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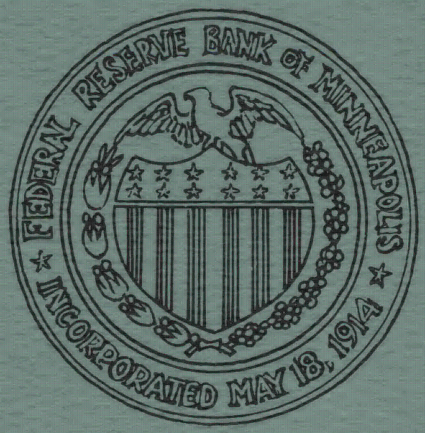

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Outlook for State and Local Government Spending

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OUTLOOK FOR STATE AND LOCAL GOVERNMENT SPENDING

By David Dahl

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Introduction and Conclusions

State and local governments will remain stronger in the Ninth District[1/] than the rest of the country. That's the main conclusion of this report, which considers these questions: How have district state and local government spending plans been affected by New York's financial crisis? What do state general fund data imply for district state and local government outlays in fiscal 1976 and 1977? And what do they indicate for national state and local government expenditures?

Judging from the last half of 1975, New York's financial crisis will not significantly affect district state and local government spending this year. The region's fiscal soundness should enable governments to continue to borrow at more favorable terms than governments elsewhere. District state and local governments can expect greater investor scrutiny of their affairs, and communities with lower credit ratings will still have to pay more to borrow. But if long-term interest rates do not rise markedly, interest rate ceilings on borrowing costs should not be a restricting factor. District governments should therefore be able to obtain funds to carry out spending plans.

Due to their agricultural and energy orientation, Ninth District state and local governments fared quite well in fiscal 1974 and 1975, when inflation and recession were severely restricting many state and local budgets. High agricultural prices strengthened revenue growth during this period, and sizeable surpluses accumulated. All district state governments except South Dakota's have been able to carry out programs and grant tax relief without raising taxes. So district state and local government spending growth will probably outpace the nation's in fiscal 1976 and 1977.

State general fund data provide a current assessment of how state policy makers view their spending plans. A method was developed to use this information to forecast national state and local government purchases of goods and services. The exercise indicates that national expenditures may expand faster than the Board of Governors' staff predicted December 11, 1975, but slower than the MRD forecast of January 14, 1976. Here, too, growth in district state and local government outlays is expected to surpass the nation's.

Impact and Implications of New York's Financial Crisis on Ninth District State and Local Governments

Municipal Bond Market Developments in 1975

New York's troubles heavily influenced municipal borrowing in the last half of 1975, but the market had other problems evident earlier. Increased use of municipal revenue bonds, especially for pollution control, helped swell municipal bond offerings to record levels. At the same time, traditional municipal bond buyers--banks and property and casualty insurance companies--cut back on their municipal bond purchases. These factors pushed up tax-exempt security yields, both absolutely and relative to yields in other markets (see Table 1).

Imposed on an already tightening situation, then, the New York financial crisis drove municipal bond rates up markedly as investor confidence in the market significantly eroded during the last half of 1975.[2/] Corporate yields remained essentially unchanged during that time, so the ratio of municipal to corporate bond yields reached record highs.

Impact on the Ninth District

How have 1975's municipal bond market developments affected Ninth District state and local government expenditures and borrowing costs in 1975? What impact are they likely to have on government spending in 1976? The first question will be answered by contrasting district municipal borrowing costs to other areas' during the New York City financial crisis and then investigating the effects of changing yields within the municipal bond market, greater investor scrutiny, and the restraints imposed by interest rate ceilings on state and local government borrowing. Based on the 1975 experience, a tentative answer will be given to the second question.

