Statement of Frank E. Morris

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I am happy to have an opportunity to testify on behalf of S.3215 which embodies, in my judgment, the best approach to broadening the market for the securities of state and local governments. Such a broadening of the market is essential if the capital needs of state and local governments are to be adequately financed in the decade ahead.

I should make it clear from the outset that I am testifying as a long-time student of the municipal bond market, not as a representative of the Federal Reserve System. As you know, the Federal Reserve has not yet taken a position on this bill.

Over the course of the past seventeen years I have had an opportunity to study the municipal bond market from a number of vantage points. As Research Director for the Investment Bankers Association, I observed the market from the standpoint of the bond underwriter. As Assistant to the Secretary of the Treasury for Debt Management (1961-63), I had an opportunity to view the market from the standpoint of the U. S. Treasury. Subsequently, I saw the market from the standpoint of the investor as a Vice President of Loomis, Sayles and Company, an investment counselling firm which buys substantial amounts of municipal bonds for its clients.

In my present capacity, I have expressed my concern that the municipal bond market, as it is presently constituted, has too narrow a base to meet the rapidly growing financial needs of state and local governments in an adequate manner. Moreover, because of its extreme dependence on the commercial banks, the existing tax-exempt market is extremely sensitive to changes in monetary policy.

All of us in the Federal Reserve are concerned about the uneven impact of a tight money policy on the various sectors of the economy. Two of the most prominent victims of a tight money policy are housing and state and local governments. We will never eliminate this problem completely until we learn to control Federal Government fiscal policy more responsibly than in the past and until we adopt measures which will mitigate large swings in

business capital investment. Nonetheless, we can do a great deal to improve the situation by strengthening the markets for the securities of the weaker claimants on the flows of capital funds.

We have undertaken to strengthen the mortgage market and our efforts have met with some considerable success. While housing did not escape the money squeeze of 1969-70, the contraction in housing starts was, in my judgment, much less than it would have been had we been operating with the same sort of mortgage market that we had in 1966. Thus far, however, we have done nothing to improve the structure of the municipal bond market.

S.3215 would create a dual market for municipal bonds. The tax-exempt market would continue to function, but the volume flowing through it would be reduced and yields on tax-exempt bonds would be lower. The breadth of the impact of the dual market will be directly related to the level of the interest subsidy paid on taxable bonds. With a one-third interest subsidy in a tight money year such as 1969, taxable bonds would amount to 20 to 25% of the total volume of new issues, with the volume of taxable bonds falling off to about 10% of the total in an easier money year such as 1968. The principal contribution of the taxable municipal market in relatively easy money years, such as 1968 or 1971, would be to act as a safety valve for periods of congestion in the tax-exempt market.

The starting point in any assessment of the costs and benefits of S.3215 is the recognition that there would then be two Federal subsidies in effect on municipal bonds: the subsidy given indirectly through tax exemption (since tax-exempt bonds under a 33% subsidy would still remain the most widely used financing vehicle) and the subsidy given directly on taxable municipal bonds. One of the most constructive results of S.3215 would be to improve the efficiency of the subsidy given through tax exemption by automatically preventing an overloading of the tax-exempt market.

There is a lot of room for improvement. The Treasury estimated that in fiscal 1968 the cost of tax exemption to the Treasury was $1.8 billion, while the interest savings to state and local governments amounted to $1.3 billion - - leaving a gap of $500 million which accrued to the benefit of high-bracket individuals, commercial banks and casualty insurance companies. Harvey Galper of the Urban Institute estimates that in fiscal 1971 the cost of tax exemption to the Treasury had risen to $3.3 billion, the interest savings of state and local governments to $2.5 billion - - leaving a gap of $800 million accruing to the benefit of private investors.

In assessing the costs, if any, of S.3215, the Congress should not forget that the Treasury is already subsidizing in a massive and grossly inefficient manner the debt issues of state

and local governments. It is, to my knowledge, the only subsidy given by the Federal Government in which the cost to the government is obviously much greater than the benefits received by the intended beneficiaries. If S.3215 were adopted, the relative size of this gap (which represents a major source of inequity in our income tax structure) would gradually be reduced, although it will never be eliminated with a one-third subsidy level.

The process of analyzing the costs and benefits of S.3215 is exceedingly complex because the results will vary from year to year depending on how the new issue volume is split between the tax-exempt and taxable markets, and this split will depend on the financial conditions prevailing in the economy at the time, given the terms of the two subsidies. An econometric capital markets model is needed if we are to attempt to quantify the costs and benefits of this bill.

Until recently, only one model had been developed which was capable of handling this problem - - the model developed at the Urban Institute by Galper and Petersen. For two years work has been proceeding at the Federal Reserve Bank of Boston under the direction of Peter Fortune toward generating a capital markets model capable of dealing with a broad array of financial problems. This model is much more complex than the Galper-Petersen model (40 equations versus 4) and, we believe, technically superior. I will not attempt to describe the model in my statement, but I am submitting a supplementary statement describing the model for the use of the Committee.

The tables which follow compare the results of the two models for the period 1968-70. Table I estimates how the market would have been divided between tax-exempt and taxable bonds during the 1968-70 period with subsidy rates of 33% and 40%. The Boston Fed model indicates that with a 33% subsidy taxable bonds would have accounted for 9% of the market in 1968, rising to about 21% in the tight money year of 1969 and falling to 14% in 1970.

