1963

Issues in the Tax Treatment Of State and Local Securities

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Issues in the Tax Treatment
Of State and Local Securities

Income from securities issued by state and local governments is exempt from the federal income tax. For years supporters and critics have debated the merits of the exemption without noticeable progress toward agreement. In an effort to clarify the issues, the Brookings Institution in 1962 called a conference of experts in taxation and capital markets. A summary of the conference and a revision of the background paper on which it was based are presented in a new Brookings study, Federal Tax Treatment of State and Local Securities, by David J. Ott and Allan H. Meltzer. Highlights of the book, which is the second in a special series of Studies of Government Finance, are presented in this Research Report. (Copyright 1963 by the Brookings Institution)*

The controversy over the tax-exempt status of state and local government bonds has kept economists, lawyers, public officials, and investors at odds for reasons that are readily understandable.

The exemption costs the federal government a sizable amount of revenue each year. Almost every Secretary of the Treasury since the income tax was first enacted has tried to have the exemption removed.

On the other hand, the exemption means large savings for state and local governments. It enables them to sell their securities at reduced rates of interest because investors—especially those in upper income brackets—are willing to accept a lower yield on bonds that offer tax-free income. The value of the exemption to the investor varies—the higher his tax bracket the greater the gain to the investor.

Substantial sums of money are at stake. In 1961, for instance, interest payments of state and local governments totaled more than $2 billion on some $70 billion of debt outstanding. The annual loss of revenue to the federal government has been estimated to exceed $1 billion in recent years.

Bills to remove the exemption have reached a vote in Congress six times but each time they have been defeated—an indication that, despite formidable opposition, the exemption still enjoys widespread support.

In the following discussion, some of the economic aspects of the controversy are analyzed. New estimates of the value of the exemption to the

* The findings and conclusions are those of the authors and do not purport to represent the views of the Brookings Institution, its trustees, officers, or other staff members.
states and localities and of the cost to the federal government are set forth; and alternative ways of achieving the objectives now pursued by means of the exemption are examined. The report deals primarily with possible changes in the tax treatment of future issues, although one section is devoted to outstanding issues. The question of the constitutionality of a federal tax on income from state and local securities is not considered.

Arguments for Removing the Exemption

Opponents of the exemption offer four main arguments against it. They claim that the exemption—by discriminating between income from municipals and from other securities, and by giving an advantage to investors in high income brackets—violates two generally accepted principles of tax equity: that an income tax should apply equally to equal incomes and that it should be progressive.

The exemption is said to divert risk or venture capital from the private sector, thereby reducing investment in productive enterprise.

The exemption is said to distort the allocation of resources within the private sector, and between the public and private sectors when state and local governments issue tax-exempt securities to finance such “business” enterprises as public utilities and housing developments, or to subsidize the growth of local industry. (Even many of those who generally favor the exemption agree that it is undesirable for municipalities to use the proceeds from the sale of so-called industrial development bonds to build tax-exempt facilities and lease them to private firms.)

The exemption is criticized as an inefficient form of subsidy. Empirical studies show that the saving in interest payments by the state and local governments is much less than the revenue loss to the federal government. It has been argued that there are less costly ways to assist or subsidize capital outlays by state and local governments. There are also more equitable methods since the more affluent governmental units benefit more from the exemption than the poorer ones. To the extent that high-income units—or those with rapidly growing incomes—tend to issue more debt, they benefit more than do the poorer units and areas.

Arguments for Retaining the Exemption

Supporters of the tax exemption offer these arguments:

Interest costs of state and local governments would rise sharply if the exemption were removed. The important distinction here is the word “sharply,” since no one doubts that interest costs would rise. Essentially the argument is that municipals are more difficult to market than corporates and other securities. Many issues are too small to appeal to large institutional buyers. Moreover, the lack of information about the finances of small units of local government discourages some investors. Thus it is said that if the municipals were fully taxable they would have to bear higher interest rates than corporate bonds of comparable quality.
The higher level of interest rates would probably discourage borrowing in some localities and thus reduce capital expenditures for public purposes. If total outlays were to rise in some areas, then state and local taxes would ultimately be increased to meet the higher interest charges. Since local taxes tend to be regressive, a greater burden would fall on the lower income groups. Finally, it is argued that the heavier financial burden on state and local governments—added to existing unmet needs for schools and roads—would intensify pressure for federal aid. An increase in federal aid would reduce the fiscal independence of states and localities and lead to greater federal participation in local affairs.

