

December 27, 1940.

THE PROBLEM OF TAX-EXEMPT SECURITIES

The magnitude of the problem.

Taxpayers hold about \$24 billion of securities, interest on which is wholly exempt from the Federal income tax, and about \$30 billion of securities, interest on which is exempt only from the normal tax, not from the surtax rates of the Federal income tax. Both types of securities are exempt from State income taxes in most states. Of about \$350 million in revenue which the Federal government annually loses because of these exemptions, about \$200 million is attributable to the complete exemption from Federal income tax of interest on the obligations of State and local Governments.

TAX EXEMPT SECURITIES HELD BY TAXPAYERS, JUNE 30, 1939
(Amounts in billions of dollars)

Type of Security	State and local	Federal	Total
Total held by taxpayers	15.3	38.0	53.3
Wholly exempt	15.3	8.5	23.8
Held by banks and insurance companies	5.8	4.4	10.2
Held by others	9.5	4.1	13.6
Partly exempt	—	29.5	29.5
Held by banks and insurance companies	—	20.0	20.0
Held by others	—	9.5	9.5

Of the \$15.3 billion of State and local securities included in the above totals the greater part is held by wealthy individuals and by trust funds administered for the benefit of such individuals. To such persons, whose income is taxable at high surtax rates, the tax-exemption feature of these securities is very much more valuable than it is to persons of moderate means or to corporations subject to the relatively low rates of the corporation income tax. For example, to any one of the 729 individuals in the United States who have incomes of over \$250,000 a tax-exempt investment yielding 1 per cent is more valuable than a taxable investment yielding 3 per cent. Our increasing reliance upon the Federal income tax as a source of revenue and the consequent upward tendency of the surtax rates means that the loss of revenue resulting from these exemptions will increase, even though there may be no significant future increase in aggregate State and local indebtedness.

Of the \$38 billion dollars of Federal Government securities in the hands of taxpayers, \$7.3 billion dollars are wholly tax-exempt bills and notes, \$1.2 billion are wholly tax-exempt bonds of Farm Credit institutions, and \$29.5 billion are Treasury bonds, interest from which is subject to surtax. ^{1/} Treasury bills and notes are held largely by banks and insurance companies who hold them because they are short-term, liquid, low-risk assets rather than because of the tax exemption feature. Although these financial institutions also hold large amounts of Treasury bonds, especially those of short maturity, the bonds are held more widely by individuals.

1/ Except for the interest derived from a principal amount of \$5000 held by an individual.

Tax exemption is given to Treasury bills and to Treasury bonds by Federal statute, notes by the discretionary authority of the Secretary of the Treasury. This authority was exercised to make the most recent issue of notes taxable. These statutes can of course be amended or repealed at the will of Congress.

Until recently it was thought that State and local securities enjoyed immunity from Federal taxation because of constitutional reasons, and for this reason the Federal income tax statute specifically exempts income from these sources. The decisions of the Supreme Court in a series of cases beginning in 1937 have reopened discussion upon this point of Constitutional law. There are three methods for preventing this presumptive immunity from applying to future issues of State and local securities. The first is the passage of a Constitutional amendment to clarify the meaning of the Constitution in this respect; the second is the making of a compact with the States to waive their presumptive constitutional rights; and the third is the passage of a Federal statute, subjecting such income to taxation. In reviewing this statute, the Supreme Court would probably reverse the former doctrine with respect to this problem.

Preventing the exemption of future issues has no importance from the point of view of immediate revenue and it will assume importance only very slowly over the period of the next quarter of a century as present issues mature and are replaced by taxable issues. The development of increased revenue from the change will be retarded not only by the long average maturity of the present debt but by the tendency of the tax-

exempt issues left outstanding at any given time to shift into the hands of the wealthier taxpayers. That is, although tax-exempt securities are now widely held by individuals who pay no surtaxes at all, as the supply of these securities diminishes they will gradually be acquired by individuals paying surtax rates of 50 per cent and upwards.