If a 40% subsidy rate were to be adopted, which I would personally favor, a much greater broadening of the municipal bond market would result. Our model suggests that taxable bonds under a 40% subsidy would have constituted about 40% of the market in 1969 and between 20% and 25% of the market in 1968 and 1970.

Table II presents our attempts to quantify the costs and benefits under both a 33% and a 40% subsidy. The most difficult point in the analysis is the assumption with respect to the average tax bracket of the investors who would be shifted out of tax-exempt bonds into taxable securities. In our model we have operated under the same assumption as Galper-Petersen. We have assumed a perfect market in which the marginal buyer of municipal bonds is at a "break-even" position relative to corporate bonds and the marginal tax rate to be applied is at the midpoint of the two "break-even" rates, before and after subsidy. This assumption has a theoretical nicety about it and it is well adapted to the needs of the computer, but I am not convinced that it is

TABLE I

SHARE OF TAXABLE STATE-LOCAL BONDS IN TOTAL GROSS ISSUES OF STATE-LOCAL BONDS DURING 1968-1970 IF TAXABLE BOND OPTION HAD BEEN ADOPTED IN 1968

	Market Share with 33% Subsidy Rate		Market Share with 40% Subsidy Rate	
Period	FRB-BOS	Galper-Petersen	FRB-BOS	Galper-Petersen
1968	8.8%	0	25.5%	20.2%
1969	20.5%	23.5%	39.7%	55.2%
1970	14.3%	11.7%	22.4%	33.3%
1968-70	13.9%	10.5%	27.9%	34.3%

Source: Model Simulations in Tables I and II of paper "The Benefits and Costs of Allowing State-Local Governments to Issue Taxable Bonds with a Direct Subsidy: Application of the FRB-BOS Capital Market Model."

TABLE II

BENEFITS AND COSTS OF TAXABLE BOND OPTION
OVER THREE YEAR PERIOD 1)

Subsidy Rate	33%		40%	
Method of Estimation	FRB-BOS	Galper-Petersen	FRB-BOS	Galper-Petersen
Direct Subsidy Cost	255	207	681	895
Higher Interest Cost 2)	18	27	50	85
Total Cost to Treasury	273	234	731	980
Additional Tax Revenues	244	134	629	570
Net Cost to Treasury	29	100	102	410
Lower S&L Interest Costs	42	40	204	199
Increased S&L Borrowing	644	1,203	1,215	3,423

1) Source: Model Simulations in Tables I and II of paper "The Benefits and Costs of Allowing State-Local Governments to Issue Taxable Bonds with a Direct Subsidy: Application of the FRB-BOS Capital Market Model."

2) Higher interest cost to the Treasury on its own borrowings due to the increased volume of taxable bonds.

necessarily descriptive of the real world. I suspect that there are major discontinuities in the market for municipal bonds and that, therefore, the cost to the Treasury of the subsidy program may well be overstated in our model. For this reason, I believe that the cost figures generated by the model should be viewed as the maximum costs rather than median or most probable costs. In any event, our model generates very small net cost figures to the Treasury, substantially lower than the estimates produced by the Galper-Petersen model. Our "maximum" cost estimates for the three-year period 1968-70 amount to $29 million under a 33% subsidy and $102 million under a 40% subsidy.

Against these "maximum" costs the model indicates an array of benefits which clearly indicate that an exceedingly high ratio of benefits to costs would be produced by this bill:

1. Lower interest costs to state and local governments which vastly exceed the "maximum" costs to the Treasury.

2. The ability of state and local governments to sell their bonds in two markets will permit state and local governments to cope much more effectively both with periods of tight money and with periods of temporary congestion in the tax-exempt market.

3. By preventing an overloading of the tax-exempt market, the efficiency of the $3.3 billion subsidy given through tax exemption would be improved substantially over time.

4. As a consequence of the improved efficiency of the tax-exempt market, the element of inequity in our tax structure stemming from tax exemption would be substantially reduced over time.

I can appreciate the concern of the Congress in contemplating the financing of a new program through a permanent, indefinite appropriation in the absence of hard data on the costs of the program. The fact is, however, that there are no hard data with regard to the tax position of the investors who would be forced out of the tax-exempt market by this bill. We cannot say with any certainty that the Treasury will not break even or even show a net gain from the implementation of this bill. The most important product of the Boston Fed model, in my judgment, is the finding that, even under the most disadvantageous assumption with regard to the average marginal tax rate of the displaced investors, the cost of the program to the Treasury would be very small and the benefits to state and local governments very large. Even under this worst possible assumption, we should look upon the bill as providing a unique form of revenue sharing in which state and local governments received several dollars benefit for every dollar spent by the Federal Government.

This is an important piece of legislation. There is a critical need to broaden the market for state and local government securities. My personal preference would be to start out with a 40% subsidy level which will generate a more continuous

dual market in state and local government securities, in contrast to the spasmodic dual market which is likely to be produced by a 33% subsidy level.

I believe there is a need for the broader market which a 40% subsidy level would produce. Nonetheless, this bill is a great step in the right direction. I suspect that once the Congress and state and local government officials gain a full appreciation of the benefits of this bill, there will be a demand for further steps.