91st Congress }
1st Session }
COMMITTEE PRINT

TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED TUESDAY, SEPTEMBER 23, 1969

PART B—ADDITIONAL STATEMENTS

(Topic: Tax Treatment of State and Local Bond Interest)

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
33-758 O WASHINGTON : 1969

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

CLINTON P. ANDERSON, New Mexico
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
FRED R. HARRIS, Oklahoma
HARRY F. BYRD, Jr., Virginia
JOHN J. WILLIAMS, Delaware
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming

TOM VAIL, *Chief Counsel*
EVELYN R. THOMPSON, *Assistant Chief Clerk*

CONTENTS

PART A—WITNESSES

Tax Treatment of State and Local Bond Interest

Page

Hon. Howard H. Baker, Jr., U.S. Senator, State of Tennessee 1

NATIONAL GOVERNORS' CONFERENCE, COUNCIL OF STATE GOVERNMENTS (PANEL)

Hon. John A. Love, Governor, State of Colorado 7
Hon. Daniel J. Evans, Governor, State of Washington 41
Hon. Norbert T. Tiemann, Governor, State of Nebraska 47
Hon. John J. McKeithen, Governor, State of Louisiana 77
Hon. Claude R. Kirk, Jr., Governor, State of Florida 95

NATIONAL LEAGUE OF CITIES AND UNITED STATES CONFERENCE OF MAYORS (PANEL)

Hon. C. Beverly Briley, Mayor of Nashville, Tenn., and President, National League of Cities 101
Hon. James H. J. Tate, Mayor of Philadelphia, Pa., and Vice President, United States Conference of Mayors 115

OTHER WITNESSES

Hon. W. W. Dumas, Mayor-President of Parish of East Baton Rouge, City of Baton Rouge, La 127
Hon. Louie Welch, Mayor of Houston, Tex 135
Hon. Ilus W. Davis, Mayor of Kansas City, Mo 179
Austin J. Tobin, Executive Director, Port of New York Authority 183
Hon. Ivy Baker Priest, California State Treasurer 199

PART B—ADDITIONAL STATEMENTS

Hon. Joseph A. Doorley, Jr., Mayor of Providence, R.I 221
John A. Kervick, Treasurer, State of New Jersey 223
State Association of County Commissioners of Florida 227
M. Don Harmon, City Manager, Council Bluffs, Iowa, and Chas. L. Campbell, Director of Finance 239
Paul A. Amundsen, Executive Director, American Association of Port Authorities 241
Kent Satterlee, President, New Orleans Board of Trade, and Alex C. Cocke, Consultant 249
J. Eldon Opheim, General Manager, Port of Seattle, Wash 251
Cornelius W. Grafton, Louisville, Ky 255
Richard L. Triplett, Superintendent, Bellevue, Nebr., Public Schools 263
Edward F. Renshaw and Donald J. Reeb, Graduate School of Public Affairs and Department of Economics, State University of New York at Albany 265
D. E. Hartley, San Francisco, Calif 283
Cecil S. Brubaker, representing Metropolitan Utilities District of Omaha, Nebr 291
Robert L. Ehlers, Minneapolis, Minn 301
Peck, Shaffer & Williams, Attorneys at Law, Cincinnati, Ohio 305
Harold B. Judell, New Orleans, La 307
Hawkins, Delafield & Wood, New York, N.Y 311

****
Summary of the Statement of Senator Howard H. Baker (R.-Tenn.) on the Tax-Exempt Status of State and Local Bonds before the Senate Finance Committee, Tuesday, September 23, 1969.
****

1. The three sections of the Tax Reform Act of 1969 adversely affecting the ability of state and local governments to meet their capital requirements should be deleted from the House-passed bill.

2. The immunity of state and local governments from federal taxation is necessary for the preservation of our constitutionally delineated duel sovereignty form of government.

3. Encroachment upon this tax exemption would be detrimental to the autonomy and independence of state and local governments.

4. If the objective is to provide a more equitable distribution of the total tax burden, then the Congress should not revoke or alter the tax exemption in such a way as to increase the cost of borrowing to state and local governments.

5. Encroachment upon this tax exemption would be inconsistent with the concept of revenue sharing and a healthy federalism.

6. In order to determine the amount of any possible abuse of this tax exemption, individuals and corporations should be required to disclose on their income tax returns the amount of tax-exempt interest received from state and local securities.

****
Statement of Senator Howard H. Baker (R.-Tenn.) on the Tax-Exempt Status of State and Local Bonds before the Senate Finance Committee, Tuesday, September 23, 1969.
****

FOR RELEASE AT 10 00 A.M., TUESDAY, SEPTEMBER 23, 1969

Mr. Chairman, the Tax Reform Act of 1969 contains three sections which, if enacted, may adversely affect the ability of state and local governments to meet their capital requirements. The first would impose a limitation on certain tax preferences, including among such preferences interest on state and local securities. The second would require that individuals allocate their deductions between taxable and tax-exempt income, including interest on municipal bonds. The third would permit state and local governments to issue at their option taxable bonds, a portion of the interest on which would be paid by the federal government. In my judgment, these three provisions should be deleted from the House-passed bill.

