

TAXABLE BOND ALTERNATIVE FOR STATE
AND LOCAL GOVERNMENTS

PREPARED FOR THE USE OF THE
COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION



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TAXABLE BOND ALTERNATIVE FOR STATE AND LOCAL GOVERNMENTS

Present Law

Interest payments received from debt obligations issued by State and local governments and their instrumentalities generally are exempt from Federal income tax (section 103 of the Code). The exemption has been provided since the adoption of Federal income tax in 1913. In contrast, interest payments on virtually all debt obligations issued by the Federal Government are subject to Federal income tax.

The tax law presently places no restrictions or conditions on issuing tax-exempt general revenue and general obligation State and local government bonds or on the use of the proceeds from these bonds. However, in the case of industrial development bonds¹ the tax-exempt status is available only for small issues of industrial development bonds (up to \$1 million annually) or where the total project costs involved are not over \$5 million. Additional exemptions also apply to site purchases and development for industrial parks and to several types of business activities carried on by governmental units, such as stadiums and coliseums, residential housing, pollution control and waste disposal, and transportation, terminal and storage facilities.

Tax-exempt status also is not available for arbitrage bonds issued by State and local governments. Arbitrage bonds, in general, are issued at the low tax-exempt bond interest rate, but the proceeds are invested in Federal Government (or other) bonds whose higher rates of interest are not taxed when held by State and local governments. Tax exemption was withdrawn from State or local bonds used for this purpose because they often produce income for the State or local government and may not be used to finance a government function.

Background: The Tax-Exempt Bond Market

Capital outlays by State and local governments, and bond issues to finance them, have increased sixfold since 1950. In addition to traditional expenditures for schools and other public buildings, highway projects and sewer and water projects, substantial capital outlays in recent years have been made for transit systems, public pollution control devices and industrial activity through industrial revenue bonds. As is indicated by table 1, State and local government bond issues have increased from about 10 percent to nearly 25 percent of the total funds raised in capital markets since 1947. Over the same period, funds raised by corporations in the capital markets have increased from about one-third of the total to nearly 45 percent of the total.

¹ Present law defines an industrial development bond as a State or local government obligation a major portion of the proceeds of which is to be used for the benefit of a taxable business, and the payment of which is secured by an interest in property used by a taxable business or is to be derived from revenue of such a property.

TABLE 1.—ISSUES OF SECURITIES BY PUBLIC AND PRIVATE ORGANIZATIONS, 1947-72

[In millions of dollars]

Year	Total	Corporations				Government bonds		
		Bonds	Common stock	Preferred stock	Corporate total	Total	U.S. Government	State and municipal
1947.....	19,941	5,036	779	762	6,577	13,364	10,589	2,324
1948.....	20,250	5,973	614	492	7,078	13,172	10,327	2,690
1949.....	21,110	4,890	736	425	6,052	15,059	11,804	2,907
1950.....	19,893	4,920	311	631	6,361	13,532	9,687	3,532
1951.....	21,255	5,691	1,212	338	7,741	13,523	9,778	3,189
1952.....	27,209	7,601	1,369	564	9,534	17,675	12,577	4,401
1953.....	28,824	7,083	1,326	489	8,898	19,926	13,957	5,553
1954.....	29,765	7,488	1,213	816	9,516	20,249	12,532	6,969
1955.....	26,772	7,420	2,185	635	10,240	16,532	9,628	5,977
1956.....	22,495	3,002	2,301	636	10,339	11,467	5,517	5,446
1957.....	30,571	9,557	2,516	411	12,834	17,687	9,601	6,958
1958.....	34,443	9,653	1,334	571	11,558	22,885	12,063	7,449
1959.....	31,074	7,190	2,027	531	9,748	21,326	12,322	7,631
1960.....	27,541	8,081	1,664	409	10,454	17,337	7,906	7,230
1961.....	35,527	9,420	3,294	450	13,165	22,363	12,253	8,360
1962.....	29,956	8,969	1,314	422	10,705	19,251	8,530	8,558
1963.....	35,199	10,856	1,011	343	12,211	22,989	10,827	10,107
1964.....	37,122	10,865	2,679	412	13,957	23,165	10,656	10,544
1965.....	40,108	13,720	1,547	725	15,992	24,116	9,348	11,143
1966.....	45,015	15,561	1,939	574	18,074	25,941	8,231	11,089
1967.....	68,514	21,954	1,959	235	24,798	43,716	19,431	14,288
1968.....	65,592	17,383	3,946	627	21,956	43,555	18,025	16,374
1969.....	52,747	18,348	7,714	682	25,744	25,093	4,765	11,460
1970.....	88,665	30,315	7,240	1,390	38,945	49,721	14,831	17,762
1971.....	106,430	31,883	10,459	3,683	46,025	60,406	17,325	24,370
1972.....	96,431	25,896	9,694	3,357	41,957	54,523	17,080	23,028

Source: "1973 Statistical Supplement to the Survey of Current Business," pp. 103-104.

From 1960 to 1972 State and local government long-term bond issues have increased from \$7.23 billion to \$22.94 billion—more than threefold (see table 2). These capital issues have been used for schools, water and sewer projects, highway projects, veterans aid, public housing, industrial aid, and other uses. The relative importance of these activities has varied during the 13-year period. Bonds issued for school purposes have more than doubled, but the relative importance of school construction has decreased from 34 percent of the total in 1960 to 23 percent in 1972. Water and sewer projects, highway projects and public housing have experienced two to threefold increases in absolute levels of bond financing, but their relative importance also have declined among all State and local government activities financed through bond issues.