Evidence bearing on some of these contentions by supporters and critics of the exemption is provided in the following analysis.

A Comparison of Yields on Taxable and Tax-Exempt Securities

What is the value of the tax exemption to state and local units of government as measured by the difference between the rates of interest on taxable and tax-exempt securities of comparable quality? Is this “yield differential” as large as defenders of the exemption assert, or has it been overstated by them?

The yield differential is related to (a) the relative supply of tax-exempt securities, (b) the tax rates on the various levels of income, (c) the wealth position of asset-holders in each tax bracket, and (d) preferences of investors for various types of securities. With the data now available, an effort to measure these variables faces formidable obstacles. However, the background paper prepared for the conference undertook to present statistical evidence on the differential, summarize the opinions of several capital market experts, and then calculate an estimated range.

Statistical Evidence. 1. A comparison of corporate and municipal yields during the period 1900-13, when neither type of interest was taxed, showed that yields on the two were about the same. This evidence suggests that restoring equal tax treatment would at least not cause municipal yields generally to rise above corporate yields.

2. The same conclusion is indicated by a comparison of Canadian municipal and corporate yields for recent years. Although interest on municipal and provincial bonds, as well as that on corporates, is subject to the Canadian income tax there was no apparent difference in yields.

3. The yields on small, unrated religious bonds were examined for an indication of what might happen to the many small issues of municipals should they become fully taxable. These bonds—issued for building churches, and church-related hospitals and schools—are generally held by the same investors who hold small municipal issues (individuals, banks, and insurance companies) and for much the same reasons: yield, depositor relationships, and local pride. The data show a range of long-term yields on small unrated
religious bonds of 5.5 to 6 percent in 1960 and suggest that even small municipal issues could be sold at this interest cost.

Some participants in the conference argued that this evidence was not conclusive. They questioned the accuracy of the 1900-13 data and its relevance to the current situation. They did not consider the published data for Canada applicable to the United States because local government units in Canada apparently raise a substantial portion of their capital funds by issuing bonds directly to provincial governments or their agencies. And they said that the yields of religious bond issues cannot be used as a basis for comparison because the demand for religious bonds is strongly affected by religious affiliation.

JUDGMENTS OF CAPITAL MARKET EXPERTS. The background paper included a summary of the views of a group of leading capital market experts. In general, they agreed that:

1. Yields on municipals would rise by more than the current differential between the yields on new issues of municipals and new issues of public corporate bonds. Yields on bonds sold through private placement are the relevant ones at which the large institutional buyers would become active in the market if the municipals were taxable, and these are higher than the yields of publicly issued bonds.

2. The yield curve for municipal securities—that is, the curve relating yield to maturity and time to maturity—would have a much "flatter" slope after removal of the exemption. Short-term yields would be closer to long-term yields than at present. This conclusion is based on two assumptions—that there will be increased institutional buying in the longer maturities and less institutional buying in shorter maturities.

3. Municipals would not sell at a discount because of the serial form of such issues.

ESTIMATED DIFFERENTIAL. On the basis of the quantitative data from the three comparisons made, together with the views of the capital market specialists, it is estimated that yields on state and local government bonds in recent years would probably have risen by some 1.19-2.02 percentage points had the exemption feature not been in effect.

At the conference, significant differences of opinion were expressed about this question, but 1.5 percentage points was roughly at the midpoint of the range of estimates provided by conference members. This is not substantially different from the estimate in the background paper.

Savings of Interest vs. Loss of Revenue

How much greater would interest payments of state and local governments have been if the exemption had not been in effect on new issues in 1960? What additional federal revenue would have been received from taxing the securities?

