CHAPTER 1

Problems of the Market for State and Local Government Securities

PURELY on the basis of size, the market for state and local government securities deserves respectful attention. During the postwar decade, the securities offered by these governmental units have accounted for more than one-fifth of the gross volume of new securities publicly offered. If federal offerings are omitted from this total, the proportion accounted for by state and local governments has been about one-third of the volume of new cash offerings in the public security markets. If the volume of state and local government borrowing is compared with a total that includes real estate financing and private placement, the proportions are, of course, somewhat more moderate: from one-seventh to one-ninth of the gross volume of new long-term financing. Clearly, the amount of funds taken by state and local government is a respectably large part of the total, no matter how measured.

The importance of state and local government security marketings, however, involves matters other than quantitative size. State and local government finance has acquired a fairly special public significance in the postwar period. In the first place, the number of services demanded of government has shown no signs of diminishing and in many ways has tended to grow. For example, most plans for educational improvement would involve a direct drain on state and local government finance. Very often they involve the kind of expenditures that imply capital market financing.

The managers of state and local government finance appear to have felt that borrowing in the later postwar capital markets was unusually difficult and costly. Those who have recently achieved an age appropriate for responsible administration of public finance have, indeed, had no experience with high interest rates. The 1930's were a period of generally low interest rates. In the immediate postwar period there was a considerable differential between state and local government interest costs and those of other borrowers. These combined facts may have accustomed the managers to very low interest rates. Later in the postwar period, when interest costs were rising, those of state and local governments went up even more. Though the interest costs of such funds remain low by historical standards, they nevertheless are considerably higher than the very low levels reached in the immediate postwar period: roughly a trebling. One of the principal problems of this inquiry, therefore, will be to seek out the reasons for the relative as well as the absolute increase in the cost of money to state and local governments and the rationale of state and local government financial managers in resisting such cost increases.

Not only has state and local government financing been of significance from the demand side of the capital market; it has presented some quite special characteristics on the supply side of the market. The supply of funds by investors for these securities has been conditioned by a complex structure of investment policies. In the first place, state and local government issues now have a virtual monopoly of tax exemption of interest income. Likewise, these obligations are generally of high credit quality. Thus, these obligations appeal to those parts of the market desiring conservative investment outlets and valuing tax exemption materially. But when rates have been adjusted to these two facts of high quality and tax exemption, they are generally too low to attract funds from investors who are willing to be aggressive and who do not put a high value on the tax-exemption feature.

Other important postwar changes also took place on the supply side of the capital markets. In the first postwar years, many investors shared the widespread view that deflation might again in peacetime become the dominant economic problem it had been during the 1930's. Safety of principal seems to have been emphasized at least briefly in the early postwar period. Later this fear disappeared and, in time, it came to be replaced by a far more optimistic view, one that put emphasis on a general expectation of growth and prosperity. Even later, the expectations of investors were even further modified toward the belief, somewhat cynical in its overtones, that secular inflation was inevitable.

This cycle of expectations had the tendency of inducing an investor predisposition toward the securities of state and local governments in the early part of the postwar decade and away from them in its later portion. It is hard to make more than a rough and general assessment of these expectations in quantitative terms. It is clear, however, that the investment policies of trustees, for example, underwent shifts of the general nature described here.

Still one other general change in the pattern of investor expectations appears to have taken place. In the early postwar decade, it appears that investors expected tax rates to be considerably reduced without much delay. For a brief period, there was some actual realization of these expectations. During the period of the Korean hostilities, tax rates went up again. Some investors, however, apparently viewed this reversal as a quite temporary one. The outcome of the presidential election in 1952, which was regarded as a conservative victory, gave at least temporary support to this belief. As time wore on, these expectations were considerably modified. The nature of international developments ultimately led most investors to the sober conclusion that sizable tax reductions were quite unlikely.