Only the taxation of existing issues of tax-exempt securities can yield revenue in the immediate future. With reference to Federal bills and notes this problem does not have great importance because the present issues of these obligations may be replaced by taxable issues within the relative short space of five years. With reference to Federal bonds and to State and local securities, while the methods mentioned above would as a strictly legal matter be adequate in removing tax immunity from existing as well as future issues, such action would raise difficult problems of equity and of fiscal expediency. The purchaser of such issues now buys them with the understanding that existing statutes and the existing construction of the Constitution protects him from taxes during the maturity of the security in question. It is widely argued that this understanding constitutes a contract between the purchaser and the Government, and that action by the Government at variance with this understanding would constitute violation of a definite pledge. There is some reluctance, however, even on the part of those who are most convinced of the truth of this general proposition to press it to its logical conclusion and thus there have been a number of proposals to do indirectly what is agreed to be objectionable if done directly. These proposals include the Glass plan to include tax-exempt income with taxable income for

the purpose of computing surtax rates and a number of proposals to shift the legal basis of the income tax from a tax "on income" to an excise tax "on the act of receiving income."

Whatever may be said on grounds of equity about the general objection and the proposal for surmounting it by indirect means, it is certain that such a step would meet with the strong disapproval of the present holders of the securities in question.

Since the holders of existing issues make up the market for future issues, a step which would strike so directly at their interests appears unlikely at the present time, when the Treasury is faced with the necessity for continued large-scale borrowing. The inexpediency of such action becomes even greater if the borrowing program is one designed to appeal to the individual investor, rather than to institutional buyers.

The legal background of the problem

The most difficult and important part of the tax-exempt security problem, namely the exemption of State and local securities, did not have its origin in the desire of governments to borrow cheaply, although the low interest costs of State and local governments of high credit standing are partly attributable to this factor. As with many other economic problems in our national history, this one developed out of the ability of special interest groups to exploit the Constitutional division of sovereignty between Federal and State governments. In this respect the explanation of the delay in dealing with this problem is essentially the same as the explanation of the delay in dealing with the problem of effective regulation of the railroads and other public utilities, the effective regulation of banking, the adequate conservation of natural resources and the creation of an effective program for

agriculture. In all these areas the States could not deal effectively with the problem of national scope because of their restricted territorial jurisdictions, and over long periods of time the Federal Government was thought to be debarred from action because of constitutional limitations.

The doctrine of reciprocal immunity has been thought to prevent Federal taxation of the income from State and local securities. Stated in general terms, the argument runs that State taxation may not interfere with appropriate functions of the Federal Government and reciprocally Federal taxation may not interfere with appropriate functions of the State.

Recent Supreme Court decisions have given ground for the belief that the Court may abandon the doctrine of reciprocal immunity in its application to income taxation.

A brief memorandum by Mr. Solomon dealing with this topic is attached. In order to provide an occasion for a decision of the Supreme Court upon this issue it will be necessary for Congress to repeal the sections of the income tax statute specifically exempting interest of this type from taxation. It is not probable that Congress will take such action in the face of continued opposition on the part of State and local officials and, with this difficulty in mind, the Treasury has initiated a series of conferences with representatives of the States and cities with the object of bringing about a withdrawal of their opposition to the measure. These efforts thus far have not been successful; in the minds of local officials the fact that this step would, after twenty-five years, increase their interest costs slightly more than the withdrawal of immunity from governmental securities (Federal, State, and local) would increase their tax collections overshadows the fact that complete

collapse of State and local finances is averted only by the continuance of Federal grants and direct expenditures.

Exemption from taxation of interest on government securities
as an economic problem.

The arguments against tax exemption are so simple and persuasive that no important government outside the United States has continued the practice into modern times. The leading argument is based upon the desirability of equity and uniformity of tax treatment of individuals in accordance with the principal of ability to pay. One man with a \$50,000 income should pay as much/^{tax}as another person with the same income, provided his position with respect to the support of dependents is substantially the same. At present this principle is violated because a person with an income of that amount derived entirely from holdings of tax-exempt securities pays no Federal income taxes at all in contrast to the tax of about \$14,000 paid by the person who derives an income of that amount from work or from the holding of property in other forms. The Secretary of the Treasury recently expressed this idea by saying that an individual with income from government securities could go to Florida and contribute nothing to the costs of national defense, while the rest of the nation was contributing both effort and money.