TABLE 2—STATE AND MUNICIPAL BONDS SOLD BY PURPOSES 1960-72

[In thousands]

Year	School	Water and sewer	Highway bridge and tunnel	Veterans aid	Public housing authority	Industrial aid	Other	Total
1972.....	\$5,348,943	\$2,341,441	\$2,082,257	\$259,700	\$953,960	\$470,695	\$10,378,836	\$22,940,843
1971.....	5,723,009	3,617,497	2,717,903	307,300	1,000,435	219,510	10,793,380	24,369,536
1970.....	4,583,101	2,329,706	1,497,392	213,000	130,790	47,593	8,560,051	17,761,645
1969.....	3,174,829	1,357,049	1,571,846	147,000	397,885	24,020	4,737,622	11,460,251
1968.....	4,717,957	1,837,228	1,564,259	155,000	524,810	1,585,269	5,939,808	16,374,332
1967.....	4,454,022	1,947,162	1,140,352	165,000	477,510	1,325,147	4,773,751	14,287,949
1966.....	3,719,296	1,637,418	1,493,202	90,000	439,705	504,450	3,204,257	11,088,939
1965.....	3,615,745	1,904,759	955,254	50,000	464,045	211,631	3,870,754	11,084,188
1964.....	3,377,700	1,702,849	954,293	120,000	635,745	191,351	3,562,133	10,544,127
1963.....	3,100,241	1,793,406	1,000,348	25,000	254,015	119,120	3,214,534	10,106,633
1962.....	3,001,795	1,319,628	1,146,000	125,000	381,800	84,317	2,499,669	8,558,200
1961.....	2,713,707	1,354,650	1,204,062	477,676	188,810	71,711	2,348,695	8,359,512
1960.....	2,432,748	1,007,859	1,072,944	200,000	382,755	46,357	2,086,317	7,229,500
Percentage distribution (selected years): ¹								
1972.....	23.3	12.4	9.1	1.1	4.2	2.1	47.9	100
1970.....	27.5	13.1	8.4	1.2	.7	.3	43.2	100
1965.....	32.6	17.2	8.7	.5	4.2	1.9	34.9	100
1960.....	33.7	13.9	14.8	2.8	5.3	.7	23.9	160
Percentage change 1960-72..	220	282	194	130	250	1,002	526	317

¹ Details may not add to total due to rounding.

Source: Bond Buyer's "Municipal Finance Statistics," vol. 11, May 1973.

Industrial aid programs, which are financed through industrial revenue bonds, increased from \$47 million in 1960 to \$1.6 billion in 1968; they decreased to \$24 million in 1969 (because of restrictions in their size provided in the 1969 Tax Reform Act) but rose to \$471 million in 1972. From 1960 to 1972, the increase was tenfold, but the 1968 level was more than 30 times the 1960 level. In table 3 are estimates of gross fixed capital formation by type, by State and local governments, from the period from 1958 to 1973.

TABLE 3.—STATE AND LOCAL GOVERNMENT GROSS FIXED CAPITAL FORMATION BY FUNCTION

[Billions of dollars]

	Total	Highways	Education	Sewer and water	Health	Airports and water terminals	All other
1958.....	13.8	5.9	3.5	1.5	0.4	0.1	2.3
1959.....	14.3	6.2	3.4	1.6	.4	.4	2.3
1960.....	14.3	5.8	3.7	1.6	.4	.4	2.5
1961.....	15.5	6.2	4.0	1.7	.4	.4	2.8
1962.....	16.3	6.8	4.0	1.8	.4	.4	2.9
1963.....	18.0	7.5	4.6	1.9	.4	.4	3.1
1964.....	19.5	7.6	5.2	2.4	.4	.4	3.5
1965.....	21.4	8.1	5.8	2.6	.5	.5	4.0
1966.....	23.8	9.0	7.1	2.5	.5	.5	4.2
1967.....	26.0	9.3	7.9	2.5	.7	.6	5.1
1968.....	28.5	10.0	8.1	3.2	.3	.8	5.6
1969.....	29.2	9.9	8.1	2.9	.9	.8	6.6
1970.....	29.8	10.7	8.1	2.8	.9	.9	6.4
1971.....	31.4	11.2	8.3	3.3	1.0	.7	6.8
1972.....	32.2	11.0	8.6	3.4	1.1	.8	7.3
1973.....	34.9	11.2	9.8	3.9	1.1	.8	8.2

Note.—Details may not add to totals because of rounding.

Source: Paul Schneiderman, "State and Local Government Gross Fixed Capital Formation," in "Survey of Current Business," October 1975, p. 23.

One of the effects of the substantial increase in the use of industrial revenue bonds which has been of concern to State and local governments is the market congestion which results from the increased number of bonds competing for buyers in the tax-exempt market. This congestion increases tax-exempt interest rates and narrows the interest differential between taxable corporate bonds and tax-exempt State and local bonds.

Interest yields on both corporate taxable bond issues and on tax-exempt State and local government issues have increased substantially since the end of World War II. As shown in table 4, average corporate yields in 1947 were 2.86 percent, and average municipal yields were 1.93 percent. By 1975, average corporate yields had risen to 9.46 percent and average municipal yields to 7.05 percent. Through this period, the ratio of government tax-exempt yields to corporate taxable yields has fluctuated between 64 percent and 80 percent. From 1969 to 1975, the ratio has varied between 67 percent and 79 percent—the lowest level in 1973 and the highest in 1969. The higher ratios have taken place when corporate or government demand for funds has increased or when a tight monetary policy has prevailed.

