1975. The JEC figures themselves suggested that this growth would be in line with the likely growth in GNP. Since the supply of savings should also grow at about the GNP rate, the general conclusion would be indicated that the marketability of State and local bonds should not change markedly relative to other bonds.

But the Joint Economic Committee report itself emphasized one reservation about this outlook, namely, the heavy reliance placed on commercial bank takings. They recognized that if commercial banks, for example, were attracted more heavily into mortgages (e.g., by the much touted housing boom of the 1970's) there would be problems for State and local governments in floating even a level of State and local issues that was growing in line with GNP.

Another set of qualifications should be added to this forecast of marketability of State and local bonds. The JEC projections basically assumed a development of current programs. They did not make much allowance for new programs.

The expansion of Federal programs that lies ahead is likely to induce even more substantial increases in State and local government borrowing than may have been anticipated in the study. The Congress has already considered a wide range of new Federal programs in a variety of areas, such as pollution control and housing. In addition, pressures on the Federal budget have recently caused attention to be focused on the potentialities of debt service grants to State and local governments, as are now used in the public housing area, rather than the lump-sum grants that have been more traditional. From a financial viewpoint, these debt service grants would shift the financing of the Federal share of local project costs from the taxable market (i.e., away from the Federal bonds that provide the funds for the lump sum grants) to the tax-exempt market to absorb the local bonds that would be issued to finance the project (the debt service grants would help defray the interest and principal on these tax-exempt bonds).

Another factor that may well have been underestimated in the JEC work is the size of replacement needs. For example, much of the physical plant in our urban school system is aged and inadequate to the school needs of urban children. Replacement will be very expensive. These replacement needs alone could cause the annual net increase in State and local bonds to double in the next five to ten years.

In summary, the growth of new programs especially Federally aided ones, the increasing reliance on debt service grants to shift Federal debt to State and local debt, and exploding replacement needs could increase the annual net growth in State and local debt from the present $9 or $10 billion as high as $30 billion a year in 10 years. *This would represent a rate of growth twice as high as the rate of growth of the savings supply.*

If State and local governments are to sell this enormous increase in tax-exempt bonds, then they will be commanding a larger share of the savings flow. To do so they will have to compete more sharply with other borrowers, such as home owners and corporations. The question is whether tax exemption is an efficient instrument with which to conduct this competition. We can take as a fact of life the exemption on tax-exempt bonds in the present market. The experts say that this exemption is "inefficient" in the sense that State and local governments get less benefit from it in lower interest costs than the Federal Government gives up in lost tax revenues. As I said earlier this could, however, be regarded as the price paid for the independence of decision-making that the interest exemption offers in general to State and local governments. What we need now to do, however, is to give serious thought to the question of how this will work out if State and local governments suddenly try to become much heavier borrowers.

The Market for Tax-Exempt Bonds

To understand the significance of this enormous potential growth in tax-exempt bonds, it is necessary to remember that the institution of tax-exempt interest has an impact not only on Federal tax returns but also on bond markets. It does save State and local governments money by reducing interest rates on their bonds, but it does so by narrowing the range of customers for those bonds. It narrows the range to groups that find tax exemption valuable. You don't find exempt pension trusts buying tax-exempt bonds.[1]

The rate on tax exempts is determined, like any other price, by demand and supply. If the supply of tax exempts is limited, they can be sold to the buyers

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[1] Tax-exempt entities have purchased tax-exempt obligations in the past and still do because of legal limitations on their investment powers. These limitations, however, are rapidly being removed.