

economic and financial data to support bond sales, understanding bond terms and comparative advantages of alternative financing techniques, marketing a bond issue and scheduling or programming capital improvements. Six State governments now provide some administrative supervision over municipal debt, borrowing, and fiscal operations; a number of States prescribe minimum standards for notices of bond sale, and filing of financial reports, and also assist in the preparation of capital improvement programs. Federal assistance to facilitate the sale of bond issues by municipalities has been minimal, and the authorized program of technical advisory services to assist municipalities in budgeting, financing, planning and constructing public facilities has never been put into effect.

### 3. *Municipal Bond Interest Rates and Tax Exemption*

#### (a) *Trends in Municipal Interest Rates*

New issue yields of municipal bonds largely result from the interaction of (1) the prevailing yields at the time of similar taxable bonds, (2) the effective income tax rates then applicable to each investor group which determine the value of tax exemption to such groups, (3) the volume of new investable funds flowing to each of these investor groups, (4) the volume of new bond financing desired by States and municipalities at around prevailing yields, (5) expectations regarding future tax rates, volume of tax exempt financing, and flows of new investable funds, and (6) institutional restrictions (laws, customs, liquidity needs) that influence investment decisions.

In the market prevailing in February 1966 tax exemption on municipal securities was advantageous to investors with marginal tax rates above 28 percent, e.g., commercial banks, fire and casualty insurance companies, business corporations, and higher income private investors, which accounted for all of the net increases of municipal bond holdings in recent years. Since the end of 1961, commercial banks have become the dominant buyer of municipal securities. As compared to other net demands for credit, the net volume of new municipal financing has been modest, accounting for about 10 percent during the last 4 years. As compared to private borrowing, where the interest cost is tax deductible (and, hence, partially paid for by the Federal Government), States and municipalities are relatively high cost borrowers.

A crucial yardstick influencing the purchase of tax-exempt bonds is the ratio of municipal bond yields to corporate bond yields of comparable maturity and credit quality, and the relation of this ratio to income tax rates. Between 1946 and 1954 the municipal-corporate yield ratio jumped from 40 percent to 80 percent and then receded to around 75 percent, where it has remained since 1955. Since 80 to 90 percent of all new credit instruments are taxable, it is the taxable yields which dominate bond market trends, and municipal yields adjust accordingly. If there is a rapid increase in the volume of municipal credit demands, the funds of the investor groups now buying might well become inadequate. If so, municipals would have to be repriced—perhaps at yields up to 90 percent of corporate yields. This would mean a 4.50 percent yield for prime municipals, if prime corporates are yielding 5 percent.

Monetary policy action or related rule changes might divert commercial banks away from municipal bonds and thereby would have