III

Tax Exempt Financing

STATE AND LOCAL TAXABLE BOND OPTION

Present Law

Since the adoption of the Federal income tax in 1913, interest on State and local government obligations generally has been exempt from Federal income tax. This exemption represents a recognition of the independent sovereignty of States and their instrumentalities under our federal system as well as the desire to enhance the strength of State and local governments, as entities closest to the people, in solving local problems.

The exemption applies to all State and local government obligations, except for most industrial development bonds and arbitrage bonds. Industrial development bonds are obligations issued nominally by a State or local government to raise funds for private development. (See discussion in TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BONDS.)

Arbitrage bonds are obligations issued to provide funds for financial investment, generally in taxable Federal securities. Since Federal credit underlies the arbitrage bonds, the issuer of such bonds is guaranteed a market and a profit at no risk to itself. Therefore, since 1969 the Code has provided that arbitrage bonds do not qualify for the exemption.

Reasons for Change

The tax exemption of interest on State and local bonds should not be interferred with in any way. Any recommendation for change in current financing mechanisms is intended only to complement rather than to replace tax exemption as a means of aiding State and local governments and to reduce the inequities and inefficiencies that arise when tax exemption provides the sole form of State and local financing.

The tax-exempt market for financing capital outlays of State and local governments is characterized by three interrelated problems. First, from the viewpoint of structural tax policy, tax exemption is an inequitable way of providing a subsidy to the State and local sector. Secondly, the subsidy provided by tax exemption is an inefficient one in that only a portion of the revenue loss to the Federal treasury results in benefits to State and local governments. Thirdly, the municipal bond market, while performing reasonably well over the long term, has, as a result of its tax-exempt character, exhibited periods of considerable instability which have been disruptive of the financial planning of States and localities. Related to this last consideration, is the longer term concern that the sources of funds for State and local borrowing may not expand sufficiently to accommodate the capital financing requirements of the sector. Each of these problems of the municipal market will be considered in some detail. Each can be mitigated by the taxable bond option which will provide State and local governments with access to the market for taxable bonds in addition to the market for conventional tax-exempt securities.

Tax exemption and tax equity. A tax-exempt source of income, such as the interest on State and local bonds, violates the principles of both horizontal and vertical equity; that is, tax-exempt income reduces the progressivity of the tax structure and fails to tax all income alike. Vertical equity is violated since taxpayers in different income classes and, therefore, in different marginal tax brackets receive varying benefits from tax exemption. Thus, $100 of tax-exempt income is equivalent to $333 in before-tax income to an investor in the 70 percent marginal tax bracket but to only $143 to an investor in the 30 percent marginal tax bracket. Also, for reasons explained below, tax-exempt bonds are generally not economic investments for those in tax brackets below 30 percent. As a significant source of tax-exempt income, interest on municipal bonds, therefore, tends to undermine the progressivity of the tax structure.

Tax-exempt income also is a violation of horizontal equity since all sources of income are not taxed equally. Two taxpayers may have the exact same before-tax income -- in one case derived from wages and salaries and in the other from tax-exempt interest -- but will pay quite different amounts of tax. It has been claimed that holders of tax-exempt bonds do, in fact, pay a tax on their interest income since they receive a lower before tax yield than may be earned on comparable taxable debt. While this is true, this implicit tax on municipal bond interest generally amounts to only 30 percent, far less than the tax high-income investors would pay on fully taxable income.

Tax Exemption as an Inefficient Subsidy. Tax exemption provides a subsidy to State and local governments by enabling them to issue bonds at interest rates below those prevailing on comparable taxable securities. However, as a device to reduce State and local borrowing costs, tax exemption is an inefficient use of Federal funds because the loss in revenue to the Treasury is greater than the reduction in interest costs to the borrower. The difference accrues in the form of windfall gains to high-income purchasers of tax-exempt bonds.

To demonstrate the inefficiency of tax exemption as a subsidy, it is first necessary to determine the actual subsidy which tax exemption provides to State and local governments. As Table IIIA-1 indicates, tax-exempt borrowers over the years have benefited from interest rates on average equal to about 70 percent of taxable rates. Thus, the implicit subsidy of tax exemption is equivalent to a 30 percent interest rate reduction. The 30 percent implicit subsidy to tax-exempt securities is an average across the maturity spectrum of State and local bonds as well as over time. The current operation of the municipal bond market provides a larger subsidy for securities with maturities of five years or less--on the order of 40 percent below taxable rates--and a smaller subsidy on 20 to 30 year securities--on the order of 25 percent. Thus, as maturities lengthen, interest rates for State and local bonds rise more steeply than those for comparable taxable debt. The reason for this is the domination of the shorter term municipal market by commercial banks. However, to simplify the analysis, the discussion which follows generally considers the market as a whole with an average implicit subsidy of 30 percent.

Although the average subsidy provided by tax exemption is 30 percent, a reasonable estimate of the average marginal tax rate of all purchasers of tax-exempt bonds -- households or individual investors, commercial banks, and other financial institutions -- 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 less than 75 percent of the Treasury revenue loss flows to State and local governments.

There is no inconsistency in the fact that tax-exempt interest rates average about 70 percent of taxable rates at the same time that the average investor is in the 42 percent marginal tax bracket. Clearly, not all holders of tax-exempt debt are in the 42 percent tax bracket. Some, such as banks and high-income individuals are in higher tax brackets and others with smaller amounts of taxable income are in lower tax brackets. High-income taxpayers generally have a strong incentive to invest heavily in tax-exempt debt, since their after-tax returns from such investments tend to greatly exceed their after-tax returns on comparable taxable securities. Indeed, high tax bracket individuals and institutions comprise the bulk of the purchasers of tax-exempt bonds.

If issuers of bonds, however, wish to borrow more funds than are generally supplied from high-tax bracket individuals and institutions, tax-exempt debt has to be made attractive to potential lenders with more moderate incomes. The only way this can occur is by increasing the tax-exempt interest rate relative to the taxable rate so that tax-exempt bonds yield a higher after-tax return even to those in less than the highest tax brackets. To be sure, the very rich may also be induced to increase their lending at more favorable tax-exempt rates, but tax-exempt rates will continue to rise until lenders across all tax brackets are supplying the exact amount of funds that State and local governments wish to borrow.

Table III A-1

Tax-Exempt and Taxable Interest Rates

Year	Tax-Exempt Interest Rate (Bond Buyer 20)	Taxable Interest Rate (Moody's Newly Issued Industrials)	Ratio
1960	3.54	4.67	75.8
1961	3.45	4.70	73.4
1962	3.17	4.53	70.0
1963	3.16	4.42	71.5
1964	3.22	4.51	71.4
1965	3.25	4.80	67.7
1966	3.81	5.52	69.0
1967	3.92	5.79	67.7
1968	4.42	6.64	66.6
1969	5.66	7.84	72.2
1970	6.36	8.86	71.8
1971	5.52	7.80	70.8
1972	5.25	7.51	69.9
1973	5.22	7.86	66.4
1974	6.09	8.87	68.7
1975	7.06	9.12	77.4
1976	6.70	8.61	77.8
1977	5.68	8.15	69.7

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This analysis indicates why tax-exempt bonds, on the average, trade at interest rates equal to 70 percent of those on taxable securities. For current levels of borrowing, it is necessary for tax-exempt rates to rise to the point where the investor in the 30 percent marginal tax bracket can benefit from buying tax-exempt bonds. Thus, while it was earlier stated that the average lenders of funds are in the 42 percent tax bracket, the last, or the marginal, lenders of funds are in about the 30 percent tax bracket. The marginal tax rate of the marginal lender determines the interest rate advantage to the issuing governments, but the marginal tax rate of all borrowers together determines the losses to the Treasury. The reason why tax exemption as a subsidy is inefficient is that the marginal tax rate of the last lender is below the marginal tax rate of all lenders taken together.

