Department of the TREASURY

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NEWS

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STATEMENT OF
THE HONORABLE DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

My testimony today relates to three bills: S. 1021, S. 1078 and S. 1467. I will begin with S. 1021, the bondholder taxable option proposal, introduced by Senator Danforth.

I. BONDHOLDER TAXABLE OPTION (S. 1021)

This innovative proposal would provide a 66 2/3 percent tax credit to the holders of tax-exempt bonds who elect to treat the income from the bonds and the amount of the credit as taxable income. This proposal would accomplish the same results as the taxable bond option proposal recommended by the Administration in 1978. It would promote tax equity, increase the efficiency of Federal tax subsidies to State and local government, and help to stabilize the tax-exempt bond market. Unfortunately, it would--as would our 1978 proposal--also provide greater economic and political incentives to expand the use of the tax-exempt market for nongovernmental purposes. In recent years, the amount of tax-exempt bonds issued for nongovernmental purposes has sharply increased. We believe that it is unwise to enact either a bondholder taxable option or a taxable bond option in this climate. If tighter limits on the use of tax exemption for nongovernmental purposes were imposed, particularly for pollution control facilities and single family housing, we would at once support the adoption of a taxable bond option, either as proposed in 1978 or in the form now proposed in S. 1021.

Similarities Between S. 1021 and Taxable Bond Option

The taxable bond option ("TBO") would provide for a direct subsidy to a State or local government electing to issue taxable bonds in an amount equal to 40 percent of the interest due on the bonds. The bondholder taxable option of S. 1021 ("BTO"), on the other hand, would provide a 66 2/3 percent tax credit to the holders of tax-exempt bonds who elect to treat the interest and the amount of the credit as taxable. BTO would thus be an option for investors; TBO would be a choice available to State and local governments.

Both TBO and BTO would lower the cost of borrowing to State and local governments. Both proposals would lower the interest rate of tax-exempt bonds from approximately 70 percent to 60 percent of the interest rate on taxable bonds of comparable risk. This change in the relationship between tax-exempt and taxable interest rates will result from market forces. For example, under BTO, investors in marginal tax brackets of less than 40 percent would have an incentive to purchase tax-exempt bonds and claim the credit because it would provide them with a higher after-tax return than taxable bonds at current interest rates.

A taxpayer in the 30 percent marginal tax bracket could, for example, purchase $100 of tax-exempt bonds paying 7 percent interest. By electing BTO, the interest would be taxable. A tax credit of two-thirds of the interest would be available which also would be taxable. The credit would exceed the tax liability resulting from the increased income, increasing the after-tax return for a taxpayer in the 30 percent marginal tax bracket from $7 to $8.17.* If, on the other hand, the taxpayer had purchased a taxable bond for $100 paying 10 percent interest, he would be subject to $3 tax resulting in an after-tax return of $7, or 7 percent. Thus, the demand for tax-exempt bonds would increase, driving up the price of tax-exempt bonds and lowering the tax-exempt interest rates. The market would reach an equilibrium when the tax-exempt interest rate is 40 percent below taxable rates (such as a taxable rate of 10 percent and a tax-exempt

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*The taxpayer's total taxable income would be $11.67 ($7 plus $4.67). At the 30 percent marginal tax bracket, his tax liability would be $3.50. He would, however, be entitled to a credit of $4.67, producing a net tax benefit of $1.17 or a total after-tax return of $8.17.

rate of 6 percent); at that point, investors in marginal tax brackets of less than 40 percent would receive the same after-tax return from holding tax-exempt State and local bonds and claiming the credit as from holding taxable corporate bonds.*

Under TBO, States and localities will initially find net interest costs on subsidized taxable bonds (60 percent of the taxable rate) lower than the net interest costs on tax-exempt bonds (approximately 70 percent of the taxable rate). As subsidized taxable bonds replace tax-exempt bonds, the supply of tax-exempt bonds will fall. The price of tax-exempt bonds will rise until tax-exempt interest rates fall to 40 percent below taxable rates. Therefore, TBO and BTO would have the same overall economic effects.

