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PSA

December 31, 1984

The Honorable Donald T. Regan
Secretary of the Treasury
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

The Public Securities Association urges the Department of the Treasury to reconsider its proposals regarding state and local government securities as advocated in "Tax Reform for Fairness, Simplicity and Economic Growth."

For more than a century, state and local governments have issued tax-exempt securities in order to provide their citizens with necessary infrastructure and other capital improvements judged by their elected officials to be of vital public purpose as defined by state law. These have included both general obligation bonds and revenue bonds funded through user fees and other financing arrangements geared to promote the public welfare through partnership with private entities, both not-for-profit and profit-making.

With the expectation of further reductions and eliminations in federal grant programs to states and localities and continued pressure on the local, state and federal levels to maintain taxes at current or reduced levels, the ability of state and local governments to borrow in the tax-exempt market is of paramount importance as a financial tool. In addition, the current Treasury Department proposal denies basic notions of Federalism and would severely restrict the sovereignty of the states.

The proposal establishes a category of municipal securities termed "private purpose non-governmental." This apparently refers to projects where there is a greater than de minimus connection to a non-governmental entity. This would include bonds issued to finance airports, ports, water supply facilities, electric generating facilities, resource recovery plants, health care facilities and low income housing among others, or about 62 percent of all municipal bonds issued in 1983. Such projects fall into the widely accepted and long established categories of public purpose. The Treasury's contention that such projects do not serve a public purpose at the state and local government level cannot be sustained and does a disservice to the discussion at hand. We note that when the same types of projects are funded at the federal level they are deemed to constitute a valid public purpose.

Indeed, the proposed requirement that no more than one percent of the revenue generated from a bond issue be used directly or indirectly by a private entity is unclear on its face. We are concerned that such a requirement will have the effect of limiting significantly the ability of states to issue general obligation and so-called "traditional" revenue securities on a tax-exempt basis. Depending on the definition and associated interpretations, such a provision could effectively curtail issuances representative of 70, 80, or even 90 percent of the municipal market in 1983. Such a broad attack on state sovereignty, cloaked in the name of tax reform, is repugnant.

Further, we believe that a partnership between government and private enterprise to provide for the needs of the citizenship is beneficial. The expertise of private enterprise has properly been combined with governmental public purpose to improve the quality of life at the state and local level and should continue to do so.

The apparent a priori belief that such a combination is wrong leaves us bewildered. Nevertheless, perhaps the gravest problem with the Treasury's restrictive definition of so-called "private purpose" is its usurpation of the fundamental ability of states and localities to determine what is necessary for the public good on the state and local level. We are dismayed that the Treasury Department believes it knows better what is in the best interest of states and localities than do the duly elected officials of state and local government; such a conclusion seems to be at odds with the Administration's early support for a "New Federalism."

Moreover, the proposal ignores the common sense reality that public purpose is an evolving concept. While building the Erie Canal may have been a public purpose over a century ago, airports and health care facilities along with economic development are identifiable public purposes today. Any static and arbitrary definition of public purpose -- such as that proposed by the Treasury -- utterly obstructs the ability of governments to meet changing circumstances and public needs.

In its attempt to mandate how and what types of securities a state or locality may issue, the Treasury Department proposal would deny "on behalf of" authorities the ability to issue tax-exempt securities. These authorities have issued tax-exempt securities for many years and essentially all of them are empowered by duly enacted state statutes. An earlier attempt by the Treasury Department to limit their ability to issue tax exempt bonds during the 1970's was withdrawn due to its unworkability. We believe that this proposal would limit the freedom of states and localities to determine how best to issue debt without providing any countervailing benefit.

On its face the proposal adds stringent restrictions to the issuance of bonds that even Treasury considers "governmental." In an apparent attempt to establish the premise with states and localities that the tax exemption is provided by the grace of the federal government, it would require costly and bureaucratic reporting of all bond issues to the federal government. This proposal smacks of federal government chauvinism. We are deeply concerned that it represents the first step towards requiring prior federal review of state and local government bond issues.

