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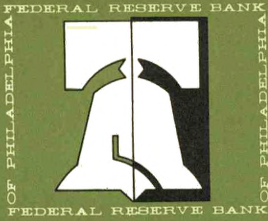

Looking into the Fed's Crystal Ball

The Unhappy, Important Consumer

The Taxman Rebuffed:
Income Taxes at Commercial Banks

FEDERAL RESERVE BANK of PHILADELPHIA

business review

1974

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. . . With confidence in the economy at a 25-year low, this year's business prospects hinge to an important degree on how quickly consumers step up their spending on "big ticket" items.

The Taxman Rebuffed: Income Taxes at Commercial Banks

. . . The U. S. tax burdens of all commercial banks are declining, but very large banks have been especially successful at trimming the taxman's take.

On our cover: Memorial Hall, a prominent fixture in Philadelphia's Fairmount Park, was built as an exhibition building for the Centennial International Exposition and dedicated on May 10, 1876 by President Ulysses S. Grant. After the exposition, the hall served as the city's art center until 1928. It is now the headquarters of the Fairmount Park Commission and Park Police Unit. (Photo by Sandy Sholder.)

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Looking into the Fed's Crystal Ball*

By David P. Eastburn, President
Federal Reserve Bank
of Philadelphia

Cloudiness is the characteristic usually associated with crystal balls. As one who has some responsibility to take frequent looks at ours for purposes of current monetary policy, I can vouch for the fact that the Fed's crystal ball shares that attribute with many others. Another characteristic of crystal balls, however, is that they tend to show what you're looking for. And, in the Federal Reserve System's ball I see, to considerable extent, what I'd like to see.

THE ENVIRONMENT

First, let's look briefly at the environment in which the Fed will be operating. It seems to me there will be two kinds of changes in this environment—quantitative and qualitative. The magnitudes with which the Fed will be dealing in future years will be much greater than now. Qualitative changes pose even greater challenges. Our society today is more complex and varied than it was, say, 25 years ago. By the end of the century it will be infinitely more so.

These observations apply to three phases of the environment in which the Fed will be operating—the economy, the payments system, and the financial system.

The *economy* has been growing in the past 25 years at an annual rate of 6.8 percent (measured by GNP in current dollars). By the year 2000 this could mean a GNP of $8 trillion. The typical

*An address given before a joint meeting of the Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants and the Delaware Valley Chapter of the Robert Morris Associates, Philadelphia, April 4, 1974.

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(median) family could well have an income of nearly $50,000 as compared with $11,000 today. Just projecting past rates of growth suggests the Fed could be dealing with a money supply of $1.5 trillion.

Simply projecting past growth could cause us to overshoot, especially if the current view of at least some thinkers that our society is too growth-conscious is shared by many others.[1] However, I believe it's a safe bet that the Fed will be dealing in economic magnitudes that could make today's look like small potatoes.

Yet it is true, I think, that increasing emphasis will be placed on the quality of life. Ours is already a rich and varied society, and it seems likely to become much more so. People's wants are insatiable. As desires for more quantity become better fulfilled, wants will be increasingly directed toward more variety. If you think life is complex now, those of us still around by the end of the century may look back on these as fairly simple times.

Above all, in terms of *both* quantity and quality, the Fed will be operating in an environment which is much more demanding than now. People today demand more of their public servants than in the past. But their expectations rise at an increasing rate, and at a rate faster than the ability of public institutions to perform. I feel sure the Fed will be doing a much better job in managing the economy than it is now, but the public still will not be satisfied, and this is as it should be. Dissatisfaction will be made known increasingly, I believe, through the political process.

The *payments system* needed to handle the vastly increased volume and complexity of transactions will differ vastly from today's. The present load of check clearing is already staggering. Around 26 billion checks are currently being written in a year and the Fed processes about a third of these. In Philadelphia we are now handling about 2¼ million checks a day. If you project our current annual growth rate of 5 to 7 percent, you can readily see that we will be pressing hard on the manpower, machinery, and space available to take care of the volume. Before too many years we should be well into the conversion from a paper to an electronic payments system.

At the same time, the *financial system* will be handling enormously greater business to service a much larger economy. Even more significant, however, will be major changes in the institutions performing these services. We are already seeing pressures to diversify functions, to overlap traditional jurisdictions. Through holding companies, commercial banks are getting into fields that formerly were reserved for insurance companies, investment companies, and nonbanking corporations. Savings banks and savings and loans are experimenting with check-type NOW accounts. Geographical restrictions are breaking down. The trend seems to me irreversible. By the end of the century the institutional structure we now have may be barely recognizable.

IMPLICATIONS FOR FUNCTIONS OF THE FED

What do these changes in the environment mean for the Fed? In approaching an answer, I want to make very clear a value judgment that influences everything I see in the crystal ball. I believe that the quantitative and qualitative changes in the environment described earlier require an attitude on the part of policymakers —including the Fed—that gives maximum scope to the free play of competitive market forces and individual choice. If I'm wrong in this assumption, my crystal ball will be wrong; and the picture will be less favorable than I am projecting.

As far as the Fed's role in the *economy* is concerned, this assumption means that monetary policy will occupy a strategic position. It is, after all, a way of influencing the economy in a manner that interferes only indirectly and impersonally with individual decisions.

Monetary policy will still have to deal with difficult questions concerning how much stimulus or restraint to apply. It seems quite possible, however, that social policies of Govern-

[1] See my "Social Man and the New Stationary State," *Business Review* of the Federal Reserve Bank of Philadelphia, May 1971, pp. 3–8.

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ment will make the trade-off between inflation and unemployment less difficult. Welfare reforms, insurance against the impacts of unemployment, better programs to train and educate the disadvantaged—these should make it easier for the Fed in fighting inflation without being overly obsessed with the social impacts of its restraints.

Similarly, we will have made progress in reducing the severe impacts which monetary restraint has on parts of the economy which have high social priority. Instead of hitting particularly hard the areas of housing and state and municipal services, policy will spread the load more evenly. This can be accomplished partly as various markets become better able to compete for funds and perhaps also as the Fed develops market-oriented means to induce lenders to allocate their funds in particular directions for social purposes.[2]

Public demands for performance will sharpen the Fed's ability to fine-tune. This is not to say the public will be satisfied; disillusionment with fine tuning may be just as great as now. But compared with current performance, the Fed should be better able to forecast and perhaps shorten lags in effects of its policy actions, and generally execute monetary policy with greater precision.

As far as *payments* are concerned, the tremendous pressures to develop an efficient payments system and the assumption that competitive forces should be given maximum play combine to form clear implications for the Fed. If we were to try to do the whole job ourselves, we might find the task so great as to divert us from our primary duties of monetary policy. In addition, we could not possibly do the job as well as competitive enterprise.

This indicates the importance of defining now with great care just what the Fed's role should be in the payments system. Without attempting to be overly detailed, I would just state my preference for a role in which the Fed would set overall coordinated standards within which private enterprise can compete. I see the Fed providing guidelines, leadership, and incentives for private participants, but being involved in a minimal way with the actual mechanics of handling transactions.

Changes in the *financial structure* have similar implications for the Fed's role in supervision and regulation. As the financial system becomes more complex and freewheeling, it will be extremely difficult, if not impossible, for supervisors to exercise minute control. Moreover, it would be counterproductive for them to try. The natural tendency for financial institutions to be creative and innovative should be encouraged, not frustrated.