TABLE 4.—COMPARISON OF YIELDS ON CORPORATE AND MUNICIPAL BONDS, 1947-75

(In percent)

Year	Average corporate yield	Average municipal bond yield ¹	Ratio of municipal to corporate bond yields
1947	2.86	1.93	0.675
1948	3.08	2.35	.763
1949	2.95	2.15	.726
1950	2.86	1.90	.664
1951	3.08	1.97	.640
1952	3.19	2.20	.690
1953	3.43	2.75	.800
1954	3.16	2.35	.755
1955	3.25	2.49	.766
1956	3.57	2.80	.784
1957	4.21	3.25	.779
1958	4.16	3.18	.764
1959	4.65	3.53	.770
1960	4.73	3.51	.742
1961	4.66	3.46	.742
1962	4.62	3.14	.680
1963	4.50	3.18	.707
1964	4.57	3.20	.700
1965	4.64	3.28	.707
1966	5.34	3.83	.717
1967	5.82	3.96	.680
1968	6.51	4.47	.687
1969	7.36	5.79	.787
1970	8.51	6.34	.745
1971	7.94	5.46	.688
1972	7.63	5.25	.688
1973	7.80	5.22	.669
1974	8.92	6.19	.689
1975	9.46	7.05	.745

¹ From Bond Buyer, 20 bonds.

Source: "1973 Statistical Supplement to the Survey of Current Business," p. 105, for 1947 through 1972; Federal Reserve Bulletin, February 1976, p. A28 for 1973-75.

Problems in the Present Tax-Exempt Market

In order to attract investors into the tax-exempt market, interest yields on tax-exempt issues rise to the level where they are equal to the yield after taxes on taxable corporate bonds (assuming the same risk). For individual taxpayers in the 70 percent marginal tax bracket

a ratio of tax-exempt to taxable interest rates as low as 30 percent would equal the after-tax yield on a taxable bond. For an individual in the 50-percent tax bracket, the ratio must be at least 50 percent, and the ratio must be 72 percent for a taxpayer in the 28-percent bracket. Table 5 shows the relationship among income tax brackets, taxable bond yields and after-tax yields, which are the rates at which an investor would be indifferent between taxable and tax-exempt bonds, assuming the same risk.

TABLE 5.—AFTER-TAX YIELD ON TAXABLE BONDS, BY SELECTED INCOME TAX BRACKETS

(In percent)						
Income tax bracket	Taxable bond yields					
	10	9	8	7	6	5
70.....	3.0	2.7	2.4	2.1	1.8	1.5
60.....	4.0	3.6	3.2	2.8	2.4	2.0
50.....	5.0	4.5	4.0	3.5	3.0	2.5
40.....	6.0	5.4	4.8	4.2	3.6	3.0
35.....	6.5	5.9	5.2	4.6	3.9	3.2
30.....	7.0	6.3	5.6	4.9	4.2	3.5

Because there are relatively few persons in the highest tax bracket, it is necessary to increase the yield on tax-exempt issues relative to taxable corporate issues substantially above the 30-percent ratio in order to attract sufficient investors. The higher yield on tax-exempt bonds (relative to the after-tax yields on taxable issues) attracts the more numerous taxpayers in the somewhat lower marginal tax brackets who then find tax-exempt issues desirable investments. This usually occurs as the volume of tax-exempt offerings increases. This also usually means that tax-exempt bonds are a larger share of total issues offered, and this in turn means that the ratio of tax-exempt to taxable interest rates probably increases to attract individual investors with lower marginal tax rates.

However, as the differential between tax-exempts and taxables is reduced in order to attract new investors, the higher tax-bracket investors receive a windfall since they would hold tax-exempt bonds even at a lower rate of interest. The amount of the windfall is the difference between the interest yield that would be sufficient to stimulate their purchase of a tax-exempt issue and the higher current market interest yield that was subsequently necessary to bring the additional investors from a lower tax rate bracket into the tax-exempt bond market. The greater the difference between the current market interest rate and the interest rate which would just induce an investor to purchase tax-exempt issues, the greater is the windfall return to the investor.

The graph on chart I, which shows the fluctuations in the municipal-corporate bond yield ratios (listed in the third column of table 4) illustrates this point. The bottom line which is drawn at the 30-percent ratio shows the ratio at which an individual taxpayer in the 70-percent marginal tax bracket would be indifferent between taxable and tax-exempt issues, that is, his after-tax yield is identical for both types of issues. For a corporate taxpayer, the indifference ratio is 52 percent, in terms of the statutory tax rate for taxable income over \$25,000 (over \$50,000 in 1975 and 1976). For a corporation with

an effective tax rate below 48 percent, the indifference ratio would be lower. For each year covered by the graph, the windfall (or subsidy) element is the difference between the ratio and the indifference line, and the windfall varies as the ratio rises and falls.



State and local governments often prefer longer-term issues to finance long-term projects and, as a result, the interest yields and the ratios of tax-exempt to taxable yields tend to be higher on these issues. Consequently, the windfall received by some taxpayers at these yields is higher, but in the existing situation these yields are necessary to attract sufficient numbers of individual investors to the tax-exempt market.

In the past, individuals have not always been major purchasers of tax-exempts, but in 1969, 1974 and 1975, as can be seen in table 6, individuals purchased more than half of the net new issues that were marketed. In 1969, individuals purchased virtually all of the net new issues.

