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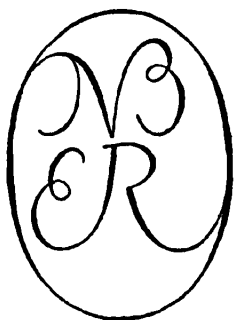
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Postwar Market  
for State and Local  
Government Securities

BY ROLAND I. ROBINSON



A STUDY BY THE  
NATIONAL BUREAU OF ECONOMIC RESEARCH



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## FOREWORD

THIS study of the market for state and local government securities during the postwar decade is the first major product of the National Bureau's Postwar Capital Market Study to be published. Like companion studies of the markets for Treasury securities, corporate securities and loans, and residential mortgages, this volume provides an analytical description of one of the main sectors of the American capital market as it operated during the postwar decade. Each of the monographs is a self-contained piece of research that, we hope, will make a contribution to study of the sector of the capital market with which it deals. All the monographs use the common statistical framework of the flow-of-funds-through-the-capital-markets statements and of national and sectoral balance sheets, both of which are described in more detail in other reports of the Postwar Capital Market Study. Because of the necessity of starting these monographs and the statistical work on some basic aspects of the capital market (flow of funds, saving, investment, wealth and balance sheets) at approximately the same time in 1956, when the Postwar Capital Market Study was initiated, it was not possible to use the same set of statistical data and the same approach in all of the monographs, even if such uniformity had been regarded as desirable. But the differences are not great.

Robinson's monograph cannot be reduced to a few simple or startling conclusions: it is a careful and realistic description and analysis of the operation of one important sector of the American capital market, the results of which cannot be boiled down into a few paragraphs without losing most of the study's value and significance. It may, however, not be amiss to explain briefly the reasons for a few limitations of the study which many readers will soon notice.

First, the statistical material used ends almost always with the year 1956 and consideration of events occurring after that date is rare. However, the fact that the study does not take specific account of developments during the last three years is in this case not a serious drawback. What has happened since 1956 has been by and large a continuation of what is described in the study. Indeed, the evidence of the last three years, which could not be anticipated when the study was written, provides a good way of checking the

## FOREWORD

relevance of the analysis. I have the impression that on the basis of this test Robinson's study is in all essentials as much up-to-date now as it was when he completed the draft of his manuscript in 1957.

There is another reason why stopping at 1956—or possibly one year later—appears justified. As a result of an expansion of the statistical activities of the Investment Bankers Association of America, we now have considerably more detailed information on several important aspects of the market for state and local government securities, particularly the amounts, character, and price of offerings, than was available during the first postwar decade. Our information is still sadly deficient on a few other aspects, primarily the volume of trading, dealers' inventories, and gross purchases and sales by the main investor groups. These gaps need to be filled before a really satisfactory analysis of the market for tax-exempt securities will be possible. It is probable, however, that when the job of analyzing the market for state and local government securities needs to be done again in a few years, the body of statistical data on which that analysis can be based will be much broader than that available to Robinson, hard as he tried to supplement the insufficient material at hand with *ad hoc* inquiries.

Second, some readers may wish the author had found it possible to devote more time and space to analysis of the relation of the interest rates on tax-exempt securities to those on other types of debt securities. These readers should realize, however, that on many of these points Robinson's study contains more information and goes further in the analysis of the material than the available literature. Moreover, the Bureau hopes to devote a special study to the analysis of interest rates in the United States, a study not limited to the postwar period or to one sector of the market. The advantage of studying the long-term record and the need to allow for the pronounced interdependence of interest rates on different types of capital market investments in any case rule out thorough analysis of interest rate developments in one sector of the capital market over the period of one decade only.

Third, some readers will feel that certain aspects of the study, primarily the relation between net purchases and sales by various investor groups, interest rate differentials and income tax rates would lend themselves well to a more elaborate statistical or

## FOREWORD

econometric treatment. We believe that the present study opens the way for such an approach to the problem. This, it is fairly evident, would have to be conceived and executed on a broad scale. An econometric treatment of the postwar market for state and local government securities isolated from complementary study of other connecting sectors of the capital market and from examination of other periods might easily do more harm than good by giving the impression of a definiteness and precision of results that actually does not exist.