At the same time, of course, the public needs to be protected against massive failure. I see a general approach of providing sufficient insurance and other safeguards so that depositors are not forced to take risks that should be borne by stockholders. To the extent possible, policing of unwise practices would be exercised by market analysts and investors in the stock of financial institutions.

When it comes to details of how these principles might be applied, the crystal ball becomes cloudy, but the general picture is clear: competition is given as much leeway as possible within general limits of public protection; the Fed is exercising less detailed supervision and regulation.

IMPLICATIONS FOR ORGANIZATION OF THE FED

The crystal ball is fairly clear, too, about the implications for the Fed's organization. *Externally,* the Fed will be responsive to the public through the political process. I have already suggested that the public will be increasingly vocal about what it expects from the Fed. This will bring Federal Reserve officials into even closer relationship to Congress and its committees. Whether this process will avoid the danger of going too far is less clear. It will be important to preserve some insulation from narrow political pressures. The Fed will still need to be able to take the long and frequently unpopular view.

[2] This theme is developed in my "Federal Reserve Policy and Social Priorities," *Business Review* of the Federal Reserve Bank of Philadelphia, November 1970, pp. 2–8.

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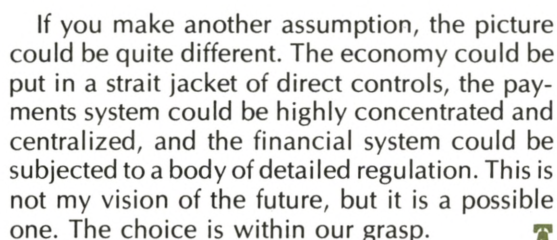
When it comes to relations between the Fed and financial institutions, it seems to me that a situation in which some institutions carry while others avoid the burdens of supporting the central bank would be intolerable. The concept of membership in the Federal Reserve System may well disappear, but all institutions exercising the same functions will carry the same responsibilities.

Internally, the kind of environment which I visualize presents at once considerable difficulties and opportunities for Federal Reserve authorities. The central bank's job will be so difficult that the Fed will find it impossible to perform effectively through detailed centralized direction. Fortunately, the Federal Reserve System is admirably constructed to meet the kinds of demands I see ahead. Machinery is well in place to provide overall coordination and decentralized execution. I see the Fed providing a leading example of how public policy can be carried out on a consistent basis without imposing the dead hand of centralized bureaucracy on all it does.

IMPLICATIONS FOR THE PUBLIC

In closing, let me return to the basic assumption that conditions my reading of the crystal ball. The assumption is that maximum reliance will be placed on competitive markets and freedom of choice. If this assumption turns out to be accurate, I see an important role for monetary policy, an efficient payments system, and a dynamic financial system. The Fed's role will be largely in the first area—exercising effective monetary policy—and concentrating in the other two areas on encouraging the private system to make the best use of its natural creative instincts.



If you make another assumption, the picture could be quite different. The economy could be put in a strait jacket of direct controls, the payments system could be highly concentrated and centralized, and the financial system could be subjected to a body of detailed regulation. This is not my vision of the future, but it is a possible one. The choice is within our grasp.

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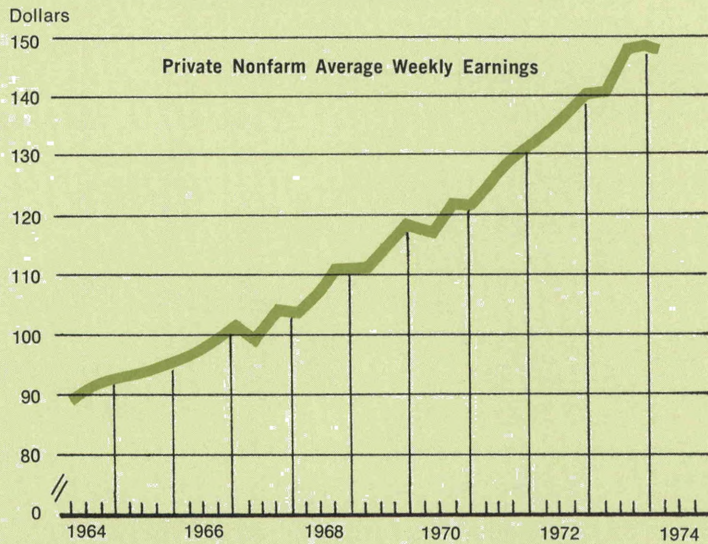
The Unhappy, Important Consumer // *By Ann Castellano*

CHART 1

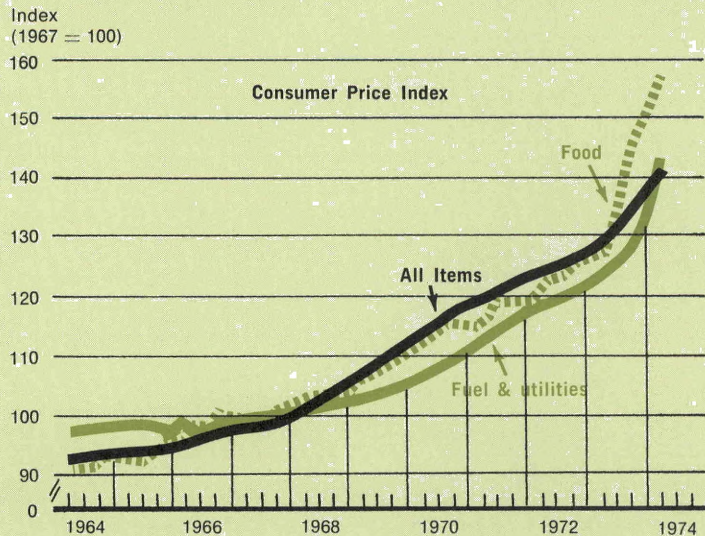
ALTHOUGH WORKERS HAVE BEEN CHALKING UP SUBSTANTIAL WAGE GAINS DURING THE PAST YEARS . . .



Source: U. S. Department of Labor, Bureau of Labor Statistics.

CHART 2

THE PRICES THEY'VE HAD TO PAY, ESPECIALLY FOR FOOD AND FUEL, HAVE SKYROCKETED



Source: U. S. Department of Labor, Bureau of Labor Statistics.

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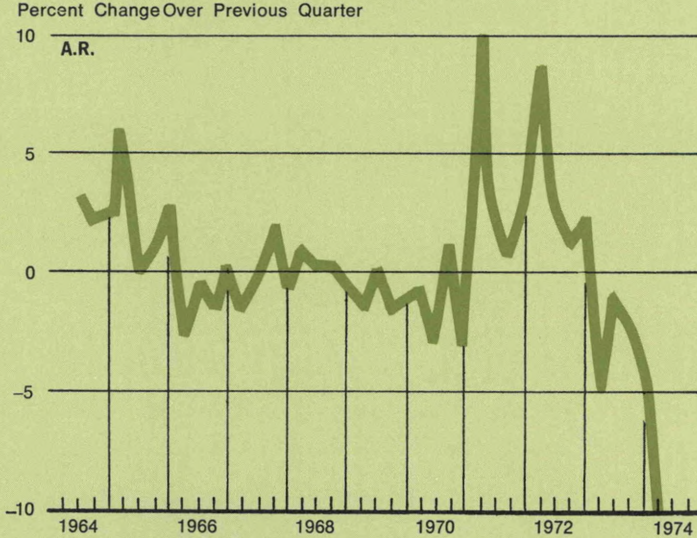
CHART 3

SO THEIR REAL SPENDABLE PAY* HAS FALLEN SHARPLY.

