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The Taxable Bond Option

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The taxable municipal bond option has been on the nation's legislative agenda for seven years. What I propose to do today is to set forth what I, as a long-time advocate of the taxable bond option, think it would accomplish and to analyze the reasoning of those who have thus far succeeded in preventing its adoption. In so doing, I will be speaking only for myself and not for the Federal Reserve System.

The taxable bond option has become associated in the minds of some with other measures designed to alleviate the financial problems of our older cities. This is an improper association. The taxable bond option is a tool to improve the efficiency of our financial markets and, at the same time, to reduce substantially the element of inequity in our income tax system which stems from tax exemption. It will reduce the interest costs on municipal borrowings, but the benefits will accrue proportionally as much to cities with strong credit ratings as to those with serious financial problems. The case for the taxable bond option was just as strong back in 1969, before the urban financial crisis had manifested itself in its present proportions, as it is today.

The taxable bond option would accomplish four things:

(1) The efficiency of the municipal bond market would be improved and the net interest costs on State and local borrowings would decline.

(2) The element of tax inequity stemming from tax exempt bonds would be reduced substantially by widening the spread between taxable and tax-exempt yields.

(3) The efficiency of the present subsidy given through tax exemption would be improved; i.e., more of the benefits of tax exemption would accrue to State and local governments and less to the bond holders.

(4) Everything else being equal, equity prices would rise relative to bond prices, strengthening our financial system.

The extent of these effects would depend on the level of the subsidy on taxable bonds. The process would be automatic and market determined, as market participants reacted to a new set of conditions.

There are three principal groups of buyers of tax-exempt municipal bonds: commercial banks, casualty insurance companies and well-to-do individuals. During the decade of the 60's the commercial banks were the backbone of the market, taking 63% of the new issue volume.[1/]

The casualty companies typically move in and out of the market, depending on their need for tax-exempt income. Individuals have been the residual buyers, filling the gap when institutional buying was not sufficient to clear the market.

As long as institutional buying was substantial, as it was during most of the 60's, the market performed reasonably efficiently. The need to broaden the market now through the taxable bond option stems from the fact that the major institutional buyer of the past, the commercial banks, has largely withdrawn from the market. Nor are the banks likely to return to their buying habits of the 60's.

In the first quarter of 1976, commercial banks were acquiring financial assets at a $25.8 billion rate, while business loans were declining in volume. In similar periods of the past, commercial banks put a substantial part of their available funds into municipal bonds. However, in the first quarter of 1976 they actually liquidated municipals at a $2 billion annual rate.[2/]

In part, this reflects the fact that commercial banks had a poor earnings experience in the first quarter of 1976; but, more fundamentally, it reflects the fact that the banks are loaded up with municipals. In the preceding 15 years, commercial banks made a major portfolio shift out of United States Government securities into municipals. This was a one-shot deal which cannot be duplicated in the future. The commercial banks simply will not have the capacity to support the municipal bond market in the future to anywhere near the extent that they did in the 1960's.

When the commercial banks pull out of the market, the residual to be taken up by individuals rises. To clear the market, interest rates on municipals have to rise relative to rates on Treasury and corporate securities in order to attract the marginal individual investor. When this happens, the high bracket individual investor receives a windfall and the split of the benefits of tax exemption is shifted toward the investor and away from State and local governments.

In the present market, there is no limit to the narrowness of the spread between tax-exempt and taxable yields. The spread must narrow to that point where the marginal individual investor can be persuaded to take up the remaining supply. With the taxable bond option, the interest subsidy rate would automatically limit the narrowing of the spread beyond a specific point. With an interest subsidy of 35%, for example, tax-exempt yields could never exceed 65% of the taxable equivalent. Whenever the tax-exempt market could not absorb the supply at that level, new issues would spill over into the taxable market.

To use a numerical example, let us assume that a municipality faced a market in which it could sell long-term bonds for 7-1/2% on a tax-exempt basis and 10% on a taxable basis. With a 35% interest subsidy on taxable bonds, the municipality facing this choice would choose to sell the bonds on a taxable basis; since the net interest cost would be 6-1/2%. Not until the available supply of tax-exempts had shrunk to the point where the marginal buyer would be willing to accept a tax-exempt yield of 6-1/2% would this municipality again sell its bonds on a tax-exempt basis.

The first product of the taxable bond option, of course, is that the municipality saved 1% in interest costs. The second product is that the supply of tax-exempt bonds would shrink, driving the yield down to the 6-1/2% level for this municipality. The resulting permanent widening of the spread between tax-exempt and taxable yields would reduce the element of inequity introduced into our income tax system by tax-exemption, since the size of the windfall to high-bracket investors is inversely related to the size of the spread between taxable and tax-exempt yields.

Futhermore, it would improve the efficiency of the present subsidy given through tax exemption. The most recent estimate I have seen is that tax exemption on municipal bonds cost the Treasury $4.8 billion in fore-gone tax receipts in fiscal 1976. Of this total, $3.5 billion was passed on to State and local governments in the form of lower interest costs and $1.3 billion was retained by private investors.[3/] In other words, for every $1 of interest costs saved by State and local governments, the cost to the United States Treasury is $1.37. The taxable bond option would, over the years, work to improve this relationship substantially.

By reducing the level of yields on tax-exempt bonds, the taxable bond option will also have one other significant product: it will tend to raise the price of equities relative to the price of debt instruments. In a well-organized capitalist economy, wealthy individuals should be induced to invest in risk-bearing assets. Tax exemption on municipal bonds, to the contrary, provides extra incentives for the wealthy to invest in relatively risk-free assets. The more inefficient the municipal market, the stronger the incentive. A 7% municipal bond yield provides a 14% taxable equivalent yield to someone in the 50% bracket, more than 14% if the interest is also exempt from State income taxes. This is formidable competition for the stock market where the historic long-term yield has been 9%.