TABLE 6.--ACQUISITIONS OF ANNUAL NET ISSUES OF STATE AND LOCAL GOVERNMENT BONDS, BY TYPE OF HOLDER, 1960-76

[In billions of dollars]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
Total.....	5.3	5.1	5.4	5.7	6.0	7.3	5.6	7.8	9.5	9.9	11.2	17.6	14.4	13.7	17.4	15.4
Households.....	3.5	1.2	-1.0	1.0	2.6	1.7	3.6	-2.2	-8	9.6	-8	-2	1.0	4.3	10.0	10.1
Corporate business.....	-3	(1)	.3	1.1	-1	.9	-1.0	-3	.5	-1.0	-6	1.0	1.0	-1	.6	-2
State and local government general funds.....	(1)	(1)	-2	-2	-1	-1	(1)		(1)	.1	.2	-3	.2	.2	.2	-1
Commercial banking.....	.6	2.8	5.7	3.9	3.6	5.2	2.3	9.1	8.6	.2	10.7	12.6	7.2	5.7	5.5	1.3
Mutual savings banks.....	(1)	(1)	-2	-1	(1)	-1	-1	(1)	(1)	(1)	(1)	.2	.5	(1)	(1)	.6
Life insurance companies.....	.4	.3	.1	-2	-1	-3	-4	-1	.2	(1)	.1	.1	(1)	(1)	.2	.6
State and local government retirement funds.....	.2	-1	-5	-5	-4	-3	-1	-1	(1)	-1	-3	.1	-1	-6	-6	1.1
Other insurance companies.....	.8	1.0	.8	.7	.4	.4	1.3	1.4	1.0	1.2	1.5	3.9	4.8	3.9	1.8	2.1
Brokers and dealers.....	.1	-1	.2	(1)	.2	-2	(1)	(1)	(1)	-2	.6	.1	-1	.2	-4	-1

¹ Less than \$50,000.

Source: Federal Reserve flow of funds data.

Because of the attraction of tax exemptions, commercial banks and insurance companies (chiefly casualty and some life insurance companies) have been major sources of funds for these bonds. Commercial banks have been the dominant purchasers, holding about 45 percent of the outstanding issues at the end of 1975. (See table 7.) They have purchased half or more of the net new issues in most of the years since 1960 (table 6). Since the statutory rate on corporate taxable income is 48 percent, yields on tax-exempt bonds need to be only slightly above 52 percent of taxable bonds to attract commercial banks.

TABLE 7.—OWNERSHIP OF MUNICIPAL SECURITIES YEAREND OUTSTANDINGS, SELECTED YEARS

[Dollar amounts in billions]

Year	Total	Households		Commercial banks		Nonlife insurance		All other	
		Billions of dollars	Percent of total	Billions of dollars	Percent of total	Billions of dollars	Percent of total	Billions of dollars	Percent of total
1960.....	\$70.3	\$30.3	43.5	\$17.7	25.0	\$8.1	11.4	\$14.2	20.1
1965.....	100.3	36.4	36.3	33.9	33.8	11.3	11.3	13.7	13.7
1970.....	144.5	45.6	31.6	70.2	48.6	17.8	12.3	10.9	7.6
1974.....	204.1	60.3	29.6	100.3	49.2	30.7	15.1	12.8	6.3

Source: Federal Reserve Board, flow of funds data.

However, commercial banks have a strong preference for assets with short-term maturities, i.e., less than 5 years, because their liabilities also are short-term. As a result, they dominate the short-term tax-exempt market, and the ratio of yields on short-term issues generally has averaged around 52 percent.

State and local governments which have substantial portions of their outstanding debt in short-term issues find themselves particularly vulnerable to short-term money market fluctuations, especially when the markets are characterized by high interest rates and/or tight money. Also, the larger the proportion of long-term issues (i.e., a longer average maturity) for any given volume of debt, the smaller the amount of annual refundings. This also means a reduced vulnerability to short-term money market changes.

With a shorter average maturity of debt that requires refunding, the local government must re-enter the money market more frequently and for greater amounts of money. In tight money periods, the larger amounts that must be raised add to the tightness of the general monetary situation. The higher rates of interest prevalent at such times raise the interest costs and also may force many governments up against statutory ceilings on rates of interest that may be paid. With a longer average maturity of the debt, although refundings will encounter identical money market conditions, a smaller proportion of the debt will require refinancing at those times. As a result, a smaller proportion of the debt is liable to encounter risks of a tight market in any year, and the borrowing structure of the government has more flexibility and diversity which enables it to better protect itself against tight money, recessions and other forms of financial stress.

The budget of a government can be affected adversely by having to incur substantial borrowings when interest rates are high. With a given level of revenues, the higher debt service charges caused by the

high interest rates reduce the amount of funds that can be spent for other local programs. At the municipal government level, the local programs basically are education, public safety and human welfare where the costs normally are not characterized by much flexibility. In addition, a relatively short average debt maturity is more burdensome for local governments in recessions when they may find it necessary to borrow to meet revenue shortfalls—in addition to necessary refinancing—or must reduce local outlays because the relative burden of debt service has reduced their fiscal flexibility.

Another important effect of the present tax-exempt financing arrangements is that the markets for State and local bonds are largely closed for certain classes of institutional investors for whom long-term bond issues with relatively high long-term rates otherwise would be desirable investments because of the relatively low risk generally associated with such issues. However, these organizations (largely retirement and pension funds and charitable, religious and educational institutions) do not purchase many tax-exempt issues because the income on their investments is also tax-exempt. These bonds would be attractive to these organizations, however, if they were taxable and had higher yields, because of their relative safety and the opportunity they would present for greater diversification of risk in their investment portfolios.