Individual investors, of course, are not the only source of funds for State and local governments. As considered below, commercial banks play a major role in the municipal bond market as well. Nonetheless, to the extent that State and local governments wish to borrow more than commercial banks are willing to lend, individual investors have to be drawn into the market. To attract individuals in lower tax brackets to tax-exempt bonds, tax-exempt rates must increase relative to taxable rates.

Thus, tax exemption as a source of tax inequity and as an inefficient subsidy are two reflections of the same image. A higher tax-exempt rate relative to the taxable rate means both a lower subsidy to State and local governments and greater windfall gains to high bracket individuals. 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 about one-half of that on taxable instruments. As municipal rates rise to 60 percent, 65 percent and 70 percent of the taxable rate, this investor finds that the after-tax return becomes increasingly above that required to induce him to invest. This extra return is purely a windfall gain for him. Thus, the higher the tax-exempt rate relative to the taxable rate, the smaller the advantage of tax-exempt financing to the borrower and the greater the windfall gains to the lenders.

The Cyclical Volatility of the Tax-Exempt Market. The tax-exempt bond market, largely as a consequence of the tax exemption itself, exhibits a high degree of volatility over the business cycle. While the long-term trend of issues of State and local government securities has been upward as shown in Table IIIA-2, there have been periods of tight money, such as the years 1966 and 1969, when the volume of new issues has either been stagnant or has declined. Moreover, as indicated by the ratio of tax-exempt to taxable interest rates in Table IIIA-1, there is a strong tendency for tax-exempt rates to increase relative to taxable rates in

Table III A-2

Volume of Gross New Issues of Long-Term Municipal Bonds by Year

Year	Gross Issues
1960	7,229
1961	8,359
1962	8,558
1963	10,107
1964	10,544
1965	11,084
1966	11,089
1967	14,288
1968	16,374
1969	11,460
1970	17,762
1971	24,370
1972	22,941
1973	22,953
1974	22,824
1975	29,326
1976	33,845
1977	44,915

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Source: Bond Buyer.

such periods. These phenomena mean that when credit conditions tighten State and local governments experience relatively higher borrowing costs and are among the first borrowers to be crowded out of capital markets.

To understand why the tax-exempt market exhibits this volatility, it is necessary to examine the behavior of the major participants in the municipal bond market. The traditional sources of lending to State and local governments consist of individuals and institutions in sufficiently high marginal tax brackets to find tax-exempt securities attractive. Three groups comprise the major sources of demand for State and local bonds: commercial banks, casualty insurance companies, and household investors. Table IIIA-3 shows the ownership of outstanding municipal securities by these three investor groups and all others taken together by five year intervals from 1960 through 1975. Table IIIA-4 indicates the annual net purchases of State and local bonds by these same investors over the period 1960 to 1976.

Table III A-3

Ownership of Municipal Securities

Year-End Outstandings, Selected Years

(millions of dollars)

Year	Total	Households		Commercial Banking		Nonlife Insurance		All Other	
		Millions of Dollars	Percent	Millions of Dollars	Percent	Millions of Dollars	Percent	Millions of Dollars	Percent
1960	$ 70.8	$ 30.8	43.5%	$ 17.7	25.0%	$ 8.1	11.4%	$ 14.2	20.1%
1965	100.3	36.4	36.3	38.8	38.7	11.3	11.3	13.8	13.8
1970	144.4	46.0	31.9	70.2	48.6	17.0	11.8	11.2	7.8
1975	221.9	67.5	30.4	102.8	46.3	33.3	15.0	18.3	8.3
1977 1/	259.1	79.7	30.8	114.2	44.1	42.8	16.5	22.4	8.7

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Source: Federal Reserve Board, flow of funds data.

1/ Estimated for end of third quarter.

Table III A-4

Net Change in Ownership of Municipal Securities

Seasonally Adjusted Annual Rates

Year	Total: Billions of Dollars	Total: Percent	Individuals: Billions of Dollars	Individuals: Percent	Commercial Banks: Billions of Dollars	Commercial Banks: Percent	Fire & Casualty Insurance Companies: Billions of Dollars	Fire & Casualty Insurance Companies: Percent	All Other: Billions of Dollars	All Other: Percent
1960	5.3	100.0	3.6	67.9	.6	11.3	.8	15.1	.3	5.7
1961	5.1	100.0	1.2	23.5	2.8	54.9	1.0	19.6	.1	2.0
1962	5.4	100.0	-1.0	-18.5	5.7	105.6	.8	14.8	-.1	-1.9
1963	5.7	100.0	1.0	17.6	3.9	68.4	.7	12.3	.1	1.8
1964	6.0	100.0	2.6	43.3	3.6	60.0	.4	6.7	-.6	-10.0
1965	7.3	100.0	1.8	24.7	5.1	69.9	.4	5.5	.0	-
1966	5.6	100.0	4.0	71.4	2.4	42.9	0.7	12.5	-1.5	-26.8
1967	7.8	100.0	-2.3	-29.5	9.1	116.7	1.5	19.2	-.5	-6.4
1968	9.5	100.0	-.5	-5.3	8.6	90.5	0.9	9.5	0.5	5.3
1969	9.9	100.0	9.3	93.9	.6	6.1	1.1	11.1	-1.1	-11.1
1970	11.2	100.0	-.9	-8.0	10.7	95.5	1.5	13.4	-.1	-0.9
1971	17.4	100.0	0.1	0.6	12.6	72.4	3.5	20.1	1.2	6.9
1972	14.7	100.0	2.3	15.7	7.2	49.0	4.3	29.3	.9	6.1
1973	14.7	100.0	5.3	36.1	5.7	38.8	3.6	24.5	.1	0.7
1974	17.1	100.0	8.9	52.1	5.5	32.2	2.2	12.9	.5	2.9
1975	13.6	100.0	5.0	36.8	1.7	12.5	2.6	19.1	4.3	31.6
1976	15.1	100.0	4.2	27.8	3.0	19.9	4.2	27.8	3.7	24.5
1977 1/	29.0	100.0	9.3	32.1	11.9	41.0	7.2	24.8	0.6	2.1

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1/ First three quarters of year expresse at annual rates.

Source: Federal Reserve Board, flow of funds data.

