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A Conspectus

Gross Tax-Exempt Securities Outstanding,¹ 1913-1953

Wholly Tax-Exempt Obligations. Since the institution of the federal income tax in 1913 three major classes of securities have been completely exempted from federal tax. Their comparative importance over the forty-year period is indicated in Chart 1.

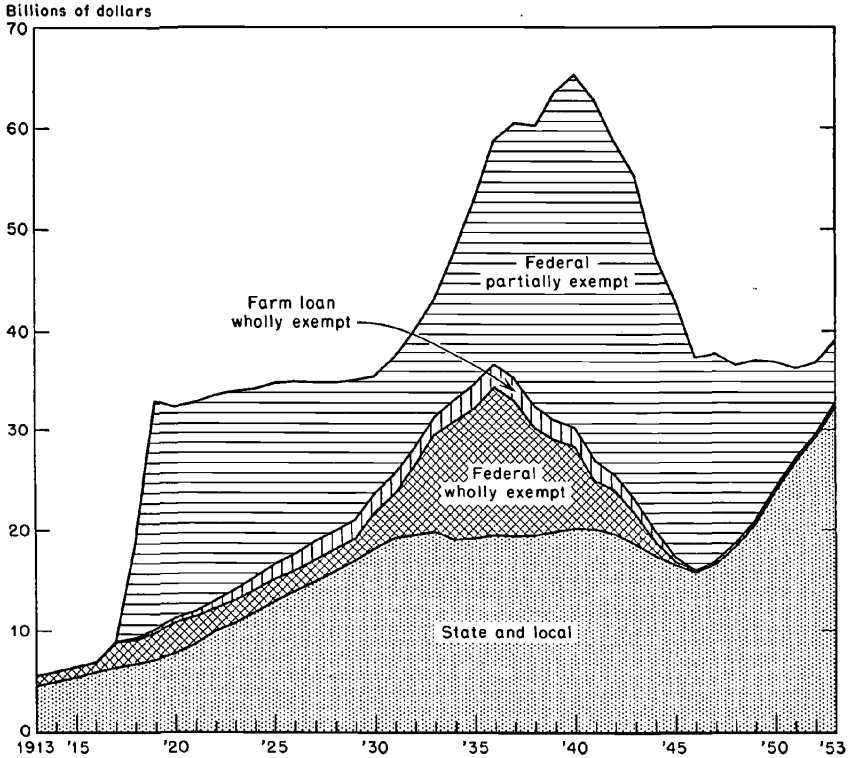
Foremost among these classes of wholly tax-free securities have been obligations of state and local government and their instrumentalities, the interest on which has been exempted by statute from federal tax. Gross obligations of state and local governments (including territories) expanded from \$4.5 billion in June 1913 to over \$19 billion in 1931. They then became stabilized at \$19-\$20 billion for a decade. After declining to less than \$16 billion during World War II, they again rose sharply to a gross amount of \$32 billion in June 1953.

The second major class of tax-free securities has consisted of direct obligations of the federal government itself. In 1913 there were outstanding about \$1 billion in federal obligations which were exempt from federal taxes under a law of 1870. During World War I the first Liberty loan in 1917 and special Victory notes in 1919 raised federal wholly tax-exempt securities outstanding to around \$3 billion. Retirement of the Victory notes by June 1922 left a total of slightly over \$2 billion outstanding until 1929, when the Treasury revived the use of tax-free securities. Deficit financing during the 1930's brought federal wholly tax-exempt issues to a peak of around \$15 billion in 1936. The Treasury then

¹ See Appendix tables for supporting data on the amount and distribution of ownership of tax-exempt debt and description of estimating procedure.

CHART 1

GROSS AMOUNT OF TAX-EXEMPT SECURITIES OUTSTANDING, 1913-1953



Source: Tables A-1 and A-2.

adopted fully taxable securities for the first time in 1940, with the financing of the new defense program. Enactment of the Public Debt Act of 1941 formally marked the end of federal tax-exempt financing. Outstanding wholly tax-exempt obligations of the federal government were liquidated by 1945, except for a modest amount of postal savings bonds maturing in 1955 and Panama Canal bonds expiring in 1961.

The third major class of fully tax-exempt obligations comprised those of the federal farm loan system, authorized by the Federal Farm Loan Act of 1913, as amended. These were federal non-guaranteed securities of federal land banks, joint-stock land banks,

and intermediate credit banks. First issued in 1918, they leveled off at \$1.8–\$1.9 billion between 1927 and 1932, and rose to \$2.4 billion in 1935. The Public Debt Act of 1941 prohibited further tax-exempt issues, and they finally disappeared in 1945.