Additionally, the proposal to impose severely restrictive arbitrage limits, in addition to those currently in place, will require states and local governments to increase the size of bond issues to accomplish any given purpose. The proposed rebate of "excess arbitrage" to the federal government appears to us to be out of step with any theory of inter-governmental comity. The proposal to all but eliminate advance refundings will curtail state and local governments' ability to take advantage of reductions in interest rates as well as to alleviate overly restrictive bond indentures. As a result, the cost of finance for states and localities can be expected to increase, and this added cost will be passed on to local and state taxpayers.

In addition to proposing to narrow severely the scope of public purpose, the Treasury Department has declared its view that the tax-exemption of state and local government securities is an anachronism. The language of the proposal leaves one with the conclusion that in the view of Treasury tax-exemption is a mere "subsidy" provided to states and localities by the federal government that may be withdrawn. We strongly disagree, as do most local and state governmental officials. The Constitutional doctrine of reciprocal immunity prohibits state taxation of interest on U.S. Government obligations just as it prohibits federal taxation of interest on state and local government obligations. It is a doctrine established in the early years of the Republic and reaffirmed with specific respect to state and municipal debt in numerous Supereme Court decisions extending over almost a century. The recently developed assertion of Treasury that tax exemption of states and municipal debt is a "subsidy", "granted" by the Administration is just not so. Such an assertion can only detract from the quality of responsible debate on the subject.

Most alarming are statements of Ronald A. Pearlman, nominee for Assistant Secretary of Tax Policy, that Treasury is considering proposals to eliminate the tax exemption for all municipal securities including general obligation bonds. Mr. Pearlman stated that Treasury has the power to eliminate the tax-exemption on such securities and that the theory behind the Treasury tax reform plan would "... argue for totally removing the exemption for governmental obligations." The remarks of Mr. Pearlman indicate that the proposals of Treasury are ultimately intended to remove the tax exemption from all state and local government securities. In this light, the arguments made by Treasury regarding so-called public and private purpose municipal bonds assume the appearance of a mere subterfuge for its true goal of eliminating tax-exemption entirely. We are troubled by the misdirection of such an approach and dismayed by the lack of respect it demonstrates for state sovreignty, local government responsibility and the long history of Constitutional doctrine and legislation surrounding the subject.

There are other elements in the set of proposals which will impact the market for municipal securities and therefore the cost at which state and local governments can accomplish financing. These range from the proposed elimination of deductability of carrying charges for municipal bonds for financial institutions to the proposed indexation for inflation of interest on taxable securities. We do not oppose tax "simplification" or the reduction of marginal tax rates. We are very concerned, however, that the Administration, Congress and the public thoroughly understand the implications of any specific legislation which proposes to make such sweeping changes in the basic tax structure of the nation.

To that end, our Association, as well as a number of our members, are currently conducting and commissioning studies to estimate the impact of all these proposals on states and localities. To aid us in conducting these studies we request your Department to provide us with the methodology it utilizes to measure the alleged revenue loss brought about by state and local government securities, as well as proposed definitions of "direct and indirect use" and other ambiguous concepts put forward in the Treasury plan. When our analysis is complete, we will share the results of these studies with you, your staff, the Congress and the general public.

The Public Securities Association is the national trade association of dealers, brokers, and banks that trade, underwrite and sell municipal, mortgage backed and U.S. government securities. Last year PSA members underwrote over 95 per cent of the state and local government securities issued. We genuinely are eager to engage in a thoughtful dialogue with you and your staff regarding these proposals.

The Treasury proposal while not perfect, is an important attempt to serve the public interest. However, we are very seriously troubled by the components of the Treasury proposal which are directed at the issuance and use of proceeds of tax-exempt municipal bonds and urge the Treasury Department to re-evaluate them. We would be pleased to discuss these matters with you at your earliest convenience.

Sincerely,

Robert C. Brown
Chairman 1984
Public Securities Association

Jean J. Rousseau
Chairman 1985
Public Securities Association