

Statement of Frank E. Morris

President, Federal Reserve Bank of Boston

Before the Committee on Ways and Means

U. S. House of Representatives, Washington, D. C.

February 23, 1973

I am pleased to participate in this panel discussion on an alternative to tax-exempt state and local bonds. At the outset, I should emphasize that I am speaking only for myself, not for the Federal Reserve System.

This is not solely a tax reform issue. There is a clear need, in my judgment, to broaden the municipal bond market so that these governments will be able to compete more effectively in the capital markets, particularly during periods of tight money. An alternative, taxable market with a Federal Government interest subsidy would accomplish this broadening of the market at the same time that it automatically reduced the element of inequity in our tax system which stems from tax-exempt bonds.

In attempting to assess the costs and benefits of the taxable municipal bond proposal it is essential to recognize that we would be creating a dual subsidy program: a direct subsidy on taxable bonds would be put in place alongside the very costly tax subsidy which already exists on municipal bonds. One of the principal benefits of the taxable bond alternative will be to hold down the interest costs on tax-exempt bonds and, in so doing, improve the efficiency of the subsidy given

through tax exemption. By "improving the efficiency," I mean increasing the percentage of the total benefits of tax exemption which actually accrue to state and local governments.

The present single subsidy system is grossly inefficient. It is estimated that in fiscal 1971 the cost of tax exemption to the Treasury was \$3.3 billion while the benefit to state and local governments in the form of lower interest costs was only \$2.5 billion. The \$800 million gap accrued to the benefit of high bracket individuals and corporations. A taxable bond alternative, by placing a limit on how high tax-exempt yields can go relative to taxable yields, will reduce this gap. Under a 40% subsidy, for example, tax-exempt yields should never be more than 60% of the equivalent taxable yields.

At present, there are no limits to how high tax-exempt yields can go relative to the equivalent taxable yields. It is purely a function of supply and demand. During the tight money phase of 1969-1970, tax-exempt yields rose to 80% of taxable yields. Under such conditions, a state government which could have sold \$100 million in taxable bonds at 7% would have had to pay 5.60% on its tax-exempt bonds. However, if a 40% subsidy program on taxable bonds had been in effect, the net interest cost to the state on the 7% taxable bonds would have been only 4.20%. In this situation, the state government would not have issued tax-exempt bonds unless the interest cost was 4.20% or less. By this process the supply of new bond issues would have been diverted into the taxable market causing the yield on tax-exempt bonds to decline. Part of the benefits to

state and local governments would come from the interest subsidy on taxable bonds, but a considerable part of the total benefits would stem from lower interest costs on the tax-exempt bonds which would continue to be sold if the subsidy rate was less than 50%.

Assessing the costs and benefits of the taxable municipal bond is exceedingly complex. In terms of our simple example, it is easy to identify the benefits. The state government which chose to sell \$100 million of taxable bonds at 7%, rather than to sell the bonds on a tax-exempt basis at 5.60%, would enjoy lower interest costs under a 40% interest subsidy of 1.4% or \$1,400,000 annually.

The cost side is a bit more difficult to assess. A 40% subsidy of the bond issue in our example would cost the Treasury \$2.8 million per year. On the other hand, the Treasury's revenues will rise because \$100 million of taxable bonds has displaced \$100 million in bonds on which the Treasury would receive no revenue. We know that the Treasury's revenues must rise as a consequence. The question is: how much?

In the first instance, the bonds might be purchased by pension funds which pay no taxes. In fact, one of the principal benefits of the taxable bond alternative is that it will open up the vast pension fund market to state and local governments. However, if the pension funds buy this bond issue, they must forego buying \$100 million in comparable taxable securities which must ultimately come to rest in taxable hands.

The question is: whose hands? If the additional taxable securities come to rest in the hands of individuals and corporations with an average marginal tax rate of 40% or higher, the Treasury will break even or make money on the operation. However, if we make the conservative assumption that the average marginal tax rate for the holders of these securities is only 35%, the Treasury's revenue would be only \$2,450,000. There would in this case be a net budgetary cost to the Treasury of \$350 thousand, against which we can attribute interest savings to the state government of \$1,400,000 - - a ratio of benefits to costs of four to one. This is revenue sharing with a multiplier.

During the past three years we have been attempting to develop at the Federal Reserve Bank of Boston a Capital Markets Model which would have the capability of simulating the impact of a wide variety of monetary policy changes as well as structural changes in the capital markets such as we are discussing today. While we have accumulated years of experience with general models of the economy, we are in the early development stages in attempting to construct models of our complex financial markets.

Using the model, we have simulated the impact of the taxable bond proposal for the period 1968-70 using subsidy rates of 33%, 40%, and 50%. While I do not believe that the model is sufficiently developed to place much credence on the precise numbers that it generates, I think it does provide some useful orders of magnitude for assessing the costs and benefits of the taxable bond proposal.

My interpretation of the results given by the model is as follows:

1. If a 33% subsidy had been in effect during the 1968-70 period, state and local governments would have saved about \$50 million per year in interest costs at no net cost to the Treasury.

2. With subsidy rates of 40% or 50%, there would probably have been a small net cost to the Treasury - - somewhere in the neighborhood of \$50 million to \$70 million per year. With these subsidy rates, the interest savings to state and local governments would have been in the neighborhood of \$170 million to \$350 million per year. Thus, the interest savings to state and local governments would have been in the area of three to five times the cost to the Treasury.

The impact of the taxable municipal bond will depend primarily on the level of the interest rate subsidy chosen by the Congress. Three subsidy levels have been suggested: 33%, 40%, and 50%. The choice among these should depend on the results the Congress is seeking.