These tables illustrate the important impact of commercial bank behavior on the municipal bond market. When money is tight, commercial banks first look to meet the demand for loans by their customary business clients, and only as their resources permit do they purchase municipal bonds. Thus, the most difficult periods of financing for States and localities are generally when commercial banks are able to absorb only a small portion of the net issues of municipal debt, such as occured in the years 1966 and 1969 and more recently in 1975 and 1976. During these periods, increased purchases of municipal debt by households only partially offset the decline in commercial bank participation. Borrowing costs to State and local governments rise, and the dollar volume of new issues falls. The reason tax-exempt rates must rise when banks leave the market is to provide a sufficient incentive for households to absorb a larger share of municipal debt. In periods of credit stringency, then, the loss of bank demand for municipal bonds is only partially compensated by increased household purchases. At the same time, the rise in the tax-exempt rate relative to the taxable rate reduces the value of the subsidy provided by tax exemption.

Tables IIIA-3 and IIIA-4 also indicate that the overall participation of commercial banks in the municipal bond market has declined in recent years. Throughout the 1960's, commercial banks absorbed 63 percent of the total supply of State and local debt. In the 1970's commercial banks have absorbed only 40 percent. Table IIIA-5 presents even more sharply the declining role of commercial banks in the municipal bond market. This table shows net changes in holdings of credit market instruments other than U.S. securities by commercial banks since 1965. Through 1971, municipal bonds generally amounted to 50 percent of commercial bank acquisitions of credit market securities. Since 1972, however, partly as a result of the availability of other sources of tax-favored income, the share of such security purchases accounted for by State and local bonds has declined to the range of 20 to 30 percent. Thus, in addition to the cyclical volatility of the market, there is some concern that traditional purchasers of tax-exempt debt will fail to provide funds for State and local capital financing over the longer term. In 1975 and 1976, other investors took up the slack of a reduced volume of purchases by commercial banks. In part these other investors were State and local pension funds whose purchases reflect the unusual circumstances in New York City and State. Since pension funds derive no advantage from tax exemption, they cannot be expected to continue as a permanent source of State and local financing.

Table III A-5

Net Changes in Holdings of Credit Market

Instruments Other Than U.S. Securities by Commercial Banks

Year	State & Local Bonds	Corporate Bonds	Commercial Mortgages	Other Mortgages	Total	State & Local Bonds as Percentage of Total
	(..................billions of dollars				................)	(..........%.........)
1965	5.1	-.1	2.0	3.7	10.7	47.7
1966	2.4	*	2.0	2.7	7.1	33.8
1967	9.1	0.8	1.6	3.0	14.4	63.2
1968	8.6	0.3	2.6	4.0	15.4	55.8
1969	0.6	-.1	1.8	3.7	6.0	10.0
1970	10.7	0.8	1.2	1.0	13.6	78.7
1971	12.6	1.2	3.0	6.7	23.6	53.4
1972	7.2	1.7	5.4	11.4	25.6	28.1
1973	5.7	0.4	6.9	12.8	25.9	22.0
1974	5.5	1.1	5.0	7.9	19.4	28.4
1975	1.7	1.8	3.2	1.1	7.8	21.8
1976	2.9	-0.6	2.6	11.0	15.9	18.2
1977 1/	11.9	-0.4	8.0	18.1	37.6	31.7

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1/ First three quarters expressed at annual rates.

* Less than $0.05 billion.

General Explanation

The Administration proposal will establish an election in the Internal Revenue Code for State and local governments to issue taxable bonds and other debt obligations with the Federal Government paying a fixed portion of the actual dollar amount of the issuer's interest cost. For obligations issued during 1979 and 1980, the Federal Government will pay 35 percent of the interest cost. For obligations issued thereafter, the Federal Government pay 40 percent. All tax-exempt State and local obligations will be eligible for this taxable bond alternative. These include general obligation and revenue bonds issued by a State and local government as well as industrial development bonds, the interest on which is tax exempt. There would be no Federal control over the purposes for which the taxable obligations could be issued. However, obligations held by related entities (such as related pension funds) would be eligible for the election only if the obligations were issued through a competitive public offering. The Federal interest subsidy would be paid to the issuer (or its paying agent) which would act as paying agent for the Federal Government. The Federal Government would not be liable for its portion of the interest until the issuer pays the remaining interest. The proposal would establish an entitlement for State and local governments to assure that funds necessary to pay the Federal Government's portion of the interest would be appropriated annually.

Analysis of Impact

The taxable bond option, under which State and local governments will have the choice of issuing either conventional tax-exempt bonds or subsidized taxable bonds, will deal simultaneously with all of the major problems in the tax exempt bond market. To determine the extent to which the taxable bond option will contribute to tax equity, the efficiency of the subsidy now provided to State and local governments, and the stability of the municipal bond market, it is first necessary to analyze how the option will operate.

Under the taxable bond option, State and local governments which choose to issue taxable bond in place of tax-exempt bonds will receive a Federal subsidy equal to a fixed percentage of the interest costs on the taxable securities. It is important to emphasize the voluntary nature of this plan. State and local governments on their own volition will decide whether they wish to issue subsidized taxable or conventional tax-exempt debt. Since this decision will presumably be made on the basis of which type of security affords the lower net interest cost, State and local governments can only benefit from the plan. If the subsidized taxable bond fails to yield lower net interest costs, States and localities simply will not avail themselves of it. Furthermore, the higher the subsidy the greater the benefits to the issuing governments.

Nonetheless, some representatives of State and local governments have expressed a concern that the subsidy rate could be too high. The basis of this concern is that if taxable bonds were made too attractive, the tax-exempt market would virtually disappear and issuers would no longer have available a tax-exempt market in the event that the subsidy to taxable bonds were discontinued. On these grounds, the subsidy should never be so high as to completely eliminate the tax-exempt market.

On the other hand, too low a rate of subsidy would clearly undermine the objectives of the plan. A low subsidy would in the first instance accomplish little in solving the basic problems of the tax-exempt market. In addition, the subsidy must be large enough to elicit a sufficiently large volume of issues of the new taxable security to generate market acceptance. If only a slight volume of taxable municipal debt were issued, such debt could very well be regarded as a mere market curiosity with little secondary trading, poor liquidity characteristics, and an attendant loss of interest on the part of potential lenders. Thus, the subsidy under the taxable bond option must be provided at a level which will maintain both the taxable and the tax-exempt alternatives for State and local financing. It must neither be so high as to eliminate the tax-exempt market nor so low as to preclude the development of a taxable municipal market. A permanent subsidy of 40 percent (after a two year transitional subsidy of 35 percent) would maintain markets for both taxable and tax-exempt municipal debt.

The permanent 40 percent subsidy on taxable bonds will operate as follows. For each of their bond issues, State and local governments presumably will accept bids on both a tax-exempt and a taxable basis. Then, after accounting for the Federal subsidy on taxable bonds, they will decide which form of security will yield the lower interest costs. Initially, with market yields unchanged, it may be expected that subsidized taxable bonds would provide the lower interest costs. In fact, to forestall too large an initial shift of financing out of the tax-exempt market which could have a disruptive impact on that market, the subsidy for the first two years of operation of the plan is set at 35 percent rather than 40 percent. As the volume of tax-exempt debt declines in response to the taxable subsidy, interest rates on tax-exempt debt also will decline, since the reduced volume will no longer require higher interest rates to attract marginal lenders.

