INFORMATION

Date: August 5, 1977

MEMORANDUM FOR: SECRETARY BLUMENTHAL

From: Roger C. Altman

Subject: Taxable Bond Option

As you know, we differ with the Tax Policy Staff concerning the advisable form of a taxable bond option. We have had several meetings with them, and have prepared the attached study. Both my debt management and State/local finance staffs support its conclusions. Moreover, we have consulted a series of outside experts. Most favor TBO, as we do, but none favors a 40% or higher subsidy.

This covering memorandum is an executive summary of our study, which concludes that a 40% TBO subsidy could induce municipalities to shift as much as 75% of their issues to the taxable market. Some of the market experts we consulted support this conclusion, but most think tnat the shift would approximate 50%. The Tax Policy staff projects a 15 to 20% shift.

The Treasury Department should recommend a subsidy on the proposed taxable bond option at a level no greater than 33 percent. Our evidence suggests that at this subsidy level a significant degree of tax reform can be achieved at an acceptable cost to the Federal Government. The initiation of a TBO at high subsidy levels (i.e., 40 percent or more) could involve several unanticipated negative effects. While a large shift of securities from the tax-exempt to taxable market would enhance the tax reform impact of the TBO, it could have the following consequences.

- The costs to borrowers in the taxable market including the Federal Government and corporate borrowers, could increase appreciably.

- Budget outlays, and the "net cost" to the Federal Government, might increase substantially.

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- The future ability of some State and local governments, particularly smaller issuers, to borrow, could be impaired.

- The initial "shock" to the market of such a substantial shift in the flow of funds and in institutional arrangements could have adverse market effects.

- The political opposition to the proposal, which we believe is more substantial than Tax Policy estimates, could become insurmountable.

Background Analysis

Our attached analysis indicates that a 40 percent or higher subsidy, under current market conditions, could cause 50% or more of tax-exempt bond issues to shift to taxable financing. Most municipal finance experts with whom we have consulted agree on this.

Since the average yield spread between tax-exempt and taxable bond issues is less than 40 percent, a 40 percent subsidy would reduce borrowing costs that municipalities now incur. There will be some widening of this yield spread, however, as tax-exempt yields fall reflecting a diminished future supply. Our analysis suggests that most issues with maturities of longer than five years could be financed at less cost in the taxable market. Obviously, from a pure municipal finance standpoint, that's a healthy result. Yet, these issues currently constitute more than 75 percent of total new issues in the tax-exempt market, or more than $27 billion annually. A shift to the taxable market of $15 or so billion* could have the following effects.

1. Treasury and Corporate Borrowing Costs

A substantial shift of tax-exempt issues to the taxable market could raise borrowing costs for the Federal Government, corporations and other participants in the taxable market. An increase in the supply of taxable new issues of $15 billion would be roughly equivalent to more than 50% of today's annual volume of net new issues by non-financial corporations. At the same time, current buyers of tax-exempts are generally not likely to become major purchasers of taxable bonds. As a result, borrowing costs in the corporate bond market probably will rise, to attract new purchasers into that market. Such an increase undoubtedly would also affect the costs of servicing the Federal debt.

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*This estimate allows for some reduction in tax-exempt yields and some increase in taxable yields which reduce the incentive to shift to the taxable market.

Eventually taxable borrowing costs may adjust to levels which would have prevailed without a TBO. Yet, over the short run, our credit markets will remain highly compartmentalized. Buyers of different, basic credit instruments -- mortgages, corporates, tax-exempts, etc. -- do not readily shift into sharply different buying patterns. Typically, they continue to invest in those instruments with which they are familiar. Accordingly, a sudden large shift in the volume of financing could result in needless cost increases to all borrowers, especially if the TBO were enacted during a period of economic growth and tight credit conditions. These costs might be avoided by a gradual phase-in of the TBO, by beginning at a subsidy level of 33 percent.

2. Budget outlays

A substantial shift to the taxable market will increase significantly the budget outlays required to support the TBO. Our staff estimates in the attached study that a 40 percent subsidy could produce an annual budget outlay of as much as $4 billion by 1982 and higher outlays in later years. There undoubtedly will be substantial increases in revenues to offset these direct outlays. We are skeptical, however, that these revenue increases will be a sufficient offset.

3. State and Local Government Borrowing Costs

A substantial shift to the taxable market could impair the ability of some state and local governments, particularly small borrowers, to market their debt. There is a viable regional market for small tax-exempt issues, but no comparable market exists to support small taxable issues. There is no reason to think that one will develop. The potential purchasers of the new taxable obligations are not the same purchasers that would buy tax-exempt obligations.

4. Political Acceptability

The taxable bond option is a very controversial political issue. State and local government officials are reluctant to support it, because they believe it is the first step toward Federal intervention in the tax-exempt market. In fact, a recent survey of Governors found 10 out of 19 opposed to TBO. And three significant interest groups, Municipal Finance Officers Association, National Association of Counties and the National Conference of State Legislators maintain their position of opposition to the TBO. State and local officials clearly are concerned about any proposal that weakens the tax-exempt market or their ability to access that market. A high subsidy TBO, which could cause a

substantial shift to the taxable market, could be perceived as an attempt to destroy the tax-exempt market. It should be pointed out that similar legislation was defeated by State and local government lobbying efforts in 1969.

Attachment