T/R - T/E Bon

SEP 30 1985

Dear Mr. Tumler:

Thank you for sending a copy of the Coopers and Lybrand analysis of the tax-exempt bond revenue estimates, which the Public Securities Association commissioned. We are most interested in thoughtful, independent economic analyses of the economic effects of taxation, including analyses of revenue estimates.

I would like to express disagreement with the Coopers and Lybrand (C&L) study in four regards:

(1) The C&L study implies that Treasury staff was unwilling to provide detailed information about the methodology and data used in the revenue estimates. That implication is simply erroneous. Several Treasury staff members spoke extensively with C&L staff, and numerous references to published studies and data were provided. Suffice it to say, the C&L replication of the Treasury estimates resulted in $12.94 billion revenue loss estimate for fiscal years 1986-1990 from repeal of private purpose bonds compared to Treasury's $13.0 billion revenue loss estimate.

(2) The C&L study asserts that repeal of tax-exempt financing will result in significantly less total savings, more corporate equity, and more public purpose tax-exempt financing. Particularly, in the case of the effect on total savings, the C&L analysis is seriously flawed in that reductions in marginal tax rates are ignored. There is no evidence supplied that savings and investment would be lower from repeal of special tax preferences (private purpose tax-exempt bonds) when included in a package that is revenue neutral and produces lower marginal tax rates. There is also no empirical evidence supplied to justify the assumed large increases in supply of corporate equity and tax-exempt bonds. Further, if there is the assumed increase in corporate equity, the C&L revenue loss is understated because it ignores the double taxation of corporate profits when they are received as dividends or realized as capital gains upon sale.

(3) The C&L measure of "reflows" is very misleading because it is estimated by looking only at the tax-exempt bond provision. Since taxes would be raised by that provision in isolation, C&L find that less investible capital would be available. The tax-exempt bond provision is part of a carefully integrated

XAA:TNeubig:et 8/28/85 retyped 9/17/85

CODE	INITIATOR XAA	REVIEWER XA	REVIEWER	REVIEWER		
SURNAME	Steuerle	Fullerton				
INITIAL/DATE	ES 9/17/85	DF 9/17/85	/	/	/	

package, however, a package which includes significant reductions in rates. The President's proposals in combination would not raise taxes, would not raise the overall cost of capital, and would not discourage investment.

We also question economic models that treat all government spending as a drag on the economy and all tax reductions as a stimulus resulting in higher GNP. A direct expenditure program that subsidizes a fraction of borrowing costs requires higher marginal tax rates to raise a given amount of revenue. Private purpose tax-exempt bonds that subsidize a fraction of the borrowing costs also require higher marginal tax rates to raise the same amount of revenue. Again the question is whether special tax preferences are more likely than marginal rate reductions to improve economic growth; most economists would argue that high marginal tax rates and special tax preferences harm economic growth. Coopers and Lybrand should reestimate the "reflow" by running their model incorporating a revenue neutral change with lower marginal tax rates.

(4) Finally, the C&L study implies that the Treasury methodology is incorrect because it does not realistically portray the workings of the capital markets. All economic forecasts necessarily involve some abstraction from the details of the market. The usefulness of economic models should be judged by their predictive powers, not on the realism of their assumptions. While the Treasury methodology involves some abstraction (as does the C&L model), the Treasury methodology provides an appropriate characterization for revenue estimating purposes. The C&L study provides no evidence to the contrary.

I also should point out that revenue estimating is an inherently imprecise art. While the C&L study only commented on reasons that our revenue estimates might overstate the true amount, there exist several other reasons that our estimates might understate it. For example, we have always tried to be conservative in our assumptions regarding the growth rate of private purpose bonds. Consequently, in the past, we have had to revise upward our revenue estimates when that growth rate exceeded Treasury forecasts.

In closing, the Treasury Department stands by its estimate. The estimated $13 billion of additional revenue raised by the proposal during fiscal years 1986-1990 reflects anticipated

changes in investors' portfolios and in the allocation of capital across sectors of the economy. This revenue pickup is only the tip of the iceberg since any tax-exempt bonds issued in those years would generate revenue losses as long as they are outstanding, which would be well into the next century in some cases. Thus, repeal of nongovernmental bonds is important for raising revenue necessary for significant reductions in tax rates.

Sincerely,

(signed) Ronald A. Pearlman

Ronald A. Pearlman
Assistant Secretary
(Tax Policy)

Mr. Jon R. Tumler
Director, Government Relations
Public Securities Association
Suite 1075
1110 Vermont Avenue, N.W.
Washington, D.C. 20005