Expectations with respect to future tax rates apparently have been paralleled by other kinds of expectations: those with respect to the supply of tax-exempt obligations. When the federal government removed the privilege of tax exemption from its own securities, starting in 1941, it was not initially clear that this would be a permanent break in policy. With the passage of years, however, it has become quite clear that the federal government has gained considerably by this policy. With the present size of the public debt, the amount that could have been saved by lower borrowing costs would have been negligible. On the other hand, the amount of tax revenues foregone would have been considerable. At present, there is no expectation that the federal government will reverse its position with respect to the taxation of interest income from its own obligations. Therefore, expectations with respect to the supply of tax-exempt securities are virtually coterminous with expectations with respect to the supply of state and local government obligations. Because tax exemption was a clear monopoly of new state and local government securities only in the postwar decade, and because this feature has a long and somewhat controversial history, this story needs review before we embark on other aspects of the study.

LEGAL FOUNDATION OF THE EXEMPTION OF INTEREST ON STATE AND LOCAL GOVERNMENT OBLIGATIONS FROM FEDERAL TAXATION[1]

Interest income from state and local government securities has been exempt from income taxation by the federal government by statute since 1913, the year in which the Sixteenth (income tax) Amendment was ratified. In the absence of circumstances that make a test of constitutionality possible, the present legal situation is not entirely clear.

The first form in which the issue arose was in the state taxation of a federal instrumentality rather than the reverse. The note issuing power of the second Bank of the United States was subjected to a very special tax by the State of Maryland. In the famous case *McCulloch v. Maryland,*[2] this tax was declared unconstitutional. Although the decision seemed to be aimed at the discriminatory nature of the tax, it is often cited as the origin of the doctrine of the reciprocal immunity. This doctrine in its simplest form was that the states could not abridge the powers of the federal government nor the federal government the power of a state by taxation. Whether this power extended to a nondiscriminatory tax was not made clear since *McCulloch v. Maryland* specifically permitted state taxation of real estate property owned by the Bank of the United States if levied in a nondiscriminatory fashion. Recent decisions suggest that the courts would not invoke the doctrine of reciprocal immunity unless a tax could be shown to be a "tangible or certain economic burden" on the government or instrumentality being taxed. *Esso Standard Oil v. Evans et al.* 345 U.S. 495 (1953) and *Mayo v. U.S.* 319 U.S. 441 (1942). Later in this study, state and local government borrowing costs are shown to be reduced only moderately by virtue of tax exemption; removing this exemption would not be very burdensome.

During the Civil War, the federal government imposed an income tax that covered both interest on state obligations and the salaries of state employees. However, in 1870 the federal income

[1] The material for this section has been drawn from two sources: Lucille Derrick's *Exemption of Security Interest from Income Taxes in the United States,* October 1946, Vol. XIX, No. 4, part 2, of the *Journal of Business* (The University of Chicago Press), Chapter III, pp. 6-37; second, an unpublished manuscript by George E. Lent on the "Origin and Survival of Tax-Exempt Securities."

[2] 4 Wheat 316 (1819).

tax on salaries of state employees was invalidated.[3] The income tax levied during the Civil War lapsed but, largely as the result of Populist pressure, an income tax was reenacted in 1894. Bowing in the direction of *Collector v. Day*, this act specifically exempted salaries of state employees but just as specifically included interest received from state and local government obligations. This tax was declared unconstitutional in the following year. Unfortunately, the initial decision was followed by a rehearing; although the two decisions reached the same final opinion they stressed somewhat different logic and therefore leave some ambiguity.[4] The first decision emphasized the doctrine of reciprocal immunity. Those who go back to the first decision of *Pollack v. Farmers Loan and Trust Company* tend to believe a federal tax on the incomes from state and local government securities unconstitutional. Under the rehearing of the case, however, the decision was based primarily on the lack of direct apportionment in the assessment of this income tax. Since the 16th Amendment specifically gave the federal government power of a tax income without direct apportionment, those going back to the rehearing of *Pollack v. Farmers Loan and Trust Company* would tend now to believe a tax on state-paid interest to be constitutional. The 16th Amendment, which became effective in 1913, provided that: "the Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." The effect of this amendment on the taxation of interest income from state and local government securities has never been tested. After the amendment had been adopted, there was some controversy as to this point, but the initial tax legislation enacted under this constitutional authority specifically exempted both the salaries of state and local officials and the income from state and local bonds from federal income taxation. Later this exemption for the taxation of the salaries of state

