Mr. Emil Sunley May 23, 1974

Harvey Galper

Tax-exempt financing for desulfurization and the attached letter

The case against the increased use of tax-exempt bonds, in general, and the particular application to financing pollution control facilities, such as for desulfurization, has been made before but is worth restating. The case can be summarized as follows:

1. Tax exemption, for whatever reasons, is an inefficient use of public funds in that the revenue losses exceed the benefits of the lower interest costs to the ultimate borrower. This occurs since the benefits to the borrower are determined by the marginal tax rate of the marginal lender of funds, whereas the revenue losses are generated by the inframarginal purchasers of the bonds with higher marginal tax rates.

2. The equity of the tax structure is eroded by tax exemption in that the purchasers of these securities are concentrated in the highest marginal tax brackets.

3. Under present law and without further liberalization, industrial revenue bond financing for pollution control has been growing rapidly since 1971 and, if environmental commitments remain firm, may well be in excess of $7 billion per year by 1976.

4. This escalating use of the tax-exempt market will force up interest rates for all tax-exempt borrowing, thereby reducing the value of tax-exemption to the prime intended beneficiaries, state and local governments, and increasing the value to those in the highest tax brackets.

5. In such a situation, the revenue losses may well reach $1 billion per year by 1980.

6. Financing pollution control in this fashion passes the costs of pollution abatement from those generating the pollution to the public at large.

7. As a result, in comparison to the case where the polluter bears these costs, incentives are reduced for the producer to adopt less polluting methods of production. Alternatively, if the main thrust of the anti-pollution program is based upon regulation rather than changes in incentives, no additional pollution abatement investment will be induced by providing lower interest costs through tax exemption.

8. To the extent that the costs of pollution are borne by the general public, they are not reflected in the prices of final products, and the incentives are reduced for consumers to shift their purchasers to goods involving less polluting methods of production.

9. Providing preferential interest rates to one form of pollution abatement, namely capital intensive separately identifiable facilities, biases the production process in favor of such a technology relative to others which may involve lower real resource costs.

These general arguments may be supported by specific analysis of the desulfurization case. In this instance, tax-exemption is requested for removing from fuel oil a potential source of pollution even though such removal may create a marketable product, namely elemental sulfur. If such tax-exempt financing were allowed, the opportunities for even wider uses of tax-exemption financing flow in two directions. First, as the letter states, not only oil interests but also producers of fuels from other sources--coal, tar sands, natural gas--would soon press for their claims on the tax-exempt market. Secondly, the way would be open for requesting such financing for any process which removed a potential pollutant from fuels prior to combustion regardless of the profitability of the product so removed. In other words, incentives would be created for searching for fuels with the largest component of potential pollutants which could be used for marketable products so that tax-exempt financing could be used for removing them. Undoubtedly, even some conventional refining could qualify for tax exemption on these grounds if burning crude oil were sufficiently objectionable environmentally (as well as possible). While the extreme case has been presented here, the objective is to highlight the incentive structure created. Thus, there are strong grounds for supporting the Treasury position which seeks to limit the use of tax-exempt financing in the area of pollution control investment.

As the letter suggests, changes are in the offing regarding the license fee system applying to imports of crude petroleum and refined petroleum products. However, the vehicle for such changes is not the adoption of a new Treasury policy, but H.R. 14462, the Oil and Gas Energy Tax Act of 1974, currently under consideration by the House Ways and Means Committee. Under this Act, such fees are prohibited unless domestic crude petroleum and petroleum product prices exceed import prices and their imposition is necessary to promote the objective of national self-sufficiency in production and refinery capacity. Moreover, if such fees are imposed, they must, with four specific exceptions, be applied in a uniform and non-discriminatory manner. The four exceptions do not contain any provisions relating to desulfurization. Thus, the statement to the effect that the Treasury is providing an economic incentive for the desulfurization of imported fuels, does not seem to be correct.

On other matters, some of the estimates cited in the letter are also suspect, albeit in a way which would reinforce rather than weaken the argument presented. In particular, the 1968 Treasury calculations, which appeared in the Congressional Record of January 24, 1968, as part of the debate on limiting the use of industrial revenue bonds, overstated the revenue loss of marginal increments to the stock of tax-exempt debt outstanding. This is because an average marginal tax rate of 40% was used in the calculation rather than the marginal tax rate of the marginal purchaser of the new bonds--closer to 30%.

However, the basic question which should be addressed here is not which of two different tax changes costs more, in this instance tax exemption versus the elimination of import fees, but rather what is the most efficient means of accomplishing the specified objective. If we wish to provide an interest-cost subsidy to desulfurization despite the reasons cited above, which argue

strongly to the contrary, then the appropriate course to pursue is a direct subsidy for this purpose. As has been demonstrated on numerous occasions, this is always less costly than the equivalent subsidy provided via tax exemption.