Table 1

Municipal and Corporate Long-Term Bond Yields

	Municipal Bond Yields	Corporate Bond Yields	Ratio of Municipal to Corporate Bond Yields
1970	6.42%	8.51%	.754%
1971	5.62	7.94	.708
1972	5.30	7.63	.695
1973	5.22	7.80	.669
1974	6.19	8.98	.689
1975	7.05	9.47	.744
1975I	6.66%	9.39%	.709%
II	6.95	9.50	.732
III	7.20	9.50	.758
IV	7.37	9.47	.778

Source: Federal Reserve Bulletin

In general, district state and local governments were able to borrow funds during the last half of 1975 at more generous terms than the rest of the country. Minneapolis, for example, was able to borrow at a slightly lower interest rate in September 1975 than in May 1974, while other cities, particularly those on the East Coast, had to pay considerably higher rates (see Table 2). A study by the Municipal Finance Officers Association also discovered this uneven regional impact (see Table 3). Incremental interest costs attributed to the New York situation in the third quarter amounted to 8.4 basis points in the North Central states (including Minnesota, North Dakota, and South Dakota) and 13.4 basis points in the Mountain states (including Montana) as contrasted to 54.8 basis points in the Middle Atlantic states, excluding New York.

The district's more favorable experience in the municipal bond market can be attributed to several factors. Recent economic conditions have been stronger here than nationally. Also, the region's governments have had to rely less on short-term borrowing, and the district has taken a conservative approach to financial affairs: A municipal finance authority considered Minnesota's high credit rating "among the best in the country because of the paucity of short-term debt, the prudent use of borrowed funds, general fiscal conservatism, increased retail sales, and balanced budgets."[3/]

Although Ninth District state and local governments have been able to borrow at more favorable rates than other areas, the recent changes within the market have boosted borrowing costs and somewhat restricted the ability to issue bonds.

Table 2

Municipal Borrowing Costs in Various Cities

City	May 1974	Sept. 1975	Yield Spread Between May 1974 and Sept. 1975
Minneapolis	5.28%	5.23%	-.05%
Topeka	5.21	5.85	.64
Phoenix	4.76	6.46	1.70
Philadelphia	5.87	8.83	2.96
Jersey City	5.89	10.36	4.47
Long Beach, N.Y.	5.46	11.50	6.04

Source: Sanford Rose, "The Trouble with Municipal Bonds is Not Just New York," Fortune, December 1975, p. 105.

Table 3

Regional Estimates of the New York Financial Crisis Impact on State and Local Government Borrowing Costs in the Third Quarter of 1975

Region	Estimated Increment in Net Interest Costs (in basis points)
New York State	45.5
Other Middle Atlantic	54.8
Northeast	41.6
NORTH CENTRAL*	8.4
South Central	17.5
Pacific	21.4
MOUNTAIN**	13.4
South Atlantic	16.7

*Includes Ninth District states Minnesota, North Dakota, and South Dakota plus Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, Nebraska, Ohio, and Wisconsin.

**Includes Ninth District state Montana plus Arizona, Colorado, Idaho, Nevada, New Mexico, Utah, and Wyoming.

Source: Ronald W. Forbes and John E. Peterson, "Costs of Credit Erosion in the Municipal Bond Market," Municipal Finance Officers Association, Chicago, Illinois, December 20, 1975, p. 8.

One change significant for this area is a trend toward greater selectivity with regard to the quality of the issues; the gap between yields on high-quality (Aaa) and low-quality (Baa) municipals has widened (see Table 4). The spread averaged 64 basis points in 1974 and by the fourth quarter of last year had more than doubled to 142 basis points.[4/] This development has increased the cost of borrowing for lower-rated Ninth District governmental units. (In Minnesota, 41 percent of the governments rated by Moody's Investment Services had a Baa rating; see Table 5.)

Closely related to the widening yield spreads is the increased investor scrutiny of state and local government financial affairs and the importance of ratings for access to the market. New Securities Exchange Commission (S.E.C.) regulations on municipal bond market dealers and underwriters are expected to intensify the need for disclosure and so make it harder for some to issue bonds.