The background paper assumed that yields on all maturities would have
been 1.19-2.02 percentage points higher. When this figure was used, it was estimated that total interest payments over the life of all municipals issued in 1960 would have risen by a minimum of $1.0 billion and a maximum of $1.8 billion, or 30.7 percent and 53.5 percent, respectively.

How much would the federal Treasury have benefited? On the basis of certain assumptions about investor reaction, it was estimated that federal revenues would have been 41-43 percent of interest payments after removal of the exemption.

If the assumptions made in these estimates are reasonably valid, the gain in revenue to the federal government would substantially exceed the increase in interest costs to the state and local governments. (If interest costs had been 30.7 to 53.5 percent higher, an “average marginal” tax rate of only 23.5 and 34.9 percent would yield additional revenue equal to the cost increase. But since the estimated “average marginal” tax rate is 41-43 percent, the additional revenue to the federal government would almost certainly exceed the cost to state and local governments.)

The conference group discussed the questions of who would purchase a taxable municipal bond and what alternative outlets present holders of municipals might seek. In general the group agreed with the background paper that individuals, commercial banks, and nonlife insurance companies would reduce their purchases of municipals substantially, but that life insurance companies, state-local trust funds, pension funds, and other nonprofit institutions would take up the slack. (It was assumed that the exemption would be removed only from new issues of state and local government securities.) There was considerable disagreement, however, over the magnitudes of the assumed shifts in ownership.

It is usually assumed that in return for the loss of the exemption the states would be granted the right to tax interest on federal obligations. However, the added revenue would only partially offset the payment of higher interest costs. Had states been allowed to tax federal interest in 1960, they would have collected about $180 million which falls far short of the additional interest charges states and municipalities would have had to pay. (This figure does not account for changes in ownership that might have taken place if the exemption were removed; nor does it make allowance for enactment of income taxes by states which do not now have personal and corporate income taxes, or for changes in rate levels in states that do have income taxes; nor does it make allowance for the relative rates of growth of federal debt and state-local debt.)

The Treatment of Outstanding Debt

Any proposal to modify the exemption would have to resolve the question of whether to tax the more than $70 billion of state and local government securities that are presently held by investors.

The gain to the Treasury from a tax on outstanding securities would reflect (1) the revenues received from taxing the interest on outstanding
bonds until they mature, (2) the yield from taxing capital gains at maturity, and (3) the loss of revenue from realized capital losses sustained when the exemption is removed. The present value of the algebraic sum of these three items is $4.5 to $5 billion. On balance, the Treasury would have a substantial net gain in receipts, in present value terms, from taxing outstanding.

If outstanding securities were taxed some account would have to be taken of the probable impact on management of the federal debt. Investors shifting into municipals in this case would probably discard more long-term federal securities than those shifting out would acquire at present yields. The decline in demand for government securities would be reflected in lower prices. In other words, yields on government bonds would rise slightly.

In the conference discussions, some supported this position, but others took the view that Treasury securities are now more difficult to market because municipals are tax exempt; thus, removal of the exemption might make Treasury obligations more attractive and lower their yields.

It was also pointed out that the problems of federal debt management cannot be discussed without considering over-all monetary policy, the revenue gain to the Treasury from removing the exemption, and possible alternative federal subsidies to the states and localities.

Proposals to remove the exemption have usually been limited to new issues only, with the notable exception of the Treasury proposal of 1942. Apparently this approach reflects the belief that taxing outstanding securities would be a breach of faith by the federal government, causing capital losses and the inequitable application of taxes to holders of existing securities. On the other hand, holders of tax-exempt issues would receive a windfall capital gain if only new issues are taxed, and some of the inequity arising from tax exemption would continue until all of the tax-exempts mature—some forty or more years. Thus, whether a tax is applied to interest on both outstanding securities and new issues or on new issues only, there would be inequities and other undesirable economic effects. On balance, however, taxing only new issues would probably involve fewer inequities and would be more acceptable politically.