As I have stated on numerous occasions, I believe that the immunity of state and local governments in the exercise of their legitimate functions from federal taxation is necessary for the preservation of our constitutionally delineated dual sovereignty form of government. I further believe that if the Congress undertakes to encroach upon the tax exemption of state and local securities, it inevitably has the power to control state and local financing and without self-control of its own financing, no government can continue as an independent and autonomous body.

The Tax Reform Act is designed to provide a more equitable

distribution of our tax burden. I support this legitimate objective. However, in attempting to insure a more even-handed distribution of the cost of supporting our government, we must consider not only the fair distribution of the federal income tax burden but also the fair distribution of the total tax burden -- federal, state and local.

It is apparent that the limit on tax preferences and the allocation of deductions provisions will, if adopted as passed by the House, result in an increase in municipal interest rates to levels close to those of corporate bonds of similar credit quality. In fact, since the House Ways and Means Committee opened hearings on this question, investment yields on new issues of local government AA-rated bonds have risen 70 base points or from about 5.50 percent to 6.20 percent. If the tax exemption is breached, investors would have little confidence that the advantages to them of holding tax-exempt securities would not be whittled away further, and they would, of course, demand higher interest rates to compensate them for the higher risk in purchasing these securities. As the cost of borrowing increases, state and local taxes, primarily property and sales taxes, will also increase, and the burden of these taxes falls disproportionately on those in the low and middle income groups. Therefore, if the objective is to provide a more equitable distribution of the total tax burden, as I believe it is and should be, then the Congress should not revoke or alter this tax exemption in such a way as to increase the cost of borrowing to state and local

governments.

It would be particularly unfortunate to increase the cost of borrowing at this time when the current operating revenue needs of state and local governments are such that proposals for federal revenue sharing are being seriously advocated and widely supported. I believe that the provisions presently in the bill adversely affecting municipal financing are inconsistent with the concept of revenue sharing and the objectives it is designed to achieve. Underlying my strong support for both retention of this tax exemption and the enactment of revenue sharing is the basic conviction that strong and financially viable state and local governments are essential both to a healthy federalism and to the best possible performance of governmental services.

I would like to make one additional point. A considerable amount of the sentiment for tax reform stems from the testimony given by former Secretary of the Treasury Joseph Barr concerning 154 individuals who in the year 1967 had adjusted gross incomes in excess of $200,000 yet paid no federal income taxes. Unfortunately, the impression was allowed to form that this was accomplished to a large measure through municipal bond ownership, even though the data submitted by former Secretary Barr did not include interest on state and local securities among the tax reducing factors utilized by the 154 individuals. Interest on state and local securities is not included within gross income and consequently does not appear at all on the income tax return. For this reason it is most difficult to determine the

degree of tax avoidance by individuals holding state and local bonds.

A possible solution to this lack of data might be to require individuals and corporations to disclose on their income tax returns the amount of interest received from tax-exempt securities. If this information were to indicate substantial abuse of this exemption, then I would support a reasonable legislative solution designed to alleviate the problem without adversely affecting the ability of state and local governments to meet their capital requirements.

####

National Governors' Conference

OFFICE OF FEDERAL-STATE RELATIONS

1735 DeSALES STREET, N.W.

WASHINGTON, D. C. 20036

CHARLES A. BYRLEY,
DIRECTOR

TELEPHONE:
AREA CODE 202 393-2662

Summary of

Statement of

The Honorable John A Love
Governor of Colorado

Chairman, National Governors' Conference

on H. R. 13270,
The Tax Reform Act of 1969

Before the
Committee on Finance
United States Senate

September 23, 1969

Mr. Chairman, Members of the Committee:

Our concern is with each of the several provisions to which your Committee is devoting its attention today - the proposed minimum income tax, allocation of deductions and federal subsidization of interest payments if state and local bonds are issued as taxable obligations. My remarks will be limited, in the main, to the tax and fiscal consequences if these provisions are enacted.

We appreciate your problem. To reform the federal income tax laws is a very difficult task. In so doing, however, we hope you will avoid disturbing the market for state and local bonds.

As you know, the pressure is enormous on state and local governments to furnish more and better services and facilities. Our capital requirements continue to grow at a rapid rate. Only 13 years ago, in 1956, total state and local bonds outstanding totaled less than $50 billion. Today that total has reached $140 billion - an increase of 180 percent. A Federal Reserve Board estimate is that it will approximate $210 billion in 1975. In other words, in 20 years the total of state and local bonds outstanding is estimated to increase by 320 percent. These figures should impress anyone who has doubts about the overwhelming capital needs of states and localities.

H.R. 13270 would enact a "limit on tax preferences," a form of minimum income tax for individuals, in the base of which would be state and local bond interest.

Treasury witnesses testified against the inclusion of state and local bond interest in the minimum tax. They did so for two reasons. Inclusion, they said would: (1) raise a constitutional issue, and (2) have an adverse effect on the municipal bond market.

Both H.R. 13270 and the Treasury would require that individuals allocate deductions between taxable income and tax preference amounts. Both would include state and local bond interest. In the House bill this provision would apply to future bond issues only, and be phased in over a 10-year period. The Treasury would have this requirement cover outstanding as well as future issues, and make it fully effective immediately.