The St. Paul school district's current situation is a good example of this impact within the district. Since 1966 the St. Paul school district has borrowed short-term funds for operating purposes and refinanced the debt in the municipal bond market, similar to New York's precipitating circumstances. Moody's removed St. Paul's bond rating, and the school district then failed to receive a bid for $23.25 million in short-term bonds to pay off $22.56 million in short-term debt coming due March 13. School district officials' plan to restore their credit rating requires an additional tax to allow them to eventually eliminate this short-term borrowing. A Moody's official largely attributed St. Paul's problems to the impact that the New York situation had on the municipal bond market.[5/] The Minneapolis school district is taking similar action to assure their bond rating.[6/]

Table 4

Yields on High-Quality (Aaa) Bonds and
Low-Quality (Baa) Bonds

	Aaa Municipal Bond Yields	Baa Municipal Bond Yields	Yield Spread (Baa-Aaa)
1970	6.12%	6.75%	.63%
1971	5.22	5.89	.67
1972	5.04	5.60	.56
1973	4.99	5.49	.50
1974	5.89	6.53	.64
1975	6.43	7.62	1.20
1975I	6.21%	7.24%	1.03%
II	6.39	7.46	1.07
III	6.50	7.76	1.26
IV	6.60	8.02	1.42

Source: Federal Reserve Bulletin

Table 5

Number of Ninth District Governmental Units Rated by Moody's, by Ratings

	Minnesota	Montana	North Dakota	South Dakota	Total
Aaa	8	1	0	0	9
Aa	35	4	3	4	46
A	272	23	47	41	383
Ba	8	0	0	0	8
Baa	223	8	6	2	239
Total	546	36	56	47	685

Source: Moody's Bond Record, January 1976

No government projects are known to have been cancelled as a result of New York's financial crisis, but the higher costs did increase concern about financing as state and local governments bumped against statutory interest rate ceilings. In Minnesota and Montana, for example, municipal bond rates hovered around 7 percent, the local general obligation bond ceiling, in the last half of 1975. The primary effect on Minnesota municipalities was a shortening of their debt structures to avoid having to pay the higher long-term rates. Although legislation to raise the 7 percent ceiling has been introduced, neither the Minnesota League of Municipalities nor the Minnesota School Board Association, two major lobbying groups for local governments, are actively supporting it.

Implications for 1976*

Judging from the district's experience in the last half of 1975, New York's financial crisis will not significantly affect district state and local government spending this year. The region's fiscal soundness should enable governments to continue to borrow at more favorable terms than governments elsewhere. Nevertheless, district state and local governments can expect greater investor scrutiny of their affairs, and communities with lower credit ratings will still have to pay more to borrow. If long-term interest rates do not rise markedly, interest rate ceilings on state and local government borrowing costs should not be a restricting factor. Consequently, district governments should be able to obtain funds to carry out their spending plans.

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*These developments also suggest possible reforms in the municipal bond market which are discussed in an addendum to this paper (see page 20).

Outlook for Ninth District State and Local Governments in Fiscal 1976 and 1977

New York's 1975 problems are not expected to curtail district state and local [illegible] plans, but what are those plans for fiscal 1976 and 1977? And how does the district outlook translate into national prospects for state and local governments? These questions will be answered in this section.

Because state general funds finance a substantial portion of both state and local outlays (and are the only complete data available), state general fund expenditures will be used as a proxy for total state and local government spending in the past and future. The apparent district outlook will then be used to project national state and local government expenditures. This outlook will be compared to the staff of the Board of Governors' December 11, 1975, forecast and the MRD Janaury 14, 1976, forecast for state and local government purchases of goods and services to see how reasonable these numbers seem to be.

Ninth District Situation

Despite the recession and rapid inflation and in contrast to most of the rest of the country, all district states except South Dakota generated significant general fund surpluses in fiscal 1974 and 1975 (see Table 6). This was mainly due to the district's economic base. According to a Joint Economic Committee study last year, states that rely heavily on agricultural income (as do Minnesota, North Dakota, and South Dakota) and states that are energy producers (as is Montana) had large general fund surpluses in mid-1975 and were not being forced to make the substantial cutbacks confronting states with high recession-induced unemployment.[7/]