There is little doubt in my mind that the taxable bond option, by reducing the level of tax-exempt yields relative to taxable yields, will drive some funds which would otherwise have been lodged in municipal bonds into the stock market. This would strengthen our financial system in a most fundamental way.

The Arguments in Opposition

If the taxable bond option has the potential for accomplishing all of these things, why has it failed thus far to pass the Congress?

The principal arguments in opposition are the following:

1. The fear that the taxable bond option will inevitably lead to the elimination of the tax-exempt privilege, leaving State and local governments even more dependent on the Federal Government than they are today.
2. The budget costs of the interest subsidy to the Treasury.
3. The notion that it would be difficult for municipal bonds to compete in the taxable market.
4. The contrary notion that so many taxable municipals would be sold as to drive up interest costs to the Treasury and corporate borrowers.
5. The concern that the taxable bond option will lead to self-dealing by State and local governments with their own pension funds.

Of these, only the first argument has much substance. Over the past four decades, State and local governments have become more and more dependent upon the Federal

Government. One of their most prized vestiges of sovereignty is their ability to issue tax-exempt bonds freely without reference to Washington. It is the fear that the taxable bond option will turn out to be a "Trojan horse" rather than a "gift horse" that has led many State and local officials to oppose it.

How realistic is this fear? Since passage of the income tax amendment to the Constitution in 1913, the Treasury Department has, more or less continuously, been seeking to eliminate tax exemption on municipal bonds.[4/] Nonetheless, tax exemption has survived. How is this political phenomenon to be explained? The answer, I believe, is that state and local government officials, whenever they are firmly united on an issue, probably constitute the most powerful lobby in Washington. The lack of awareness of this political muscle among State and local officials stems from the fact that they are seldom firmly united on any issue. It is impossible to find a substantial community of interest between the officials of large cities and the administrators of rural countries on such issues as urban mass transit and welfare reform, or between northern and southern officials on the price of heating oil.

On the issue of municipal bond tax exemption, however, state and local government officials, from large cities and rural counties, and from North and South, have spoken with one clear voice to Congress. Tax exemption on their bonds is a universally prized privilege that they are not going to permit Congress to take away from them. Their unanimity on the issue has succeeded for more than 50 years in defeating efforts of tax reformers to eliminate the exemption. I see no reason to believe that they will be less successful in the future.

The cost of the direct interest subsidy is probably the second most influential argument used against the taxable bond option. Estimates of the cost of the subsidy will vary depending on the level of the subsidy and the set of assumptions used. Two things are certain: regardless of the assumptions used, any costs will be modest when compared to the cost of tax exemption and the interest cost savings to State and local governments will be a multiple of any costs to the Treasury.[5/] This subsidy, when used, would displace the inefficient subsidy now given through tax exemption--a subsidy through which the interest cost savings to State and local governments are substantially less than the costs to the Treasury.

That there should be any substantial concern about the cost of the taxable bond option to the Treasury is a reflection of the fact that both the Congress and the Treasury assess direct subsidies much more carefully than they do tax subsidies.

The notion that the obligation of State and local governments, which by and large are high grade credits, somehow cannot compete in a taxable market is absurd. It is true that the serial form of municipal bonds, which is the norm today, is not well adapted to the pension fund and life insurance market. This is going to require a shift to more single-maturity issues with sinking funds. Since this shift will also carry with it a better secondary market for municipals, it will be an independent factor working toward lower interest costs.

The contrary notion that so many taxable municipals would be sold as to drive up interest rates sharply on Treasury and corporate securities is vastly exaggerated. In 1975 the total of funds raised through debt instruments by the non-financial sectors of the economy was $194.6 billion, of which $15.4 billion were State and local obligations. Even if we assume that half of the State and local obligations were sold on a taxable basis, this would increase the total volume of taxable debt instruments by only 4.3%. A substantial part of this increase in taxable instruments would be financed by funds which otherwise would have gone into the displaced tax-exempt bonds. To the extent that some of these funds flow instead into the equity markets, causing an upward revaluation of equity prices relative to the prices of debt instruments, which I suspect would happen, I would consider that development a net plus for the financial system.

Finally, the concern that the taxable bond option might lead to self-dealing by municipalities with their own pension funds is something that can be dealt with by legislation. H.R. 12774, the taxable bond option bill voted out this year by the House Ways and Means Committee, attempts to meet this potential problem by requiring that not less than 25% of the obligations sold must be acquired by persons who are not related entities. If this should prove insufficient to meet the problem, more restrictive legislation could be imposed.

Tallying up the modest potential costs of the taxable bond option against its very substantial potential benefits leads me to believe that it will ultimately become law. Since I first began writing about the taxable bond option in 1970, I have always concluded my remarks by stating that it was "an idea whose time had come." I have been a bit premature in this judgment, but with every passing year the logic of the proposal is gaining more adherents.

Footnotes

1/ Federal Reserve Flow of Funds Accounts.

2/ Ibid.

3/ John Petersen, "Changing Conditions in the Market for State and Local Government Debt", a study prepared for the use of the Joint Economic Committee, Congress of the United States, April 16, 1976, p. 56.

4/ James Maxwell, Financing State and Local Governments, 1965, p. 190.

5/ Peter Fortune, "Impact of Taxable Municipal Bonds: Policy Simulations with a Large Econometric Model", Federal Reserve Bank of Boston (1974).

6/ Federal Reserve Flow of Funds Accounts.