Both TBO and BTO would provide a more efficient subsidy to State and local governments than the current system. The current system is inefficient. Tax-exempt borrowers over the years have benefited from interest rates which on the average have been about 70 percent of taxable rates. Thus, the implicit subsidy of exemption to State and local governments is equivalent to a 30 percent interest rate reduction. Although the average subsidy is 30 percent, a reasonable estimate of the average marginal tax rate of all purchasers of tax-exempt bonds is about 42 percent. In other words, if municipal bond interest income were subject to tax, issuers of this debt would lose a subsidy of 30 percent of the taxable rate and the Treasury would gain revenues equal to about 42 percent of the taxable rate. This means that, with the present stock of tax-exempt debt outstanding, less than 75 percent of the Treasury revenue loss flows to State and local governments. Under both TBO and BTO, the incremental benefit to State and local governments in lower

*The taxpayer in the 30 percent marginal tax bracket would thus receive $6 of interest from the tax-exempt bond and would be entitled to a tax credit of $4 (2/3 of $6). The additional tax, on the other hand, would be only $3 (30% x $10 taxable income comprised of $6 (interest) + $4 (taxable credit)). The $1 excess of the credit over the tax increases the return on the tax-exempt bond from $6 to $7, the after-tax return from a taxable bond.

BTO would require some system for allowing the IRS to verify that taxpayers claiming the tax credit have in fact received interest entitling them to the credit. The most effective system would be to require issuers to file information returns with the IRS as is presently required for interest on taxable bonds.

interest costs will exceed the increased budget cost to the Federal government, thereby increasing the efficiency of tax exemption as a subsidy. As described below, this improvement is derived from a reduction in the windfall gains to high bracket investors.

TBO and BTO, therefore, would also improve the equity of the tax system. Much of the inequity under current law stems from the high tax-exempt interest rate as compared with the taxable rate. An investor in the 50 percent tax bracket, for example, would be willing to buy tax-exempt bonds as long as the return was just above one-half of that on taxable instruments. Tax-exempt bonds thus have an implicit "tax" resulting from the acceptance by the investor of a lower return than that which is otherwise available. If municipal rates were in fact one-half of taxable rates, tax-exempt bonds would have an implicit tax to the investor in the 50 percent bracket of 50 percent; the implicit tax would equal his marginal tax bracket. As municipal rates rise to 60 percent, 65 percent and 70 percent of the taxable rate, this investor in the 50 percent marginal tax bracket finds that the after-tax return becomes increasingly above that required to induce him to invest. This extra return is purely a windfall gain. Thus, the higher the tax-exempt rate relative to the taxable rate, the greater the windfall gain. By lowering the interest rate on tax-exempt bonds from 70 percent to 60 percent of the taxable interest rate, both TBO and BTO would reduce this inequity by increasing the implicit tax to 40 percent.

Both TBO and BTO would broaden the market for State and local securities by making them potentially attractive to taxpayers in low brackets and to tax-exempt institutions. Under TBO, low bracket investors would be attracted to subsidized taxable bonds issued by State and local governments. Under BTO, low bracket investors would generally select the taxable option. By so broadening the market for State and local debt, both proposals would reduce the volatility of the tax-exempt bond market.

<u>Differences Between S. 1021 and Taxable Bond Option</u>

There are several significant differences between TBO and BTO. Under BTO, unlike TBO, all State and local borrowing would continue to be conducted by issuing tax-exempt bonds and therefore BTO would not alter existing arrangements for marketing State and local debt. Institutions currently involved in underwriting and marketing tax-exempt bonds will not be adversely affected by BTO because the volume of tax-exempt issues will not be reduced.

Under TBO, the subsidy to State and local governments would appear on the expenditure side of the budget. In contrast, BTO would be a tax expenditure; it would be

recorded as a reduction in tax revenues. As such, BTO might appear to be less subject to review under Executive Branch and Congressional Budget Procedures.

Because of these two differences, States and localities may regard BTO more favorably than TBO. Although Treasury's advocacy of TBO was intended to help State and local governments by making an existing subsidy deeper, more stable, and more efficient, some organizations feared that TBO might be a first step toward elimination of tax-exemption. We have always viewed TBO as a supplement, not a substitute for tax-exemption. While accomplishing the same economic objectives as TBO, BTO may appear less suspect to States and localities because it does not directly affect the institutions that issue tax-exempt bonds and because, as a tax provision, it may appear less subject to future dilution than an expenditure program.