These three major classes of wholly tax-exempt securities increased in the aggregate from a gross amount of \$5.5 billion in 1913 to a maximum of \$36.6 billion in 1936, of which state and local issues represented about one-half. Virtual liquidation of federal direct and nonguaranteed tax-exempt issues left only \$16 billion in state and local issues in 1946. Since then the volume of state and local securities has expanded at the most rapid rate in their history, to around \$32 billion in June 1953.

Federal Partially Tax-Exempt Obligations. The second Liberty loan, October 1917, limited tax exemption of federal securities to the flat-rate normal tax, except for interest on a specified principal amount of bonds, originally \$5,000, which was exempt from surtax as well. Such tax exemption was designed to limit the interest cost on war borrowing without unduly sacrificing equity under the progressive income tax structure. Succeeding issues raised the principal amount of a taxpayer's holdings exempt from surtax for limited time periods, depending on the proportions in which they were held. These various surtax exemptions were finally consolidated by the Revenue Act of 1921 to an aggregate amount of \$125,000 for two years after the official end of the war (July 2, 1921) and an amount of \$50,000 for two more years. After July 1923 interest on only the original \$5,000 principal amount of holdings was exempt from surtax, in addition to unlimited exemption from normal tax.

These partially tax-exempt securities reached a level of \$22.6 billion in June 1919. By June 1930 federal debt retirement reduced the amount outstanding by half. Failing authorization by Congress of wholly tax-exempt bonds, the Treasury again employed this class of long-term security to finance the depression deficit until the amount outstanding reached around \$36 billion in 1941. With the shift to taxable bonds in 1941, partially tax-exempt obligations outstanding declined to \$6.7 billion in June 1953, the last of which are not callable until 1960.

Comparative Magnitudes. State and local obligations outstanding have always been exceeded by the volume of corporation bonds in the hands of the public (Table 1). During the 1920's the par amount of corporation bonds was double that of such tax-free obligations.² By the early 1940's, however, the comparative importance of corporation bonds had declined to around one-third more than gross state and local obligations. (During the 1930's federal issues raised aggregate wholly tax-exempt securities to more than the amount of corporation bonds outstanding.) Following World War II, corporation bonds continued to exceed state and local securities by a similar margin.

Federal partially tax-exempt obligations initially exceeded the par amount of corporation bonds outstanding but declined to about 40 per cent of the latter during the early 1930's. Partially tax-exempt issues then increased to more than corporation bonds by 1942, only to drop below again after 1945.

Interest payments on wholly tax-exempt securities increased from less than \$200 million in 1913 to over \$1 billion during the 1930's. (Net payments to private holders were reduced, of course, because of sizable government holdings.) By 1947 gross-interest payments declined to one-half this amount but since then have recovered some. Gross interest on state and local obligations reached a peak of around \$850 million during the 1930's. Despite the greater volume of such obligations outstanding in 1952, lower interest rates reduced interest payments to around \$725 million. Comparable interest payments on corporation bonds are not available, but they undoubtedly greatly exceeded wholly tax-exempt interest payments.³

Gross partially tax-exempt interest payments never exceeded \$1 billion per year and were less than half this amount during the early 1930's. By 1952 such interest amounted to only \$222 million, compared with \$4.7 billion taxable interest on publicly owned United States government securities.

² Inclusion of corporate obligations other than bonds would further increase the ratio.

³ In 1942, total interest payments by nonfinancial corporations (including interest on short-term obligations) aggregated \$1,750 million, and in 1947, \$1,700 million. Bureau of Internal Revenue, *Statistics of Income for 1942 and 1947*, Part 2.

TABLE 1

GROSS TAX-EXEMPT OBLIGATIONS COMPARED WITH OTHER PUBLIC AND PRIVATE TAXABLE OBLIGATIONS, SELECTED YEARS, 1913-1952

JUNE 30 ^a	WHOLLY TAX-EXEMPT				PARTIALLY TAX- EXEMPT FEDERAL	TAXABLE OBLIGATIONS	
	Total	State Local	Federal Direct and Guaran- teed ^b	Federal Non- guaran- teed		Federal	Corpo- ration Bonds ^c
<i>Gross Amount Outstanding (billions of dollars)</i>							
1913	5.6	4.6	1.0	17.4
1922	13.0	10.0	2.3	0.7	20.4	...	21.8
1927	17.8	13.8	2.2	1.8	15.7	...	27.3
1932	28.1	19.5	6.8	1.8	12.1	...	31.7
1937	35.0	19.3	13.5	2.2	25.4	...	28.6
1942	25.5	19.5	4.3	1.7	33.0	31.4	26.8
1947	16.8	16.6	0.2	...	20.9	206.7	24.4
1952	29.3	29.1	0.2	...	7.4	211.6	35.8 ^d

Interest Payments (millions of dollars)

1913	187	164	23	n.a.
1922	555	450 ^e	72	33 ^e	918	...	n.a.
1932	1,026	840	116	70 ^e	473	...	n.a.
1937	1,109	795	239	75 ^e	698	...	n.a.
1942	764	707	57	...	963	166	n.a.
1947	523	516	7	...	596	3,755	n.a.
1952	728	724	4	...	222	4,687	n.a.