**Alternatives to the Exemption**

An important criticism levelled against the exemption feature, it will be remembered, is that it is inefficient. The size of the benefit increases directly with the amount of borrowing and the credit rating of the securities issued. Neither of these factors is a suitable index of relative "need" of the state and local governments for financial assistance. A state-by-state comparison of per-capita state and local debt and per-capita personal income indicates that borrowing is apparently inversely related to income level. Average credit quality of securities for the various states does not seem to be related—either directly or inversely—to average income.

Because opponents of the exemption concede that some desirable investment in social capital might be curtailed if the localities had to pay higher
interest charges, they have often coupled suggestions for abolishing the exemption with proposals to provide alternative federal subsidies. These have generally taken one of two forms: (1) subsidies that are tied to state and local borrowing and may be considered a quid pro quo for giving up the exemption feature, and (2) subsidies tied to capital outlays rather than borrowing and thus not allocated strictly according to exemption benefits lost.

The former type includes:

*The Seltzer plan*, which proposes that the federal government pay a percentage of the annual interest costs of state and local governments. This would (a) eliminate the inequity of the exemption yet preserve the borrowing advantage of the states and localities; (b) be simple, definite, and fairly easy to administer; and (c) maintain approximately the differential advantages of the exemption feature to different borrowing units, since it would be proportional to interest payments.

*The Fitch tax credit proposal*, which calls for a tax credit to future purchasers of outstandings to be used to maintain the borrowing differential to the states and localities. This would in principle equalize the after-tax yield on corporate and taxable municipal bonds and would allow municipals to sell at lower before-tax yields than corporates without inequity among taxpayers. It would not be as simple administratively as the Seltzer plan.

*Distribution to states and localities of revenues from taxing future issues*, in proportion to the annual interest payments on fully taxable issues made by each borrowing authority. The weakness of this plan is that the compensation to particular state and local governments might not be the same as the rise in interest costs of that government.

*Special intermediary assistance* through a federal or semi-official institution which could lend at low rates. Proposals of this type have been criticized because they would add to the already lengthy list of special federal lending agencies and because they involve a somewhat hidden subsidy, less subject to public evaluation.

If the only question were which subsidy would satisfy more pressing "needs" per dollar spent, one tied to capital outlays might be more desirable. Some kinds of federal aid are of this sort, for example: aid for highway construction, housing and urban renewal, and, to some extent, outlays for health and natural resources, education, and science. Several proposed programs would incorporate this feature in one way or another; the new "depressed areas" legislation and the proposed federal-aid-to-schools programs would give priority to capital outlays of poorer regions.

**Political Considerations**

Although the background paper was limited to the economic aspects of the exemption question, one session of the conference was devoted to political aspects. Principally, attention was given to the proposed subsidy, which had been criticized as involving increased federal control over state
and local fiscal affairs. Some participants declared that even the possibility of more federal control is a sufficient argument against removal of the exemption. In their view, inefficiencies or tax inequities arising from the exemption are trivial compared to the dangers of more centralization of fiscal activity.

Others argued that efficiency and tax equity are important enough to justify exploring the possibility of substituting for the tax exemption an alternative formula which would not involve any greater degree of federal control. They regarded any one of a number of "automatic" formulas as acceptable. These include suggestions to return a fixed proportion of interest costs to the state and local governments or, if this were not acceptable, a tax credit for bondholders.

Still others argued that the federal government might want to have a voice in how its revenue would be used. In their view the exemption feature is a subsidy and should be acknowledged as such; hence, what is needed is not some automatic alternative, but a program of direct federal support for state-local outlays rather than borrowing.

These differing views are irreconcilable, and it seems clear on the basis of this conference that modification of the exemption would not be strongly approved by representatives of state and local governments and of municipal security dealers unless an alternative method of compensation could be devised which would not involve any federal participation, let alone interference, in the purposes for which state-local borrowing is undertaken.

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Federal Tax Treatment of State and Local Securities
by David J. Ott and Allan H. Meltzer

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146 Pages March 1963 Paper $2.00 Library Edition, Cloth, $3.00

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