

Statement of  
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ATLANTIC BOND

Of the many issues in municipal finance which might be discussed here today, I propose to focus on two which seem to me to be among the most critical: the problem of inflation control and the need to restructure the municipal bond market. I would emphasize that I am speaking only for myself and not for the Federal Reserve System.

We have learned in recent years that a high rate of inflation has a devastating impact on municipal finance. The costs of operating cities and the costs of borrowing money are very responsive to inflation. However, the revenues of most cities, being so dependent on the property tax, are not very responsive to inflation. The result has been a severe financial squeeze from which few cities have been immune.

The immediate economic imperative, of course, is to get the economy growing again. The policies needed to accomplish this are in place and we now have rather conclusive evidence that the third quarter upturn, which has long been forecast, will in fact occur.

The second economic imperative is to get the economy on a growth path that will be compatible with a continued diminution of the inflation rate. Politically, this will be difficult to accomplish; since it will require that the American people accept for a few years higher levels of unemployment than we have been accustomed to think of as tolerable. However, if in the interest of getting the unemployment rate down more rapidly, we attempt to exceed the growth path which is optimum for the longer run, we are very likely to pay the price of a return to double-digit inflation. In that event, the financial problems of the cities are likely to be much more severe in 1979 and 1980 than they are today.

I have distributed a chart showing unemployment rates in the United States and New England since 1950. It shows that the early years following World War II, the unemployment rate in New England was consistently above the national average. The gap was closed in the mid 50's and until 1969 New England had a sufficiently good growth record to keep our unemployment rate close to the national average. Since 1969, however, our growth rate has been very poor. In fact, it might be said that the New England economy never fully recovered from the recession of 1969-70. As a consequence, we

have an unemployment rate some 2-1/2% above the national average.

If the growth record of New England is no better in the last half of the 70's than it was in the first half, the financial problems of New England will continue to multiply. While I know that this session is oriented toward national economic policies, I could not let this occasion pass without calling attention to the critical need for state and local government policies designed to make New England more attractive for investment capital.

Turning to the national unemployment picture, the chart shows two projections of the unemployment rate nationally through 1980. One was prepared by the President's Council of Economic Advisors and shows the unemployment rate declining gradually to 5.1% in 1980. To accomplish this would require a real growth rate averaging about 6-1/2% for the 1976-1980 period, a rate of real growth greater than that which we achieved in the first half of the 60's. It is estimated that this rate of growth would be compatible with a gradual decline in the inflation rate to 4% in 1980.

The second growth path has been proposed by Professor James Tobin of Yale University, who advocates a much more expansionary policy in order to get the unemployment rate down more rapidly to 5-1/2% by the first half of 1978.

He would be willing to accept a substantially higher inflation rate than 4% in 1980 to accomplish this.

I present these projections for two purposes: first, to emphasize the fact that the American people and their political leaders are going to have to make some extremely difficult trade-offs between unemployment and inflation in the years ahead, the most difficult trade-offs in my memory; and second, to point out that, no matter what course we take, the average unemployment rate is going to be very high in the next five years. Furthermore, there is a growing consensus among economists that full employment should now be defined in the area of 5% to 5-1/2% unemployed. Below that level of unemployment, due to the changing structure of our labor force, we would encounter shortages of skilled labor and, at least for the next few years, materials bottlenecks.

This suggests to me that our philosophy for dealing with the unemployed needs to be changed. The philosophy developed in the years following World War II, that we should pay the unemployed for not working, may have been a viable and efficient one when the unemployment norm was 3%; it is something else again when the unemployment norm is 5-1/2%.

We look around our cities and find so much work to be done together with so many people with nothing to do, many of them young people. It seems to me that we will need, for the next five or six years, large scale permanent manpower training and public employment programs funded by the Federal Government. I will leave to those who are authorities on the labor market to recommend the precise form of such programs. Perhaps we need to revive such instruments of the 30's as the Civilian Conservation Corps and the W.P.A. Whatever the form, if the American people are to accept for the last half of the 70's 5-1/2% unemployed as the full employment norm in the interest of washing inflation out of our economy, then it seems to me that a large manpower training and public employment program will be essential.

