This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: The Ownership of Tax-Exempt Securities, 1913-1953

Volume Author/Editor: George E. Lent

Volume Publisher: UMI

Volume ISBN: 0-87014-361-1

Volume URL: http://www.nber.org/books/lent55-1

Publication Date: 1955

Chapter Title: Introduction to "The Ownership of Tax-Exempt Securities, 1913-1953"

Chapter Author: George E. Lent

Chapter URL: http://www.nber.org/chapters/c6453

Chapter pages in book: (p. 1 - 5)

Introduction

The tax exemption of income from government securities has long characterized the federal income tax system. Not only has complete tax exemption been granted to income from state and local securities since 1913, but it has also been provided for federal securities at various times and even for obligations of quasi-private businesses, such as farm loan banks. (Much of the federal debt has been exempt only from normal tax, that is, partially tax-exempt.) The effects of tax exemption on the investment policies of individuals and investment institutions is of special interest to those concerned with the incompatibility of tax exemption with progressive tax rates and the tax treatment of corporations.

Through ownership of tax-free securities some taxpayers legally escape their share of federal taxes. In an income tax system founded upon progressive rates the tax-saving incentive to own such securities is far greater for those in the upper- than in the lower-income brackets. Even if taxes were limited to a single flat rate, however, those who depend mainly on earned income and have little or nothing to invest could not take advantage of tax saving permitted by ownership of tax-exempt securities.

On the other hand, by virtue of tax exemption, state and local government units enjoy substantial advantages in the financing of public improvements. It might be regarded as good public policy to offer special encouragement to the purposes for which such loans are made, even at the expense of taxpayers generally.

Before the ratification of the income tax amendment to the federal Constitution in 1913 it was adjudged unconstitutional for the federal government to tax securities issued by states or their sub-

ordinate governments. The income tax amendment is thought by some to supersede this judgment since it grants to the federal government the right to tax income from any source. This constitutional question has never been fully resolved, however, because Congress has never repealed the statute granting the states tax exemption despite several attempts to do so.

This study does not suggest answers to these questions of economic and legal policy. It is intended to analyze trends in the volume and ownership of tax-exempt securities and thereby provide some of the relevant facts upon which intelligent policy decisions may be based.

The Volume of Wholly Tax-Exempt Securities

The gross amount of tax-free securities rose from $4.5 billion in 1913 to a peak of $36.6 billion in 1936, when certain federal as well as farm loan and state and municipal securities were wholly exempt from tax. Thereafter the volume declined to a low point of about $16 billion in 1946. Since then it has increased to about $32 billion (June 1953). These securities now consist almost entirely of state and local obligations because the federal government abandoned issuance of tax-exempt securities in 1941. Since the end of World War II the volume of state and local obligations has doubled and is still growing.

Who Owns Wholly Tax-Exempt Securities?

In June 1953 holdings of wholly tax-exempt securities by governmental agencies amounted to about 15 per cent of the total. The income from government-held securities is of course not taxable in any event.

Of the privately owned tax-free securities, institutions held about 56 per cent. The major part, about 40 per cent of the privately owned total, was held by commercial banks. Life insurance companies held slightly less than 5 per cent.

The remainder of institutionally held tax-exempt securities was largely accounted for by taxable corporations, including fire and casualty insurance companies. Fraternal organizations, which are tax-exempt, held some of these securities. Mutual savings banks,

which were completely tax-exempt until 1952, held a negligible amount.

About $12 billion, or 44 per cent of the privately held total, was in the hands of individuals.

Trends in Individual Holdings

One of the significant recent changes in the ownership of tax-exempt securities has been the relative decline in individual ownership. Between 1913 and 1932 individual holdings of state and local securities rose from less than one-half to about two-thirds of the privately held total. Since then they have declined to around 44 per cent. The principal competing demand has been that of commercial banks, whose share of the supply rose from about 15 per cent in 1932 to about 40 per cent in 1953. Since the end of the war, banks have absorbed about 45 per cent of the net increase in private holdings.

Available data indicate a high degree of concentration in individual holdings among high-income groups. Estimates for 1941, for example, show that the upper 1 per cent of the population accounted for about two-thirds of total individual investments in municipal securities. These data evidence substantial shifts in concentration between 1924 and 1941 which tend to reflect changes in the level and graduation of individual income tax rates. Concentration in individuals' holdings reached its lowest ebb during 1931–1932, following the gradual income tax reductions through 1929. After that, increased concentration appeared to follow higher income tax rates.

Federal estate tax statistics also show that the proportion of estate investments represented by wholly tax-exempt securities, including federal obligations, increases significantly with the size of estates. During the period 1942–1949, for example, wholly tax-exempt securities ranged from an average of 1.7 per cent of the value of estates between $100,000 and $200,000 to 18.6 per cent of estates over $5 million.

There is no evidence in the estate data, however, that the attractiveness of tax-exempt securities to those with larger incomes has limited their ownership of corporation capital stock. Ownership

of stock has remained a much larger and more stable proportion of big estates than ownership of tax-exempt issues.

The Interest Differential and Investment Policies

Because of the tax-saving feature of wholly tax-exempt securities, interest rates (yields) on these securities have generally been substantially lower than on taxable securities of comparable quality. However, it is difficult to isolate the effects of various market factors bearing upon the size of the interest differential between tax-exempt and taxable securities. The height and degree of graduation in income tax rates, the comparative supply of municipal and various competing types of securities, the relative attractiveness of safety and speculative gain, the requirements of various types of investors, the credit policies of federal agencies, and other factors may all play a part. Perhaps the most critical factor, however, has been the level of the corporation tax rate and its relationship to the graduated income tax schedule. Changes in the corporation income tax rate applicable to commercial banks have been highly correlated with changes in the interest differential. With the rise in the level of this rate during the last two decades and the spreading yield differential, a more highly differentiated market for tax-exempt securities has developed. The increasing concentration of holdings in the hands of commercial banks has been accompanied by a declining investment interest on the part of mutual savings banks and life insurance companies, which have enjoyed preferential tax treatment for all their income. One of the most notable developments in recent years has been the sharp increase in the tax-exempt holdings of taxable fire and casualty insurance companies.

During the 1920's the narrow yield spread tended to broaden the individual market for tax-exempt securities, although the concentration in ownership among high-income groups was substantial. The significant increase in the yield differential since then, however, has tended to reduce the incentive for individuals to hold tax-exempts and probably largely accounts for their declining share in the total despite the higher level of individual income tax rates.

The relatively greater decline in the price of municipal securi-

ties compared with prices of other securities after mid-1952 greatly narrowed their yield differential. This development apparently reflected the interaction of the expanding supply of tax-exempt securities placed on the market—a net increase of $3 billion between June 30, 1952, and June 30, 1953—and the credit contraction which left municipal securities in a less favored position than other types of investments. This experience evidences the comparatively narrow market for tax-exempt securities, resting heavily on commercial banks and high-income individuals, which leaves their prices more than ordinarily exposed to changes in tax rates and credit conditions.