While the primary purpose of this study, as of the other parts of the Postwar Capital Market Study, is the quantitatively founded description and analysis of the operation of one sector of the American capital market during the first postwar decade, consideration was unavoidable of one problem of public policy—exemption of the interest from state and local government securities from federal income tax. Robinson shows that the price state and local government borrowers have received for the tax exemption privilege, measured by the differential in net yields between tax-exempt securities and taxable securities of similar character and quality, has declined sharply during the postwar decade; and is now at an unprecedentedly low level compared to the rates of income tax payable on otherwise comparable taxable securities. At the very least, Robinson has made it impossible for us to ignore any longer the question of whether the tax-exemption privilege is being granted without an adequate *quid pro quo*. Robinson's presentation ends with 1956; since that time the devaluation of the tax-exemption privilege has proceeded further.

In conformity with the Bureau's general policy, Robinson raises questions but makes no suggestions regarding policy. Similarly, Robinson, without taking a position himself, adduces enough material to make it doubtful whether the tax-exemption privilege of state and local government securities rests on anything except a grant by Congress in the income tax law, so that what Congress has given, Congress can take away. Whether this is so must of course remain primarily a question for constitutional lawyers to decide. If the decision should be in the direction to which Robinson's discussion in Chapter 1 points, the policies to be adopted with regard to the tax exemption of state and local government

## FOREWORD

securities will be a purely political and economic matter freed from the supposed fetters of a constitutional mandate.

In that situation, careful consideration certainly would have to be given, both from a political and economic point of view, to two possible ways of dealing with the tax-exemption privilege: its abolition by Congressional action, limited for reasons of equity to future issues of state and government securities; and an offer by the federal government to pay a subsidy to future issuers of state and local government securities, a subsidy the exact size of which would have to be carefully determined. Robinson presents data which show that the federal government could offer most issuers of state and local government securities more than they now save by issuing their obligations in tax-exempt form, and yet leave the Treasury with a net increase in income. These conditions may change, and buyers may again have to pay more for the tax-exemption privilege—in the form of substantially lower rates—than they do now. But if the basic demand-supply situation in the market for tax-exempt securities is as Robinson outlines it, such a change is not highly probable.

RAYMOND W. GOLDSMITH  
*Director, Postwar Capital  
Market Study*

## PREFACE

THIS study is a part of the National Bureau's inquiry into the capital markets of the United States. The central purpose of this inquiry has been to use the gross flows of funds within the capital markets derived from the extensive financial data compiled by Dr. Goldsmith in his study of saving as a tool for analysis of the market process. In addition to this central project, however, it was necessary to examine in detail the institutional characteristics of various sectors of the market. This report is a study of one of these sectors.

The tendency of economists to focus their attention mainly on the fiscal policies and operations of the federal government has led them to neglect, relatively, the financial problems of state and local governments. This sector has nevertheless been of mounting importance during the postwar era. Current state and local government receipts and expenditures grew, but the pressure on these governments to make long-deferred capital improvements caused state and local government capital expenditures to grow even more rapidly. Capital outlays, in turn, led to more borrowing. This inquiry thus was made during a period of rapid development in the market for state and local government tax-exempt obligations.

The major problem isolated in this inquiry is the erosion of tax exemption as means of supporting state and local government financing. The problem has grown more acute during the past few years and in many ways this study should be considered an interim report on the factors that accounted for this sizable erosion.

All of the exploratory work and most of the drafting underlying this report were completed during the year 1955-1956 when I was on leave from Northwestern University. During that year I was greatly helped by Justine Rodriguez and Jack Farkas, both of whom were then on the National Bureau staff. Morris Mendelson supplied invaluable assistance both in construction of the statistical foundation and later in the process of integrating these statistics into the general flow-of-funds material prepared in connection with the capital markets inquiry. My debt to him is very large. Revising and polishing of this study has been done mainly in spare time while working in the Division of Research and Statis-

## PREFACE

tics at the Board of Governors of the Federal Reserve. I am grateful to Ralph A. Young, Director of that Division, for his encouragement in completing this task.