Table 6

District State General Fund Finances[1/]
Fiscal Years 1973-1977

	Millions of Dollars					Percentage Changes			
	1973	1974	1975	1976	1977	1973-4	1974-5	1975-6	1976-7
[2/] Minnesota									
Beginning Balance	11.5	74.5	233.7	403.0	274.4				
Revenues	1730.3	1885.5	2106.1	2245.6	2467.3	9.0	11.7	6.6	9.9
Expenditures	1667.3	1726.3	1936.8	2374.2	2676.9	3.5	12.2	22.6	12.7
Annual Surplus or Deficit	63.0	159.2	169.3	-128.6	-209.6				
Ending Balance	74.5	233.7	403.0	274.4	64.8	213.7	72.4	-31.9	-76.4
[3/] Montana									
Beginning Balance	6.7	24.6	40.8	48.3	37.3				
Revenues	112.6	131.8	156.6	162.2	178.0	17.1	18.8	3.6	9.7
Expenditures	94.7	115.6	149.1	173.2	191.8	22.1	29.0	16.2	10.7
Annual Surplus or Deficit	17.9	16.2	7.5	-11.0	-13.8				
Ending Balanace	24.5	40.8	48.3	37.3	23.5	66.5	18.4	-22.8	-37.0
[4/] North Dakota									
Beginning Balance	29.5	52.3	89.5	155.9	124.3				
Revenues	135.8	173.2	220.4	183.1	198.4	27.5	27.3	-16.9	8.4
Expenditures	113.0	136.0	154.0	214.7	227.8	20.4	13.2	39.4	6.1
Annual Surplus or Deficit	22.8	37.2	66.4	-31.6	-29.4				
Ending Balance	52.3	89.5	155.9	124.3	94.9	71.1	74.2	-20.3	-23.7
[5/] South Dakota									
Beginning Balance	10.8	23.5	27.2	13.5	15.9				
Revenues	114.0	126.7	139.3	157.3	170.6	11.1	9.9	12.9	8.5
Expenditures	101.3	123.0	153.0	154.9	178.4	21.4	24.4	1.2	15.2
Annual Surplus or Deficit	12.7	3.7	-13.7	2.4	-7.8				
Ending Balance	23.5	27.2	13.5	15.9	8.1	15.7	-50.4	17.8	-49.1
Four-State Total									
Beginning Balance	58.5	174.9	391.2	620.7	451.9				
Revenues	2092.7	2317.2	2622.4	2748.2	3014.3	10.7	13.2	4.8	9.7
Expenditures	1976.3	2100.9	2392.9	2917.0	3274.9	6.3	13.9	21.9	12.3
Annual Surplus or Deficit	116.4	216.3	229.5	-168.8	-260.6				
Ending Balance	174.9	391.2	620.7	451.9	191.3	123.7	58.7	-27.2	-57.7

= estimated

[1/] General funds are designated to defray the general costs of state governments, not for specific purposes. They contain some education monies, but highway funds are excluded.

[2/] Figures last revised September 1975; updates for 1976-77 expected in mid-February.

[3/] No change in 1977 revenue and expenditure estimates due to tax relief initiatives on November 1976 ballot. Only beginning and ending general fund balances revised.

[4/] Estimates for 1976 and 1977 are based on legislative action so far.

[5/] Includes proposed sales tax change (remove tax on food, increase tax 4-5% on everything else). Revenues drop $6-8 million if proposal doesn't pass. Will be revised after February 14.

Sources: State budget documents and officals

Things will be different in fiscal 1976 and 1977, though. The nation's economy should be expanding as inflationary pressures ease. And district state and local government revenue gains will not be quite as high.

The past two years' strong growth in district tax receipts is generally expected to slow (see Table 7). State officials don't see farm income gains boosting tax receipts in fiscal 1976 and 1977, and in North Dakota, tax cuts have been enacted. All district state governments except South Dakota have avoided increases in general fund taxes. (The South Dakota legislature is currently considering a sales tax increase.)

Another major source of revenue is discouraging too: The 1977 federal budget indicates that federal aid to state governments will not increase much either.

Despite the expected easing in revenue growth, however, district state spending should increase substantially in the next two years. Budget surpluses at the beginning of fiscal 1976 have helped states avoid cutbacks and maintain or improve programs. In fact, general fund expenditures are expected to rise 21.9 percent in fiscal 1976 and 12.3 percent in fiscal 1977. Part of these increases are earmarked for local government aids and will be used to check property tax increases. Another large part will pay for wage increases and other rising costs. So the impact on the economy may not be as great as the percentages suggest. Still, the increases are big enough to indicate some expansion in the district's state and local government sector.