Proposals and Previous Committee Action

Several proposals have been made to provide a taxable bond with an interest subsidy by the Federal Government as an alternative to tax-exempt financing of State and local government capital outlays. The differences among these proposals primarily involve the rate of the Federal Government interest subsidy to be allowed; the existence and identity of Federal requirements or conditions to be imposed in order to qualify for the interest subsidy; the manner in which the Federal interest payments should be made; and the proper treatment of the Federal funds to pay this interest under the new Congressional budget procedures.

1969 House proposal

In 1969, the House version of the 1969 Tax Reform Act included a Federal subsidy for taxable bonds that could be issued at the election of the State or local government. The Federal subsidy was to vary between 25 and 40 percent of the yield on the taxable bond (between 30 and 40 percent prior to January 1, 1975). The subsidy ratio was to be determined quarterly by the Secretary of the Treasury, who would set the rate after considering the relationship of tax-exempt and taxable yields in view of prevailing money market conditions. No other requirements or conditions were established for any State or local obligation to be eligible for the Federal interest payment if taxable bonds were issued. A "dual coupon" system could be elected under which the Federal share of the interest payment would be paid directly to the bondholder through a separate coupon. This amount was to be paid even if the issuing government defaulted on its interest payment. A permanent appropriation was to be established for Federal subsidy payments.

Treasury proposal

In 1973 and again this year the Treasury Department has recommended an elective taxable bond alternative with a fixed subsidy of 30-percent of the net interest cost. If that net interest cost exceeds 12 percent, however, no interest subsidy would be paid on the excess. The subsidy would be adjusted to reflect any discount or premium and Federal administrative expenses. The subsidy would be assured for the life of the issue, irrespective of any changes in the law that affect subsequent issues. Only obligations presently eligible for tax exemption (under section 103(a)(1) which are issued through competitive public offerings (rather than negotiated directly with the lenders) would be eligible for the taxable option. Obligations maturing within one year, those with unrealistically high net interest expenses (as determined by the Treasury Department), and those held by State and local governments or by agencies owned in part or all by the Federal Government would also not be eligible. In most cases the subsidies could be obtained automatically through certification that the statutory requirements were fulfilled. The interest subsidy would be paid directly to the paying agent of the issuing government without any dual coupon option as in the 1969 bill. Treasury's proposal makes no recommendation regarding how the appropriation of funds for the interest subsidy should be provided.

H.B. 11214 (introduced by Mr. Russ) and S. 2800 (introduced by Senator Kennedy)

Each of these bills establishes a 40 percent fixed Federal interest subsidy for taxable State and local debt obligations. Each bill extends the subsidy to any taxable State or local bonds, other than those guaranteed by the Federal Government, which would otherwise qualify for tax exemption under the code (sec. 103(a)). Issuing governments are given an entitlement to whatever Federal funds are needed to finance interest payments. The funds to fulfill the entitlement are to be appropriated annually. Payments are to be made to the issuing State or local government or to a paying agent of the issuing government. The bill also establishes a Municipal Technical Assistance Office within the Department of Housing and Urban Development to undertake research and to provide technical assistance to State and local governments concerning municipal capital market management and budgetary planning.

H.R. 12774 (introduced by Mr. Ullman and Mr. Conable)

This bill establishes an election in the Internal Revenue Code for State and local governments to issue taxable bonds and other debt obligations with the Federal Government paying 35 percent of the net interest cost. All State and local obligations (other than industrial development bonds and arbitrage bonds), which are or would be exempt from tax under the code, are to be eligible for this taxable bond alternative. However, obligations held by related entities (such as related pension funds) are to be eligible for the election only if those obligations are issued through a competitive public offering. The bill establishes an entitlement to the Federal funds needed to finance the interest payments. Funds are to be appropriated annually to fulfill the entitlement. The Federal interest subsidy is to be paid to an issuing government (or its paying agent) which will act as paying agent for

the Federal Government. The Federal Government is not to be liable for its portion of the interest until the issuing government pays the remaining interest.

Areas for Committee Consideration

Economic Impact of Subsidized Taxable Bond Alternative

Impact on State and local government taxable bond issues.— If a taxable bond option were available, State and local governments could be expected to issue them, other things being equal, as long as the interest rate they have to pay minus the Federal subsidy is less than (or equal to) the interest rate they would have to pay if they issued tax-exempt securities. For example, a State and local government that had to pay 6 percent on its tax-exempt securities would be indifferent between tax exempt obligations and taxable obligations with a 35 percent subsidy if the interest rate on the taxables were 9.2 percent (9.2 percent minus the 3.2 percent resulting from the 35-percent Federal subsidy leaves a net cost of 6 percent to the State or local government). If the interest rate on the taxable bond is less than 9.2 percent, the State and local governments would prefer taxable issues.

Taking into account actual market yields, tax-exempts currently are yielding about 6 percent, and taxable corporate bonds currently are yielding slightly over 9 percent. Probably taxable State and local government bonds would initially (although probably not in the long run) require a slightly higher interest rate than would corporate securities. Therefore, given the present corporate rate of about 9 percent, it is reasonable to expect that with a 35-percent subsidy the taxable State and local bond interest rate would reach an equilibrium somewhere between 9 and 9.5 percent. This means that taxable State and local securities would be attractive to State and local governments but would not be so attractive as to induce State and local governments to switch entirely to taxable issues. The Treasury staff and the Joint Committee staff have estimated that with a 35-percent subsidy rate approximately \$200 million worth of short-term and \$2.9 billion of long-term taxable bonds would be issued in the first full year. This and similar estimates for other subsidy rates are shown in table 8 below.