This decline in tax-exempt rates will itself keep tax-exempt financing attractive, and the flexibility of financial markets will soon effect an equivalence of interest costs between subsidized taxable and tax-exempt debt. The issuing governments themselves, along with the underwriters of their debt, will be instrumental in bringing this equivalence about since States and localities will tend to issue debt in that sector of the market providing the most advantageous financing terms. Thus, State and local governments will generally face a situation where the interest costs of taxable borrowing (net of the Federal subsidy) will equal the costs of tax-exempt borrowing. At this point, the issuing governments will be indifferent to the particular type of debt they issue, and the form of debt will merely reflect the market preferences of lenders for tax-exempt as opposed to taxable securities.

The voluntary nature of the plan assures that States and localities will gain significant benefits in terms of reduced borrowing costs. They will only choose the taxable option if it offers cost advantages. As long as taxable bonds are issued, however, tax-exempt interest costs will also decline. Thus, a saving in interest costs will occur on the total volume of debt issued and will be independent of the form in which it is issued. The equilibrium outcome, then, will be that under the 40 percent subsidy, tax-exempt interest rates will be 40 percent below taxable rates and States and localities will be indifferent between issuing subsidized taxable or tax-exempt debt.

The benefits of the taxable bond option will accrue to all issuers of tax-exempt debt regardless of their relative credit standings. The Federal Government's agreement to pay a portion of the interest cost on taxable bonds will not in any way constitute a guarantee of the issuer's obligation to pay principal or its portion of the interest cost. Consequently, the taxable bond option will not enable issuers with a poor credit standing to gain any greater access to financial markets than that available to more creditworthy issuers. The taxable bond option will establish a tax-exempt rate for all grades of issuers at approximately 60 percent of the taxable rate for comparable credits. All issuers, therefore--both those with good and poor credit standings--will benefit from a reduction in their borrowing costs.

The new volume of issues of taxable and tax-exempt debt under a 40 percent subsidy is not easy to estimate. It depends not only on what lenders will wish to hold in their portfolios at the new structure of interest rates but also on how quickly they will be able to adjust their portfolios from their current pattern of holdings. A reasonable calculation, based on informed market opinion as well as on estimates derived from econometric models, is that after an adjustment period of possibly five years, about 25 percent of State and local bond issues will be in taxable form and 75 percent in tax-exempt form. This is the likely response to tax-exempt rates 40 percent below taxable rates rather than 30 percent as under current law. In the short run, however, in order to bring about this large a portfolio shift in long-run asset holdings, perhaps 50 percent of the market will be taxable until final equilibrium is achieved. The revenue estimates provided below reflect these assumptions.

Effects on Equity. On equity grounds, a 40 percent subsidy will mean a higher implicit tax rate on those holding municipal bonds -- 40 percent rather than the current implicit tax rate of about 30 percent. Very high-bracket taxpayers will continue to find tax-exempt bonds to be an advantageous investment since even the increased implicit tax of 40 percent will remain below the explicit taxes they will pay on taxable debt. Nonetheless, the after-tax income distribution in general will exhibit greater equity as a result of the reduced opportunity for tax avoidance by those in high-income tax brackets.

The improvement in tax equity will be brought about in two ways. First, there will be a smaller volume of tax-exempt debt available as some State and local governments choose to issue subsidized taxable rather than tax-exempt debt. Secondly, the tax-exempt debt which continues to be issued will command lower interest rates on the market. For both of these reasons, the dollar volume of interest income avoiding tax would be reduced by about 35 percent under the taxable bond option. At current levels, this will amount to a reduction of tax-exempt interest income of about $4.0 billion.

Effects on Tax Exemption as a Subsidy. The taxable bond option also will increase the efficiency of the current subsidy which tax exemption provides to State and local governments. Under current law, these governments receive less than 75 cents in reduced interest costs for each dollar of tax revenue foregone by the Federal Treasury. The incremental benefit to cost ratio under the taxable bond option is much more favorable. In the first five years of the plan, each dollar of Federal subsidy net of revenue gain will provide between $2 and $2.50 of interest savings. In the long run, this number will rise to over $4 per dollar of net Federal cost.

The high leverage of the taxable bond option as measured by State and local interest saving per dollar of net Federal cost results from two sources. The first, as already noted, is that the subsidy is only paid on issues of taxable bonds, whereas States and localities also benefit from the lower interest rates which will prevail on tax-exempt bonds. The second source of the high leverage of this plan is the fact that a portion of the cost of subsidizing taxable municipal bonds will be recouped as increased tax revenues on the new taxable securities. The result is that the net cost of the taxable bond option is considerably lower than the gross outlays for the subsidy. Under the assumption that the option is made available on January 1, 1979, the saving in interest costs for States and localities beyond that currently provided by tax exemption is as follows:

Calendar Year
($ billions)

1979	1980	1981	1982	1983
0.1	0.3	0.5	0.9	1.3

Effects on Cyclical Volatility. The taxable bond option will also help to solve the problem of the cyclical volatility of the municipal market. The main source of this short-run volatility, as well as a possible troublesome development in the long run, is the tendency of commercial banks to abandon the tax-exempt market causing tax-exempt interest rates to rise. Under the taxable bond option, the tax-exempt rate will be linked necessarily to the taxable rate by the subsidy percentage. With a 40 percent subsidy, borrowers trying to minimize interest costs will maintain the tax-exempt rate at 60 percent of the taxable rate. If the tax-exempt rate were to temporarily rise to more than 60 percent of the taxable rate, State and local governments would switch their new issues from the tax-exempt to the subsidized taxable market until the tax-exempt rate again declined to 60 percent of the taxable rate. Since the taxable bond option will assure that the tax-exempt rate is effectively tied to 60 percent of the taxable rate, the withdrawal of commercial banks from the tax-exempt market will not cause a rise in State and local borrowing costs. Instead, a decline in commercial bank participation will be reflected in an increased volume of taxable issues as State and local governments compensate for the lost bank demand by turning to other sources of lending such as tax-exempt institutions, life insurance companies and individual investors who are not interested in tax exemption. The taxable bond option will allow these governments to retain the benefit of a constant borrowing cost differential below taxable rates because they will be able to tap new sources of funds and new investors beyond those who now derive advantages from tax-exempt interest income.

Effective Date

The taxable bond option will apply to obligations issued after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
—	156	465	863	1355	1808

Outlay Estimate

Change in Outlays
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	199	592	1115	1770	2374

Technical Explanation

The Internal Revenue Code will provide an election for State and local governments, possessions or territories of the United States and the District of Columbia, to issue taxable obligations. The Federal Government will provide an interest subsidy of 35 percent of the interest cost on taxable obligations issued during 1979 and 1980, and 40 percent for obligations issued thereafter.

Form of Election. The election will be made in the form of a notice to the Secretary of the Treasury (or another official designated by the Secretary).