[3] *Collector v. Day* 11 Wall 113 (1870). The relevance of this case to the general problem of the power of the federal government to tax state salaries may be doubted. A Massachusetts judge was the subject of this case and the supreme court, in declaring the tax invalid, said that it "fell upon the right of the state to administer justice through the courts." Later, the courts permitted federal taxation of the salaries of state employees including judges. *Helvering v. Gerhardt* 306 U.S. 466.

[4] In the cases of *Pollack v. Farmers Loan and Trust Company* 157 U.S. 429 (1895) and rehearing 158 U.S. 601 (1895).

and local government officials was rescinded and the constitutionality of such a tax was upheld.[5] The exemption of income from state and local government bonds, however, was never removed from the statutes, thus the absence of a court test.

At present, legal opinion as to this constitutional issue remains divided. Some of the law firms specializing in the delivery of opinions on municipal bonds include a phrase in their opinion to the effect that federal taxation of the interest income from such obligations by the federal government would be unconstitutional without the consent of the issuing state or local government. Other firms content themselves with simply the opinion that the obligations are exempt from federal income taxation "under existing legislation."

The Treasury Department, in an effort to obtain a ruling on the constitutional question despite the independent statutory exemption, brought suit against several bondholders of the Port of New York Authority for payment of income taxes on interest received from bonds issued by that Authority. The primary ground of the suit was that the Authority did not constitute a state or local government. It appears, however, that the Treasury Department was hoping that it might get some clue as to the basic constitutional situation into the public record in the settlement of this case. The tax court ruled against the federal government on the statutory issue but left the constitutional issue open. The Treasury Department thereupon appealed. The Circuit Court of Appeals for the Second Circuit handed down a split decision (*Commissioner of Internal Revenue v. Shamberg's Estate,* 144 Federal Reporter, 2nd Series 998 [1944]).

The majority ruled the Port Authority to be a governmental instrumentality and therefore exempt. But none of the judges went beyond the statute to the constitutional question that the Treasury Department sought to have adjudicated.

The authority of the federal government to include state and local government securities in the assessment of estate taxes has been upheld as constitutional.[6] Likewise, the assessment of capital

[5] *Helvering v. Gerhardt* (Port of N.Y. Authority) 306 U.S. 466. States may also tax the income of federal employees. *Graves v. O'Keefe* 306 U.S. 466; 59 S. Ct. 595.

[6] *Greiner v. Llewellyn,* 258 U.S. 384; 42 S. Ct. 324; 66 L. ed. 676 (1922).

gains taxes on transactions in state and local government securities has been upheld.[7]

In 1938, the Department of Justice prepared a long (219 pages) legal study of the constitutionality of federal taxation of the income from state and local obligations.[8] They believe it to be clearly constitutional and said so in quite emphatic language. In the same year, the attorney generals of several states prepared a consolidated answer debating the constitutionality of such a tax. Since both sides might be considered parties at interest, a neutral observer can do no more than look toward academic opinion on this point. To the extent that law review articles may be used as evidence, it appears that this opinion is slightly balanced toward the side of believing such a tax constitutional. This opinion, however, tends to be held by legal authorities otherwise identified with "liberal" positions. So-called conservatives tend to be less certain. The only judgment that a nonlegal observer can safely venture is that adjudication of the issue probably would depend on the make-up of the Supreme Court at the time of decision.

