STATES GOVERNMENT

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Washington, D.C.

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DATE: July 6, 1973

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SUBJECT: Some Thoughts on the Advance Refunding Proposal and the Interrelationship of This Proposal with the Proposal for Optional Taxable Municipals

A simpler way to prevent arbitrage than that proposed by the Treasury on April 30, 1973, would be to require advance refunding monies, if reinvested, to be invested in other tax-exempt bonds. This would guarantee that a municipality or state could not profit by "converting" taxable securities into tax-exempt ones. Furthermore, this simpler proposal would avoid two unfortunate consequences of the Treasury proposal:

1. the need for the Treasury to issue new securities and to decide on what the appropriate yield should be in the case of each refunding, and

2. changes in the level of Federal debt at the initiative of state and local governments.

I assume that the simpler proposal outlined above was not adopted because Treasury wanted to minimize the opposition of state and local governments to the proposal. That is, Treasury can argue that under its proposal, state and local governments are better off by one-eighth of a percentage point. Requiring state and local governments to re-invest in other tax-exempt bonds would make them worse off by one-eighth of a percentage point. However, the objective of Congress in its 1969 enactment of section 103(d) was to close this loophole in spite of the displeasure of these issuers. The proposal made here would hopefully complete this task. We might want to check with Snyder and Cavanaugh in Debt Analysis for their opinion.

Should municipalities be allowed to issue taxable bonds with Federally subsidized interest , the advance refunding problem becomes more complex. A state or local government can refund taxable or tax-exempt bonds by issuing new taxable or tax-exempt bonds and reinvest the proceeds in taxable or tax-exempt bonds. It seems that Treasury need be concerned only if the refunding has the effect of arbitraging between taxable securities and tax-exempt ones.

We don't know if anyone has considered the advance refunding problem in a world with both tax-exempt and taxable municipals. Even in this world, it may be reasonable to require advance refunding monies, if reinvested, to be invested in tax-exempt issues. If they were allowed to be reinvested in taxables, the interest surely should be taxed at the subsidy rate.