Turning to the municipal bond market, we find it in great disarray. The market, as it is presently structured, is not likely to serve state and local governments well in the decade ahead. Two things are needed: first, to deal with inflation, which has seriously weakened all of our capital markets; and second, to broaden the municipal bond market by providing to state and local governments a taxable bond option with a 40% interest subsidy from the Federal Government. The 30% interest subsidy proposed by the Administration, while it would be a step in the right direction, would not, in my judgment, be sufficient to do the job properly.

Our capital markets generally will not be restored to full health until the investor is convinced that inflation has been brought under control and will be kept under control in the future. As long as the investor fears a high rate of inflation in the future, he will respond by sticking to short maturities, leaving the intermediate and long-term bond markets very thin and unable to cope with the demands placed upon them.

However, even if we succeed in persuading the investor that we have inflation under control, there will still be a need to broaden the base of the municipal bond market, which now is restricted for the most part to commercial banks, casualty insurance companies, and wealthy individuals. This market served state and local governments well in the decade of the 60's only because commercial banks were in a position to absorb 70% of all state and local government offerings. For a number of reasons, which I do not have time to go into here, I am convinced that the commercial banking system will not be able to provide this kind of support to the municipal bond market in the future. In fact, during the first five years of the 70's, the commercial banks' take of net new state and local government offerings

declined to 47% from the 70% level of the 60's. The sharply reduced ability of commercial banks to support the municipal bond market is, in my judgment, one of the major reasons for the current weakness in the market.

State and local governments clearly need the authority to issue bonds both on a taxable and tax-exempt basis--permitting them to have not only the traditional markets for their securities, but also to tap the great bond-buying potential of the pension funds, both private and public, which are now foreclosed to them.

Under such a dual market system, state and local governments would ask the underwriters of their securities to bid on both a taxable or a tax-exempt basis, or some combination of the two. Often underwriters would find a combination offering to produce the lowest interest cost--with the short maturities, which the commercial banks will still be buying, sold on a tax-exempt basis, while the longer maturities are sold on a taxable basis in the pension fund market.

Such a dual market would offer lower net interest costs to state and local governments. Having the option to sell taxable bonds with a 40% interest

subsidy would mean that tax-exempt bonds would never be sold at an interest rate higher than 60% of the equivalent taxable rate. The result would be that the element of inequity in our income tax system introduced by tax-exempt bonds would be substantially reduced.

The taxable bond option has been held back in the past by the fears of state and local government officials that it would lead ultimately to the elimination of the tax-exempt privilege. This fear seems to me to be unrealistic. State and local government officials, if they are ever in full agreement on any subject, constitute probably the strongest lobby in Washington. One of the few things they have been able to agree on is that the tax-exempt privilege shall not be taken away from them. For more than 50 years they have defeated the efforts of the United States Treasury Department to eliminate tax exemption. I see no reason why they should not be able to do so in the future.

The taxable bond with a 40% Federal interest subsidy, which would cost the Federal treasury little or nothing, would provide an extremely valuable additional financing tool which state and local government officials are going to sorely need in the decade ahead.

Finally, I would urge the repeal of the present law providing tax exemption to industrial pollution control bonds, replacing this privilege with a special investment credit for anti-pollution related investments.

I believe this country needs to stimulate investment and I think it entirely appropriate that we aid corporations which are required to make substantial additional investments in the interests of cleaning up our air and water. However, I believe that tax exemption on industrial pollution control bonds is a very poor device to achieve these ends. The industrial pollution control bonds have overloaded our tax-exempt bond market, increasing the cost of financing for all traditional state and local government investment purposes. Furthermore, it has had the effect of narrowing the spreads between tax-exempt and taxable bonds and, thereby, contributing toward increasing the inequities in our income tax system.

# UNEMPLOYMENT RATES: UNITED STATES AND NEW ENGLAND