As a practical matter, the two governmental authorities exempt income from each other's securities from taxation: states, the income from federal obligations; and the federal government, the income from state and local government obligations. Each level of government treats its own securities as it sees fit. Most states exempt the interest on their obligations and those of local governmental units in their jurisdiction from taxation, but do not exempt the interest income of the obligations of other states and their subsidiary units. During World War I the federal government offered many complex versions of partial and complete exemption from its own income taxes of the interest income from its securities. Prior to 1941 most securities of the federal government enjoyed exemption from so-called "normal" taxes; a few of them enjoyed complete exemption. The basis of exemption was usually the security itself, but sometimes exemption depended on the tax status of the holder or the amount of his holdings. For example, prior to 1941, income on the first $5,000 of holdings of savings bonds was exempt from taxation but holdings in excess of such amounts were taxed. When the future need for large bor-

[7] *Willunts v. Bunn,* 282 U.S. 216; 51 S. Ct. 125; 75 L. ed. 304 (1931).

[8] *Taxation of Government Bondholders and Employees*; Department of Justice, 1938.

rowing became likely in early 1941 the federal government made interest income from all of its future issues fully subject to its own income taxes. Subsequent events have justified the wisdom of this step. All secretaries of the Treasury, from Mr. Mellon through Mr. Morgenthau, advocated the removal of the exemption on both federal and state and local government securities. When the federal government removed exemption from its own securities, it had to take this step unilaterally. In retrospect, it is hard to picture the courage as well as foresight that this action required.[9]

THE SUPPORT OF PUBLIC INVESTMENT BY TAX-EXEMPT FINANCING

Few kinds of investment, public or private, are as closely geared to and dependent upon external financing as state and local government capital outlays. State and local governmental units that are large enough to have continuous capital expenditure programs can sometimes finance these outlays on a pay-as-you-go basis. This is true of road construction by some state governments and true of larger water and sewerage systems, and even of school construction, by some larger cities. But when the needs for capital improvements bunch, as was characteristic of the postwar period, borrowing is required. Thus the state of the market for state and local government securities may be a determining influence on the rate of capital expenditures by such governmental units.

In the 1946-1955 decade, state and local governments are estimated by the National Income Division of the Department of Commerce to have spent $50.8 billions on new capital construction. During this same decade the gross long-term borrowing of state and local government amounted to $38.7 billions; a modest fraction of this was for veterans' bonuses or other noncapital purposes. With allowance for this factor, it appears that about two-thirds of the capital outlays of state and local government were initially financed by borrowing. Debt repayment, however, is a form of saving. Over the decade as a whole, state and local government saving in this and other forms financed one-half of their capital outlays. While this later fraction is of interest when one tries to balance the income and capital accounts of the decade, the former

[9] H. C. Murphy, *National Debt in War and Transition* (McGraw-Hill, 1950), pp. 31-34.

fraction is the one that measures the strategic role of the capital markets in initiating capital expenditures.

COMPARISON OF THE STATE AND LOCAL GOVERNMENT SECURITY MARKET WITH OTHER SECTORS OF THE CAPITAL MARKETS

For general orientation, it may be useful to start with some relatively simple comparisons of the market for state and local government securities with the other principal capital markets.

The securities of state and local governments are similar to those of the federal government in several respects. All Treasury securities and a large majority of state and local government obligations[10] depend ultimately on the power of the issuing government to tax and to collect the taxes due it. State and local government obligations have, in practice, high credit quality.

But it would be unwise to push the analogy of state and local government credit to that of federal government credit too far. In terms of institutional structure, the market for state and local government obligations is much closer to that of corporate bonds than to the market for Treasury securities. Treasury obligations are traded mainly by commercial banks and a small group of specialized dealers. State and local government obligations are underwritten by banks and by the great investment banking firms, but a large number of small dealers also operate in the state and local government market. The secondary market for state and local government obligations is more like the secondary market for corporate bonds than the Treasury security market.

