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UNITED STATES GOVERNMENT

Memorandum

Department of the Treasury
Washington, D.C. 20220

TO : Susan Magee

DATE: Jan. 20, 1978

FROM : Harvey Galper

SUBJECT: Briefing Material for the Secretary's Meeting with the Mayors

Enclosed are briefing materials for the Secretary's meeting with the U.S. Conference of Mayors on Jan. 26. The materials consist of:

1. Talking points for the meeting on the subject of the Tax Program and Urban Policy

2. Fact Sheets on the President's Tax Program on the Taxable Bond Option and Industrial Development Bond Proposals

3. Q's and A's on these two proposals

4. A Background Fact Sheet on the relationship between the Tax Program and Urban Policy

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FACT SHEET

State and Local Taxable Bond Option

The President's Proposal:

State and local governments will have the option of issuing either conventional tax-exempt bonds or taxable bonds which will receive a subsidy from the Treasury for a fixed percentage of their interest costs. The choice will be entirely a matter for the state or local government to decide. For 1979 and 1980, the Federal Government will pay 35 percent of the interest costs on taxable bonds issued by state and local governments. For bonds issued thereafter, the interest subsidy will be 40 percent of the interest costs.

Present Law:

Interest payments received from debt obligations issued by state and local governments and their instrumentalities are exempt from Federal taxes. In contrast, all debt obligations issued by the Federal Government are subject to Federal income tax.

Reasons for the Recommendation:

The proposal will make an important contribution to tax fairness and increased efficiency in the use of public resources.

The tax exemption of interest on state and local bonds is essential to local government and should not be interfered with in any way. At the same time the windfall to higher income persons who do not pay tax on such interest can be reduced.

The tax exemption on state and local bonds is also an inefficient means of aiding state and local governments, since less than three quarters of the tax loss to the Treasury actually accrues to state and local governments through

lower borrowing costs. Providing a subsidy to state and local governments which issue taxable bonds will be a more efficient means of reducing the borrowing costs of these governments since in the long-run each dollar of net subsidy cost will provide $4 of benefits to the state or local governments. With the proposed subsidy on taxable bonds, state and local governments will save interest costs equal to $90 million the first year and $1.3 billion in the fifth.

Jurisdictions continuing to issue tax exempt bonds will also gain because the reduced supply of such bonds will allow governments to sell them at lower interest rates.

Effect on Taxpayers:

The proposal will have a direct tax effect only on those persons who wish to purchase tax exempt bonds as a means of shielding part of their income from taxation. Because some state and local bond issues will be taxable, the supply of tax exempt issues will be reduced. Thus tax exempt bonds will be sold with lower interest rates, reducing their benefit to taxpayers and lessening tax avoidance.

The proposal will also provide a benefit to state and local taxpayers through lower interest costs on government borrowings.

Effect on Revenue:

The net cost to the Federal Government of the taxable bond option will consist of the subsidy payments on taxable bonds, minus the higher revenues from taxes on interest income on the taxable bonds. The estimated net costs for calendar year 1979 and 1983 are less than $50 million and $0.6 billion, respectively.

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Taxable Bond Option - Inefficiency of Present Bond Market

QUESTION: Why does the Treasury want to give state and local governments the option to issue taxable obligations with a Federal interest subsidy?

ANSWER: Interest on state and local obligations is exempt from Federal income tax in recognition of the independent sovereignty of state and local governments and of the role of state and local governments, as the governmental entities closest to the people, in solving local problems. The exemption is, in effect, an indirect subsidy to these governments which allows them to borrow at reduced cost. We do not propose to repeal this exemption.

The present subsidy is an inefficient form of assistance, however, since the loss of federal tax revenue is greater than the reduction in interest costs to state and local governments. This is because the tax-exempt market is limited to relatively high bracket taxpayers who are able to offset lower yields on tax-exempt debt with income tax savings. However, the supply of debt is greater than the highest bracket taxpayers are able to absorb. Therefore, the tax-exempt market has had to expand to include lower bracket taxpayers. These lower bracket taxpayers demand higher yields since the tax exemption will afford them lower tax savings. In this situation, high bracket tax savings exceed that necessary to compensate them for lower yields. This windfall is a drain on the Federal Treasury which goes to wealthy bondholders, and not to state and local governments.

