

Effectiveness of Local Debt Control in New Jersey

By ROBERT G. LUTZ

IN 1933 New Jersey had the unenviable distinction of having the highest proportion of municipal debt defaults to be found in any state. Out of a total of 564 municipalities, it is estimated that from 96 to 130 were in default, depending on a definition of the term "default". This is a high proportion under any definition. Such a situation was the outcome of a combination of factors, extending all the way from ineffective legal remedies to inexorable economic forces. It appeared necessary, therefore, to re-examine the field of state-local fiscal relations and to formulate a policy to cope with this situation.

The function of state control over local debt is a comparatively new field of state activity in the United States, and New Jersey with its local bond act of 1916 was one of the pioneers in this field. The aims of this act were "to bring both temporary and permanent financing of all improvements under uniform procedure and within the scope and control of a single statute." The methods used to accomplish this were briefly these: The borrowing power of a municipality or county depends on the assessed value of property within its borders, and thus its ability to meet debt principal and interest payments. The law fixed an over-all debt limit of 7 per cent of total assessed value as being a safe maximum which a local government unit could carry. The law also established detailed procedure for issuing debt obligations of various kinds in all classes and sizes of counties and municipalities.

Sound budgetary procedures and statutory debt limitations are closely related aspects of the general field of government

finances. Thus, the following year, 1917, saw the passage of the local budget act which was designed to achieve uniform and effective budgetary techniques in all local units. It was anticipated that the two laws would result in a conscious and well considered control of revenues and expenditures which would ultimately help to prevent debt incurment for current purposes and which would help limit debt to well considered and approved capital purposes.

The situation leading up to the need for a re-examination of state-local relations was this: the municipalities of New Jersey during the twenties had undertaken an ambitious program of public improvements, financing them by bond issues. In some cases assessed values of real estate were raised to allow new debt issues; in other cases municipalities took advantage of the law permitting debt for local improvements to be deducted from the statutory net debt limit. When taxable property values and every other source of municipal revenue collapsed about 1931, local taxpayers had a sad awakening. Taxes and assessments rose beyond the ability of the taxpayer to meet them and in the next few years 96 municipalities defaulted. Many others were and still are in financial straits, though not actually in default. All of this difficulty seems to stem directly from municipal borrowing in excess of capacity to meet debt charges, which in turn is the obvious outcome of undermining by amendments the original strict limits of the 1916 bond act.

Thus in April, 1931 the legislature established the Municipal Finance Commission¹ which had the duties of passing on the issuance of new indebtedness,

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1. New Jersey, *Public Laws* (hereinafter cited P. L.) 1931, ch. 340.

reviewing the annual budget with power to limit increase, appointing an auditor to review expenditures if there were sufficient appropriations to do so, and preparing and certifying resolutions for refinancing the debt of the defaulted municipality. Municipalities could come under the jurisdiction of the Municipal Finance Commission in either of two ways: by their own accord when they realized that their position was hopeless, or through action by their bond holders. The Municipal Finance Commission acquired control over 12 municipalities between 1931 and 1935.

The legislature and the State of New Jersey as a whole realized by 1934 the seriousness of the local financial situation and the inadequacy of the measures set up to deal with it. Between 1934 and 1938 the legislature enacted five laws which, it was hoped, would put local government finances on a sound basis once and for all.

New Jersey's first piece of municipal finance legislation of the current series passed the legislature in 1934 and is commonly known as the "cash basis" act.² This act authorizes issuance of bonds by a municipality to pay or refund existing indebtedness provided that the municipality form a covenant with the bondholders to go on a "cash basis" by setting up a tax overlay. That is, actual tax collections must equal budget expenditures—the tax levy must be in excess of budget expenditures by the amount of tax delinquencies of the preceding year. The purpose of these two principal provisions is to remove all indebtedness from the current accounts and to place it with the capital debt accounts, while making sure through the "cash basis" requirement that current borrowing to supplement tax collections, formerly a constant source of trouble, will in large measure be prevented.