The pairing in marketing institutions, however, is not the same as the pairing of securities in investors' portfolios. It would be much more common to find Treasury bonds and corporate bonds paired by life insurance or pension fund investors; the tax position and investment outlook is similar. On the other hand, state and local government obligations are more likely to be paired by individual investors or casualty insurance companies with holdings of corporate equities. Individuals who seek tax exemptions are often the

[10] The principal exceptions are state and local government revenue obligations which are not based on the "full faith and credit" of such governmental units as are "general obligations" but are secured only by specially designated revenues. Because revenue bonds have different market characteristics they will be dealt with separately in Chapter 7; many of our comments prior to that time will apply principally to the market for "full faith and credit" obligations.

less aggressive, more conservative investors, much like commercial banks.[11]

In most respects the market for state and local government securities is quite different from the market for mortgages. But these two markets share one important characteristic: a considerable fraction of each is still quite local in character. While the fraction is larger in the mortgage market, this survey indicates that a sizable part of the market for state and local government securities is also essentially local in nature, and is thus insulated from some of the influences of central capital markets.

COMPETITIVE BIDDING IN STATE AND LOCAL MARKET

Public competitive bidding is almost universal in the initial sale of full faith and general credit state and local government obligations. The mechanics of competitive bidding have required some agile management of the investment banking machinery. The units in which state and local government securities are offered on the market are often quite small. Syndicate managers, therefore, must develop economical and efficient operational organizations in order to file an adequate number of bids without incurring considerable expense. While the investment banking machinery has not yet had to adopt true mass production techniques, the circumstances surrounding the purchase of state and local government obligations raise related operating problems. The competitive bidding requirement has, in fact, led to quite a bit of active bidding for the choice types of obligations and has led to the formulation of a continuity of bidding and buying groups.

Although competitive bidding remains dominant in the offering of full faith and credit obligations, negotiated financings seem to be becoming more frequent in the offering of revenue obligations. This may mean that the greater continuity of contact between underwriter and the financing body has been found to have distinct advantages for this type of financing.

LEGAL RESTRICTIONS ON BORROWING AND BORROWING PRACTICES

State and local government borrowing is hedged about by many constitutional and statutory restrictions. The complexity of many

[11] J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, *Effects of Taxation: Investments by Individuals* (Graduate School of Business, Harvard, 1953), Chapters II and XI.

bond issues grows out of the necessity of complying with these restrictions. The harness of legal restrictions appears to be more and more binding as one goes down the size scale of local governmental units. This raises an important question: Have all types, sizes, and locations of state and local governmental units been able to get fair and equitable access to this market? Asked differently: does the market discriminate against some governmental units in an arbitrary or capricious way? The impersonal rule of the market has sometimes been challenged in business finance; for example, small business is thought by some to suffer from discriminatory practices. Are similar circumstances encountered by the financial managers of small municipal and local government units?

DOES TAX EXEMPTION HANDICAP OTHER BORROWERS?

The existence of tax exemption is sometimes thought to attract a flow of investment funds in the capital markets to the detriment of other borrowers. More specifically, it has been averred that tax-exempt financing by state and local government works to decrease the supply of funds available to business. This question was the subject of an extended and detailed Congressional inquiry as early as 1922. In the first three months of that year the House Ways and Means Committee held hearings on the subject and later sponsored a joint resolution which would have removed the privilege of tax exemption from state and local government financing. This was passed by the House in early 1923 but it died in the Senate under the pressure of state and local governments.[12] It is significant that there appears to have been a fairly real conviction on the part of many witnesses, including many from the financial community, that tax exemption limited the supply of funds available for private finance.

The issue was revived against a considerably different economic background in 1939 at hearings before another Congressional committee.[13] This time the emphasis was less on the disadvantage of tax exemption to business financing, and much more on the way

[12] The economist for the House Committee, C. O. Hardy, recounts the story in his *Tax-Exempt Securities and the Surtax* (Macmillan, 1926). Chapter 2 is most directly relevant to this story, but fragments of it appear in some of the later discussion.

[13] 76th Congress, 1st Session, Hearings before the Special Committee on Taxation of Governmental Securities and Salaries.

tax exemption thwarted the effects of progressive income taxation. Much the same point was repeated at the TNEC hearings and reproduced in the staff monographs produced in this inquiry.[14]

HOW GREAT IS THE ADVANTAGE TO BORROWERS OF TAX EXEMPTION?