Recent history indicates that tax-exempt bonds have approximately a 30 percent lower yield than comparable taxable securities. This means that a windfall will accrue to any taxpayer whose marginal tax rate exceeds 30 percent since his tax savings will exceed the reduction in yield attributable to buying a tax-exempt security rather than a taxable security.

The taxable bond option will improve the efficiency of this Federal assistance in two ways:

-- If a state or local government elects the option, the entire Federal expenditure will go directly to the government as an interest subsidy, rather than to bondholders as a windfall.

-- If a state or local government does not elect a subsidy it should nonetheless benefit from reduced interest costs as long as other governments elect the option. The election of other governments to issue taxable debt will reduce the supply of tax-exempt debt and, therefore, the need for tax-exempt debt to appeal to lower bracket taxpayers. This will reduce state and local government interest costs and reduce the windfall to high bracket bondholders.

Taxable Bond Option - Eventual Elimination of Tax-Exempt Bonds

QUESTION: Will the taxable bond option restrict the right of state and local governments to issue tax-exempt obligations? Is it a foot-in-the-door towards eliminating the tax exemptions?

ANSWER: No. The taxable bond option only offers state and local governments an election to issue taxable bonds and, if they so elect, to receive a direct Federal interest subsidy in lieu of the indirect subsidy which they receive on tax-exempt debt. It is _only_ an option. State and local governments will remain free to borrow in the tax-exempt market and it is expected that the bulk of municipal debt will continue to be issued in tax-exempt form.

BACKGROUND: Many representatives of state and local governments - and their associations - have expressed the fears that the taxable bond option is the first step toward eventual repeal of the tax exemption for interest on municipal bond. We must assure them that it is not.

Taxable Bond Option - Benefit to Municipalities

QUESTION: How will state and local governments benefit from the taxable bond option?

ANSWER: State and local governments will benefit in two ways. Those issuers who elect to issue taxable bonds will, of course, receive the 40 percent interest subsidy; at this rate state and local governments will receive a greater reduction in their interest cost than the 30 percent reduction now available through issuing tax-exempt debt.

In addition, those who elect the option will enjoy a broad market for their taxable obligations. This market should be greater than the market for their tax-exempt obligations since ti will include tax-exempt institutions for whom tax-exempt debt has no attraction. In addition, many smaller issuers typically place their obligations with small, local banks. The attractiveness of tax-exempt debt to these banks depends in large part on their tax position. The option of being able to issue taxable debt will enable governments to tailor their security issues to the needs of their lenders rather than being dependent upon a narrowly-based tax-exempt market.

Those municipalities which do not elect the option will benefit from lower tax-exempt interest rates. The lower interest rates will follow from a reduction in the supply of tax-exempt debt attributable to the election of other issuers to issue taxable debt.

We estimate that the interest savings to state and local governments will amount to $90 million in the first year, rising to $1.3 billion in the fifth year of the program.

Taxable Bond Option - Conditions Attached for Subsidy

QUESTION: Are there any conditions attached to obtaining this subsidy? For example, can the Treasury specify the purposes for which the bonds be issued?

ANSWER: There are no conditions attached to obtaining the subsidy. The issuer must merely file the election form with the Treasury. The purposes for which the bonds are issued will not affect eligibility for the subsidy except insofar as they affect the eligibility of the bonds for tax exemption. For example, if the proceeds are used in a manner which would make the bonds industrial development bonds or arbitrage bonds, the bonds would not be tax-exempt and would not be eligible for the subsidy.

Taxable Bond Option - Bail Out for Troubled Cities

QUESTION: Isn't the taxable bond option a "bail out" for the cities of the Northeast or for those that have poorly managed their credit standing?

ANSWER: No. Under the taxable bond option the Federal Government is only committed to pay 40 percent of the interest cost of the issuer's obligation. The states and localities regardless of their circumstances must pay the other 60 percent themselves. The subsidy does not in any way constitute a Federal guarantee to pay the issuer's portion of the interest cost. Since Federal credit will not underlie the obligations, the taxable bond option will not enable fiscally troubled and uncreditworthy issuers to gain access to a market which is not available to more prudently managed governments.