The second of these laws was the local bond act of 1935. This act repealed the 1916 bond act with all its amendments, and all other acts inconsistent with it. The 1935 act aimed to "simplify, revise and consolidate all the previously existing

acts and parts of acts relating to the incurring of indebtedness and the issuance of bonds by counties and municipalities." This act covers such matters as authorization of bond issue, which must be by county resolution or by municipal ordinance, all covered by exact procedure. It requires that municipalities make an appropriation in the budget of the year following authorization of the bond issue toward the cost of the project, in addition to budget requirements for principal and interest payments. The act prohibits any contract, payments under which are to be made by bond or note issuance under the bond act until the resolution or ordinance authorizing them shall have taken effect and until 20 days after the duplicate original debt statement has been filed in the office of the State Auditor. This prevents a municipality from entering into a contract before ascertaining whether it will have the legal power to finance the project. Last but not least, the debt limits of the 1916 bond act have been restored minus the numerous exceptions and exemptions. The limit is 7 per cent of assessed value for municipalities and 4 per cent for counties; any exceptions are rigidly restricted. School debt may be incurred up to 6 per cent, which allows a total school and municipal debt of 13 per cent. In large cities having relatively smaller need for school debt, the combined total limit is set at 11 per cent. The debt of self-liquidating utilities may be excepted, since they are not likely to become a direct burden on the taxpayer over and above the service rates charged.

The local budget act³ forms the third link in the chain. It requires a municipality to adopt a procedure in the liquidation of "floating" or current debt such that a mandatory "cash basis" budget could be adopted by 1943. This can be accomplished in one of two ways—either by collecting 100 per cent of the current levy, something extremely rare in practice, or by providing a "tax overlay" which means an additional tax levy sufficient to make actual tax collections cover budgetary needs. The local budget act is an essential supplement to

2. P. L. [1934], Ch. 60.

3. P. L. [1936], Ch. 211.

the debt legislation because it requires those municipalities adopting it to operate on a business basis. Their actual cash receipts from taxes and other sources must balance their budget expenditures. And as long as income and expenditures balance, there will be no need to resort to short-term borrowing, tax anticipation or tax revenue notes to provide for current services. Such borrowing is now eliminated where formerly it had to be funded, often at high interest rates, thus becoming part of the general debt burden and furnishing another step toward ultimate financial difficulty. The coverage of municipalities on "cash basis" under the 1936 local budget act is not complete nor is it expected to be before 1945. About 300 municipalities have adopted current "cash basis" financing to date; the remaining 260 municipalities have not been in a position to do so, as the law provided for when it included the "escalator clause" postponing "cash basis" for those municipalities unable to achieve it without an undue increase in the tax burden. These, however, are working toward "cash basis" by funding current debt, improving tax collections, and exercising economy in current services and their arrival at a sound fiscal position is only a matter of time.

Two years later, in 1938, the fiscal supervision act and the local government act completed this current series of financial legislation. The fiscal supervision act, an entirely new act, imposed special preventive restraints on municipalities in, or in danger of falling into, an unsound financial condition. The act lays down five tests of when an unsound financial condition exists, which include default on bond obligations; payments to other jurisdictions more than two years in arrears; in "cash basis" municipalities, a "cash deficit of the preceding year" for two years in succession in excess of 5 per cent of total property taxes levied; tax collections less than 50 per cent during the year of levy for the two preceding years, and more than 25 per cent tax delinquency of the first year's taxes at the end of the second year; liquidation of floating debt under the local budget

act requiring an appropriation of more than 25 per cent of the total of all other items of the preceding year's budget. When any of these conditions exists, no new debt obligations may be issued except for refunding, current financing or mandatory capital outlays and, with the approval of the state board, for work relief projects; the state board may authorize the liquidation of floating debt in accordance with a special plan and the commission is authorized to make a special analysis, with recommendations, of the fiscal conditions of any municipality subject to the act.

