THE PROPOSAL TO TAX INCOME FROM GOVERNMENTAL SECURITIES

I. THE CASE FOR TAXATION

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When the federal income tax was enacted in 1913, it was assumed, without particular inquiry or discussion, that taxing the interest on state and local bonds would constitute taxation of a state instrumentality, forbidden under the rule of *Collector v. Day*.[1] A few years later, to establish a better market for the Liberty Loans, they were made partially or wholly exempt from federal income taxation; the tradition of partial exemption was maintained in later federal debt issues. With the expansion of state borrowing during the 1920's, and of federal borrowing during the 1930's, there were outstanding in 1939 thirty-five billion dollars of governmental issues whose interest was wholly exempt from federal income taxation and thirty-three billion dollars whose interest was exempt from the federal income surtax.

Individual fiscal writers discussed the economic aspects of the problem during the 1920's and early 1930's, but legislative interest in the issue was nil. In 1938 the Treasury Department opened the subject to popular and legislative controversy by its claim that there were no constitutional bars to immediate taxation of the interest on state and local securities, and its recommendation that the interest on future state and local issues be taxed under federal law. Coupled with this recommendation were the proposals that the federal government discontinue issuing tax-exempt securities on its own account, and that future federal issues be made subject to nondiscriminatory state taxation.

Hearings on these proposals were held by a special Senate committee during January and February 1939.[2] These hearings provide a complete source for statistics on the subject and for the arguments on both sides of the issue. The present article summarizes the economic and fiscal arguments and evidence presented by the author

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[1] 11 Wall. 113 (U. S. 1871).

[2] *Taxation of Governmental Securities and Salaries: Hearings before the Special Committee on Taxation of Governmental Securities and Salaries* (Consolidated Report of Hearings) 76th Cong., 1st Sess. (1939).

and others at these hearings in support of the propositions that the practice of issuing tax-exempt federal securities should be discontinued and that the interest on future state and local issues should be subjected to federal taxation, provided that a reciprocal tax right be extended by judicial construction or by specific legislative enactment to the state governments. The constitutional aspects of the issue are treated in a later article.[3]

I.

The basic argument of those who recommend the ending of tax exemption of the interest on government securities is that every tax-exempt bond issued involves a revenue loss to the taxing governments that outweighs any saving of interest to the issuing government. It should be a self-evident proposition that in general no bond buyer will pay more, through lower yield, for tax exemption than such exemption is worth to him.[4] If he can purchase tax exemption for less than it is worth to him, in terms of yield differential, of course he will do so. As will be shown, most if not all bond buyers do purchase tax exemption for much less than it is worth to them. Whatever such bond buyers gain is a net loss to the taxing governments not offset by any interest rate saving to the issuing governments.

The market for tax exemption is definitely limited—much more limited than the market for government bonds which, while providing tax exemption, also yield such financial values as security, approved place on legal lists, and eligibility for sinking funds. We cannot assume that all the earning capital of individual and business income tax payers is potentially convertible into government securities for the purpose of translating taxable income into tax-exempt income, and that the market for tax exemption is coextensive with individual and business earning capital. Most of this individual and business capital represents "operating" or "control" investment, and no tax saving could tempt the owners to substitute government bonds in place of it. Only "nonoperating" individual and business investment funds are potentially in the market for tax exemption. My guess, based upon statistics for individual, business, and institutional holdings of governmental issues, is that the present market for tax exemption in the United States is not much greater than, and possibly less than, the sixty-eight billion dollars of governmental securities now outstanding.

Because of the progressive character of the federal personal income tax rate schedule, the principle of diminishing utility applies to this demand for tax exemption. To the fortunate individual with $5,000,000 or more of taxable income, tax exemption for his "nonoperating" capital is worth, in interest rate differential, four fifths of the current market interest rate. To the business corporation it is worth one sixth of the current interest rate. To the man with $4,000 of taxable income, it

[3] Rouzer, *Legal Problems in Taxing Income from Governmental Securities*, *infra* p. 235.