The financial managers of state and local governmental units probably are disposed, after experience during the postwar decade, to belittle the significance of the question we have just raised. The one they would like to have answered is: How much, if any, does tax exemption help in reducing state and local governmental borrowing costs?

During the postwar decade, the advantages of tax exemption passed largely from borrowers to investors. In the early postwar months, the yields on tax-exempt securities were only about four-ninths of those prevailing on fully taxable high-grade obligations. In other words, the market was discounting a marginal tax rate of close to 55 per cent. Since the volume of funds available for market investment by investors in such a tax bracket was small, just about all of the advantage of tax exemption was being retained by state and local government borrowers.

This changed greatly during the postwar decade, at the end of which the larger share, by far, was being taken by investors. State and local governments were able to retain very little. This made tax exemption a quite ineffectual subsidy. It cost the federal government a considerable amount but gave borrowing state and local governments little advantage. The fragments of evidence that explain this development appear in several places in this inquiry: in the study of investors who buy the obligations and in the inquiry into differential interest rate developments.

One related factor must be singled out for special attention: the quality of state and local government credit. If all levels of government gain equally from tax exemption, the form of subsidy has some measure of equity even if it be an ineffectual subsidy. But if the gain is uneven, then a still different kind of question is raised. Evidence developed later suggests that only the better quality governmental borrowers retain a significant portion of the subsidy implicit in tax exemption.

[14] TNEC Monograph No. 20, pp. 189-199.

STRATEGIC PRACTICES OF THIS MARKET

This market is one in which strategy plays a vital part. The skill of municipal finance officers is partly a skill of strategy and timing. The skill of underwriters is one of tactics and strategy. The skill of investment managers for the principal institutional investors that buy tax exempts is partly a skill of timing: picking the times to hold off and wait for better yields, deciding when to "buy the market" boldly. The secondary market in state and local government securities is honeycombed with institutions of strategic significance: for example, a limited number of brokers do nothing but act as agents for recognized dealers, a kind of informational shield between buyer and seller. (The principal stock in trade of these brokers is knowledge of the markets, a record of speedy executions, and an iron reputation for concealing the identity of their principals—their capital is often nothing but office rent and a switchboard.)

METHOD OF INVESTIGATION

The character of this investigation, its limits as well as its ambitions, were set by the nature of the larger project of which this study is one part. This study is one of three market studies, the other two of which deal with the market for corporate securities and the market for nonfarm mortgages. These three market studies, in turn, are part of a general study of postwar capital markets. This parent project is, in turn, related to two earlier projects: the Study of Saving,[15] conducted by Raymond W. Goldsmith, and the Study of Capital Formation and Financing, headed by Simon Kuznets.[16] The study of postwar capital markets is being built upon a social accounting foundation: an application of the flow-of-funds technique to an analysis of capital markets.[17] While simplified versions of the sources-and-uses technique have been variously applied before, this system attempts to tie together nonfinancial as well as

[15] National Bureau of Economic Research; published in three volumes by Princeton University Press, 1955 and 1956.

[16] Only part of the studies growing out of this project had been published at the time this was written. Further work is reported in the Thirty-ninth Annual Report of the National Bureau (May 1959).

[17] The intellectual origin of this technique is detailed in Morris Copeland's *Moneyflows in the United States*, published by the National Bureau in 1952. The *Flow of Funds in the United States*, published by the Federal Reserve Board in 1955, extends the figures and the period covered.

financial factors as causal elements in the system of capital market determination. Against this larger frame of reference, a study of the state and local government security market should emphasize the points at which this market ties to other markets, the extent to which it creates influences that spread to other capital market sectors, and the degree to which this market is influenced by events in other sectors. The questions posed in the preceding section should cluster about such general framework of economic considerations.