A separate election will be made by the issuer for each taxable issue. It is intended that the election be made at any time before the obligations are, in fact, issued (i.e., before there is a physical delivery of the evidences of indebtedness in exchange for the issue price). Thus, the issuer will be able to request dual bids (separate bids for tax-exempt bonds and for taxable bonds) and make the election based upon the bids received for both types of bonds.1/

An election with respect to any issue will be irrevocable once the obligations are issued. Thus, any notification to the Federal Government relating to an election could be withdrawn at any time before obligations are issued. No advance ruling or any other form of advance approval by the Secretary or any other Federal official will be required before the election can be made.2/

Eligibility. In general, all obligations the interest on which is exempt from tax under the Internal Revenue Code will be eligible for the taxable bond election. This includes general obligation bonds, revenue bonds, and short-term obligations such as tax anticipation notes. Also, industrial development bonds, the interest on which is exempt from tax under the Internal Revenue Code, and obligations the interest on which is presently tax-exempt under the Housing Act of 1937 will be eligible for the election. The election will not apply to arbitrage bonds, which are denied tax exemption under the Code, non-exempt industrial development bonds and obligations whose exemption derives from provisions other than the Internal Revenue Code or the Housing Act of 1937.

Obligations on which the United States guarantees all or part of the principal or interest or is liable to pay any part of the principal or interest will not be eligible for the subsidy. Further, obligations which the United States is committed to purchase as a means of providing financial assistance will not be eligible for the subsidy. For example, the United States may purchase or promise to purchase obligations at a price higher than the market price as a means of guaranteeing the bonds or subsidizing their interest payments.

Obligations will be eligible for this subsidy, however, even though the United States indirectly provides funds for the payment of part of the principal or interest. For example, obligations issued under Section 8 of the Housing Act of 1937 will be eligible for the subsidy.

Related Entities. The election to issue taxable bonds will not apply to any obligation which is held by an entity related to the issuer if the obligation is not issued pursuant to a public underwriting. This requirement is intended to prevent issuance of taxable bonds at an inflated rate to take advantage of the Federal subsidy. Since a State or local government may be making payments to related entities in any event, its share of an inflated interest rate may not be a real cost. Where these obligations are distributed through a public underwriting, the Federal Government can be assured that the interest rate on any obligation held by related entities is not overstated. In limited circumstances where a State or local government needs immediate funding and there is no public market for the obligations, the Secretary may waive the requirement of a public underwriting if he is satisfied that the interest rate is not artificially inflated.

An issue of obligations will be considered to have been issued pursuant to a public underwriting if the obligations are purchased by independent underwriters for resale to the general public. An issue will not be considered to have been purchased for resale to the general public unless at least 40 percent of the face amount of the issue is acquired for investment by persons which are not related entities. Further, in any case in which an issue is composed of obligations bearing different rates of interest, at least 40 percent of the face amount of the obligations issued at each separate interest rate must be acquired for investment purposes by persons who are not related entities.

Related entities include, in the case of a State, any political subdivision of the State, and, in the case of a political subdivision of a State, the State itself and any other political subdivision of the same State. Thus, unless issued in a public underwriting, bonds of one municipality purchased by another municipality within the same State will not be eligible for the taxable bond election. Furthermore, the State cannot, except through a public underwriting, buy eligible obligations of any of its municipalities nor can municipalities buy eligible obligations of their State. Any agency or instrumentality of a State or political subdivision (including any trust or plan for the benefit of the employees of a State or political subdivision) will be treated as part of the State or political subdivision. Thus, a municipality's pension fund is a related entity of the municipality, of all other municipalities of the State, and of the State. However, a municipal bond bank, whose function is to assist the marketing of obligations of small governmental issuers, will not be treated as a related party. Finally, in the case of obligations issued by an instrumentality of two or more States, all of the States involved and political subdivisions within those States will be considered related entities to the instrumentality.

Arbitrage. The arbitrage bond provisions of the Code currently applicable to tax-exempt bonds will be applicable to taxable bonds issued under the election. Thus, bonds denied the tax exemption under the arbitrage rules of the Code will not be eligible for the subsidy. In determining whether or not an obligation is an arbitrage bond (i.e., whether its proceeds are reasonably expected to be used to acquire securities which will produce a yield materially higher than the yield on the obligations issued), the yield on the issue will be determined with reference only to that portion of the yield which is to be paid by the issuing State or local government. In this way municipalities will have no incentive to issue taxable obligations in order to reinvest the proceeds in other taxable securities.

Payment of Subsidy. The Federal Government will make a payment of 35 or 40 percent (depending on the date on which the obligation was issued) of the interest liability of the issuer on each obligation to which a taxable bond election applies. The Treasury Department will pay its portion of the interest to the issuer (or to a paying agent appointed by the issuer). However, the Federal Government will not be liable for its payment on the obligation until the issuer has paid its portion of the interest on the obligation. Thus, if a State or local government defaults on its interest payment, the Federal Government will not be required to pay its portion of the interest on the obligation. Of course, the Federal Government will pay its portion at any time that the issuer cures its default by making its payment to the holders of the obligation.

The interest subsidy payment will be made without any condition or requirement by the Secretary of the Treasury. Thus, unless the bond or other obligation is determined to be ineligible for the election under the Code, the payment will be made automatically. In addition, the purposes for which the obligation is issued will not be reviewed by the Secretary as long as the obligation qualifies for the election under the Code.

The availability of funds necessary to finance the Federal interest subsidy will be assured by establishing an entitlement for State and local governments to the amount of appropriations necessary to pay the full accrued cost of the interest subsidy. Annual appropriations of the necessary funds will be automatic since, if no funds are appropriated, State and local government issuers will be able to sue the United States in the Court of Claims for payment of the funds. Such legal action will not be necessary since the Congress has not once failed to appropriate funds under entitlement programs.

Footnotes

1/ It is anticipated that bids on issues of serial bonds (i.e., where the bonds in the issue have varying maturities) will often indicate that a State or local government should split its issue, with the longer term bonds being taxable and the shorter term bonds tax-exempt. Nothing in this proposal will prevent a State or local government from splitting such an issue. For purposes of these provisions, however, the taxable bonds and the tax-exempt bonds will be considered to be separate issues.

2/ Of course, if a tax ruling is requested by the issuer prior to making the election, the Treasury Department will require that appropriate documents, as is the case today for tax-exempt bond rulings, be submitted or be made available to show that the obligations included in the issue qualify for the election under the Internal Revenue Code.

TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BONDS

Present Law

Industrial development bonds (IDBs) are obligations which raise capital for private business enterprise but are nominally issued by State or local governments. Most frequently, the proceeds of an issue of IDBs are used to acquire or to construct a facility; the facility is then "leased" to a private user for a rental exactly sufficient to pay debt service on the bonds. The lease generally provides that the private user may purchase the facility for a nominal amount at the end of the lease term. Payment of debt service on the bonds is secured by the rental payments and the facility itself. Generally the nominal issuer is not liable for payment of debt service on the bonds and the holders must look solely to the credit of the private user.

In issuing IDBs a State or local government essentially lends its tax exemption to a private business to enable it to finance facilities at the lower interest rates prevailing in the tax exempt market. In addition, the "lease" agreement between the issuer and the private user is generally treated as a conditional sale contract for Federal income tax purposes; the user is, therefore, able to obtain the tax benefits associated with ownership of the property, including investment tax credits and accelerated depreciation or amortization. State and local governments use IDB financing to assist local industrial development. Since these governments incur no liability on the bonds, which are universally recognized as a debt of the private user, the issuance of IDBs has no direct consequence to the nominal issuer.