An inquiry into a market organization must depend on the willingness of those intimately acquainted with the institutional arrangements of the market to talk freely and frankly; bare statistics cannot convey the kind of knowledge an investigator needs. Interviews for the purpose of exploring the matter were arranged for me by Mr. George Wanders, editor of *The Bond Buyer*. The list of respondents was long but special mention must be made of those who not only submitted patiently to the interview process but subsequently gave me written comments on the manuscript or made supplementary responses to the special questions addressed to them. Mr. John Linen, who recently retired from the Chase Manhattan Bank; Mr. Cushman McGee of R. W. Pressprich & Company; Mr. Neal Fulkerson of the Bankers Trust Company, and Mr. Harry Severson, a financial consultant on the market, all gave me a great deal of time and help. Mr. Norris Johnson of the First National City Bank of New York gave parts of the manuscript a very helpful reading. Frank Morris of the Investment Bankers Association contributed more to this project than indicated by the many footnote references to his work in this field. Professor Harry G. Guthmann read the entire manuscript and gave me particularly helpful suggestions on the use of tax-exempt securities by investors.

The National Bureau organization was of invaluable aid. I received early counsel from Solomon Fabricant, William J. Carson, and Geoffrey H. Moore. The staff reading given my manuscript by Raymond Goldsmith, W. Braddock Hickman, Geoffrey Moore, Morris Mendelson, and C. Harry Kahn is gratefully acknowledged. The debt to Geoffrey Moore and Harry Kahn is particularly great. Moore opened up an important line of development for Chapter 6 and Kahn undertook the quantitative research that made application of this idea possible. In addition I am indebted to Professor Lawrence H. Seltzer and to Laszlo Ecker-Racz for a number of helpful suggestions. The directors of the Bureau who read the manuscript—Professor Walter Heller, Albert J. Hettinger, Jr., and Percival F. Brundage—not only fulfilled their basic judicial role but gave me some useful ideas for further improvement.

## PREFACE

Acknowledgment should also be made to the Advisory Committee on the Study of the Postwar Capital Market, which assisted in drafting plans for this investigation. Members of the Committee were: W. A. Clarke, George T. Conklin, Jr., W. Braddock Hickman, Norris O. Johnson, Arnold R. LaForce, Aubrey G. Lanston, Robert P. Mayo, Roger F. Murray, James J. O'Leary, Winfield W. Riefler, Robert V. Roosa, R. J. Saulnier, William H. Steiner, Donald B. Woodward, and Eugene C. Zorn, Jr.

The specific debt to Raymond Goldsmith acknowledged above fails to represent my full obligation to him. It was he who gave a considerable amount of direction to the project in its beginning, who helped mold rough ideas into operational research plans, who read innumerable drafts constructively, and finally who constantly rekindled my enthusiasm when it tended to flag. My debt to him is more than I can express adequately here.

The charts were drawn by H. Irving Forman with his usual competence. The style of the manuscript was inestimably improved by Cornelius J. Dwyer. Miss Anita Perrin managed, in ways I do not understand, to assemble a presentable manuscript from the scribbled scraps of paper that I presented to her.

Each of these persons, in his own way, helped me to eliminate or moderate many flaws that were in the original manuscript. But flaws remain. These are my undivided responsibility.

ROLAND I. ROBINSON

*Washington, D.C.*

*March 13, 1959*



# CONTENTS

FOREWORD, BY RAYMOND W. GOLDSMITH	ix
PREFACE	xiii
SUMMARY AND CONCLUSIONS	3
State and Local Government Demand for Funds	5
Size of the Market: The Investors	7
The Marketing of New State and Local Government Issues	9
The Secondary Market in Tax-Exempt Securities	11
Pricing the Privilege of Tax Exemption	12
The Market for Revenue Obligations	16
I. PROBLEMS OF THE MARKET FOR STATE AND LOCAL GOVERNMENT SECURITIES	19
Legal Foundation of the Exemption of Interest on State and Local Government Obligations from Federal Taxation	22
The Support of Public Investment by Tax-Exempt Financing	26
Comparison of the State and Local Government Se- curity Market with Other Sectors of the Capital Markets	27
Competitive Bidding in State and Local Market	28
Legal Restrictions on Borrowing and Borrowing Practices	28
Does Tax Exemption Handicap Other Borrowers?	29
How Great Is the Advantage to Borrowers of Tax Exemption?	30
Strategic Practices of This Market	31
Method of Investigation	31
The Problem of Data	32
Sources of Quantitative Market Data	33
Nonquantitative Evidence	36
2. THE DEMAND FOR FUNDS BY STATE AND LOCAL GOVERNMENTS	37
Summary	37

