Outlook for State and Local Government Holdings of U.S. Treasury Securities

In 1982 and 1983, state and local governments financed a significant portion of the Federal deficit, as they increased their holdings of Treasury securities by $17 2 and $39.6 billion, respectively.[1] Most of the investments in these two years appear to have come from the unused proceeds of municipal security issues Those issues were extremely high, particularly in 1983, as a result of the strength in the bond market and the rush to beat the deadlines for issuing bearer bonds and single-family mortgage revenue bonds. Most experts in the municipal markets expect levels of issuance to be substantially lower in the coming months By contrast, only a part of the 1983 acquisitions of U S. Treasury

[1]This analysis deals only with state and local governments *per se*, and not their pension funds, which independently buy Treasury obligations, along with other securities

obligations can be explained by the budget surplus at the state and local government levels

The ability of state and local governments to invest the proceeds of tax-exempt securities, whether in Treasury instruments or in anything else, is restricted by guidelines established by the U S Treasury. In general, the Treasury has ruled that if the proceeds of a municipal bond are invested at a materially higher yield than the interest paid on the bond, the interest on the municipal bond will not be exempted from Federal income taxes Therefore, to retain the bond's tax-exempt status, the yield earned on the unused proceeds of the bond may be at most slightly higher than the cost of funds

In practice, however, several exceptions to the rule drastically lessen the constraints on how state and local governments may invest the proceeds of bond issues for temporary periods of time The trouble is that once the temporary time period lapses the investments must be liquidated The guidelines are strict enough to make it likely that state and local governments will be required to disinvest the unused proceeds of past bond issues in the near future In fact, net purchases of Treasury securities have already fallen to $2 billion in the first quarter of 1984, compared with an average quarterly rate of $10 billion in 1983

These are the key elements of the guidelines.

(1) When the securities are issued to raise "new money," the unused proceeds on most general obligation and revenue bonds can be invested without yield restriction for a "temporary period" of up to three years if at least 85 percent of the proceeds are spent within three years

(2) When the securities are issued to refund outstanding issues, the restriction-free "temporary period" is generally two years, provided that the principal and debt service of the original bond are repaid at the end of this "temporary period"

Because the time limit based on the heavy issuance of municipal securities in the 1982-83 period is coming up and because the special factors which operated to create that period of heavy issuance have vanished, the likelihood is that state and local holdings of Treasury securities will be run off, with new acquisitions sharply limited [2] Therefore, this substantial source of Treasury financing will be much less important in the near future

[2]The authorization to issue tax-exempt single-family mortgage revenue bonds, which expired at the end of 1983, was reinstated by the recently passed Deficit Reduction Act of 1984 This may increase somewhat the issuance of new tax-exempt securities, and hence municipalities' purchases of Treasury securities, relative to the first quarter of 1984

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