Interest on State and local government obligations is generally exempt from tax under the Internal Revenue Code. However, the Revenue and Expenditure Control Act of 1968 denied tax exemption to IDBs, with certain exceptions. In general, a bond is an IDB under the Code if (1) the proceeds of the issue are to be used in any trade or business not carried on by a government or tax-exempt organization and if (2) repayment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in a trade or business. Obligations issued by a State or local government to raise funds for use by a non-profit, charitable organization in its trade or business are not generally treated as IDBs and are thus tax exempt.

The exceptions to the general rule allow tax exemption for IDBs issued to finance certain enumerated facilities and for certain "small issues". The enumerated facilities for which tax-exempt IDBs may be issued without any dollar amount limitation, include:

(1) Residential real property for family units,

(2) Sports facilities,

(3) Convention or trade show facilities,

(4) Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to these facilities,

(5) Public utility facilities used to provide sewage treatment or solid waste disposal and facilities designed for the local furnishing of electric energy or gas,

(6) Air or water pollution control facilities,

(7) Facilities for the furnishing of water, if available on reasonable demand to members of the general public, and

(8) Industrial parks.

There is also an exemption for "small issues" of IDBs in amounts of $1 million or less if the proceeds are used for the acquisition or construction of land or depreciable property. The $1 million limitation applies to all bonds issued to provide facilities in one municipality or county for the same person or group of related persons. At the election of the issuer, the $1 million limitation may be increased to $5 million; if elected, however, the higher $5 million limitation is restricted to projects where the total capital expenditures over a 6-year period will not exceed $5 million.

Reasons for Change

Prior to 1968, interest on industrial development bonds (IDBs) issued by State and local governments had been exempt from Federal income taxation. The use of such IDBs had been growing in importance as a mechanism by which State and local governments sought to attract plants to their communities. Through the use of IDBs, these governments had been able to extend the tax exemption afforded to interest on their securities issued for public investment to interest on bonds issued for essentially private purposes. Of course, as many

States and localities came to utilize this method, the competitive advantage was lost and the increased volume of tax-exempt financing affected the interest cost of public issues. These factors, and fear of increasing revenue losses to Treasury as use of this method of financing long-term private debt expanded, led to the limits on tax-exempt IDBs included in the Revenue and Expenditure Control Act of 1968.

In this Act, Congress did not remove the exemption for all industrial development bonds. In terms of the dollar volume of obligations, the most important of the exceptions that remain is for financing pollution control expenditures. As Table IIIB-1 shows, pollution control IDBs for the years 1973 - 1977 accounted for over 80 percent of private tax-exempt borrowing, and for 6 to 7 percent of all tax-exempt borrowing.

Table IIIB-1

Tax-Exempt Borrowing: 1971-1977

Year	Gross Long-Term Tax-Exempt Borrowing ($millions)	Private IDBs 1/ Pollution Control ($millions)	Private IDBs 1/ Others ($millions)	Pollution Control as Percent of: All Tax-Exempt	Pollution Control as Percent of: Private IDB's
1971	24,370	77	220	0.9	25.9
1972	22,941	563	471	2.5	54.5
1973	22,953	1771	270	7.7	86.8
1974	22,824	1673	340	7.3	83.1
1975	29,326	2134	518	7.3	80.5
1976	33,845	2064	357	6.1	85.3
1977	44,915	2982	476	6.6	86.2

Source: Weekly Bond Buyer

1/ Includes pollution control, small issues and industrial park IDBs. Does not include IDBs of a quasi-governmental character, such as airports, docks, wharves, and residential real property for family units.

As recently as 1971, in contrast, tax-exempt financing of pollution control facilities accounted for less than one percent of all tax-exempt borrowing. In fact, the annual volume of tax-exempt pollution control financing today is more than double the total annual volume of all industrial development bond financing in 1967 ($1.4 billion) which had motivated legislation to limit the use of tax-exempt IDBs. 1/

Table IIIB-2 shows how dramatically tax-exempt borrowing has increased as a source of funds for pollution control expenditures. Using estimates on air and water pollution control expenditures supplied by McGraw-Hill, the table shows that tax-exempt borrowing financed only 2.4 percent of pollution control expenditures in 1971. In contrast, tax-exempt borrowing has accounted for between one-fourth and one-third of all pollution control expenditures for the years 1973 through 1976.

Table IIIB-2

Importance of Tax-Exempt Borrowing for Pollution Control Expenditures

Year	Industrial Pollution Control Borrowing ($millions)	Air and Water Pollution Control Expenditures BEA ($millions)	Air and Water Pollution Control Expenditures McGraw-Hill ($millions)	% of Pollution Control Expenditures Financed by Tax-Exempt Borrowing BEA	% of Pollution Control Expenditures Financed by Tax-Exempt Borrowing McGraw-Hill
1971	77	n.a.	3245	n.a.	2.4
1972	563	3913	4501	14.4	12.5
1973	1771	4938	5687	35.9	31.1
1974	1673	5219	6922	32.1	24.2
1975	2134	6152	6702	34.7	31.8
1976	2064	6336	7713	32.6	26.8

Source: Weekly Bond Buyer, various issues, U.S. Department of Commerce, Bureau of Economic Analysis (BEA) Survey of Current Business, July issues, McGraw Hill, Pollution Control Expenditures; Annual Surveys

In permitting the pollution control exception in 1968, Congress could not have contemplated this large a volume of tax-exempt financing. It was argued at that time that private investments for pollution control could justify some type of Federal subsidy since these investments produced benefits to the public in terms of environmental improvement for which firms might not be compensated in private markets. Moreover, it was argued that the low level of spending on such investments assured that the revenue loss from exempting the interest on IDBs used to finance them would be small.

Furthermore, whatever their merit in the past, the reasons for allowing tax free interest on IDBs for pollution control no longer apply. In recent years, many pollution control investments have been effectively mandated by the requirements of Federal law and by EPA regulations that firms meet specified emissions standards.2/ Because these regulations compel firms to undertake the desired investments, tax exemption no longer functions as an effective incentive.

Moreover, continuing to allow tax-free IDBs to finance pollution control facilities has three undesirable effects:

1) It lessens tax equity by increasing the amount of interest income which is tax-exempt.

2) It creates economic inefficiencies by encouraging the wrong types of investments in pollution control equipment and by subsidizing some industries relative to others.

3) It raises the cost to State and local governments of borrowing in the tax-exempt market for public sector investments.

Thus, as discussed in detail below, the elimination of tax-exempt financing for pollution control equipment would promote tax equity and economic efficiency and would lower the cost of borrowing to State and local governments.

The two other types of tax-exempt IDBs that relate to borrowing for essentially private purposes are small issue IDBs and IDBs for industrial parks. Repealing the tax-exempt treatment of these bonds would also improve tax equity, increase economic efficiency, and reduce borrowing costs to State and local governments. However, an exception should be made for small issue IDBs in some economically distressed areas to promote economic development where it is most needed.

Finally, it is desirable to limit the use of tax-exempt bonds in financing hospital construction. Limits on such financing are complementary to other proposals included in the Administration's Hospital Cost Containment Act designed to prevent excess expansion of hospital facilities.

General Explanation

The Administration proposal will revise the tax law relating to IDBs in three respects. First, it will repeal the tax exemption for IDBs issued to finance pollution control facilities and industrial parks. These facilities will be placed on the same footing as other purely private facilities. The proposal will thus restrict access to the tax-exempt market to bonds issued to finance activities and facilities which are generally governmental in nature, thereby improving the access of those bonds to the market.