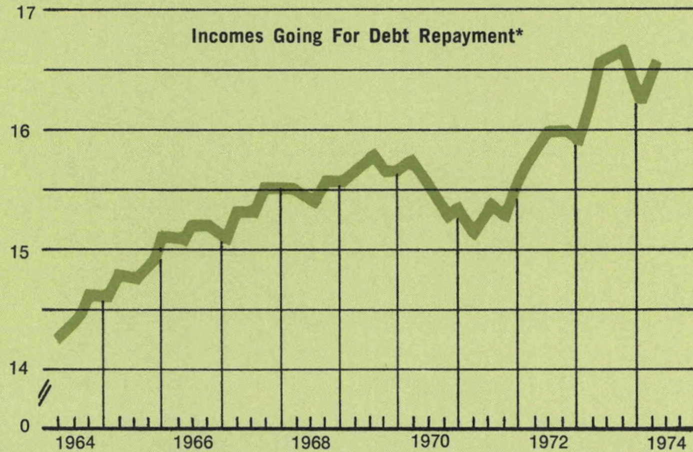


* Real spendable pay—gross earnings minus Social Security and Federal income taxes, adjusted for price changes.

Source: U. S. Department of Labor, Bureau of Labor Statistics.

CHART 4

IN ADDITION, CONSUMERS HAVE GONE HEAVILY INTO DEBT WITH $1 OUT OF EVERY $6 OF INCOME NOW GOING FOR DEBT REPAYMENT.



* Consumer credit repayments as a percent of disposable personal income.

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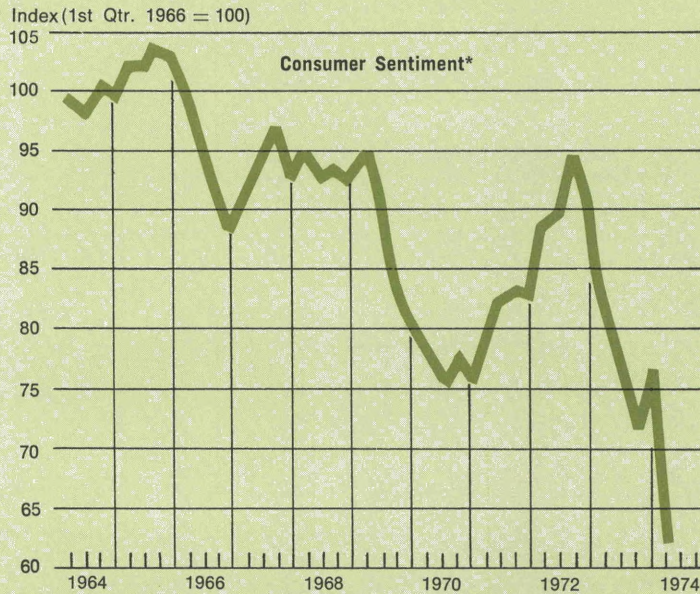
CHART 5

AS A CONSEQUENCE, CONSUMER SENTIMENT ABOUT THE ECONOMY HAS PLUMMETED TO THE LOWEST LEVEL IN OVER TWENTY YEARS.

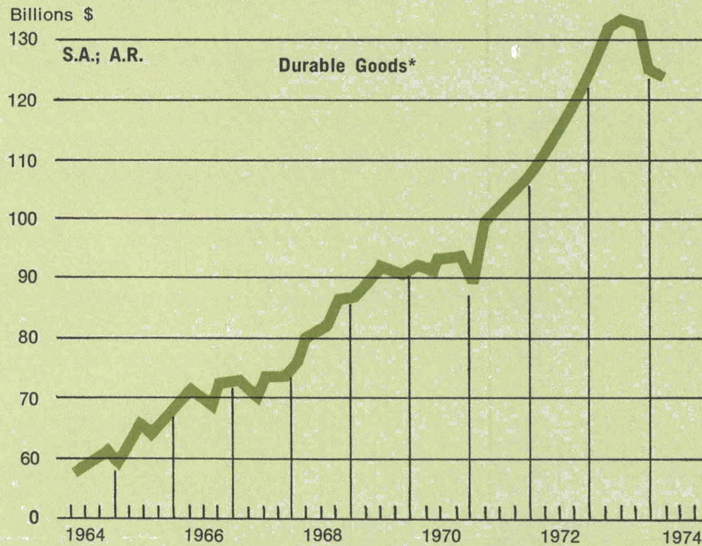


* Changes in the attitudes, expectations, and buying inclinations of consumers.

Source: University of Michigan, Index of Consumer Sentiment.

CHART 6

AND THE PURCHASE OF "BIG TICKET" ITEMS HAS LEVELED OFF AND STARTED FALLING.



* Includes automobiles and parts, furniture, and household equipment.
Source: U. S. Department of Commerce.

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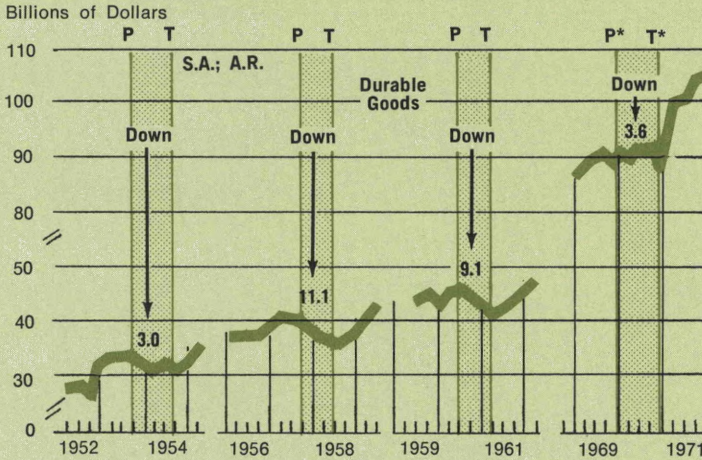
CHART 7

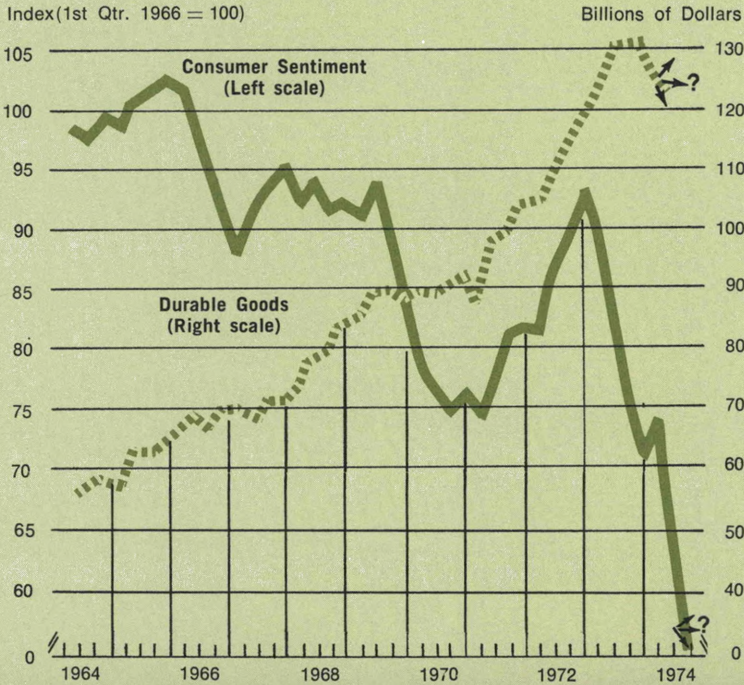


Shaded areas denote recession periods. "P" refers to peak in economic activity prior to each recession and "T" refers to the trough, or low point of each recession. The number in each shaded area shows the percentage decline in durable goods purchases associated with each recession.