Thus, while the subsidy does provide a greater advantage to state and local governments than tax-exemption now produces, it does so equally for all borrowers.

All governments, both those with good and bad credit standing, will benefit from the option because of reduced borrowing costs and an improved access to credit markets.

Taxable Bond Option - Eligible Obligations

QUESTION: What obligations will be eligible for the taxable bond option?

ANSWER: Any obligation which is exempt from Federal income tax under the section 103 of the Internal Revenue Code or under section 11(b) of the Housing Act of 1937 will be eligible for the taxable bond option.

BACKGROUND: The Department of Housing and Urban Development has expressed concern that their housing bonds continue to be exempt from tax and also be eligible for the option. The proposal will not affect the tax-exemption for their bonds and will allow such bonds to be eligible for the option. However, the basis for their exemption should be transferred from the Housing Act to the Internal Revenue Code to assure that all tax-exempt securities adhere to the same rules and regulations.

TAXABLE BOND OPTION

QUESTION: What is the proposed rate of subsidy on taxable obligations? How is it determined?

ANSWER: The proposed rate of subsidy will be 35 percent for obligations issued during 1979 and 1980 and 40 percent for obligations issued thereafter. The subsidy was set at the permanent level of 40 percent to provide a significant additional benefit to state and local governments beyond the 30 percent subsidy which tax exemption currently provides. (The 30 percent subsidy is the average differential of tax-exempt rates below taxable rates.)

With a 40 percent subsidy on taxable bonds, states and localities would be induced to shift a significant amount of borrowing into the taxable market thereby improving the equity of the tax system. It is estimated that a 40 percent subsidy would cause approximately 25 percent of the municipal bond market in the long run to take the form of subsidized taxable securities. In other words, financial investors in the long run would wish to hold in their portfolios a 25 percent smaller stock of tax-exempt securities with tax-exempt rates at 40 percent rather than 30 percent below taxable rates.

In the short run, however, to bring about this large a shift in portfolio holdings, a very high percentage of new municipal securities would be issued on a taxable basis. To facilitate the market adjustment to a 40 percent subsidy, we have proposed a subsidy of 35 percent for a transitional two-year period. Under this program, the share of new municipal issues which will be in a subsidized taxable form is expected to be approximately 40 percent for the first two years, rising to a 50 percent share with the initial introduction of the 40 percent subsidy and then falling gradually to the long-run share of 25 percent.

Taxable Bond Option - Payment of Subsidy

QUESTION: How can bondholders and state and local governments be sure that the federal government will pay the interest subsidy?

ANSWER: The Treasury proposal will establish an entitlement for those issuers which have issued taxable debt under the taxable bond option. The entitlement will establish the right of the issuers to the subsidy without condition. Congress has never failed to appropriate funds to fund entitlement programs, and if it should fail to do so, issuers of taxable debt would have standing to sue the United States for the funds.

Taxable Bond Option - Mechanics of Subsidy

QUESTION: What are the mechanics for issuing taxable bonds with the federal interest subsidy?

ANSWER: The mechanics for issuing taxable bonds are very simple. Each issuer will make an election with respect to each issue of obligations. We expect that in issuing bonds issuers will frequently seek bids on both a taxable and tax exempt basis. After bids are received the issuer will be in a position to decide which is the more advantageous basis on which to issue its debt.

If the issuer decides to issue taxable bonds, it will file a simple form with the Treasury. We expect this form will be no more than a single page. The form will simply call for the name of the issuer, the principal amount and maturity date of the obligations, and the interest rates which the obligations bear.

The Treasury will then pay its portion of the interest to the issuer (or to a paying agent appointed by the issuer) at the time that the issuer pays its portion of the interest on the obligation. If the issuer fails to pay its portion of the interest on the obligation, the federal government will not pay its portion until the issuer cures its default at a later time.

BACKGROUND: The municipalities fear that the mechanics of the option will be complex, require voluminous paper shuffling and result in the creation of a new federal bureaucracy.