The final piece of municipal finance legislation in this chain is the local government department act of 1938. This act creates a special state agency, the State Department of Local Government, "to administer state regulatory and supervisory authority affecting local finances." Where formerly municipal financial legislation was administered by various state agencies, the new legislation combines most of this legislation under the single administration of the Local Government Board. The State Department of Local Government is composed of two units, each with separate powers and duties—the Commissioner of Local Government and the Local Government Board. The commissioner, who is chairman of the board, administers the work of the department including administration of state laws under its jurisdiction, prescription of its organization and recommendation to the board of rules and regulations for the interpretation and administration of these laws. The board itself has the duty of studying the whole field of New Jersey local government which includes promulgation of reasonable rules and regulations for administering and interpreting laws under its jurisdiction, the holding of hearings, and reporting to the Governor and legislature on its accomplishments and problems remaining unsolved.

The board received rather wide latitude to prescribe uniform accounting systems, forms for financial reporting and similar procedures as well as having delegated to it all powers and duties applying to

local government legislation formerly vested in the State Auditor. For instance, the board may determine when the "unsound conditions" specified in the fiscal supervision act shall apply, and it has so determined in 53 cases. In short, the board acts in a general supervisory position, exercising its powers with due regard for the particular needs and peculiarities inherent in municipalities of widely differing size and wealth. Municipalities no longer carry on their affairs unobserved, in good fashion or bad, as the case may be. The board is in touch with every municipality in the state through annual reports and immediately knows of any impending financial trouble. New Jersey has never had, but has long needed such a "watch dog."

The results of the period 1934-1938 in the matter of local government financial legislation would ordinarily lead one to expect that the financial troubles of New Jersey municipalities will soon be a thing of the past. The five major laws mentioned lay out a well-rounded plan of action which seemingly fill the gaps left by former legislation and make it almost impossible for a municipality to get into financial trouble. But such is not the case. The local bond act has been weakened by amendments permitting additional relief borrowing⁴ and extending bond maturity dates⁵. The local budget act has been impaired by four amendments which modify floating debt requirements, appropriation requirements, "cash basis" requirements and postpone unpaid obligations or liabilities.⁶ The fiscal supervision act was unavoidably modified to provide for certain small and financially weak municipalities which found themselves unable to comply with its provisions or those of the local budget act, particularly

the provisions concerning adoption of a "cash basis."

Certainly there has been no shortage of sound legislation. The five laws in question were not carelessly or haphazardly enacted; they were drafted with extreme care after a lengthy examination of the financial afflictions of New Jersey municipalities. At the time of their enactment they were held up as "model" laws. Yet inside of one year, three of these laws had their effectiveness impaired and if history repeats itself, within a few years more all will have gone the same road as the 1916 bond act and the 1917 budget act. The question is not, then, the effectiveness of present financial legislation in New Jersey. It has already thoroughly proved its worth during the short period of its existence. The question which confronts New Jersey is how to maintain these sound and adequate laws at their original effective level, how to protect them from amendments which seem harmless or even useful at the time, but which ultimately nullify the whole purpose of the law. What New Jersey needs are special laws applying to the 30 or 40 weak municipalities which are hopelessly entangled, pending a final solution of their affairs. The good of the state as a whole should not be made to suffer through modification of an entire program of legislation, just to bring temporary aid to a few special cases.

4. P. L. [1938], Ch. 101.

5. P. L. [1938], Ch. 236.

6. These four amendments were broad modifications of the 1936 budget act, passed specifically to relieve a few municipalities which found themselves unable, even by the greatest effort, to comply with it. In those cases where the liquidation of current debt of the inclusion of unpaid obligations and any item required by law in the budget would cause an undue increase in the tax levy, the municipality may apply to the Commissioner of the Local Government Board for relief, except that there shall be no modification as to the payment of bond interest or principal. The "cash basis" requirements of the 1936 act were for a time wiped out, but were later restored on an optional basis.