* Tentative and subject to revision.

Source: U. S. Department of Commerce.

CHART 8



Source: University of Michigan; U. S. Department of Commerce.

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The Taxman Rebuffed: Income Taxes at Commercial Banks

By Donald J. Mullineaux

Today "nothing in this world is certain except death and ________." Inflation, pollution, or political corruption might well be touted as "plain, plump fact," but would anyone proffer Ben Franklin's well-known judgment—taxes? The "Philadelphia philosopher" apparently had no inclination that come 1967 some 21 millionaires would pay no Federal income tax.[1] Indeed, it's far from easy to infer his response to such news. The duty-minded patriot might have reproached the nontaxpayers with acerbic wit, but the resourceful entrepreneur in Franklin could have made him an active practitioner of tax-avoidance activities—*lawful* actions which shrink an individual's current tax liability. Thus, a modern-day Franklin might well be a home owner, a buyer of municipal securities, an aggressive seeker of low-priced assets likely to yield capital gains, and a philanthropist *par excellence*. Given his income, all of these activities would reduce his total tax bill.

Because corporations as well as individuals must pay income taxes, they too devote time and effort to finding ways to cut their taxes. However, tax avoidance by corporations is hardly an end in itself. Businesses instead operate with a view toward maximizing their profits. But since their stockholders are concerned with earnings *after taxes*, businessmen must consider the impact of taxes on net profits in making their decisions as well as factors such as operating expenses, risk, and liquidity. The lower a corporation's taxes, *other things equal*, the more funds will be available for paying dividends or for plowing back into further expansion.

[1]Nor is tax avoidance on the wane. The March 4, 1974 *Wall Street Journal* reports an announcement by Senator Walter F. Mondale that 402 Americans with incomes over $100,000 paid no Federal income tax in 1972 (p. 18).

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Although income tax rates have been little changed, some businesses have been dispensing proportionately less of their earnings into Uncle Sam's coffers in recent years. Among financial corporations, commercial banks have been particularly adept at trimming their tax bills. Tax burdens (measured by the ratio of taxes to income) have diminished especially sharply at *large* commercial banks that can pursue a number of tax-reducing activities which are not generally available to smaller banks. The fact that the taxman has been left with a continuously smaller portion of bank income opens traditional questions of equity and efficiency. In addition, it plays an important role in the current debate concerning the restructuring of the financial marketplace. As their tax burden declines, it becomes increasingly more difficult to justify continuation of commercial-bank prerogatives (such as the ability to issue checking accounts) on the grounds that they offset the high tax burden of commercial banks relative to other financial institutions.

A SHORT COURSE IN "TAX AVOIDANCE": BANKS EARN HIGH GRADES

Expending time and energy on attempts to reduce tax liabilities naturally uses up some of the scarce resources of individuals and firms. Nevertheless, such activities represent a rational response to potential government appropriation of income as long as the gain from successful tax avoidance more than offsets these resource costs. If the revenues generated by tax-reduction activities were less than these costs, profits would be reduced, and the actions should not be undertaken. For example, tax-free municipal securities sell at lower interest rates than taxable corporate bonds, and this yield differential represents part of the "cost" of buying municipal bonds. If corporate bonds are yielding 8 percent and municipals 5 percent, the cost is $30 per $1,000 of tax-exempts purchased. If the tax rate is 50 percent, however, an investor saves $40 in taxes by purchasing the municipal security. Since the tax saving exceeds the cost, the tax-exempt bond is the superior investment. If the rate on municipal bonds is 3 percent, however, the cost exceeds the benefit, and the taxable security should be purchased. Similar sorts of calculations must be made for other activities which reduce taxes, and the costs may well include hiring the services of specialized tax lawyers and accountants. An activity should be undertaken *only* if it contributes positively to profits after taxes.

Legal avoidance of taxes is neither immoral nor unpatriotic. The famous jurist Learned Hand once ruled that "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Popular acceptance of this view has meant that tax minimization is a fact of life for practically all types of economic units—individuals, households, partnerships, and corporations.

Specific activities which diminish the size of the Government's tax bite can usually be classified into one of four broad tax-avoidance schemes. These include searching for:

1) Categories of untaxed income (exclusions), such as interest on municipal securities;
2) Income from items with preferential tax rates, such as capital gains;
3) Tax "credits," which allow an explicit deduction from calculated tax liabilities, such as the 7 percent investment tax credit;
4) Deferrals of tax payments until future periods, such as utilization of advanced depreciation schedules.

In recent years, large commercial banks have engaged in all four broad categories of tax-avoidance strategy, while smaller banks have typically made use of only the first two groupings.

A glance at tax and income data in recent years suggests that, as students of tax avoidance, commercial banks have earned high grades. Table 1 and Chart 3 depict the trend of the tax burden of all insured commercial banks since 1961. Tax burdens are measured by effective tax rates which consist of a measure of tax payments relative to the "income" earned from all commercial-banking activities (see Box 1). The only major interruption in the downhill slide of

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TABLE 1

TAX BURDENS AT INSURED COMMERCIAL BANKS HAVE DIMINISHED SIGNIFICANTLY SINCE 1961

YEAR	AVERAGE EFFECTIVE TAX RATE (Income Taxes/Economic Income)*
1961	38.3%
1962	33.4
1963	31.7
1964	27.0
1965	23.1
1966	20.1
1967	21.3
1968	19.1
1969	20.3
1970	23.2
1971	18.9
1972	16.8

* Economic income is defined as explicit receipts from all sources of banking activity less explicit expenses incurred in generating these receipts.

Source: *Annual Report,* Federal Deposit Insurance Corporation.

Box 1

MEASURING THE TAX BURDEN OF COMMERCIAL BANKS

Taxes represent a burden for individuals and corporations because the income flowing to the Treasury cannot be used for satisfying consumption desires or adding to wealth. Thus, stating the dollar amount of Federal tax liabilities incurred as a percentage of income earned over a given accounting period is one way to measure the burden of Federal income taxes. This ratio—termed "the effective tax rate"—relates "provision for Federal income taxes" in the numerator to "economic income" in the denominator. Economic income is defined as explicit receipts from all sources of banking activity less explicit expenses incurred in generating these receipts. The figures required to construct effective tax rates for commercial banks are contained on the Reports of Income submitted annually to the various regulatory agencies.