#### A One-Third Subsidy

If the Congress chooses a one-third subsidy, the volume of taxable bonds issued would be relatively small except during very tight money markets such as 1966 or 1969. A one-third subsidy would be more useful for the longest maturities, where the tax-exempt market is least efficient. I would, therefore, expect to see a good many issues split, with the long-term maturities sold on a taxable basis and the shorter maturities remaining tax exempt.

As a tax reform measure, a one-third subsidy would produce only a relatively marginal improvement over the existing situation. It would be extremely useful in providing a broader market for municipal bonds in tight money markets, but the taxable municipal bond would not assume a very large share of the market in years such as 1971 or 1972. One advantage of a one-third subsidy is that it should involve no net cost to the Treasury.

On balance, I am inclined to believe that the Congress would be disappointed in the limited results that a one-third subsidy program would produce. Furthermore, I believe that once state and local officials gained a full appreciation of both the greater financial flexibility and the lower interest costs which would result from their ability to sell both tax-exempt and taxable bonds, they will come to the Congress asking for a higher subsidy level which would accomplish more.

#### A 40% Subsidy Rate

A 40% subsidy rate would produce much greater results at relatively little net cost to the Treasury. A continuous dual market in municipal bonds would result. Taxable bonds would tend to predominate in tight money markets, but under more normal circumstances tax-exempt bonds would continue to be marketed in large quantities, although at substantially lower interest rates. As a consequence, the efficiency of the tax subsidy on tax-exempt bonds would rise sharply.

A 40% subsidy would accomplish a great deal more than a one-third subsidy both in the interest of tax reform and in the interest of broadening the market for municipal bonds. Furthermore, a 40% subsidy program could be implemented with very little

disruption to the capital markets, since the tax-exempt bond market would continue to function.

A 50% Subsidy Rate

A 50% subsidy would effectively eliminate the tax-exempt bond market. With a 50% subsidy the only investors who would find tax-exempt bonds especially attractive would be individuals in tax brackets significantly higher than 50%. Since this would be such a thin market, underwriters would probably be reluctant to attempt to underwrite any substantial issues of tax-exempt bonds. The underwriting risk would be much less with taxable bonds which could be sold in a much broader market.

With the passage of time and the maturing of outstanding issues, the tax equity aspect of tax-exempt bonds would no longer be a matter of public concern. From a cost-benefit point of view a 50% subsidy gets the highest marks. Our Capital Markets Model suggests that it would generate interest savings to state and local governments of around \$350 million a year at a very modest cost to the U. S. Treasury - - somewhere in the neighborhood of \$50 million a year. Thus the interest savings to state and local governments would be about seven times the net cost of the program to the Federal Government.

A major disadvantage of a 50% subsidy program is that it is likely to produce some considerable short-term disruption in the capital markets, since the bond underwriters would be forced over night to shift from marketing tax-exempt bonds to taxable bonds. I would not want to exaggerate the length of time or the extent of the problems the capital markets would encounter in making this adjustment, but there would inevitably

be some short-term problems. I suspect that many state and local officials would prefer to see a taxable municipal bond market firmly established before the tax-exempt market were, de facto, eliminated.

It is for this reason that my own preference at this juncture would be to establish a 40% interest subsidy on taxable municipal bonds. This will establish the taxable municipal bond market on a firm and continuing basis. With a strong taxable market firmly established, the Congress could then move to a 50% subsidy program without running the risk of creating short-term instability in the financing of state and local capital projects.

#### The Need to Broaden the Market

For a number of years I have been arguing the need for a broadening of the market for state and local securities if these governments are to be able to finance their capital requirements in a reasonably efficient manner in the decade ahead. My conviction stems not only from an expectation of a sharply rising trend in the volume of municipal bonds to be offered in the years ahead, but also from a belief that commercial banks, which have been the primary underpinning of this market in the past dozen years, are not likely to be in a position to support the market in the future on the scale that they have supported it in the past.

During the decade of the 60's the commercial banks absorbed almost 70% of the total volume of new issues of state and local bonds. At the end of 1960 municipal bonds amounted to less than 9% in commercial bank portfolios; by the end of 1970 this percentage had risen to more than 15%.

Commercial banks found room in their portfolios for this great increase in municipal bonds by reducing the percentage of their assets held in United States Government obligations from almost 31% at the end of 1960 to a little over 13% by the end of 1970.

We calculate that if the commercial banks were to absorb 70% of the net new issues of state and local government bonds through 1980, it would mean that their holdings of municipal bonds would have to rise to 21% of their total portfolios. This, in my judgment, is not likely to happen.

Commercial banks, both large and small, have already reduced their portfolios of United States Government bonds close to a practical minimum. They are not in a position to make further shifts in portfolio composition in favor of municipal bond holdings at the expense of United States Government bond holdings, nor do I think they will reduce their loan portfolios for this purpose.

There are other reasons why I think the banks will have relatively less interest in municipal bonds in the decade ahead. The larger banks in the country which have mature foreign branches are now generating substantial foreign tax credits which reduce the need for tax-exempt income. In addition, the bank holding company vehicle is providing commercial banks with new ways of employing their funds which will compete powerfully in profitability with investments in tax-exempt municipal bonds.

In summary, I believe there was a one-shot quality in the level of support of the municipal bond market by commercial banks in the 60's. In my judgment, the commercial banks will not be in a position to support this market on a similar scale in the 70's, and without heavy support by the commercial banks,

the tax-exempt municipal bond market is not likely to be able to carry adequately the financing load which will be imposed upon it in the years ahead. Quite apart from considerations of tax equity, there is a need to be planning now for the establishment of an alternative taxable market for municipal bonds.