THE PROBLEM OF DATA

The market for state and local government securities is not illuminated by an adequate amount of systematic public information. One reason is that this is an unregulated market. Public regulation tends to increase the amount of systematic and reliable data available. For example, the regulation of larger public offerings of corporate securities has led to the filing of registration statements and the publication of prospectuses that contain data of considerable interest and unquestioned reliability. The same cannot be said of many state and local government security sales. So-called official statements are sometimes issued in the sale of state and local government revenue obligations. These statements look like prospectuses, they are printed by the firms that print prospectuses, and they follow the same general typographical and organizational style. But the information contained in them is far less comprehensive. A security analyst or economic investigator usually does not find in them the wealth of detail that he can count on in looking at corporate registration statements and prospectuses. Such information as is shown probably is reliable, but the penalties for misstatements or concealment of relevant information are by no means as severe.

The lack of data is further aggravated by the fact that the market for state and local government securities is an over-the-counter market. Our knowledge of these markets is quite limited. The Wharton School survey of over-the-counter securities markets[18] is the only comprehensive and systematic study of this subject. Unfortunately this study is less revealing with respect to the market

18 Irwin Friend, G. Wright Hoffman, Willis J. Winn, Morris Hamburg, and Stanley Schor, *Over-the-Counter Securities Markets* (McGraw-Hill, 1958).

for state and local government obligations than with respect to other over-the-counter securities markets. The reason is an eloquent commentary on the understandable reluctance of businesses (or individuals) to reveal themselves except under the pressure of law or public opinion. The responses to the questionnaire underlying that survey were far more comprehensive for the registered brokers and dealers than for the exempt ones who limit their activities to governmental securities.[19] While the registered brokers and dealers account for quite a large fraction of the market for state and local government securities, the exempt dealers, particularly the dealer departments of commercial banks, appear to do an even greater part of the total business. The margins of error of estimates relating to the state and local government security market (and Treasury security market) are thus far greater than for the estimates relating to corporate bond or stock activities.

SOURCES OF QUANTITATIVE MARKET DATA

State and local government finance has been the subject of much economic research, but no investigation appears to have dealt with the marketing of the securities of these governmental units. About the only research material having a direct bearing on the subject of markets are the estimates of ownership, the principal published one being by Lent.[20] An estimate by Menderhausen of the ownership of various types of assets by size of estate can be used to ascertain the relative importance of state and local government security ownership at various income levels.[21] But this is only indirect evidence about the nature of the markets.

Direct evidence about the functioning of the state and local government security market can be found only in trade publications. The principal ones are: the *Bond Buyer* (the word "*Daily*" is added to the daily edition of this publication), the *Blue List of Current Municipal Offerings* (more commonly known by the first two words of its title), the *Investment Dealers Digest,* and several investors services, such as Moody's and Standard & Poor's.

[19] *Ibid.*, Appendix A, "Activity on Over-the-Counter Markets."

[20] "The Ownership of Tax-Exempt Securities, 1913-1953," Occasional Paper 47 (National Bureau, 1955). Goldsmith's *Study of Saving* presents estimates of individual ownership by size of estate (Vol. III, Table E-53).

[21] *Study of Saving*, Vol. III, Part III.

The (Daily) *Bond Buyer* is best known to statisticians as the compiler of weekly and monthly figures of "municipal"[22] bond sales. These figures of public offerings have become the principal source of such data and are widely quoted; they are also used by the Securities Exchange Commission in its statistics of public security offerings. In addition the *Bond Buyer* compiles:

a. Two indexes of municipal bond yields

b. An estimate of the 30-day visible supply of securities (securities for which a public sale is scheduled within the next 30 days)

c. Transactions in major (underwriting) accounts, including purchases during the week, and amounts unsold at the end of the week (usually Thursday) from which the amounts sold out of major accounts can be estimated

d. A monthly series of bond sales approved in municipal elections.

The *Bond Buyer* also carries two regular features which explain much of its use in the trade: a detailed record of leading proposed bond sales, including details on previous sales of the governmental unit announcing the new sale; advertisement of these sales in official form; and a record of individual "Municipal Bond Sales, in Detail," including a listing of unsuccessful bidders and the prices of terms they offered as well as the price paid by the successful bidder. Other tabulations, mainly of narrow interest to underwriters as such, are also published.

