to: Don

room: ________ date: 11/6

Department of the Treasury
Office of the Secretary
Office of Tax Analysis

Attached is a revised memorandum on the CEA debt/tax substitution issue which is better suited for sending to Charlie Stuart. The incoming original is attached.

The main purpose of my memorandum to you was to explain that we had thought of the issue they raised and are forced to make exact estimates of those behavioral effects for our revenue estimates.

Tom N

Attachment

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Don Fullerton November 6, 1985

Tom Neubig

CEA Memo on Substitutability of Tax-Exempt Bonds for Deductible Taxes

Thank you for sharing the memorandum of Bizer/Stuart of the Council of Economic Advisors concerning the effects of repealing deductibility of state and local taxes while retaining tax-exempt bonds. Outside analyses, such as the CEA memorandum, are useful in raising theoretical issues that should be considered in our economic analyses, including revenue estimates. In this particular case, the revenue estimate does incorporate some debt/tax substitution, but we do not believe it would be very large, particularly in the short-term.

Three quick comments:

1) They are correct that tax and debt financing are possible substitutes. I question their assumption that they are "close" substitutes and that there would be a "substantial" shift between debt and tax finance, particularly in the short-run during the relevant revenue-estimating horizon. A recent paper by Slemrod and Gordon indicates that even the long-run substitution effect would be relatively minor. There is currently an incentive for low-income communities that benefit little from itemized deductions to borrow, but they still rely greatly on tax finance. Several institutional features are overlooked:

- o Most states and localities have self-imposed borrowing limits which in many instances are truly binding; and
- o Generally accepted budgeting practices do not allow use of long-term debt to pay operating expenses.

2) They suggest that "the revenue gains from eliminating tax deductibility may be largely illusory" as a result of the debt/tax substitution. They state that the amount of the offsetting revenue loss "depends on individual saving behavior." I would disagree with their implication that the offset would be large since the empirical evidence does not indicate close substitutability. I had recommended to Karen Sider that the

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revenue estimate for state and local tax deductions be adjusted downward to allow some loss due to substitution of business taxes or other deductible taxes if there is selective repeal, as well as for a small amount of loss due to increased debt finance. We would be interested in the point estimate of the appropriate debt/tax substitution elasticity that they would suggest using for the FY 1986-1990 revenue estimates.

3) I would agree that their recommendation to repeal all tax-exempt bonds as well as deductibility makes economic "sense". In fact, the OTA staff made the same recommendation at the beginning of the tax reform process. Unfortunately, it is wishful thinking politically.