Economic income is calculated by adding nonoperating income (gross securities gains or losses, gross extraordinary credits or charges and the like) back into net operating income (called "income before taxes and securities gains and losses" after 1969). In computing the tax burden over the period 1961–72, however, a problem arises because of accounting changes in bank income statements in 1969. In comparing 1969–72 data with previous years, "net

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operating income" is understated in the recent period because of the inclusion of additional items in operating expenses, such as interest on capital notes and debentures. Consequently, this item was excluded from operating expenses over 1969–72. In addition, *nonoperating* income is overstated in the recent period relative to earlier years, because transfers to loan loss reserves were charged against net income in the former period, but not in the recent period. In the 1969–72 period, a "provision for loan losses" is charged against operating revenue. Consequently, actual net loan losses were "expensed" against operating revenues in the 1961–68 period in calculating effective tax rates for that period.

tax burdens at commercial banks occurred in 1970, following passage of the Tax Reform Act (TRA) of 1969 (see Box 2). The House Ways and Means Committee tried framing the TRA so that the effective tax rates of both commercial banks and nonbank savings institutions (mutual savings

Box 2

IMPACT OF THE TAX REFORM ACT OF 1969 ON FINANCIAL INSTITUTIONS

The Tax Reform Act (TRA) produced momentarily higher taxes at commercial banks via several channels. Most important, it tightened existing limits on the size of the deductions allowed to banks for additions to their reserves for bad debt. Through 1969 banks were permitted to add to loan-loss reserves out of pretax income until such reserves reached a maximum level of 2.4 percent of eligible loans*, but the TRA immediately reduced this level to 1.8 percent of eligible loans. This maximum level will decline further to 1.2 percent after 1975, and to 0.6 percent after 1981. After 1987, all banks must use the "experience method" which permits banks to establish reserves only up to the average actual losses experienced over the most recent six-year period. Transfers to bad-debt reserves in excess of these permissible maxima are subject to taxation. The other major elements of the TRA which affected bank taxes were the elimination of the application of the favorable capital gains tax rate to profits earned on securities sales, an increase in the capital gains tax rate, and the establishment of a Minimum Tax on Tax Preference Items. The latter designates certain categories of income taxed preferentially under the tax code to be subject to a second round of taxation.

The tax liabilities of mutual savings banks and savings and loan associations were likewise boosted by the TRA. Again, the principal factor accounting for increased taxes at savings institutions was a change in the formula for determining bad debt reserves. The Minimum Tax also appears to have significantly affected the taxes of these intermediaries, more so than for commercial banks.

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*Eligible loans exclude loans insured or guaranteed by the U.S. Government, such as FHA or VA loans, as well as other loans deemed by the Treasury to be relatively risk-free.

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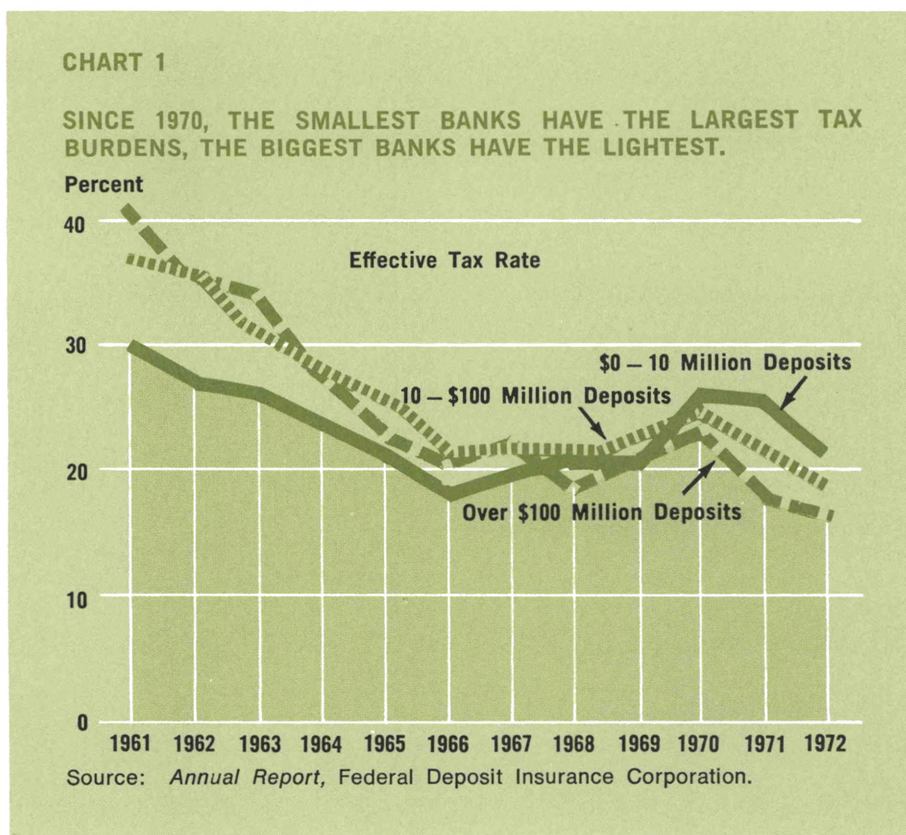
banks and savings and loan associations) were raised, but that some margin of tax advantage was retained for savings institutions to "preserve the inducement for them to continue investing in real estate mortgages."[2]

Although tax bills have been sliced at banks both large and small, some banks have reduced their tax burdens more than their rivals. Chart 1 demonstrates that large banks have been considerably more successful at trimming tax liabilities than their smaller counterparts. Through the middle '60s, bantam-sized banks bore the lightest tax burden of the three size classifications shown, but during the 1970s these same banks have topped the tax-remittance derby. The largest-sized banks paid the highest taxes in the early 1960s, but by the '70s bore the smallest burden of all three size groupings. Indeed, in 1972 effective tax rates at the biggest institutions were about five percentage points *lower* than rates at the smallest banks, whereas in 1961 the tax burden of banks with over $100 million in assets had been over ten percentage points *higher* than the small-bank burden.

Shrinking tax burdens at commercial banks of all dimensions during recent years reflect both Government actions and tax-saving activities undertaken by banks themselves. For example, the corporate tax rate was reduced from 52 to 48 percent during the Kennedy tax cut (1964) and in 1962 the Treasury made a favorable (from a bank's viewpoint) change in the definition of deductible additions to bad-debt reserves. How-

[2]As cited in *Tax Reform Act of 1969: A Consideration of Provisions Affecting Commercial Banks* (Washington: Carter H. Golembe Associates, Inc., 1969), p. 1.



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ever, the bulk of the recent decline in tax liabilities can be attributed to bank-initiated actions to trim the taxman's take. Indeed, the ability of large banks to outshine their smaller rivals in this pursuit can be attributed to the relatively larger menu of profitable opportunities at their disposal.

MAJOR TAX AVOIDANCE OPTIONS FOR COMMERCIAL BANKS: MUNICIPALS, LEASING, AND FOREIGN OPERATIONS

Since growth in size is typically accompanied by increasing specialization of tasks, large banks can better afford tax lawyers and accountants to furnish advice on how to pare their tax bills. More than good advice is required, however, since in some cases a bank must have achieved some minimum size before it can profitably undertake certain activities which are advantageous from a tax viewpoint. Equipment leasing and foreign branch or subsidiary operations represent several examples. However, the option which has probably been the principal avenue for tax avoidance by most banks in recent years—purchases of tax-exempt municipal securities—is readily available to banks of all sizes.

Tax-Exempt Securities. Year-end balance-sheet statements for 1972 reveal that commercial banks held nearly $90 billion of tax-exempt securities, nearly half the total outstanding debt of state and local governments. These holdings have increased some 350 percent since 1961 when banks held but 25 percent of outstanding tax-exempts. Since total bank assets have increased but 166 percent over the same period, the proportion of municipal securities in bank portfolios has more than doubled.

