

to be profitably bought by persons in the highest tax bracket. The yield on tax exempts would tend toward 80 percent of the yield on taxables. However, as the supply of tax exempts increased, the demand of buyers in the lower income tax brackets would have to be tapped. If buyers in the lowest tax brackets are brought in, the yield will rise to 80 percent of the yield on taxables. In this instance, they are the marginal buyers, that is, those whose income after tax is the same whether they buy tax-exempt or taxable securities. Since this is an undifferentiated market, all buyers of tax-exempt securities receive the same yields as the marginal buyers.

This is a somewhat simplified statement of investor choices. One could postulate that an investor in the 70-percent bracket chooses between a taxable bond, a tax-exempt bond, and an equity—half of the yield of which would be realized as capital gain. Because of the attraction of the capital gain feature of the equity, the investor might demand a better return on a tax-exempt bond than 1.5 percent even though comparable taxable bonds are yielding 5 percent. The point of the foregoing argument still applies, that is, the lower the tax rate applicable to an individual the higher must be the yield on tax-exempt bonds for these to be an attractive investment.

As the volume of State and local government borrowing rises, State and local securities must appeal to lenders with medium or low marginal tax rates, that is, the yield on State and local securities must move closer to the yield on comparable taxable securities. This means that the lender whose marginal tax rate is higher than the rate applicable to the marginal buyer will find that his tax saving is greater than the amount of interest foregone. The standard assumption of free capital markets and rational investors implies that there would be a negligible number of investors who would buy tax-exempt securities when the tax saving to them is less than the loss of interest. In the aggregate, therefore, it can be expected that the interest cost saving to State and local government borrowers due to tax exemption is less than the revenue loss which results from the exemption feature. Sections B and C provide some evidence on the yield differential and interest cost savings to State and local governments under the assumption that these governments continue to borrow from the same borrowers.

It is possible that in the absence of exemption the patterns of savings flows in capital markets would be very different than they are now, and this in turn could mean a variety of further changes which are not easily predictable. Section E offers some comment on this matter of possible shifts of existing savings flows.

B. EVIDENCE ON THE YIELD DIFFERENTIAL IN RECENT YEARS

Given the total stock of all securities, the differential in yield between taxable and tax-exempt securities is influenced by the supply of tax-exempt securities; the tax rates applicable to each bracket; the wealth position of individuals in each income bracket and investment preferences among various investors. Over the decades the differential has widened or narrowed in response to pressures from these forces.²

² Identifying the precise effect of the variables which have influenced the differential in the past presents many difficulties. In particular, statistical evidence on the two latter variables is quite meager.