Table 7

Changes in District General Fund Tax Revenues
Percentage Changes From Previous Fiscal Year, 1974-77

	Minnesota	Montana[1/]	North Dakota[2/]	South Dakota[3/]
Personal Income Tax				
1974	46.5	2.2[4/]	82.7	n.a.
1975e	13.7	12.5	40.4	n.a.
1976e	12.0	18.3	-50.5	n.a.
1977e	12.2	18.3	6.0	n.a.
Corporate Income Tax				
1974	20.2	25.0	44.4	n.a.
1975e	6.3	41.2	32.3	n.a.
1976e	-13.8	6.4	-40.2	n.a.
1977e	17.5	-14.9	8.3	n.a.
Sales Tax				
1974	16.3	n.a.	15.5	17.2
1975e	10.3	n.a.	16.6	12.2
1976e	8.1	n.a.	4.0	7.4[5/]
1977e	9.0	n.a.	2.9	6.6

e = estimated

1/ Montana does not have a state sales tax.

2/ Estimates reflect recent legislative changes in North Dakota tax laws for fiscal 1976 and 1977.

3/ South Dakota has neither a personal nor a corporate income tax and budgets annually instead of biennially.

4/ Montana's 40 percent income tax surcharge was dropped to 10 percent in 1974.

5/ Does not include South Dakota's proposed sales tax increase.

National Situation

How does the Ninth District state and local government outlook translate into national state and local government spending prospects for fiscal 1976 and 1977?

To answer this question a simple methodology was developed linking state general fund expenditures to national state and local government purchases of goods and services. This approach relies on the fact that stable or explainable relationships exist between district state general fund expenditures and spending by district state and local governments and between district government spending and national state and local government purchases of goods and services.

By dividing district state general fund expenditures by its projected share of total district state and local government expenditures, an estimate is obtained for total district state and local government expenditures. This estimate is then divided by the district's projected share of national state and local government purchases of goods and services to arrive at a national figure.

Comparable district data are limited to fiscal 1966, 1973, and 1974, but a relationship here is clear. State general fund expenditures amounted to only 10.5 percent of total government expenditures in fiscal 1966 but increased to 36.1 percent in fiscal 1973 and 35.6 percent in fiscal 1974. More state aid to local governments accounts for the rising share, and based on 1975 legislative action, it will probably rise further, to about 38 percent, in fiscal 1976 and 1977.

During the fiscal period 1967 to 1974, the relationship between district state and local government expenditures and national state and

local government purchases of goods and services has been quite stable. In this eight-year period, district expenditures averaged 3.46 percent of national purchases, with the range varying from 3.3 to 3.6 percent.

Since fiscal 1974, when this ratio was 3.3 percent, available data indicate that the district state and local government sector has been growing faster than nationally. This suggests that in fiscal 1976 and 1977 the ratio will probably approximate the 1967-74 average of 3.46 percent.

These two ratios, combined with district state general fund expenditures budgeted for fiscal 1976 and 1977, produce varying forecasts of national state and local government spending for goods and services (see Table 8). The most likely predicts faster growth than the Board staff does but slower than the January MRD, assuming the district's share of national expenditures approximates its average share from fiscal 1967 to 1974. The lowest forecast assumes the district's highest share during that period, and the highest forecast the lowest share. Also, district state and local government expenditures are expected to rise faster than nationally during the forecast period.

How useful are district general fund data for projecting national state and local government purchases of goods and services? The traditional approach has been to project the trend rate of growth for the last several years. Recently, however, inflation, recession, and demographic and voter attitude changes have made this method less reliable.