TABLE 8.—ESTIMATED AMOUNT OF TAXABLE MUNICIPAL BONDS ISSUED, TAXABLE INTEREST, INCREASED FEDERAL INCOME TAX LIABILITY AND AMOUNT OF FEDERAL SUBSIDY, BY SUBSIDY RATE (1ST FULL YEAR EFFECT)

[Millions of dollars]

Subsidy rate	Average tax rate on taxable interest (percent)	Short-term maturities				Long-term maturities				Total		Net cost to the Treasury
		Amount of taxables issued	Taxable interest (0.675)	Tax	Treasury subsidy	Amount of taxables issued	Taxable interest (0.092)	Tax	Treasury subsidy	Tax	Treasury subsidy	
30 percent.....	25.0					1,400	128.8	32.2	38.6	32.2	38.6	6.4
35 percent.....	27.5	200	15.0	4.1	5.3	2,900	266.8	73.4	93.4	77.5	98.7	21.2
40 percent.....	30.0	500	37.5	11.3	15.0	4,500	414.0	124.2	165.6	135.5	180.6	45.1
45 percent.....	32.5	1,000	75.0	24.4	33.8	6,200	570.4	185.4	256.7	209.8	290.5	80.7
50 percent:												
Individual.....	35.0	1,500	112.5	39.4	56.3	7,200	662.4	231.8	331.2	271.2	387.5	
Corporate.....	48.0	13,000	975.0	468.0	487.5	6,500	598.0	287.0	299.0	755.0	786.5	
Total.....		14,500	1,087.5	507.4	513.8	13,700	1,250.4	518.8	630.2	1,026.2	1,174.0	147.8

The estimated reduction in State and local interest costs resulting from the taxable subsidy program (discussed more fully below in the section on "Benefits and Market Adjustments") is shown in the bottom row of table 9 below.

TABLE 9.—ANNUAL COSTS AND BENEFITS OF TAXABLE MUNICIPAL BOND PLAN WITH 35 PERCENT SUBSIDY
[Millions of dollars]

	Total for 10 years	Year									
		1	2	3	4	5	6	7	8	9	10
Gross subsidy cost.....	6,327	99	202	311	425	545	671	803	942	1,088	1,241
Revenues generated.....	4,970	77	159	244	334	428	527	631	740	855	975
Net subsidy cost.....	1,357	21	43	67	91	117	144	172	202	233	266
Reduction in State and local interest costs.....	10,053	157	321	494	676	866	1,066	1,276	1,497	1,728	1,972

Impact on bond purchasers.—The likely composition of investors in State and local taxable securities depends primarily on the level of interest subsidy chosen. At a 35-percent subsidy rate, it is estimated that approximately 70 percent of securities of the taxable State and local issues will be held by taxable investors and about 30 percent by tax-exempts. Thus, the success of such a program does not depend on a large influx of tax-exempt organizations into the State and local bond market. The estimated ownership pattern among the major holders of State and local securities is shown in Table 10 below.

TABLE 10.—ESTIMATED SALES OF NEW MUNICIPAL BONDS BY MATURITY STRUCTURE AND BY MAJOR CLASS OF PURCHASERS
[In millions of dollars]

	Maturity (years)		Total
	1 to 15	15 and over	
Purchaser:			
Banks.....	12,000	3,000	15,000
Households.....	2,000	8,500	10,500
Insurance companies.....	1,000	3,500	4,500
Total.....	15,000	15,000	30,000
Assumed yields:			
(a) Tax exempt issues.....	.05	.069	
(b) Taxable issues.....	.075	.092	
(c) Ratio a/b.....	.67	.75	

The taxable bonds paying a significant interest rate will, however, attract some tax-exempt investors regardless of the level of interest subsidy. In part, this is because of the portfolio preferences of some tax-exempt investors compared to taxable investors. For example, banks appear to be reluctant to increase the proportion of their assets held in the form of State and local securities because it is dangerous to have too large a portion of one's portfolio in long-term assets which are backed up by short-term deposits. On the other hand, pension funds are engaged in long-term commitments on the liability side, and they have less reluctance to carry long-term investments on the asset side. Therefore, some broadening of the market for State and local government securities will probably be provided by tax-exempt organizations. But the bulk of the securities will still be purchased by taxable entities, such as banks, insurance companies, and individuals.

Cost to Treasury.—Treasury and the Joint Committee staff estimate that the first-year cost to the Treasury of a 35-percent subsidy rate program, which would result in the first-year issuance of \$3.1 billion worth of taxable securities, would be \$98.7 million. This figure is shown on the next to the last column on table 8. If \$3.1 billion of taxable securities are issued at a 9-percent interest rate, about \$280 million of taxable interest will be generated. Assuming bondholders have a 27.5-percent average tax rate, the tax revenue from these bonds will be \$77.5 million a year, which leaves a net cost to the Treasury of \$21.2 million. Table 8 shows these calculations under a 35-percent subsidy and comparable calculations at other subsidy rates. With a gross subsidy at a 35-percent rate, the tax revenues generated and the net subsidy cost to the Treasury are shown for a 10-year period in table 9.

