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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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POSTWAR MARKET
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SECURITIES

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 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 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 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 Statistics 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.

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

TABLES

CHARTS