Using general fund data has the advantage of projecting policy makers' current spending proposals to the national level, instead of relying on historical trends which may no longer hold. The fact that

Table 8

Projections of National and District
State and Local Government Purchases of Goods and Services
Fiscal Years 1976 and 1977

	1975 Actual	1976 Estimated	1977 Estimated	Percentage Changes 1975-6	Percentage Changes 1976-7
NATIONAL FORECASTS (mils.)					
Board of Governors' Staff (December 11, 1975)	$ 202.3	$ 218.0	$ 242.6	7.8%	11.3%
MRD (January 14, 1976)	202.3	229.3	259.8	13.3	13.3
State General Fund[1/]					
Most Likely	202.3	221.9	249.1	9.7	12.3
High	202.3	232.6	261.2	15.0	12.3
Low	202.3	213.2	239.4	5.4	12.3
DISTRICT FORECAST (thous.)					
State General Fund[2/]	6,646.9	7,676.3	8,618.2	15.5	12.3

[1/] The state general fund forecast is obtained by dividing district state general fund expenditures by the ratio of district state general fund expenditures to total district state and local government expenditures (DSGF/DSLGS) and the quotient is divided by the ratio of district state and local government expenditures to national state and local government purchases of goods and services (DSLGS/NSLGS) to obtain an estimate of national state and local government purchases of goods and services. Below are the ratios in the above forecasts.

Most Likely: DSGF/DSLGS = .38, DSLGS/NSLGS = .0346
High: DSGF/DSLGS = .38, DSLGS/NSLGS = .033
Low: DSGF/DSLGS = .38, DSLGS/NSLGS = .036

[2/] Obtained by dividing district state general fund expenditures by (DSGF/DSLGS) and for fiscal 1975, (DSGF/DSLGS) = .36.

state government has become the dominant partner in state and local fiscal relations is another point in its favor. Also, although the material is being used differently, the Joint Economic Committee is surveying states for general fund data.

Still, these estimates should be viewed as a demonstrative effort, since discretionary judgment helped develop the forecast ratios. If this method appears useful, more work must be done on estimating these ratios.

ADDENDUM

Possible Municipal Bond Market Reforms

Conditions in the municipal bond market have improved since last fall's tumultuous events, and the question now is whether those developments were one-time occurrences or precursors of future crises. Structural changes in the municipal bond market--such as the recent growth in pollution control revenue bond financing and decreased commercial bank interest in municipal bonds--will continue to complicate municipal bond financing and suggest that reform is needed. To improve the municipal bond market's vitality, actions must be taken to restore and maintain the creditworthiness of state and local governments and to improve municipal bonds' marketability.

State and local governments' creditworthiness is primarily their own responsibility, and investors' acceptance of this region's bonds last year indicates that district state, and local governments are fiscally sound. But they are far from free of financial difficulties, as indicated by the St. Paul school district's problems. Examples of a current effort to preserve this area's creditworthiness are the following Minneapols-St. Paul Metropolitan Council policies concerning long-term debt:

> The Metropolitan Council will seek to manage the credit of the region by limiting metropolitan agency borrowing and reporting on local borrowing. The Metropolitan Council will estimate periodically the capacity of the area to borrow for regional purposes and keep such borrowing well within this capacity.
>
> Concerning the borrowing capacity of the area for regional purposes, the Metropolitan Council will attempt to maintain sufficient unused credit as a reserve for contingency and uncertainty equal to twenty percent of the estimated borrowing capacity of the area for regional purposes.[8/]

While state action is not precluded, efforts to improve municipal securities' marketability will require federal legislation. Because tax exemption is an inefficient and costly method of subsidizing state and local governments, a better remedy would be to give municipalities a direct subsidy rather than the present indirect subsidy implicit in the tax-exempt feature. State and local governments, however, would have the choice of issuing either tax-exempt or taxable bonds. Whether a community chose the tax-exempt or the taxable route would depend on the size of the subsidy and the condition of the market. Legislation supported by the Ford Administration is pending in Congress that would have the federal government pick up a third of the municipal bond interest costs.