Purchase of municipal securities offers commercial banks a unique tax-abatement opportunity. The IRS prohibits nonbank investors purchasing tax-exempts from deducting any interest costs associated with funds borrowed to finance such investments. While commercial banks have no blanket exemption from this restriction, the IRS has conceded that banks may deduct interest paid on money obtained in the ordinary course of doing business so long as there is no direct connection between the indebtedness and the purchase of tax-exempt securities. Consequently, if a bank purchases $100,000 worth of municipal securities yielding 5 percent by using funds borrowed from time depositors at 5 per-

TABLE 2

PURCHASE OF $100,000 OF MUNICIPALS YIELDING 5 PERCENT WITH FUNDS BORROWED AT 5 PERCENT YIELDS A TAX SAVINGS FOR BANKS

	Bank Investor	Nonbank Investor
Interest Income	$5,000	$5,000
Gross Taxable Income	0	0
Deductible Interest Expense	5,000	0
Net Taxable Income (2-3)	–5,000	0
Tax Due (48 percent rate)	–2,400	0
NET INCOME	$2,400 (Tax Reduction)	0

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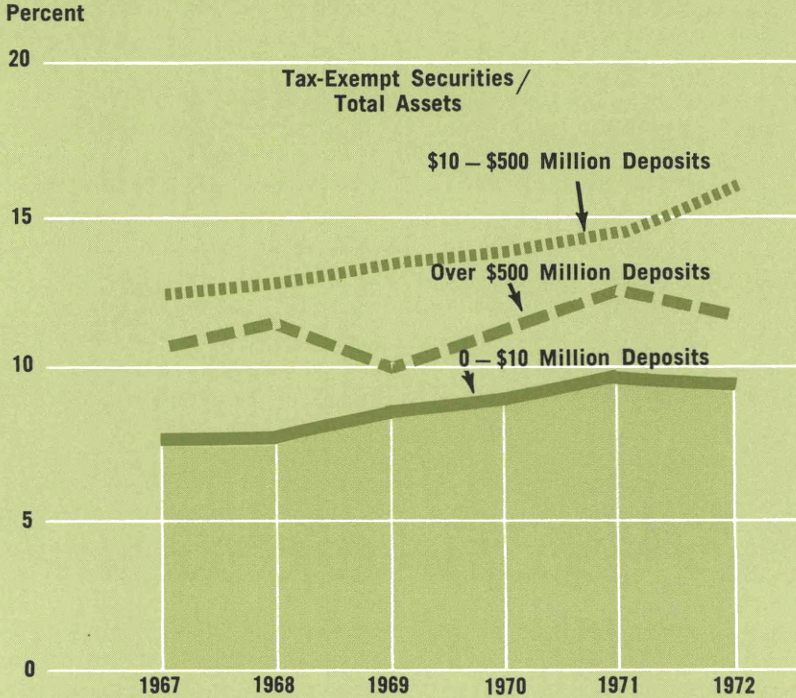
CHART 2

SMALL BANKS HOLD FEWER TAX-EXEMPTS AND HAVE INCREASED THEIR HOLDINGS MORE SLOWLY THAN LARGER BANKS.



Source: *Annual Report*, Federal Deposit Insurance Corporation.

cent, it earns a tax reduction of $2,400.[3] The nonbank investor, however, would earn nothing. (See Table 2).

The disparate success of different-sized banks in lightening their tax burdens is partially explained by the pattern of tax-exempt holdings across large and small banks. As Chart 2 demonstrates, banks with deposits of $10 million to $500 million hold more than half again as many state and local issues relative to total assets than do banks in the smallest size classification. In addition, intermediate and larger-sized banks have generally been increasing the proportion of tax-exempts in their portfolios in recent years, while the smallest banks have invested a fairly constant percentage of their funds in municipals.

A number of factors can be suggested to explain why small banks hold proportionately fewer tax-exempts. Since the tax rate on the first $25,000 of income is 22 percent (rather than 48), municipals will be less attractive to very small banks with income in this range (generally banks with deposits less than $5 million) relative to taxable securities.[4] In addition, the secondary

[3]The corporate tax rate is assumed to be 48 percent.

[4]Likewise, municipals are relatively less attractive to very large banks who have reduced their effective tax rates significantly by means other than holding municipals.

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market for municipals is only now becoming better developed, and smaller banks consequently may have to pay substantial transactions costs when selling tax-exempts through the correspondent system. Thus, while municipals are an available mechanism for cutting small-bank taxes, they are relatively less attractive as an investment medium to smaller institutions. The other major devices that large banks use to trim the Treasury's take—equipment leasing and foreign banking operations—do not represent feasible alternatives for small banking institutions.

Leasing Operations of Banks. Even without its tax advantages, profit-motivated banks would have no doubt embraced equipment leasing as a potentially profitable mode of operations during the expansion-minded sixties. The simple reason is that leasing represents a rational and flexible means of paying for an equipment purchase. It consequently complements the various financing alternatives banks can offer their customers. The advantages typically cited for leasing include protection against risk of obsolescence, conservation of working capital, ease of negotiation, minimization of red tape, and the ready availability of ancillary services such as insurance, maintenance, and recordkeeping. In addition, leasing may convey benefits to *both the lessor and the lessee*. As a purchaser of new equipment, the lessor is allowed a tax credit, presently equal to 7 percent of the value of the equipment. In addition, the lessor can take advantage of accelerated depreciation allowances, which defer tax payments to some future period. Although the liability will eventually be incurred, accelerated depreciation nonetheless yields benefits since the funds "saved" by avoiding taxes today can be invested in interest-yielding assets.

The lessee likewise can benefit from the lease arrangement if he himself is unable to capture the tax advantages accruing to the acquisition of capital assets. The lessor can capture the tax benefit and pass the gain on to the lessee in the form of lower rental rates. In a sense, the lessee "sells" some of his tax advantages to the lessor, a process termed depreciation trading. For example, in the mid-sixties many airlines suffering losses had unused tax losses to carry forward on their books. Consequently, they could not take advantage of tax credits and accelerated depreciation available from new aircraft purchases. By leasing the aircraft, banks were able to take the tax write-offs for themselves and provide financing for the airlines at better terms than they could get by borrowing or issuing new debt. Further benefits may accrue to the lessee when banks are able to traffic in heavy equipment markets at lower per unit costs than the firms in the industry themselves because of the considerable size of bank purchases.

Banks have been involved in lease financing for several decades, but until 1963 were legally limited to "indirect leasing" which conveys no direct tax benefits. Such activities consisted, for example, of loans to lessors for the purchase of equipment or financing leases offered directly by manufacturers. "Direct lease" financing was spawned in 1963 when the Comptroller of the Currency ruled it a permissible activity for national banks and has grown enormously in the intervening period (see Table 3). Today, state-chartered banks are likewise empowered to engage in direct leasing in 41 of the 50 states (but no data are yet published for state-bank activity). In addition, the Federal Reserve Board has included equipment leasing as a permissible activity for subsidiaries of bank holding companies. Among the 50 largest commercial banks in the U.S., 47 are engaged in equipment leasing either directly or through subsidiaries or holding company affiliates.

Although growth has been spectacular, leasing hardly represents an attractive alternative for each and every bank. Several technical problems are involved—legal documentation, accounting, state and local taxes, purchasing equipment, insuring proper insurance coverage, and disposal of equipment at the lease's end. A large initial investment is typically required to get a leasing operation off the ground. Given these considerations, it is not surprising that most of the tax benefits from leasing accrue to larger banks. In the corporate tax year July 1969

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TABLE 3

BOOM IN DIRECT LEASE FINANCING BY NATIONAL BANKS CONTINUES

End of Period	Amount Outstanding (Millions)	12-Month Growth Rate (Percent)	Number of Banks Reporting
1963	$ 24.0	—	N/A
1964	81.0	237.5	N/A
1965	271.0	234.6	N/A
1966	331.0	22.1	N/A
1967	412.1	24.5	259
1968	541.9	31.5	303
1969	693.8	28.0	353
1970	789.8	13.8	390
1971	871.0	10.3	446
1972	1073.0	23.2	510

N/A: Not available.