Second, the Administration proposal will revise the small issue exemption by doubling the $5 million small issue limitation to $10 million. The proposal will also limit this exemption to IDBs issued to finance the acquisition or construction of land or depreciable property in economically distressed areas. The utility of the small issue exemption will thus be enhanced, while at the same time the subsidy afforded by tax exemption will be targeted towards those areas in which it is most needed.

Third, as part of the Administration's Hospital Cost Containment program, the proposal will revise the definition of industrial development bonds to deny tax exemption to obligations issued to finance certain hospitals for which a certification of need has not been issued. Under present law, obligations issued by a State or local government to raise funds for use by a non-profit, charitable organization in its trade or business are not generally treated as IDBs and are thus tax-exempt. Under the Administration proposal, the definition of a taxable IDB will be expanded to include obligations issued to finance hospital facilities that are operated by such organizations, unless a need for the facilities has been established under the relevant provisions of the Public Health Services Act or the Social Security Act. If a need for the facility has been established, interest on the bond will remain tax-exempt.

Any industrial development bonds which can be issued on a tax-exempt basis may, at the election of the issuer, qualify for the Federal interest subsidy provided for State and local government issues under the Administration's taxable bond option proposal. (See TAXABLE BOND OPTION.)

Analysis of Impact

Pollution Control Bonds

It is undesirable to continue financing of pollution control investment with tax-exempt bonds because they decrease tax equity, reduce economic efficiency, and increase State and local borrowing costs.

Tax Equity. The existence of an opportunity to earn tax free income from any type of investment reduces the effective progressivity of the tax system by enabling high-income individuals to earn greater after-tax returns on capital than they otherwise would obtain. This windfall to high bracket lenders occurs because individuals in high tax brackets have more to gain from owning a tax free asset than individuals in low tax brackets. As the relative volume of tax-exempt borrowing increases, the interest rates on such bonds as compared to the rate on taxable bonds must rise to make them attractive to investors in lower tax brackets. As a result, the interest rate differential, in equilibrium, between tax-free and taxable bonds will be determined by the relative supplies of the two types of securities and by the statutory schedule of marginal tax rates. In the equilibrium thus determined, the lowest bracket buyer is indifferent between holding tax-exempt and taxable assets, while the higher bracket buyer receives a higher rate than needed to attract him to the tax-exempt asset.

In recent years, the interest rate differential between equivalent quality tax-exempt and taxable bonds has been equal to approximately 30 percent of the taxable interest rate. This means that any taxpayer with a marginal tax rate of above 30 percent would obtain a higher after-tax yield from tax-exempt bonds than from taxable bonds. In effect, the high income investor will pay an implicit tax, reflected in a lower gross interest rate, of 30 percent on tax-exempt securities rather than the rate that would otherwise be determined by his marginal tax bracket.

If the relative supply of tax-exempt bonds continues to increase by the issuance of more pollution control IDBs, the interest rate differential between taxable and tax-exempt bonds will fall, lowering the implicit tax on owners of tax-exempt bonds and increasing their windfall gain. The effective progressivity of the tax system will decrease, moving another step away from the nominal progressivity reflected in the statutory schedule of tax rates.

Eliminating the use of tax-exempt IDBs to finance pollution control investments will increase the amount of interest income subject to tax. The windfall gains to high income lenders from tax-exempt interest would fall, making the tax system more progressive relative to current law.

Economic Efficiency. It may be generally viewed as improper to allow private borrowers to avail themselves of the tax-exempt market. While this view is based on a common notion of fairness, allowing some firms to borrow at privileged rates also can have very harmful effects on economic efficiency by encouraging misallocation of scarce capital resources. More specifically, any special incentive for investment in pollution control equipment has undesirable efficiency effects in the context of legislated environmental standards.

The efficiency losses from such subsidies are of two kinds. First, because any definition of pollution control investment is necessarily arbitrary, only a limited number of the alternative ways of reducing pollution are subsidized. For example, a firm may reduce pollution by changing production processes or inputs used. However, under current law, only the installation of specifically designated "pollution control" equipment would be eligible for subsidized financing through IDBs.

Secondly, even if firms were to choose to purchase the same type of equipment without the subsidy, the subsidy still causes an efficiency loss through a misallocation of economic resources. The efficiency loss in this case occurs because the subsidy lowers the total cost of production in industries where significant outlays for environmental controls are required, thereby leading to relatively lower prices and relatively higher output in those industries as compared to what market forces would determine. The resource misallocation results from a failure to transmit to the consumer the appropriate economic signals which would induce him to purchase relatively less of those products involving high pollution control costs.

The proposed elimination of tax-exempt pollution control financing will provide firms with an incentive to select the lowest cost alternative among methods of pollution control consistent with existing Federal regulations. It will end the bias towards the defined eligible investments such as "end of the line" types of pollution control equipment fostered by present law tax incentives, and move in the direction of requiring consumers to pay the full cost of pollution control.

Furthermore, efficiency losses from providing a tax subsidy for pollution control facilities are much greater for new plants than for existing plants. Frequently, with existing plants, addition of pollution control equipment eligible for a tax subsidy is either the only feasible way of achieving environmental standards or the lowest cost method even in the absence of a subsidy.

It may also be argued that mandated pollution control investments for plants already in existence should not be fully borne by the firm and the consumers of its products. At the time the plant was initially built the firm may not have anticipated these extra capital requirements. The original investment was presumably made on the assumption that society did not place a high cost on emissions and would not compel firms to reduce pollution.

Current tax law does provide such subsidies for old plants. In addition to tax-exempt IDB financing, pollution control equipment installed in plants in use before January 1, 1976 is eligible for 5-year amortization and a 5 percent investment credit.

To provide continued assistance for existing plants, it is proposed elsewhere in the Administration's tax program to raise the investment credit from 5 percent to 10 percent for pollution control facilities amortized over five years (see REVISIONS TO THE INVESTMENT CREDIT.) Such investments may also be eligible for tax-exempt IDB status under present law. The proposed increase in the investment credit to 10 percent will typically more than compensate the investor for the loss of the interest savings realized by borrowing in the tax-exempt market.

Another proposal in the Administration's tax program is to provide States and localities with the option of issuing taxable bonds with a Federal subsidy in all cases where tax-exempt borrowing is currently allowed. (See TAXABLE BOND OPTION.) The efficiency losses from continuing to allow tax-exempt borrowing for pollution control equipment would be even greater under this plan for a taxable bond option (TBO) than under current law. TBO will lower the interest rate on tax-exempt borrowing from about 70 percent to 60 percent of the taxable rate. Because the subsidy rate to tax-exempt borrowers is thereby increased, the efficiency losses resulting from providing tax exemption for pollution control IDBs are also increased. Thus, while it is desirable to remove pollution control bonds from the tax-exempt market under current law, it is even more important under TBO.

