Chapter 18

The Effect of Credit Conditions on State and Local Bond Sales and Capital Outlays Since World War II*

Introduction and Summary

This paper is divided into two sections. The first reviews the literature on postwar interactions among overall credit conditions, State and local borrowing, and State and local capital outlays. The second section explains in nontechnical language the writer's own regression model and findings on the market for State and local bond issues since 1951. The regression model is based on two theoretical models, one for borrowers and one for lenders. It tests indexes of State and local needs for structures, interest rates and rate spreads, and "institutional" variables such as fluctuations in the wealth of high-tax-bracket savers for their power and reasonableness in explaining State-local bond sales. A technical appendix presents the model in the manner familiar to econometricians and explains certain deviations from what may already be called the classical lagged stock adjustment model.

Findings may be summarized as follows. The literature reviewed agrees, in general, that interest rates paid on State and local bonds affects the timing of gross new issues and may have an impact on the amount of issues placed in the long run. But the latter is probably of very moderate size, relative to total issues, and may well be of a one-shot nature (after initial changes in borrowing, States and municipalities adjust their tax rates to provide for changing interest costs rather than permanently raising or lowering their borrowing targets). The evidence for a significant impact of interest rates on State and local construction is weak, but this may reflect deficiencies in the very few studies focusing on this variable rather than the "true" state of affairs.

The writer's regression model explains up to four-fifths of fluctuations in semiannual State and local bond issues (including federally guaranteed ones) around a trend of wealth and taxing power which is represented by permanent income. The lagged stock-adjustment coefficient, which is the mean of the unknown actual ones for borrowers and for lenders, is of the correct negative sign and of a size according quite well with reasonable assumptions on the reaction speeds of bond buyers and State and local borrowers. The interest rate coefficients are interpreted as meaning that State and local borrowers do form and act upon expectations on future interest rates, while buyers of new issues are more influenced by current changes in the spread yields on

---

* Prepared by Paul F. McGouldrick. Division of Research and Statistics, Board of Governors of the Federal Reserve System, with minor editing by committee staff. The author wants to acknowledge the stimulating criticisms and suggestions offered by Frank deLeeuw and Edward Gramlich of the Board of Governors of the Federal Reserve System. Editorial assistance was also provided by Mrs. Mary Ray of the Board of Governors and by Paul McGann. The author, of course, takes responsibility for all errors of omission and commission.