who are most anxious to get them. If more tax exempts are to be sold, the price of those tax exempts will have to fall, i.e., their interest rate must increase. The price fall will be necessary to get existing buyers to take more tax exempts (and thus less of other investments) and to induce new buyers to enter the tax-exempt market.

It is significant that interest of all kinds—taxable and tax exempt together—is a modest component of the income of upper income individuals. That income consists mostly of dividends and capital gains, reflecting the fact that the wealth position of these individuals inclines them to the higher risk-higher return features of equity investment (which features are also associated with favorably taxed capital gains and untaxed unrealized appreciation). Inducing these investors into the relatively safe investment of State and local government bonds through tax exemption is in a sense swimming against the tide.

By and large since the most distinctive feature of these State and local bonds is their tax exemption, the process of selling more bonds must involve widening the market by appealing to taxpayers with lower marginal tax rates than those now acquiring tax-exempt bonds. The appeal must involve the process of selling tax-exempt bonds at rates more closely comparable to those on taxable bonds, so as to make the exempt bonds attractive to those who get less tax advantage from the exemption.

The Inevitable Increase in Interest Rates on Tax Exempts—and Higher Costs to Local Governments

It is not possible to say exactly how much tax-exempt bond interest rates would rise with an increase in the relative share of tax exempts in the market. Obviously, it depends for one thing on the levels of general interest rates, which are subject to a great many forces. We can make some progress if we assume the present level of rates and talk about the differential between high grade municipals and high grade corporates. Presently, high grade municipals sell at close to 70 percent of the rate on similar high grade corporates.

In 1945–46 the level of outstanding municipals, as well as new municipal issues, was very low. Municipals constituted only 3.2 percent of net public and private debt, and the interest yield on outstanding municipals was only 40 percent of the yield on corporate Aaa bonds. By 1954 the State and local indebtedness had risen to about 5.8 percent of net debt, and the yield ratio had risen to 70 percent of the corporate bond yield. The yield ratio has hovered about this level since 1954, rising to about 80 percent in 1957 and averaging about 67 percent in January–August, 1968. The large item accounting for the recent pattern of a wider spread despite a still increasing State and local debt share (now 8.0 percent of net debt) is the sharp growth in holdings of municipals by commercial banks (associated with some pause in the growth of demand for mortgage money between the immediate post-World War II housing boom and the coming housing boom that will be associated with the World War II baby boom) and the unusual spurt in corporate bond flotations.

I am including a Table—Table 1—that presents some estimates of the possible response of the State and local bond rate to future developments. The table covers a range of possibilities respecting the size of State and local borrowing and the role of commercial banks in the market, since they are now the dominant institutional investor in municipal bonds. The future course of that role is of obvious importance—can the banks continue that role, keeping in mind that business loans are their primary function? What happens when they reach the limits of their taxable income, as some are now doing, so that the use of expenses, in fact allocable to tax-exempt issues, against taxable income as now permitted no longer produces tax savings?

Table 1 shows that the interest rate increases resulting from a high volume of tax-exempt securities could be put as likely to be about one-half point (keeping in mind that it might come to a full point). At current levels of State and local debt issuance ($15 billion gross) this would mean an increased anual interest cost of around $75 million on one year's issues. This annual cost would of course cumulate if the increase persisted for subsequent new issues. With new issues rising at 10 percent a year, a persistent increase in the State and local bond interest rate of one-half point would increase the annual cost by about $500–$600 million in seven years. This increased cost, remember, does not include the increased debt service itself, which would be something in addition. The increased cost is just the cost of the interest *rate increase* caused by the increased debt. It is the increase in cost caused by going to the well too often.

This is a substantial burden to put on local property taxpayers.