The *Blue List of Current Municipal Offerings* is a record of the bonds being offered for sale by virtually every state and local government security dealer of consequence. The *Blue List* thus becomes a daily record of the inventory of securities *being offered for sale.* The last four words of the preceding sentence deserve some emphasis. The *Blue List* total is widely quoted as representing dealers' inventories of state and local government obligations. But there is a great deal of speculation in the trade as to the degree of understatement of *Blue List* figures. Our investigation did not give us an insight of sufficient accuracy to permit an estimate of the amount of understatement. Evidence was found, however, indicating that ownership of state and local government securities by nonbank dealers in state and local government securities is probably con-

[22] The word "municipal" is still widely used in the trade to embrace all classes of state and local government obligations.

siderably greater than the amounts they offer in the *Blue List.* The difference, however, is not necessarily securities temporarily withheld from the market but sometimes represents securities held in investment accounts. When dealing with the matter of market strategy, we shall discuss the actions of dealers in showing or concealing their inventory position.

A new source of statistical and analytical data has recently appeared and has come to be of considerable use in appraisal of the state and local government security market. The *Investment Bankers Association of America* has inaugurated a detailed study of new offerings and publishes a monthly statistical survey of these offerings and a quarterly analytical summary. This new source was used extensively in this report particularly in connection with an analysis of the financings deferred because of tight money markets presented in Chapter 2.

The *Investment Dealers Digest* publishes the concessions offered by the major accounts to NASD members who are not members of the buying groups, and frequently presents a rather frank discussion of the sales experience of the leading individual accounts, including comments about the institutional character of buying interest in individual issues, something that is not regularly reported elsewhere.

Moody's Investors Service publishes ratings of the leading issues being offered for sale and compiles weekly and monthly estimates of yields on state and local government securities by security ratings. The published ratings of this service have vast market influence, and its more detailed and confidential analyses of the leading issues being offered for sale carry considerable weight both with underwriting firms and investors. *Standard Statistics-Poor's* also maintains a rating service, as does *Fitch. Standard Statistics-Poor's* ratings seem to have an appreciable market influence. *Dun and Bradstreet* does not publish security ratings but prepares analyses of the financial standing of various state and local governmental units and indirectly of the various securities they issue. They cover fewer issues than reached by the rating agencies, but their influence appears to be substantial in the cases they analyze. *Standard Statistics* and *Dow-Jones* both publish weekly indexes of municipal bond yields; the latter also published an index of revenue bond yields until February 1957.

NONQUANTITATIVE EVIDENCE

In the absence of more formal and comprehensive sources of market data a considerable amount of reliance had to be placed on the opinions of persons who were close to this market. Many were interviewed: the managers of municipal bond syndicates in the great investment banking houses, the managers of municipal bond departments in commercial banks (both dealer and non-dealer banks), the specialized brokers who act only for dealers, the investment managers for institutional investors who buy tax-exempt obligations, and finally the editors of the principal trade publications.

Research by interview can be enormously educational for the interviewer. But the faithful transmission of what he finds involves many dangerous steps. An effort was made to conduct these interviews in a reasonably systematic way: to have standard questions that could be used many times. But in the end it was found that the most illuminating fragments of interviews came, not from following such a systematic procedure but from pursuing what often started out as an incidental issue or a side comment. The footnotes of conversation thus often proved more illuminating than the text. One of the reportorial problems has been that of giving generalized expression to facts that were shown this interviewer in confidence. The standards of documentation and reproducibility of research reporting becomes strained under these circumstances. And still, to assume blandly that this evidence did not exist would have amounted to suppression of valuable data. The compromise followed was that of reporting only those opinions which were expressed by two or more persons, and to seek confirmation of most facts, opinions, or ideas from several sources. But to preserve anonymity, the following pages report many opinions without acknowledging their sources. This was necessary. To make this doubtful practice acceptable we have tried to assume the role of being an honest reporter as well as an inquiring economist.