^a Except for corporations, which are mostly on a calendar year basis, and for state and local data prior to 1940, data are for the fiscal period ending June 30. Only debt on which interest payments have not ceased is included.

^b On basis of public debt accounts.

^c Nonfinancial corporations only. Data as of beginning of year.

^d Data for 1951.

^e Estimated by the author.

... indicates none outstanding.

n.a. = not available.

Source: Interest data: State and local, Bureau of the Census, *Historical Review of State and Local Government Finances*, 1948, p. 19, and *Summary of Governmental Finances in 1952, 1953*, p. 29; federal, Dept. of the Treasury, *Annual Report of the Secretary of the Treasury on the State of the Finances, 1948*, p. 539, 1952, p. 645. Other data: Public debt, Appendixes A, B, and D; corporation bonds, W. B. Hickman, *Trends and Cycles in Corporate Bond Financing* (National Bureau of Economic Research, 1952), Table A-1. Federal data are exclusive of special issues to government agencies and trust funds.

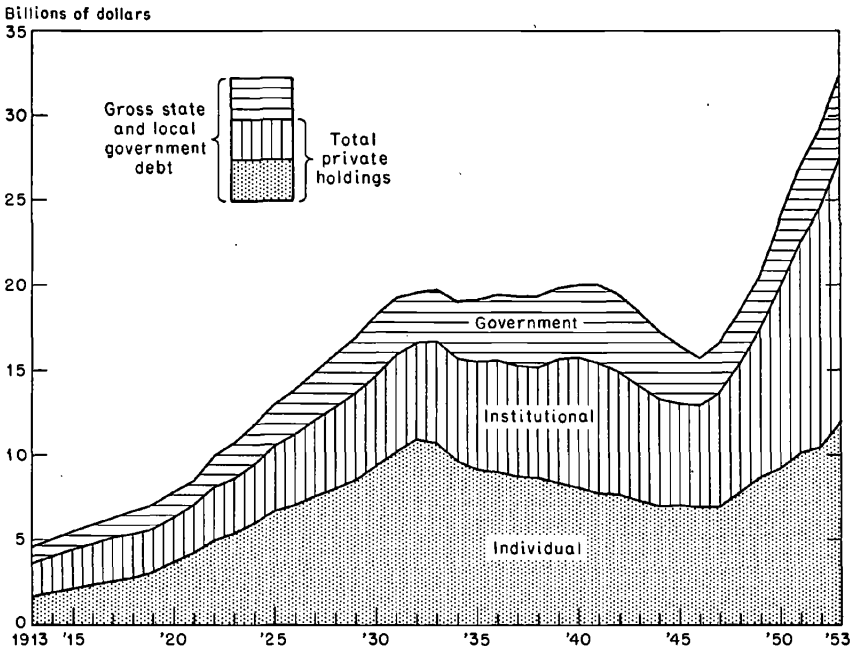
Government Holdings of Tax-Exempt Obligations

State and Local Securities. Holdings of state and local securities by sinking funds and investment and trust funds of federal and state and local governments have limited the amount available for private investment. Since 1933 the federal government itself, through its various agencies, has maintained substantial holdings of state and local obligations.

Total government holdings reached a prewar peak of \$4.6 billion in 1941-1942 (Chart 2). During World War II they increased somewhat. By 1952 they had returned to the 1942 level and in 1953 surpassed it.

Between 1913 and 1930 state and local government holdings averaged around 19 per cent of the gross amount outstanding. A

CHART 2
DISTRIBUTION OF STATE AND LOCAL SECURITIES BY PRINCIPAL CLASSES
OF HOLDING, 1913-1953



Source: Tables A-1 and B-1.

decline in sinking-fund investments was largely responsible for a drop in government holdings to a low of about 15 per cent in 1932 and 1933. At this time the federal government first acquired state and local securities, and trust-fund holdings continued to expand, with the result that total government holdings rose to almost one-fourth of the outstanding state and local debt in 1942 and 1943.

After 1943 a shift in state and local trust-fund and sinking-fund investments to federal securities was largely responsible for a decline in the importance of total government investment in state and local securities to around 15 per cent of the total. The generally greater attractiveness and higher yield of federal securities and the declining importance of the sinking-fund institution largely explain this development.

Federal Partially Tax-Exempt Obligations. Until 1930 government investments in partially tax-exempt obligations were limited to around 5 per cent of the total outstanding. The share of these securities held by government agencies (including the Federal Reserve banks) and trust funds doubled between 1933 and 1944. Government holdings reached a total of around \$4 billion in 1940–1941. Since then such holdings have declined to around 1 per cent.