Source: This Table is reproduced from Steven Weiss and Vincent McGugan, "The Equipment Leasing Industry and the Emerging Role of Banking Organizations," *New England Economic Review*, November/December 1973, p. 17.

through June 1970, commercial banks claimed some $50 million in investment tax credits on corporate tax returns. Over 87 percent of these credits were claimed by banks with assets over $100 million.[5] These same banks claimed over 70 percent of the $803 million in depreciation deductions taken in 1969–70, which is about the proportion of total assets held by banks in this size classification. Banks with assets less than 10 million, which held some 6.5 percent of total assets in the 1969–70 tax year, took less than 3 percent of all investment tax credits and about 7 percent of depreciation deductions. That the investment credits claimed by large banks reflect mainly leasing operations is suggested by the fact that savings and loan associations (S&Ls) claimed credits only 2.5 percent as large as those of commercial banks in the same tax year, though total assets of S&Ls are some 25 percent as large as those of banks. S&Ls are not presently permitted to engage in the types of leasing operations pursued by commercials.

Foreign Operations. During the last decade, the foreign lending activities of U.S. commercial banks flourished at a pace thrice that of their domestic lending. However, the *geographic locus* of bank lending to foreign citizens and corporations shifted abruptly in the middle sixties from domestic to foreign soil, and bank taxes were consequently affected. The match in the powder barrel setting off the explosion in foreign-based bank operations was the advent of the Voluntary Foreign Credit Restraint Program

[5]The 1969–70 corporate tax year is the most recent date for which tax credit data is available by size of the institution.

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(VFCR) in 1965. The VFCR was designed to influence the U.S. balance of payments favorably by placing limits on the amounts of loanable funds U.S. banks could transfer abroad. As a measure of its effect, annual average growth in foreign deposits at head offices in the U.S. declined from 10.1 percent from 1960–64 to 3 percent during 1965–72. During the latter period, banks attempted to attract funds to their foreign-based branches from which they could be relent without the restraints of VFCR guidelines. Indeed, the number of U.S. banks operating overseas offices jumped from 11 in 1964 to 108 in 1972 and the number of foreign branches more than tripled from 181 to 627. By 1972, foreign branch deposits accounted for nearly 30 percent of total deposits of all U.S. banks operating abroad, versus only 6.3 percent in 1964.

Much like the effect of expanded leasing operations, this substantial extension of foreign activities has diminished the *domestic* tax burden of commercial banks. While domestic corporations are in principle taxed on their world-wide income, corporations are allowed a tax credit for payment of taxes to foreign governments of countries in which they operate. This credit, which results in a dollar-for-dollar reduction in U.S. taxes, is designed to help corporations avoid the *double taxation* which would occur if both the U.S. and the host country should levy a tax on income earned in the latter. Thus, the foreign tax credit serves to reduce *domestic* tax liabilities for banks operating overseas relative to banks operating only in the U.S. What is lost to the U.S. Treasury, however, ends up in the foreign taxman's pocket. Thus, the *world-wide* tax burden of banks which operate branches

TABLE 4

FOREIGN TAX CREDITS CLAIMED BY COMMERCIAL BANKS HAVE GROWN CONSIDERABLY FASTER THAN INVESTMENT TAX CREDITS

Tax Year*	Foreign Tax Credits (Millions)	Investment Tax Credits (Millions)
1967	$ 63	$37
1968	88	46
1969	78	51
1970	114	26**
1971	218	58

* July of the year stated through June of the following year.

** The 7 percent investment tax credit was repealed by the Tax Reform Act of 1969, then restored by the Revenue Act of 1971 as the "job development investment credit."

Source: Statistics of Income, Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service.

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both at home and abroad is not reduced by foreign operations.[6]

From fiscal year 1967 to fiscal year 1971, foreign tax credits claimed by banks have more than tripled (see Table 4). These credits are predominantly taken by the largest banks, with over 98 percent of the credits claimed in fiscal 1970 accruing to banks with assets over $100 million. These foreign tax credits, which Table 4 shows are considerably larger than investment tax credits, represent the dominant factor accounting for the declining domestic tax rates at very large banks in the wake of the Tax Reform Act of 1969. In fact, the proportion of total industry foreign tax credits claimed by commercial banks has doubled from 2 to 4 percent over the period from tax year 1967 to tax year 1971. Although the VFCR was revoked in January 1974, growth in foreign operations of U.S. banks is likely to continue at a rapid pace, given the continuing expansion in international commerce.

REFORMING THE TAX REFORM ACT?

Substantial expansion in foreign business and domestic leasing activities represent the principal avenues of continued tax avoidance by large commercial banks on the heels of the Tax Reform Act of 1969. Given these developments, questions concerning the "proper" relative tax burden between (1) small and large banks and (2) banks and other kinds of financial institutions are likely to call forth some Congressional review of the corporate tax code. As in most tax debates, equity will no doubt form the warp and woof of the discussion.

Tax Equality and Commercial Bank Size. Despite the progressivity built into the statutory tax rates for corporations, since 1970 the effective U.S. tax structure of the commercial banking industry has shown the smallest banks paying the highest taxes. Having a larger proportion of their earnings flow to the Treasury appears to place small and medium-sized banks at a relative disadvantage in terms of their potential growth.[7] Retained after-tax earnings have traditionally represented the kernel of growth in smaller-bank capital because of the high cost of obtaining funds from external sources. Assessing the fairness of the distribution of taxes on the basis of Chart 1, however, ignores the real burden of taxes paid to foreign governments. A comparison of world-wide tax burdens is more relevant to equity discussions than domestic burdens. If foreign taxes are added to U.S. taxes paid in order to gauge effective tax rates on a world-wide basis, then the largest banks had slightly larger tax burdens than medium-sized banks in 1970 and 1971.[8] The smallest institutions, however, continued to have the biggest burdens. Taking account of the burden of foreign taxes thus removes some of the inequities apparent in the tax structure, but fails to eliminate all of the regressivity.

Tax Equality and Financial Institutions. Commercial-bank lobbyists have for ages and aeons pleaded the case for "horizontal equity"

[6]This does not mean there are no tax advantages to foreign operations. Income earned by foreign *subsidiaries* (rather than branches) of U.S. corporations is not subject to U.S. taxation until repatriated to the parent corporation. Such a deferral results in benefits in the same manner as those accruing from the utilization of advanced depreciation allowances.

[7]In addition to inequities, society may suffer additional costs from these tax preferences if they direct scarce resources toward production of goods which society "values" less than some other combination of output. For example, the investment tax credit and accelerated depreciation allowances make equipment leasing more attractive to banks relative to, say, term loans to businesses. In other words, tax loopholes or preferences can distort the relative price or returns on goods or financial assets. If society wishes to encourage more leasing activity, it may be less costly (society will have to give up less of other goods) to pay direct subsidies to leasing firms than to distort the relative-price mechanism artificially.