[4] One exception may be noted to this generalization—if bond buyers willing to pay full value for tax exemption were to evaluate that exemption on the basis of continuing high tax rates or higher future rates, and if such eventuality did not materialize, then the long-run saving in interest to the issuing governments would be greater than the long-run revenue loss to the taxing governments. As will be evident from the argument that follows, this exception, should it occur, would operate to mitigate, not prevent, revenue loss.

is worth one twenty-fifth of the current interest rate. The outstanding supply of governmental securities carrying tax exemption will determine how far down the curve of diminishing utility the marginal value of tax exemption will be found. My contention is that, given the present demand curve for tax exemption as determined by the volume of "nonoperating" individual and business capital, and as affected by the income tax rate schedule and the present supply of governmental debt issues, the marginal value—and hence the interest rate differential—of tax exemption is close to nil. The volume of tax-exempt securities issued during the past twenty years has made tax exemption almost a "free good" and has killed its value to issuing governments. Were tax exemption abolished today, federal, state and local units could issue taxable bonds tomorrow at practically the same interest rates as they did tax-exempts yesterday.[5]

By this I do not mean to imply that governmental issues now enjoy no interest differential over corporate issues. Besides providing tax exemption, governmental issues also yield such financial values as security and approved position on legal lists and for sinking funds. The market for these financial values, which embraces purchases by savings banks, charitable foundations and other agencies to whom tax exemption is valueless, as well as purchases by all individuals willing to pay for security of capital by accepting lower yield, is wider than the market for tax exemption. While demand for these financial values is also subject to the law of diminishing utility, the variation in its marginal utility is much milder than that for tax exemption. I suspect that, with the supply of governmental securities on the market today, the marginal utility of the financial values of these securities may well be higher than the marginal value of tax exemption inherent in these securities. If this should be so, then any interest rate differential on governmental issues is determined by their financial values and not by tax exemption. If the marginal utility of tax exemption is still somewhat greater than that of the financial values of governmental securities, then the net market worth of tax exemption is only the spread between the two values. The yield differential of governmental bonds assumed by most observers to be a measure of the value of tax exemption is in reality wholly or in major part a measure of their special financial value.[6]

How can the conclusions presented above be reconciled with the statement generally made by defenders of tax exemption that such exemption saves security-issuing governments .6% interest on every bond they issue? No reconciliation is possible.

[5] If tax exemption were to be denied to all future issues of governmental securities, while outstanding issues continued to enjoy the privilege, the gradual reduction of the supply of tax-exempt securities would slowly raise the marginal value of exemption. After a period of years, this marginal value would be quite high, and the remaining supply of tax-exempts would enjoy a substantial yield differential. This consideration does not constitute an argument for continuing exemption, for it would be the *abolition* of exemption for future governmental issues that would give value to the exemption of the remaining older issues.

[6] The argument developed above is considerably more extreme than the one I presented a year ago to the Special Committee. Then I accepted the Treasury's position that there existed a .4% "tax exemption" interest differential. Now I am persuaded that the Treasury economists erred in interpreting a "financial value" interest differential as a "tax exemption" interest differential.

This .6% figure is derived from a report made by Professor Harley L. Lutz of Princeton University to the Special Committee last year. His argument for this figure was that it constituted an average of the judgment of "expert market opinion," and that it was supported by observation of the yield difference between a group of selected government bonds and another group of corporate issues. The Treasury economists showed that the range of judgments of the "expert market opinion" was from .3% to over 1%, so that a .6% "average" was statistically meaningless, and they attacked Professor Lutz's choice of bond lists used for comparison. The interest differential they offered was .4%. But they also erred, in my opinion, in attributing this differential to tax exemption rather than to the special financial values of governmental securities.

2.

Defenders of tax exemption argue that while the federal government loses revenue because of the exemption of state and local issues, the state and local governments gain by the interest differential, though somewhat less than the federal government loses.[7] The mayors and fiscal officials of hundreds of cities protested to the Special Committee last year that elimination of the tax exemption of local securities would impose a crushing additional cost burden upon their governments, which would be passed along only to the already overtaxed property owners. Of course, this argument is vitiated by the finding that the "tax exemption" interest differential, and hence the profit of tax exemption to issuing governments, is negligible. Cities, towns, villages, counties and state governments would have to pay nothing, or little more, in debt service if the exemption of interest on their securities from federal taxation were abolished.