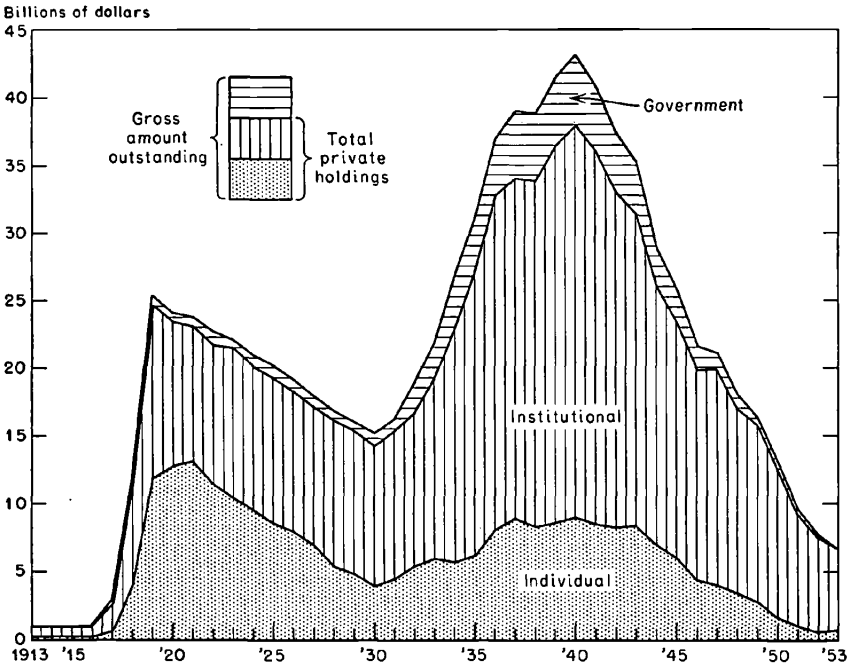
Institutional Holdings

State and Local Securities. During the decade 1913–1923 investments of banks, insurance companies, and other corporations in state and local securities gradually declined from around 55 per cent to less than 40 per cent of total private holdings. Holdings of such institutional investors then remained fairly constant at around 35 to 37 per cent of the total until 1933. By 1941, however, they increased to around one-half of total private holdings and during the war dropped only slightly. Following the war, institutional investors—principally commercial banks—again steadily increased their share of total private investments to around 57 per cent in 1952–1953.

Federal Securities. The share of privately owned federal tax-exempt obligations held by institutional investors, including business corporations, has always exceeded their share of state and local

holdings (Chart 3). Prior to World War I institutions held around 80 per cent of the outstanding federal debt. This consisted of wholly tax-exempt securities which carried the circulation privilege as security for national bank notes, held principally by commercial banks. The institutional share of total private holdings then declined to around 43 per cent in 1921 as a result of the rapid expansion in wartime debt. Outstanding federal tax-exempt debt then became increasingly concentrated in the hands of institutions. Between 1934 and 1945 they held around three-fourths of all private holdings; by 1951 this proportion rose to around 90 per cent.

CHART 3
DISTRIBUTION OF ALL FEDERAL TAX-EXEMPT SECURITIES BY PRINCIPAL CLASSES OF HOLDING, 1913-1953



Source: Tables A-2 and B-2.

Holdings of Individuals

Wholly Tax-Exempt Securities. Estimated individual holdings of state and local securities increased from less than \$2 billion in 1913 to almost \$11 billion in 1932 and 1933, and declined to around \$7 billion between 1944 and 1947. Individuals then steadily increased their investments until by 1953 they amounted to about \$12 billion. The share of individuals in the total was stabilized at around 63 per cent of total private holdings during the 1920's and increased slightly during the early 1930's. Individual holdings then declined to around one-half the total between 1940 and 1949, and by 1952 dropped to 43 per cent.

Total wholly tax-exempt securities owned by individuals—including federal issues, farm loan obligations, and state and local securities—have experienced an even greater fluctuation. Between 1913 and 1932 they rose from less than \$2 billion to almost \$16 billion and then declined more than half to \$7 billion in 1946. By 1953 they recovered to \$12 billion.

Partially Tax-Exempt Securities. Investments of individuals in partially tax-exempt obligations declined from over \$11 billion in 1921 to less than \$2 billion between 1931 and 1933. They rose to almost \$7 billion in 1940–1941 and then gradually dropped to less than half a billion dollars in 1952. Their share of total private holdings similarly declined from around 57 per cent to about 16 per cent in 1934. After rising to 25 per cent of the total in 1937 and again in 1944–1945, they have declined steadily to around 5 per cent in 1953.