It is also true that revenue lost through this form of tax avoidance, like others, has to be made good through borrowing in order to finance the expenditures that, apart from such loopholes, would be covered by tax receipts. The magnitude of the borrowing problem created is greater than is immediately apparent, because the persons who reduce their taxes in this way are responsible for a very large part of the

aggregate savings of the community. When the government has assumed responsibility for maintaining stability in economic life, there will be frequent occasions when it finds itself under the necessity of making expenditures in order to restore to the stream of purchasing power the amounts which savers have withdrawn. If the tax system is such that it makes available for governmental use funds which would have been saved if left in the hands of taxpayers, the problem of economic instability is greatly diminished in magnitude. If, however, the tax system contains loopholes, such as the exemption of interest on government securities, then the government will periodically find it necessary to borrow from and pay interest to those who have successfully avoided taxation. The exemption of governmental securities from taxation is therefore one of the reasons why the efforts of the Federal Government to attain economic stability have involved a considerable growth in the national debt. No end to this process is in sight unless this and other avenues of tax avoidance are effectively closed.

The existence of tax exempt securities not only accentuates the problems which grow out of fluctuations in the aggregate volume of savings; it also has undesirable effects upon the economic effectiveness of savings. The American capital market is so organized that a large volume of savings are dependent for their economic disposition upon the action of financial institutions who should, and for the most part do, act as trustees charged with the custody of other peoples' money. Because of this relationship the investment of these funds must naturally be made in a highly conservative fashion. The laws regulating the investments of insurance companies and trustees, the regulations of the

banking supervisory authorities, and the safeguards set up for the operation of savings banks and building and loan associations all reflect this basic fact. Because this large volume of savings must be conservatively invested, it is all the more important that some savings should be made available for the risky ventures that are bad investments for the bankers but good investments for the economy. Many attempted applications of inventions and technical improvements involve a high degree of risk. Even though many investments of this nature are now made by large corporations out of internal funds, it is desirable that new enterprises or small, growing enterprises should find funds available on the capital market to finance activities of this nature and, more generally, to keep competition alive as an element in the business process.

This is the field of investment which has traditionally been financed by well-to-do individuals who can afford to bear the risk of heavy losses in return for the promise of large gains. The existence of tax-exempt securities, however, means that persons of great wealth can purchase assets of high grade whose yield equals and often exceeds the yield of risky investments after the payment of income taxes. This possibility artificially restricts the supply of funds for risky investment. A new technical device must hold out the prospect of extremely large returns before it becomes attractive to wealthy investors who have open to them the alternative of buying virtually risk-free securities. Tax exemption not only restricts the supply of savings for use in risky investments, but diminishes the supply of secure investments available to savers of moderate means, who are not in a position to take risks.

These are the chief arguments against tax exemption of governmental securities.

It is difficult to find general arguments in its favor. The defense of the present practice usually takes the form of arguments against the removal of tax exemption after it has existed for a considerable period of time. One of these is the abstract legalistic argument against any Federal action which can be interpreted as an encroachment upon the rights of the States. It is noteworthy that, although this argument should in theory be raised whenever any proposal is made to deal effectively with a problem beyond the scope of State governmental powers, it is, in fact, raised only on occasions when Federal action threatens to interfere with the vested interests of some group hitherto enjoying some form of privilege or immunity.. It is not usually raised when the Federal government confers benefits by exercising a function which strict construction of the Constitution would describe as one of the powers reserved to the States.