But assuming that there were some gain in tax exemption to these governments, would this justify a continuation of tax exemption? I say no. The state and local governments are simply setting up a claim of vested interest in a fiscal defect that they believe, mistakenly, operates to their advantage. Were there any gain to these governments through tax exemption, the solution would be, not a continuance of tax exemption, but a substitution of grants-in-aid or distributed revenues to compensate for the extra debt service cost.

[7] Last year Professor Lutz carried his argument to an extreme length, and argued that the annual interest differential gain on tax exemption was $79,000,000 greater than the tax loss. *Taxation of Governmental Securities and Salaries, supra* note 2, at 93-202. Few defenders of tax exemption go to this length. The argument rests on the improbable first premise that bond buyers in general pay more for tax exemption than its total (not merely marginal) value. Moreover, the statistics and calculations that lay behind this $79,000,000 figure were subjected to sharp challenge by the Treasury's economists. The latter disputed Professor Lutz's statistics purporting to show a .6% interest differential between first-grade municipals and first-grade taxable bonds, and presented tabulations that indicated that the interest differential between such issues varied widely from time to time according to market judgment of the relative security of such issues; indeed, at times in 1933, 1934, 1937, and 1938, the differential favored taxable issues. Secondly, the Treasury economists pointed out that, even on the basis of a .6% differential, Professor Lutz had undercalculated the tax loss to the taxing governments, and overcalculated the interest saving to the issuing governments. *Id.* at 575-646.

3.

At whatever point we place the marginal value of tax exemption—at zero or at some higher figure—it must be granted that all inframarginal purchasers of tax exemption realize a gain upon the purchase. For individuals, this profit is greater or less according to whether the purchaser's income is large or small, because of the progressive character of the federal personal income tax rate schedule. As stated earlier, for an individual with $5,000,000 of taxable income, the saving is equal to four fifths of the current market yield on his capital minus any "tax exemption" differential that may exist, while for individuals with $4,000 of taxable income the saving is equal to only one twenty-fifth of such return. In short, the profit of tax exemption to the purchaser of government securities is progressive according to his income bracket. And yet the cost, if any, of such tax exemption, in terms of interest differential, is the same to all purchasers. With our present income tax system, the sale of tax-exempt securities constitutes a bounty granted to rich individuals for being rich.

The "progressive" nature of governmental security tax exemption serves to weaken the "progressive" character of the personal income tax rate schedule. The heavier the tax rates in the higher income brackets, the greater the inducement to avoid the tax by investing "nonoperating" capital in tax-exempts. Some writers have argued that the presence of this avenue of escape "nullifies" progressive income taxation. Such an argument rests on the assumption that rich men could be induced to invest all of their capital in tax-exempt securities. This is a false assumption, as was pointed out earlier in this article, since only "nonoperating" and "noncontrol" capital—usually a small fraction of a rich man's wealth—is susceptible of transfer into tax-exempt securities. But even though progressive personal income taxation is not "nullified" by the existence of tax-exempt securities, it is rendered uneven, and therefore unjust, in the distribution of its burdens.

4.

Finally, we may note the argument that it is the rich who, out of their "nonoperating" and "noncontrol" funds, should supply the "venturesome" capital for new enterprises that entail risk but hold forth the greatest promise of economic advance for the nation. This proposition is one of the many in the field of economics that can only be asserted, without possibility of proof or disproof. If any weight is given to it, we have still another case against exemption of governmental securities. For, unquestionably, a strong inducement is offered to the rich to seek the security of governmental issues, with their bounty of tax exemption, rather than the taxable risk of new ventures. Because of the existence of tax-exempt securities, new ventures to some extent must fail to obtain the financial support they deserve, or they must gain such support from investors in lower income brackets, who should be the ones to invest for security rather than risk.