Benefits and Market Adjustments.—One purpose of a taxable bond alternative with a Federal subsidy is to provide lower borrowing costs to State and local governments in a more efficient manner than through a tax exemption alone. This is accomplished principally by reducing the windfall gain to tax-exempt bondholders (as discussed above) and thereby transferring a larger portion of the lost Federal revenues from the tax exemption to State and local governments rather than to the high-bracket taxpayer who holds tax-exempt securities. In effect, what would happen is that as some taxable bonds are issued instead of tax-exempts, competition for buyers in the tax-exempt market will be reduced and thus interest rates on tax-exempt obligations will be relatively lower. Holders of tax-exempt securities will have their windfall reduced, and issuers of tax-exempt securities will pay lower interest costs. The effect of lower interest costs is shown in table 9. This indicates the estimated size of the reduction in State and local interest costs under a 35-percent subsidy proposal. For example, the first-year estimate shows a reduction in State and local interest costs of \$157 million of which \$99 million is the direct subsidy and another \$58 million is the general reduction in tax-exempt interest rates. Thus, at a net cost to the Federal Government of \$21.2 million, the program is expected to generate savings to State and local governments of \$157 million.

However, there has been some concern expressed about the impact that market shifts, induced by a taxable bond alternative, might have on financial markets generally and on the market for tax-exempt and taxable securities. Specifically, two major concerns have been expressed. The first is that the tax-exempt market would be eliminated and the second is that any possible savings of State and local governments from an interest subsidy (and any reduction in tax-exempt interest rates) would be offset in other parts of the economy by a rise in interest rates on taxable securities.

As discussed above, the first development is not likely to occur. The staffs estimate that only \$3.1 billion out of \$30 billion of annual State and local government offerings would shift over to the taxable bond market. This is only 10 percent of the total tax-exempt market, but it can be expected to have a fairly significant impact on the interest rate for tax-exempt securities, generating substantial savings to State and local governments over and above the savings resulting directly from the subsidy.

On the other hand, the transfer of \$3.1 billion of funds to the taxable securities market is unlikely to have any significant effect on that market or the interest rates prevailing in that market. The flow-of-funds data indicate that the estimate for 1976 of the total amount of funds to be raised in 1976 is \$252.5 billion (see table 11). Subtracting from \$252 billion the estimated net new financing of State and local government issues of \$13.5 billion reduces the total demands on the market to about \$239 billion. The transfer of approximately \$3.1 billion from the tax-exempt to the taxable market represents an additional of \$3 billion to a base of \$239 billion, or 1.3 percent. This is likely to have a minimal impact on the interest rates in the taxable securities market.

TABLE 11.—THE FLOW OF FUNDS THROUGH THE U.S. CREDIT MARKETS

[In billions of dollars]

	1972	1973	1974	1975 ¹	1976
Total funds raised.....	198.3	239.4	218.1	209.0	252.5
U.S. Government.....	17.3	9.7	12.0	82.0	70.0
Federal credit agencies.....	6.2	19.6	22.1	8.0	10.0
State and local governments.....	14.2	12.3	16.6	13.5	13.5
Households.....	63.1	72.8	44.0	46.5	71.5
Mortgages.....	39.8	45.6	34.0	34.8	44.0
Other.....	23.3	27.2	10.0	11.7	27.5
Corporate business.....	55.3	67.2	77.1	32.0	51.0
Bonds, mortgages, and equities.....	39.2	34.5	36.3	46.0	34.0
Other.....	16.1	32.7	40.9	-14.0	17.0
Noncorporate and farm business.....	15.3	17.9	15.0	9.5	14.5
Financial sectors.....	22.7	32.4	15.9	4.5	12.0
Foreign.....	4.3	7.5	15.4	13.0	10.0
Total funds advanced.....	198.3	239.4	218.1	208.0	252.5
U.S. Government.....	2.6	3.0	7.4	11.0	10.0
Federal credit agencies.....	7.0	20.3	24.1	9.0	11.0
State and local governments.....	3.6	0.4	.3	4.0	5.0
Households.....	1.1	21.5	22.1	11.0	24.0
Corporate business.....	2.6	7.9	7.5	16.0	9.0
Noncorporate business.....	1.1	1.3	.9	1.0	1.0
Foreign.....	16.7	3.5	12.1	8.0	8.0
Insurance companies.....	20.4	20.6	20.6	22.0	23.0
Pension funds.....	14.3	16.4	20.4	26.5	29.0
Thrift institutions.....	49.9	35.4	27.0	58.0	46.0
Other financial.....	16.1	18.9	11.3	-3.5	10.0
Federal Reserve System.....	.3	9.2	6.2	8.5	9.0
Commercial banks.....	68.8	80.9	58.2	37.5	67.5

¹ Forecast.

Source: Kidder, Peabody & Co., Inc.

It would thus appear that the taxable bond subsidy provides a larger amount of the benefits to the State and local government per dollar of cost to the Treasury than does the present system. Under the present system, it costs the Federal Government approximately \$1.50 in foregone tax revenue to provide \$1 of benefits to the State and local governments. This is a State and local-Federal benefit-cost ratio of 1 to 1.5. As indicated above, under the taxable bond subsidy, the State and local-Federal benefit-cost ratio is estimated to be 7.1 to 1.

Essentially, the taxable bond subsidy transfers to the States and local governments an important part of the windfall (or consumer surplus) presently being received by the higher tax bracket taxpayers

who are receiving an interest rate substantially higher than that necessary to induce them to purchase tax-exempt securities because of the necessity to have a high enough rate to attract lower tax bracket taxpayers. The taxable bond subsidy, in effect, reduces the size of this windfall both by reducing the rates on tax-exempt securities and by reducing the amount of tax-exempt securities sold and transfers this benefit to the State and local governments in the form of a subsidy. In turn, the Federal Government is reimbursed for the majority of the subsidy through tax revenues derived from the taxable issues induced by the subsidy.