CONTENTS

Capital Expenditure Is the Prime Cause of Most State and Local Government Borrowing	40
Borrowing Policies of State and Local Governmental Units	46
Legal Restraints on State and Local Government Borrowing	49
State and Local Government Borrowing at Various Levels	53
Cyclical Influences on the Timing of State and Local Government Borrowing	55
Strategic elements in the timing of borrowing	56
Interest elasticity of demand for funds	56
Experience during periods of tight money markets	58
Experience in periods of ease	59
The Ability of State and Local Governmental Units to Service Debt	59
3. THE SUPPLY OF FUNDS BY INVESTORS IN STATE AND LOCAL GOVERNMENT OBLIGATIONS	67
Summary	67
The Market for State and Local Government Obligations among Individuals	70
The Market for State and Local Government Obligations among Commercial Banks	81
The Market for State and Local Government Obligations among Fire and Casualty Insurance Companies	89
The Market for State and Local Government Securities among Life Insurance Companies and Mutual Savings Banks	93
State and Local Governments, and the Funds They Control as Investors in Their Own Securities	95
Other Investors in State and Local Government Obligations	96
Some Conclusions with Respect to the Size of Market for State and Local Government Obligations	99
4. THE MARKETING OF NEW STATE AND LOCAL GOVERNMENT ISSUES	101
Marketing process	101

## CONTENTS

Commercial Banks as Underwriters of State and Local Government Offerings	103
Structure of Syndicates	106
Management of the Syndicates	107
Buying Strategy	108
Setting a coupon structure	113
Gross underwriting margins	117
The margin between bids	119
National Versus Local Syndicates	121
Selling Strategy of Syndicates	122
Concessions to dealers	123
Divided and undivided accounts	125
Inventory Policies of Underwriters	126
Effects of Size of Issue on Marketability	128
The Effects of Competitive Bidding on the Market- ing of New State and Local Government Issues	134
 5. THE SECONDARY MARKET FOR STATE AND LOCAL GOVERNMENT OBLIGATIONS	 137
Economic Function of Secondary Market	137
Organization of Secondary Market in State and Local Government Securities	139
The Role of Dealers in the Secondary Market for State and Local Government Obligations	141
Size of Secondary Market in State and Local Gov- ernment Obligations	143
Character of Issues in the Secondary Market	148
Buyers and Sellers in the Secondary Market	150
Prices in the Secondary Market for State and Local Government Obligations	150
The Marketability of State and Local Government Obligations	153
Marketing Costs for State and Local Government Securities in Secondary Market	155
 6. TAX-EXEMPT INTEREST AS A COST TO BORROWING GOVERNMENTS AND AS A YIELD TO INVESTORS	 158
Summary	158
Relatively Great Increase in Tax-Exempt Yields During Postwar Decade	161

## CONTENTS

Wide Price Fluctuation of State and Local Government Securities	167
The Influence of Credit Quality on Yield	173
Term Structure of Yields on State and Local Government Obligations	180
Dividing the Tax-Exemption Subsidy	188
Appendix Note to Chapter 6: Measurement of Yields in State and Local Government Market	197
<b>7. THE MARKET FOR TAX-EXEMPT REVENUE OBLIGATIONS</b>	<b>202</b>
Factors Accounting for Recourse to Revenue Financing	205
Form of Revenue Obligations	207
Nature of the Market	207
Investors in Revenue Obligations	208
Costs and Yields for Tax-Exempt Revenue Financing	209
Interest Cost of Revenue Financing	210
<b>APPENDIX A:</b>	
Statistics of State and Local Government Debt, 1945-1956	213
<b>APPENDIX B:</b>	
Results of Conventional (Nonaccrual) Method of Computing Interest Cost Which Prevails in Competitive Bidding for State and Local Government Issues	217
<b>INDEX</b>	<b>225</b>

