purchasing the bonds. Such characteristics as the issue's size, security backing, maturity structure, credit rating, method of

Rural Bond Issues Rated Lower



Source: Public Securities Association.

Financing Rural Growth

Many rural communities found that population growth in the seventies strained public facilities. Existing water and sewer lines, streets, highways, and schools had become inadequate. Local officials often had to undertake large capital projects to maintain service quality and meet the demand for more public services that often accompanied population and economic growth.

Enormous growth in Federal and State intergovernmental aid programs during the seventies made coping with population changes easier for local officials. Many grant and loan programs were aimed specifically at aiding local government capital projects. But, even with this assistance, local governments nearly doubled their long-term debt levels during the seventies. The current movement toward State tax limits and tightening Federal budgets may force rural governments to rely more on debt financing.

sale, and degree of competition among underwriters interested in purchasing the issue affect the interest costs of municipal bonds. Many rural governments, because of the nature of their bond issues, paid relatively high interest costs on their bonds.

Size of bond issue. Because of their limited size and capital needs, rural governments generally sell bonds in relatively small issues. The average size of rural bond issues in 1977 was \$2.5 million, less than half the average issue size of metro governments. Small bond issues generally have high interest rates.

Security backing. Relatively few rural government bond issues are secured with a pledge of the jurisdiction's full taxing power. Revenue bonds, those backed by specified revenue sources, restrict the funds investors can rely on for payment of principal and interest. Investors thus demand higher yields on revenue

bonds than for comparable unrestricted, or general obligation, bonds.

Revenue bonds comprised 64 percent of the debt issued by rural governments in 1977. Heavy reliance on revenue bonds adds to the interest cost of debt financing of many rural governments.

Credit rating. More than half the rural bonds issued in 1977 had no published credit rating. Of those issues that were rated, only 1 in 10 was judged a prime or excellent grade investment.

Two nationally recognized rating agencies evaluate creditworthiness of municipal bonds: Moody's Investors Service and Standard and Poor's Corporation. Each agency will render a judgment on most types of bonds, if the issuing jurisdiction provides the required financial and socioeconomic data and pays the rating fee. Moody's rated 43 percent of the rural issues in our 1977 sample; Standard and Poor's rated 7 percent. More than 70 percent of the dollar amount of debt issued by rural governments was rated by at least one agency.

Obtaining a credit rating can be an important factor in marketing local government bond issues. Credit ratings for larger issues that must be marketed regionally or nationally are needed to attract sufficient underwriter and investor interest. Large unrated issues tend to be difficult and costly to market. Most large issues are rated for this reason, which explains why both metro and non-metro governments purchased ratings for a high proportion of the dollar amount of their debt. Having a small bond issue rated may not be worth the time and expense, particularly if it is marketed locally.

Most small issues sold by rural governments were not rated in 1977. Although lack of a rating generally restricts a bond's marketability, it may not add to the overall cost of rural borrowing. However, of issues that were rated, low ratings adversely affected the cost of rural government debt financing. A low rating indicates a relatively high degree of risk and, therefore, increases the yield investors demand. In 1977, only 16 percent of the dollar amount of rated non-metro bonds was given an excellent or prime-grade rating.

Rural government debt has costly characteristics

	Metro	Nonmetro
	Percent	
Type of security:		
Revenue bonds	46.2	63.9
General obligation bonds	53.8	36.1
Method of sale:		
Competitive auction	62.6	46.8
Preselected underwriter	35.1	49.3
Direct sale by issuer	2.3	3.9

Source: Public Securities Association

Marketing method. Local governments do not usually sell bonds directly to investors. Generally, the entire bond issue is purchased by an underwriting firm or syndicate of firms that then sells the bonds to the investing public. The underwriter can be selected through competitive bidding, or the issue can be sold at a negotiated interest cost to a preselected firm. Non-metro governments sold a much higher proportion of their bonds through a preselected underwriter than did metro governments.

A negotiated sale does not always increase the cost of marketing municipal bonds. There are instances when negotiation results in a lower interest cost than might result from a competitive sale. For example, issues which fail to attract any bids when offered competitively can often be sold through negotiation. Generally, however, selling bonds to a preselected underwriting firm costs more than selling them through competitive bidding. Non-metro governments that rely on negotiated sales generally pay higher interest costs.

Rural/Urban Costs Comparable

Revenue bonds, negotiated sales, and small issues with low credit ratings add to the cost of local government debt financing. However, demand for bonds of many rural governments was high enough in 1977 to make the overall interest rate on rural government bonds comparable to the rate on metro government bonds. Rural areas paid a lower net interest cost than metro areas on their general obligation bonds and only slightly higher costs on their revenue bonds. Strong local markets for nonmetro bond

issues likely contributed to the relatively low interest cost of new capital debt issued by nonmetro governments.

Policy Implications

Market acceptance of reported bond sales in 1977 does not guarantee acceptance in the eighties. Changes in economic conditions, bank regulations, and tax laws could radically alter demand for tax-exempt bonds. Ease of marketing rural bonds relative to metro bonds could also be affected. But, rural governments that had access to local, regional, and national bond markets in 1977 should be reassured by the fact that interest costs of rural bond issues were comparable to those of metro government bonds.

There are several areas where Federal, State, and local governments could significantly improve the efficiency of debt-financed development in rural areas. State and Federal government actions can improve the market for rural government bond issues and help reduce borrowing costs by providing technical expertise for local officials and helping decisionmakers examine all their options. More rural governments should consider issuing general obligation rather than revenue bonds and marketing their issues through competitive bidding rather than through negotiation. □

Can There Be Size Economies in Providing Government Services?

William F. Fox*

The view that per capita costs of providing a public service decline as the amount of the service produced increases is currently popular. However, a review of economic studies shows that the potential for size economies varies among the services provided and among communities of the same as well as of different sizes.

Economies of size can best be achieved when a service has high fixed costs (such as for capital facilities), when the service can be centrally located, and when efficient large-scale machinery is available. Economies of size are generally limited for services like police or fire protection, but they may be substantial for water and wastewater treatment.

Even for services where potentials for size economies are greatest, some local governments may have little more potential for lowering their costs. Larger units of governments providing a high volume of a given service may have already achieved their full potential for economies of scale.

Local Education

Because 45 percent of local government expenditures are for education, efforts to cut costs are often directed at school budgets.

Economies of size in local education may come from several sources.

*The author, an Economist with the Economic Development Division, is at the Department of Finance, University of Tennessee, in Knoxville, Tenn.