In addition to this abstract argument, a powerful factor in the opposition to the elimination of tax exemption has been the idea that it will greatly increase the costs of borrowing for State governments and their political subdivisions, and that this increased expenditure will outweigh the fiscal advantage of the ability to tax interest on Federal obligations. It is probably true that the interest costs of State and local governments are perhaps as much as 20 per cent lower than they would otherwise be because of the immunity of the securities from Federal taxation. Two considerations are important in appraising the significance and

probable magnitude of the increase in cost that will result from the removal of immunity. The first is that interest rates as we actually find them in the money markets are determined by basic factors which, over relatively short periods of time, produce changes in the yield of securities of any given type which overshadow the influence of secondary factors such as their tax status. The level of national income, the amount of savings seeking investment, monetary influences such as gold inflow, Federal Reserve policy, the attitude of the financial community toward liquidity, the volume of borrowing by business and government - these are the basic factors at work. It was their action which lowered yields on long-term government obligations from 4 per cent, in the middle Twenties, to 2 per cent at the present time and which will continue to dominate interest rates generally.

In the second place it must be kept in mind that the proposal now being made by the Administration relates only to new issues of the State and local governments. The over-whelming volume of such securities are issued to refund existing obligations. During the next few years the issues to be refunded are those which bear the relatively high coupon rates of the early and middle Twenties. The fall in the general level of interest rates has been such that the securities which will be sold to replace the maturing issues will cost less than the non-taxable securities they will replace even if the new issues are taxable. The increase in the interest costs of State and local governments attributable to the removal of tax exemption will be for some years only a theoretical increase -- an increase over what they would have had to pay if their securities had retained their tax-exempt status -- rather than an actual increase.

To sum up, the interest burden of State and local governments will be fixed for many years to come by the interest rates which prevailed at the time that the bulk of the currently outstanding State and local indebtedness was issued. As these securities mature, the interest cost of the securities which will replace them will be determined basically by the underlying economic forces which determine interest rates in general. The working of these forces in recent years has been such that interest rates are now very much lower than they were at the time that the bulk of State and local securities were issued. Because of this decline, there will be an actual decrease in the interest costs of State and cities as a result of refunding obligations even though the interest costs on the new issues will be somewhat higher than they might have been had the tax exemption of these securities continued.

The effects of the elimination of tax-exempt securities in the money and capital markets.

Since the removal of tax exemption applies only to maturing issues which each year amount to a small fraction of outstanding government debts, the effects of this measure will be slow in working themselves out and are likely to be obscured by the effects of the more basic factors that determine conditions in the money and capital markets. As the existing volume of tax-exempt debt matures and is replaced by taxable issues, the old issues having the tax-exempt feature are likely to become more and more valuable to wealthy individuals and an increasing proportion of these securities will pass into the hands of such individuals. On the other hand, these individuals will no longer find the new and re-

funding issues of governments attractive, and such issues are therefore likely to yield somewhat more attractive rates of return than are now available. They will help to supply a badly needed outlet for the savings of individuals of moderate means, including the amounts entrusted to commercial and savings banks, and to insurance companies.

After a period during which the prices of outstanding tax-exempt issues will be forced up to levels that will more nearly reflect the full tax savings than at present, wealthy individuals will be faced with the problem of finding other outlets for their investment funds. Their search for such outlets may be expected to result in a gradually increased demand for high-grade mortgages, corporation bonds and ultimately in increased demand for equities. It must again be repeated that these tendencies may be completely overshadowed by the operation of more powerful factors influencing the market for these particular types of investment. For example, a boom in residential construction might result in such a demand for mortgage money that rates would rise even though an increased supply of such funds was forthcoming as a result of the process we have just been describing. Similarly, stock prices will not reflect increased demand from wealthy investors when the stock market is dominated by the doubts and uncertainties which have influenced its movements in recent months.

So far as the structure of interest rates is concerned, the removal of tax exemption may be expected to increase slightly the yields on the securities directly affected and to lower interest rates in other areas of the money and capital markets. This measure will, therefore, tend in some measure to reduce the unusual spread which now exists between the yields of high-grade securities and yields on loans of secondary quality, such as mortgages, loans to small business and various types of consumer credit.