## TABLES

1. Long-term State and Local Government Borrowing, by Purpose, 1946-1955	40
2. Long-term State and Local Government Borrowing, by Purpose (Dollars), Annually, 1946-1956	42
3. Long-term State and Local Government Borrowing, by Purpose (per cent), Annually, 1946-1956	43
4. Borrowing for Capital Expenditure Compared with New Construction Outlays of State and Local Governments, 1946-1956	44
5. Long-term and Short-term State and Local Government Debt (Interest Bearing), Year-ends, 1945-1956	49
6. Long-term State and Local Government Debt: Amount Outstanding in 1954 and New Issues, 1946-1955	55
7. Percentage Distribution of State and Local Bonds Rated by Moody's Investors' Service, by Rating Group, 1945-1955	66
8. Annual Acquisitions of State and Local Government Securities by Private Investors, 1946-1956	69
9. Holdings of State and Local Government Securities by Individuals, Annually, 1945-1955	71
10. State and Municipal Bonds as a Percentage of Gross Taxable Estates	75
11. Commercial Banks' Holdings of State and Local Government Securities, 1945-1956	82
12. Estimated Yield Earned on State and Local Securities by Insured Commercial Banks, 1946-1955	85
13. Maturity of State and Local Government Obligations Owned by Insured Commercial Banks, June 30, 1947 and June 30, 1956	88
14. Fire and Casualty Insurance Company Holdings of State and Local Government Securities, Annually, 1945-1956	90
15. Life Insurance Company Holdings of State and Local Government Securities, Annually, 1945-1956	94
16. State and Local Government Securities Owned by the State and Local Governments Themselves, Annually, 1945-1956	97

TABLES

17. Principal Managing Underwriters of New Municipal Issues, 1957	109
18. Gross Margins on Reofferings of State and Local Government Securities Competitively Bought	118
19. Gross Margins on Reofferings of State and Local Government Securities Competitively Bought, by Quality and Maturity	119
20. Concessions Made to Members of the National Association of Security Dealers by Syndicates Reoffering State and Local Government Securities, December 1955	124
21. Winning Bidding Groups for Public Offerings of State and Local Government Securities, December 1955	130
22. Number of Bids in Relation to Size of Public Offerings of State and Local Government Securities, December 1955.	132
23. Method of Offering Municipal Bond Issues, 1957	134
24. Amount of Bonds Resold in Over-the-Counter Market Compared with Amount Outstanding	144
25. New Issue Sale and Resales by Registered and Non-registered Brokers and Dealers, September to November 1949	145
26. Maturity-Yield Relationship for Aaa State and Local Government Obligations	183
27. Alternative Estimates of Revenue Loss to Federal Government by Tax Exemption on State and Local Government Securities, 1947-1955	191
28. Reduction of State and Local Government Borrowing Costs as a Result of Federal Tax Exemption; Estimate for First-year Cost Reduction on Obligations Issued 1947-1955	194
29. Percentage of Federal Tax Loss Retained by State and Local Governments as Reduced Borrowing Cost	196
30. New Issue Reoffering Yields, 1957 to June 1958	201
31. Nonguaranteed State and Local Government Long-term Debt	203
32. Revenue Obligations as a Proportion of New State and Local Government Security Offerings	204
A-1. Gross State and Local Government Debt, End-of-Year, 1945-1956	213

*TABLES*

A-2. Publicly and Privately Held State and Local Government Securities, End-of-Year, 1945-1956	214
A-3. Privately Held State and Local Government Securities, End-of-Year, 1945-1956	215
A-4. Percentage Distribution of Privately Held State and Local Government Securities, End-of-Year, 1945-1956	216
B-1. Hypothetical Illustration of Conventional (Nonaccrual) Method of Computing Interest Cost Prevailing in State and Local Government Borrowing, Part 1	218
B-2. Hypothetical Illustration, Part 2	220
B-3. Hypothetical Illustration, Part 3	223

## CHARTS

1. State and Local Government Securities Sold by Public Offering, Monthly at Annual Rates, 1946-1957	57
2. State Government Debt per Capita, by States, 1955	62
3. City Government Debt per Capita, in Major Cities, 1954	63
4. Ratio of State Government Debt (Gross) per Capita to Personal Income per Capita, 1954	64
5. State and Municipal Bonds as a Percentage of Gross Taxable Estates	76
6. Selected Examples, Coupon Structure Relative to Reoffering Yield, State and Local Securities	116
7. State and Local Government Securities Reoffered in the Secondary Market	146
8. Municipal Bond Yields as a Percentage of Comparable Corporate Bond Yields	162
9. Relative Price Movement of Corporate and Municipal Bonds	168
10. Municipal Bond Yield Differentials by Quality of Issue, in Basis Points	174
11. Municipal Bond Yield Differentials by Quality of Issue, in Relative Terms	175
12. Basic Yield Curves for Aaa and Baa Municipal Bonds, Selected Years	186
13. Offering Yields on Toll Road Bonds Compared with Yields on Outstanding Revenue Bonds	212