State and Local Borrowing Costs. Allowing private firms to use tax-exempt IDBs for pollution control equipment raises the cost of borrowing to State and local governments. As the supply of tax-exempt bonds increases, their price must fall to attract additional investors in lower marginal tax brackets. Thus, the expansion of the use of IDBs in recent years has had the effect of raising the interest rate paid by State and local borrowers. It is for this reason that the National League of Cities and the Municipal Finance Officers Association have consistently opposed the financing of pollution control investment through the tax-exempt market. 3/

Recent studies have estimated that for each extra billion dollars of tax-exempt borrowing, interest rates on tax-exempt issues rise by 5 to 20 basis points. (A basis point equals .01 percent.) 4/ In 1977, tax-exempt borrowing for pollution control IDBs was equal to almost $3 billion (See Table IIIB-1). Thus, the research findings imply that tax-exempt interest rates in 1977 were from 15 to 60 basis points higher than they would have been if there were no pollution control IDBs. Using a conservative estimate of 25 basis points or 1/4 of 1 percent, the additional annual interest cost on the $41.5 billion of non-IDB State and local obligations issued in 1977 can be estimated to be in excess of $100 million. This additional cost will occur for each of the 20 or more years these bonds will be outstanding. Savings of this magnitude will occur upon removal of these bonds from the tax-exempt market.

Another way of viewing this saving is to note that at prevailing levels of tax-exempt interest rates, 25 basis points is equal to a reduction in interest costs of slightly over 4 percent. At current levels of debt service (about $9 billion annually), this amounts to an annual interest savings of $360 million when all outstanding obligations have been issued under the new rules.

Elimination of tax-exempt IDBs for pollution control equipment would, therefore, lower the cost of financing State and local public services. The potential loss to State and local governments from continuing this tax-exemption is likely to become greater in future years, because borrowing for pollution control equipment is likely to increase.

The above analysis of the interest savings to State and local governments does not take into account the effects of the proposal to provide State and local governments with the option of issuing subsidized taxable bonds (See Taxable Bond Option). Under the taxable bond option, the tax-exempt interest rate will be a fixed proportion of the taxable rate. In this case, the increase in IDB tax-exempt financing would increase the volume of municipal bonds shifted from the tax-exempt into the subsidized taxable market, but the ratio of tax-exempt interest rates to taxable rates would remain unchanged.

The cost to the Treasury, however, of providing the subsidy to taxable municipal bonds would be increased by allowing pollution control IDBs to remain in the tax-exempt market. Since a relatively larger supply of municipals or tax-exempt IDBs implies a larger volume of subsidized taxable issues, greater subsidy payments are required of the Treasury. Removing pollution control bonds from the tax-exempt market will, therefore, reduce the Federal costs of maintaining the taxable bond option.

Other Industrial Development Bond Provisions

Small Issue IDBs. The $1 million and $5 million small issue IDBs are frequently used by States and localities to promote economic development by attracting new plants. If their use is available to everyone, however, then any potential benefit to one locality in attracting plants is cancelled by the use of IDBs by other localities. For this reason, it is proposed here to retain the use of small issue IDBs only for those areas most in need of relief. In those areas of economic distress, it is proposed to extend the dollar limit on the amount of capital expenditures eligible for tax-exempt financing from $5 million to $10 million. For areas which do not qualify as economically distressed, the use of tax-exempt small issue IDBs will be disallowed entirely.

This proposal will reduce the losses in tax equity associated with tax-exempt financing, while at the same time channeling the tax subsidy to areas currently experiencing economic distress (for example, urban areas with very high unemployment rates) and requiring special assistance.

Industrial Parks. The tax-exempt financing of industrial parks allowed under current law also represents an unwarranted extension of the privilege of tax-exempt borrowing for purely private purposes. It raises the same issues of tax equity and economic efficiency already discussed. It also contributes to higher costs of State and local borrowing for public facilities.

Hospital Bonds. Finally, it is desirable to limit the use of tax-exempt bonds in financing hospital construction. Under present law, the definition of a taxable industrial development bond generally does not include an obligation issued to finance a trade or business carried on by a private, non-profit charitable organization. Thus, many bonds issued by State and local governments to finance facilities for private non-profit hospitals are not considered to be taxable IDBs and are eligible for tax exemption on the grounds that they have been issued directly or indirectly by States and localities.

The Administration is concerned that excess expansion of hospital facilities is increasing costs of medical care and has, therefore, proposed, in its Hospital Cost Containment Act, that the number of certificates of need for hospital construction be drastically reduced. In order further to reduce incentives for construction of excess hospital facilities, the Administration proposal will not allow tax-exempt IDB financing for hospitals operated by charitable organizations for which a certificate of need has not been issued.

Effective Date

In general, the proposed changes will apply to obligations issued after the date of enactment. The proposed changes will also apply to obligations issued after February 1, 1978 unless it is reasonably expected on the date of issuance of the obligations that at least 85 percent of the "spendable proceeds" (as defined in Proposed Treasury Regulation 1.103-14(b)(iii)) will have been expended within three years of the date of issuance of the obligations.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years				
1979	1980	1981	1982	1983
26	80	138	198	260

Technical Explanation

The tax exemption for small issues of IDBs provided by section 103(b)(6) of the Code will be amended to provide exemption only for issues the proceeds of which are used for the acquisition or construction of land or depreciable property located in an economically distressed area. For this purpose economically distressed areas will be defined by reference to such factors as (1) an average annual unemployment rate in excess of the national average rate and (2) an average annual growth in employment below the corresponding national rate. These criteria identify those areas with chronic unemployment problems which are attributable to an inability to absorb employable resident workers.

In addition, the proposals will be implemented by amending section 103(b)(6)(D) of the Code to substitute $10,000,000 for all references to $5,000,000, and by deleting sections 103(b)(4)(F) (relating to pollution control facilities) and 103(b)(5) (relating to industrial parks). Finally, section 103(b)(3)(B), which generally provides an exemption from industrial development bond treatment for obligations issued to raise funds for non-profit, charitable organizations, will be amended to deny the exemption to (and thus treat as taxable) obligations issued to finance hospital facilities for such organizations, unless a certificate of need for the facilities has been issued under section 1523 of the Public Health Services Act or construction of the facilities has been approved under section 1122 of the Social Security Act.

Footnotes

1/ Congressional Record, Volume 114, Part 7, March 28, 1968, p. 8148.

2/ Federal and State regulation issued under authority in Clean Air Act 42 U.S.C. 1857 et. seq. (1970) (prior to 1977 amendments), and Federal Water Pollution Control Act Amendments of 1972, 33 U.S.C. 1341 - 1345 (1972)

3/ See, for example, Municipal Finance Officers Association Policy Resolution adopted April 30, 1975 in Montreal, Canada; and National Municipal Policy, official policy positions of the National League of Cities, most recently adopted in San Francisco, in December, 1977.

4/ John E. Peterson, The Tax-Exempt Pollution Control Bond, Municipal Finance Officers Association, March 10, 1975; Peter Fortune, "Impact of Taxable Municipal Bonds: Policy Simulations With a Large Econometric Model," Federal Reserve Bank of Boston, 1974; John E. Peterson, "Changing Conditions in the Market for State and Local Government Debt," Joint Economic Committee Study, April 16, 1976; and George E. Peterson and Harvey Galper, "Tax Exempt Financing of Private Industry's Pollution Control Investment," Public Policy, Volume XXIII, Winter 1975, Number 1.