

there has been an increase in revenue bond financing by State and local governments. During the period, 1961-65, total long-term issues totaled some \$65.2 billion, of which about 25 percent were of the revenue type.¹ Short-term issues during the same period amounted to almost 30 percent of total flotations. As to purpose, the major use of proceeds of State and local debt continues to be for education, highway construction, and local utilities.² There is little reason to suppose that bank portfolios in recent years have not shared in these general patterns of State and local financing.

B. PORTFOLIO CONSIDERATIONS

1. GENERAL CONSIDERATIONS

Probably the most important element making municipal securities attractive to investment officers of banks is the tax exemption feature. Institutions that are subject to high Federal income taxation display a considerable interest in tax exempts, with the greatest demand coming from commercial banks which are subject to the standard corporate income taxes. Tax exemption, however, is a form of Federal Government subsidy, only part of which accrues to the investors. How this subsidy is shared between investors and borrowers depends on the market forces existing at a particular time. If the supply of tax exempts is high relative to demand then the cost of borrowing would be high also and investors would benefit more from the subsidy than otherwise. If the supply is small relative to demand, borrowing costs would be down and it would be the borrowers that would benefit more than otherwise.

Another advantage that makes municipals attractive is the security of such investments. With the exception of Treasury and Federal agency bonds, municipals generally involve the least risk and enjoy the lowest default rate of any form of investment. In addition, banks are constantly under pressure to assist local government units either in order to secure the deposits of such units or for the sake of the broader customer-banker relationships.

The difficulties encountered by banks in the purchase and sale of municipals may be summarized as follows:

First, investing in municipals presupposes a high degree of specialized knowledge not always available to all banks.

Second, marketability in the secondary market is considered less than adequate to insure easy liquidation of most municipals.

A third difficulty is perhaps the most serious factor impeding bank investment in municipals. Commercial banks during business cycle swings have a particularly difficult task in adapting their investment policy vis-a-vis State and local bonds to their major function as a private lender.

On the supply side, the postwar period has demonstrated that non-Federal governmental units have tended to be relatively heavy borrowers of funds in periods of business ebullience. While there is some interest elasticity in the supply of municipal bonds, the decrease or postponement of new issues is scarcely sufficient to free adequate funds

¹ Moody's Municipal and Government Manual, 1966, p. a21.

² Ibid, p. a19.