[8]Data are not yet available *by size classification* for foreign tax credits taken in tax-year 1970 and later years. Consequently, it was assumed that the largest banks claimed the same percentage of total foreign credits in 1970 and 1971 as taken in tax-year 1969 (98 percent). Foreign taxes paid in *calendar* 1970 were assumed to be the average of foreign tax credits claimed in tax years 1969 and 1970. Data are not yet available for calculating the worldwide burden for 1972.

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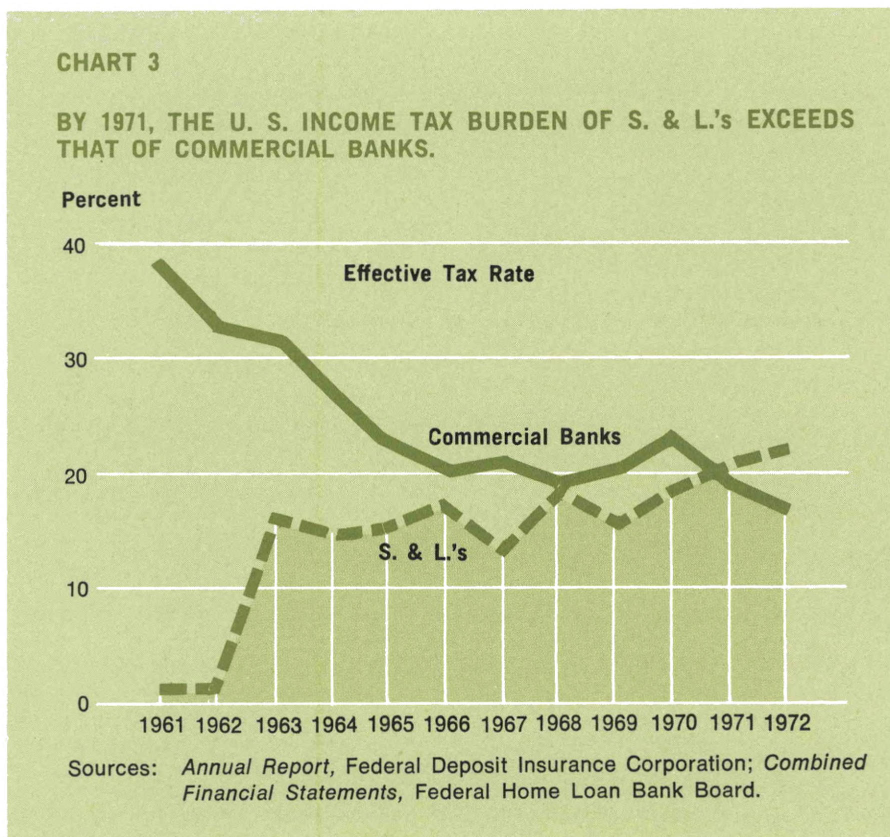
or tax equality across types of financial institutions. Indeed, a special committee of the American Bankers Association has recently made tax equality a necessary condition for commercial-banker assent to the Hunt Commission proposals to redesign the structure of financial institutions and markets. (The official name of the Hunt Commission is the President's Commission on Financial Structure and Regulation.) The Hunt blueprint recommends among other things broader investment powers and checking-account privileges for savings and loan associations and mutual savings banks.

Until recently, commercial bank protagonists had little difficulty mustering evidence to support their charge of "unfair" treatment, and consequently the ABA proviso could have served to block the Hunt Commission recommendations. An examination of data for the last several years, however, suggests that the day of domestic tax equality (measured by effective tax rates) has already dawned—at least between banks and S&Ls. Chart 3 depicts the behavior of the U.S. income tax burden of both types of institutions since 1961. Before 1963, liberal allowances for additions to bad-debt reserves allowed S&Ls to pay negligible taxes. (Prior to 1951, S&Ls were completely tax-exempt). Bad debt deductions were trimmed in both 1962 and 1969, however.[9] In addition, the Minimum Tax on Preference

[9]The Revenue Act of 1962 limited the deduction allowance to 60 percent of taxable income or to an amount necessary to increase the reserve on real property loans to 3 percent. In 1969, the Tax Reform Act again decreased the bad-debt deduction from 60 to 40 percent of income over a 10-year period starting in 1970.



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Income established in the Tax Reform Act also added to the S&L tax burden. Basically, this tax is a flat 10 percent rate applied to the sum of certain "preference items" which are excluded from taxation, less both a $30,000 exemption and regular taxes paid net of all credits. Reserves for losses on bad debts are one such preference item, as are long-term capital gains and accelerated depreciation on leased property. Interest earned on tax-exempt securities and earnings from investment and foreign tax credits are *not* classified as preference items, and are consequently not subject to a second-round swipe by the IRS. Commercial-bank taxes were only mildly and temporarily affected by the Tax Reform Act of 1969, as Table 1 shows, despite tightened restrictions on tax-free transfers to reserves for bad debts (see Box 2). The S&L tax burden burgeoned, however, as a result of both reduced bad-debt allowances and the application of the Minimum Tax. As a result, in 1971 S&Ls paid higher U.S. taxes than commercial banks for the first time in history.[10] The *world-wide* tax burden of commercial banks was slightly higher than that of S&Ls in 1971, however.[11]

What the future holds for taxation of financial institutions is particularly difficult to predict at the moment. The Report of the Ways and Means Committee accompanying the 1969 TRA suggests that Congress did not anticipate that commercial-bank taxes would continue to decline in the 1970s or that the average domestic tax burden of S&Ls would exceed that of commercials. On these grounds, some might conclude that changes in the corporate tax code as it applies to financial institutions will be forthcoming. For example, the Minimum Tax could be amended to fall more heavily on large banks and less heavily on S&Ls.

Difficulties arise with a patchwork approach, however. Tax code changes aimed at financial institutions could have undesirable impacts on other industries. Another problem arises because of the uncertain nature of financial institutions in the years ahead. Thus, Congress might delay any consideration of tax changes until discussion of the reform of financial institutions where taxation questions will no doubt play a key role.

SUMMING UP

In summary, the pursuit of higher profits has resulted in a trimming of the taxman's take at commercial banks in recent years. Because of their ability to reap the tax advantages of equipment leasing and foreign operations, large banks have achieved the biggest tax savings. Relative tax burdens are not as unequal as *domestic* effective tax rates suggest, however, because these ignore *foreign* tax burdens, almost all of which are borne by the largest banks. Nevertheless, the smallest banks continue to pay the highest taxes even after accounting for foreign tax burdens. In addition, S&Ls are currently paying higher U.S. taxes on average than commercial banks. The crystal ball yields a hazy forecast of future tax burdens at financial institutions, however, since tax questions will play a key role in Congressional debates concerning the restructuring of financial institutions and markets.

[10]An ABA subcommittee published a report in 1971 which proposes an "ideal" measure of the tax burden of financial institutions. In *Toward A More Viable Financial System: Recommendations of a Special Committee of the American Bankers Association Submitted to the Presidential Commission on Financial Structure and Regulation,* the tax burden of commercial banks is estimated to be almost three times that of S&Ls once the appropriate corrections are made. For a scathing criticism of this ABA study, see Edward J. Kane, "Taxation of S&Ls and Commercial Banks," *Federal Home Loan Bank Board Journal* 73 (1973): 10–17.

[11]Since S&Ls do not operate branches in foreign countries, their domestic tax burden is equal to their world-wide burden. Data are not yet available for comparing world-wide burdens between banks and S&Ls in 1972.

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