

Municipal credit is generally excellent, defaults are rare, and there is no need for the redundancy of Federal guarantee.

c. *Effects of Federal guarantee in lieu of tax exemption*

The survey of stock companies noted that the exchange of tax exemption for a Federal guarantee would not necessarily make these securities attractive as investments. Municipals, whether taxable or tax exempt, must compete on the basis of yield after tax. If taxable, but U.S. Government guaranteed, they would sell at yields similar to those of AAA corporates with minor variations reflecting marketability. To the extent that the aftertax yield spread compared to alternative investments was reduced, guaranteed municipals would lose their competitive attractiveness.

Among the mutual companies, the consensus seems to be that making State-municipal bonds subject to Federal income tax in return for a Federal guarantee would make them less attractive. Some felt they would not purchase municipals at all under such conditions. Inasmuch as 30-year federally guaranteed municipals (PHA bonds) in May 1966, afford a taxable equivalent yield (6.64 percent) significantly higher than either 30-year corporates (4.95 percent) or 30-year Treasuries (4.80 percent), there seems no reason to accept a lesser spread on other municipals under the circumstances outlined. Because of the soundness of municipals in general, together with their record of negligible defaults over the years, a Federal Government guarantee would add very little to their attractiveness as an investment. Addition of a Federal debt service guarantee would tend to lower their yield and make them less attractive to the institutional investor. A Federal guarantee in exchange for taxability of municipal bonds would be too high a price to pay. Short Treasuries, agencies, and AAA-rated corporates now are all yielding 5 percent or better, fully taxable. At current corporate income tax rates this return would be reduced to about 2.50 percent. Government-guaranteed, fully taxable municipals would have to yield considerably more than the latter to make them attractive, because of the historical objective of a minimum 4 percent tax-free municipal yield. Under the proposal municipals would take on the nature of U.S. Treasury Department bonds, which are not in any short supply at the present time. No doubt communities would have to pay considerably more for their borrowings than they do now or have in the past. It would seem reasonable that the yield on a municipal bond which is federally guaranteed, but taxable, would fall somewhere between the returns on Federal agency securities and U.S. Treasury bonds. Federal agency securities are not guaranteed by the Government, and therefore would have a slightly smaller degree of attractiveness than a municipal bond as far as credit is concerned. This is in the context that the Federal guarantee would be a full unlimited guarantee, and would not be in the nature of an agency affiliation. It is possible that the supply alone may force a higher interest rate level for both U.S. Treasury Department securities and municipals, and as a result both categories of bonds would suffer in terms of interest costs. Under the proposal the quality of municipal bonds would be improved, and their attractiveness increased in the sense that they could be purchased with a minimum of research and analytical effort. To the extent that the yield reflected this change they might be less attractive relative to other alternative investments