Under current market conditions, any subsidy much larger than 20 percent would induce some communities to issue their long-term bonds in taxable form. As a result, the supply of tax-exempt bonds would decline, reducing those yields, while the supply of taxable bonds would increase, raising costs to private borrowers. The ratio of yields on tax-exempts to yields on taxables would therefore fall--perhaps in a few years to the point where it would be cheaper for some local communities to shift back to more tax-exempt issues. With regard to the Ninth District, the implementation of this proposal would probably benefit both those lower-rated municipalities paying higher rates, which would benefit from the subsidy, and the higher-rated units, which would be able to continue to sell tax-exempt securities at lower rates.

Another benefit to subsidizing taxable municipal bonds would be a much broader market for this type of debt. Taxable municipals would appeal to a large class of institutional investors that now have

no appetite for tax-exempt bonds because they bear only an extremely light tax burden, or none at all. Included in this category are pension funds, foundations, colleges and universities, and mutual savings banks. The cost of subsidizing municipal bonds has been a much debated subject, and several studies have indicated that additional tax revenues would be able to offset the subsidy costs. Opposition to efforts to provide subsidies have come from state and local governments that fear becoming too dependent on direct federal handouts and control.

One reform already enacted by Congress is the S.E.C.'s new authority to regulate municipal security dealers and underwriters which is expected to increase required disclosure of state and local governments' financial situations. Eliminating pollution control bonds' tax-exempt status is also a possibility. And a new market for tax-exempt debt could be provided if Congress allowed federal trust funds to purchase municipal securities.

In addition to federal reforms, state governments could implement measures to reduce local governments' cost of borrowing and eliminate some administrative difficulties. Several states, for example, have established bond banks which package the bond issues of small- and medium-sized communities and sell them on the open market. These packaged bonds received interest rates lower than those on the bond issue of an individual community because some type of state guarantee backs them up.

Another approach is for state governments to guarantee local government bonds and so lower interest costs. In 1971, for example, the Minnesota Legislature enacted the Municipal Debt Service Aid Law which provides a limited guarantee or pledge by the state of its full faith and credit behind the general obligations of local units of government.

This guarantee, however, has only had limited use in Minnesota because of the extra cost to obtain the guarantee and a $2.5 million lending limit. Private insurance to guarantee municipal general obligation bonds has not been used in this area either because of its high cost.

Texas established a municipal advisory council which provides financial information and reports to rating services. Municipalities that might otherwise have gone unrated or received substandard ratings are thus more accurately rated, and their borrowing costs drop. Rated municipalities in Texas rose from 200 in 1955, when the council was established, to about 600 in 1971, and the annual savings in interest costs is estimated at $9 to $12 million.

Since financial conditions have improved and interest rates eased, the urgency to reform the municipal bond market has let up. Nevertheless, the underlying forces recently affecting this market are not expected to vanish, so change will be necessary. At the federal level, subsidies for tax-exempt securities appear possible. State and local action should focus on preserving and improving their own creditworthiness, but states have several available options for helping local governments market their bonds. In the Ninth District today, there is no strong pressure to enact such legislation.

Footnotes

1/ For the purposes of this report, the Ninth District will be defined as the four complete states of Minnesota, Montana, North Dakota, and South Dakota.

2/ The market's inability to absorb Municipal Assistance Corporation bonds in July can be viewed as the pivotal event which set off widespread investor concern about the quality of municipal credit.

3/ Richard Gibson, "N.Y. Bond Shockwave Rolls Through Market," The Minneapolis Star, January 16, 1976, p. 12A.

4/ During the first nine months of 1975, 44 points of the 113 basis point spread between Aaa and Baa municipal bonds can be attributed to the general market deterioration associated with New York's problems. See Ronald W. Forbes and John E. Peterson, "Costs of Credit Erosion in the Municipal Bond Market," Municipal Finance Officers Association, Chicago, Illinois, December 20, 1975, p. 8.

5/ John Greenwald, "Bond Rater Looks to Minneapolis," Minneapolis Star, January 16, 1976, pp. 1A and 5A.

6/ "School Fund Voted for Loan," Minneapolis Star, February 4, 1976, p. 9B.

7/ U.S. Congress, Joint Economic Committee, The Current Fiscal Position of State and Local Governments, December 17, 1975, pp. 3-4.

8/ "Development Guide Chapter," Metropolitan Investment Framework, October 9, 1975, p. 16.