Reasons BTO or TBO Should Not Be Enacted At This Time

Notwithstanding the advantages of these proposals, the Administration does not support enacting either proposal at this time. Our principal concern is that a substantial portion of the increased subsidy would inure to the benefit of private persons and that the increased subsidy would provide further political and economic incentives to even further increase the amount of tax-exempt financing for nongovernmental purposes.

In recent years, the volume of tax-exempt bonds issued for nongovernmental purposes--principally for housing, private hospitals, pollution control and small issue industrial development bonds--has increased sharply as a share of the total tax-exempt market. There are indications that this trend is likely to increase. Just last week the Senate Finance Committee voted to significantly expand the exceptions to the industrial development bond provisions dealing with electric energy and solid waste disposal facilities.

A rough picture of the increased importance of the nongovernmental use of tax-exempt financing is provided by data compiled by the Public Securities Association. The PSA data subdivide new tax-exempt borrowing by purpose. Two of the categories are industrial aid (which includes pollution control bonds and all other industrial development bonds issued for corporations) and social welfare (which includes housing bonds and hospital bonds). These two categories--which include most tax-exempt borrowing for nongovernmental use--have increased, from 9 percent of all new tax-exempt borrowing (excluding refundings) in 1970, to 20 percent in 1972, 28 percent in 1976, 35 percent in 1977 and 41 percent in the first six months of 1979. In addition, there is evidence that PSA data underestimate the recent growth in small issue industrial development bonds because most small issues are direct placements which usually are not reported.

Congress is currently considering legislation to limit the use of tax-exempt bonds for home mortgages which have in part been responsible for this increase. However, this legislation, under consideration since last May, has not been enacted; nor has last year's Administration proposal to eliminate the use of tax-exempt bonds for pollution control facilities. In addition, we have no doubt that imaginative promoters are turning their attention to finding other legal devices to use tax exemption to finance nongovernmental activities. The increase in the subsidy under BTO would encourage this activity as well as making existing opportunities more attractive. It would aggravate the misallocation of limited capital resources which occurs when some industries can borrow at the tax-exempt rate while others cannot. Finally, it would insulate the tax-exempt market from the rise in interest rates which would normally accompany expansion of borrowing in the tax-exempt market. Thus, it may be some time before there is firm and effective legislation limiting tax exemption to governmental purposes or at least constraining the nongovernmental uses of tax-exempt borrowing to an acceptable level.

S. 1021 attempts to deal with the problem of tax exemption for nongovernmental purposes by not allowing the bondholder taxable option for interest received from tax-exempt industrial development bonds. Unfortunately, market forces would defeat the laudable intent of this provision. This provision would not affect the general level of tax-exempt interest rates. Its only effect would be to cause low bracket investors and tax-exempt institutions, who would seek to claim the credit, to concentrate on holdings of public purpose State and local bonds while high bracket investors, who would not claim the credit, would concentrate on holding tax-exempt industrial development bonds. Because the spread between tax-exempt and taxable interest rates would be equal to the subsidy rate provided by BTO, all tax-exempt borrowers, including users of the proceeds of industrial development bonds, would receive the same benefit from BTO.

Conclusion

Treasury reluctantly concludes that BTO should not be enacted at this time. The benefits that would flow to nongovernmental activities, and the encouragement given to expansion of nongovernmental uses of tax exemption, outweigh the benefit which would be derived by State and local governments in financing governmental facilities.

Treasury strongly supports tax-exempt State and local borrowing. We believe, however, that this tax exemption should not be used as a device to provide an indirect Federal subsidy to a wide range of nongovernmental activities, such as pollution control facilities and single family housing.

Treasury believes that the first legislative priority in the area of tax-exempt financing is to control the nongovernmental use of tax-exempt borrowing. Once this has been accomplished, we would support proposals such as S. 1021 or TBO which would contribute to tax equity and provide greater, more efficient Federal support for State and local governments.