Permanence of taxable bond subsidy program

If any taxable bond alternative is to be attractive to a substantial number of State and local governments, it must contain assurances that the funds required to finance the Federal interest subsidy will be available in a timely fashion. The simplest way to provide this assurance under the new Congressional budget procedures would be to establish in the legislation an entitlement for State and local governments to the amount of appropriations necessary to pay the full accrued cost of the interest subsidy. The assurance given by this entitlement is that if no funds are appropriated, State and local governments have the right to sue the United States in court to obtain the necessary funds under the entitlement. Thus, annual appropriations of the necessary funds would become virtually automatic. This approach is followed in H.R. 12774.

Some representatives of State and local governments fear that the Congress might some year decide not to pay the subsidies on taxable bonds that have already been issued. This, of course, would be a breach of faith on the part of the Congress and Congress has not acted this way in the past. More importantly, entitlement programs impose legal obligations on the Federal Government which can be enforced in the Federal court of claims.

Types of eligible obligations

The types of tax-exempt obligations issued by or through State and local governments include general obligations bonds, revenue bonds, short-term loans (most frequently tax or revenue anticipation notes) from banks, some industrial development bonds, and certain obligations issued for housing and other special purpose programs where one of several statutes (other than the Internal Revenue Code) provides for tax exemption.

It has been argued that the tax exemption for interest on these obligations is the equivalent of a Federal interest subsidy, and that as a result under any taxable bond alternative all obligations eligible for the tax exemption should be eligible for the Federal interest subsidy. On the other hand, the Federal Government has already provided limits on the extent to which tax exemption is to be provided, and there would seem to be no requirement that in providing a new taxable bond option, this program be extended to bonds such as industrial revenue bonds. Moreover, it would appear that industrial development bonds could be denied the subsidy because the primary benefits of these bonds go directly to private businesses. In any case the industrial revenue bonds will gain from the fact that tax-exempt bonds generally will bear a lower rate of interest.

In addition, obligations that are exempt through statutory provisions outside of the Code could be denied eligibility because any direct subsidy for these obligations might be more appropriately authorized through the legislation relating to the programs involved.

A separate problem arises in determining what State and local obligations should be eligible for the taxable bond election where an obligation (especially a note) is held by an entity which is related to the issuing government. For example, a local government could issue a note or bond to its local pension fund, or a State government could issue a note to its local government, with the recipient of the note obtaining a Federal interest subsidy. Particularly if these transactions involve no real transfer of funds or reflect less than arm's-length terms, the potential for abuse exists.

A provision which denied eligibility to any obligations held by related entities would prevent the possibility of abuse in this area. However, it would also prevent legitimate investors, such as government pension funds, which have a definite stake in the finances of their own governments, from owning any of their related governments' bonds.

A different approach would be to allow only obligations with a term of one or more years to be eligible for the subsidy (since most loans between related entities involve short-term obligations). However, this limitation alone would not end the possibility of abuse to the extent longer-term issues are involved. Moreover, it would prevent legitimate arm's-length borrowings, such as tax anticipation loans with banks, from being eligible for the interest subsidy.²

Alternatively, the committee may be interested in allowing related entities (including pension funds) to invest in taxable obligations only if those obligations are distributed through competitive public offerings (under which independent underwriters submit competitive bids for the right to sell the bonds and the issuing government accepts the lowest substantive bid) and then only if a substantial portion of the obligations are sold to unrelated entities. The argument for this approach is that the public offering process insures that the terms of any issue are set at arm's-length, particularly where the process results in a number of unrelated parties purchasing the obligations. Under this approach (which is followed in H.R. 12774), however, revenue bonds as well as privately negotiated notes issued as taxable obligations could not be held by related entities, since they are normally not distributed through a public offering. But general obligation bonds, which are in many cases distributed through a public offering, could often be held by related entities.

Subsidy payment liability and procedures

Generally, two alternative plans for distributing Federal interest subsidy payments have been proposed. The 1969 House proposal would have established an elective dual coupon system for taxable bonds, under which the holder of the bond would be paid separately by the Federal Government and by the issuing government. The Federal Government was to be liable for its payment whether or not the issuing government had paid the interest it owed.

² Treasury has argued that this limitation is also desirable because it presents unnecessary administrative expenses. Also, it may be argued that a direct subsidy on obligations with maturities of less than 1 year is unnecessary since the differential between the interest rates on tax-exempt obligation and taxable obligations is greatest on these short-term obligations except in periods of extremely tight credit.

The double coupon approach with a fixed U.S. liability for its interest portion may have the effect of improving the credit rating of the issuing government because the Federal guarantee of its interest portion may have the effect of improving the credit rating of the issuing government since the Federal guarantee of part of the interest liability should decrease the risk on payment of part of the interest. To avoid this result H.R. 12774 and the Treasury proposal do not make the Federal Government liable for its interest payment unless and until the issuing government's interest portion has been paid.

Under H.R. 12774 the Federal payment is to be made to the issuing government (if it acts as its own paying agent) or to its paying agent. Under the Treasury proposal payment is made only to an outside paying agent. Thus, any issuing government which ordinarily acts as its own paying agent would have to obtain an outside agent if it issues taxable bonds.