H.R. 13270 contains a plan for a federal subsidy of a portion of state and local government interest costs if they chose - and the plan is optional with them - to issue taxable obligations. The Treasury promised to submit a substitute proposal for the House - approved plan.

Mr. Chairman, the revenue yield from inclusion of municipal bonds in the House LTP provision, according to the Treasury's estimate would be $35 million and for its own allocation of deductions proposal, $45 million. These are not large sums, but the impact on the market of these provisions would be far greater.

Attached to my statement are certain exhibits. Most of them indicate what has happened as a result of the threat of taxation. Should the threat prove real, we may expect an even more severe impact.

Historically the yield relationship of comparable municipal and corporate bonds has been in the vicinity of 70 percent. In other words, if a corporate bond were sold at 8 percent, one would expect a comparable municipal to yield 5.6 percent.

Graphs No. 1 and 2, employing different indices, illustrate the municipal-corporate bond yield relationship over the past two years. Please note that they show a yield relationship of about 80 percent.

Today, if a corporate bond were to be sold at 8 percent, a comparable municipal might be expected to bear an interest rate of 6.4 percent. Note, too, that virtually all the change in relationship has occurred in 1969 - the period during which this legislation has been under consideration.

Graphs Nos. 3 and 4 show the yields of tax exempt and taxable bonds over the past two years as indicated by representative indices. Again the closing of the gap can be seen.

Tables No. 1-3 show in tabular form the same data as Graphs 1-4. Please note on Table No. 1 the interest spread of 1.78 percent in August 1967. In January 1969, there was about the same spread, 1.77 percent. By July 1969, the gap had shrank to 1.39 percent. On Table No. 2 a similar change can be seen. The respective interest rate differences were 1.80, 1.87 and 1.51. Table No. 4 shows that the yield relationship between municipals and U.S. Government 20-year bonds has been altered drastically, too. The interest rate differences were 0.93, 0.95 and 0.19 respectively.

Mr. Chairman, tight money caused all these interest rates to climb. The much more rapid climb in municipal bond interest rates can only be ascribed to the threat of taxation.

Also attached to my statement are two schedules. Turning first to Schedule II, it shows in columns 1-4 the issuances of tax exempt municipal securities for the years 1965-1968 on a state-by-state basis as reported in the IBA Statistical Bulletin. The figures shown include issuances by local units of government as well as the state.

Columns 5 and 6 represent projections of bond sales by state for 1969 and 1970. They assume a conservative 10 percent per year increase

over 1968, 5 percent due to inflation and 5 percent to a real increase in outlays. To put it more accurately, they represent reasonable estimates of need. Based on first quarter statistics, bond sales in 1969 on an annual basis will be less than $11 billion, 40 percent below what might have been expected.

Turning now to Schedule I, it shows estimates of interest costs increases that would be incurred if the provisions of H.R. 13270 relating to municipal bonds were enacted. Two estimates are made - one based on actual volume for 1968, the other on projected volume for 1970.

Column 2 represents calculations of the annual debt service on bonds issued in 1968. The interest rate used - 4.5 percent - approximates the average of the Bond Buyer's Index for 1968. As can be seen, debt service totaled $1.24 billion for all states.

Column 3 shows debt service on a taxable basis. Columns 4 and 5 show additional interest costs by year and over the assumed 20 year life of the bonds. The interest rate increase assumed for purpose of computation is 2 percent.

Given these assumptions, the additional interest costs for one year would be $222 million, and over the life of the bonds $4.45 billion.

Columns 6-10 contain information similar to that of columns 1-5, but based on projected issuances for 1970. Please note the total of column 9, the assumed interest cost increase, approximately $270 million. If the same total were issued in 1971, the increase would be $540 million. By the tenth year increased interest costs would add up to $2.7 billion, assuming no year-by-year increase in state and local financing.

Mr. Chairman, Members of the Committee, some may feel we have over-estimated the increase in interest costs that would result from enactment

of H.R. 13270. Some may feel that the Treasury proposals would result in a smaller increase. If one reduces the estimated increase by one-half or even more, what remains is an undeniably heavier debt service burden that must be borne by state and local governments and their tax payers.

Secretary Kennedy testified that the impact on the market of the Treasury allocations of deductions proposal would be minimal. Neither he nor we know if his opinion is valid. We know he estimated the revenue yield to be $45 million. Presumably that was based on a total of bonds outstanding in 1969 of $154 billion ($140 billion in 1968 plus 10 percent). Assuming an additional 10 percent increase in bonds outstanding at the end of 1970 would mean a total of $170 billion. On such amount, revenue accruing to the Treasury would increase by 10 percent, also, to $49.5 million.

Look now at what the increased state and local debt service cost would be for 1970. Would it be one percent, $135 million or one-half of one percent, $67 million? That additional cost, whatever it might be, would continue over the life of the bonds.

No one can know until after the fact what the actual debt service cost increase would be. It would be in any case greater - and probably much greater - than the revenue yield.

Let me state at this point that the Treasury allocations of deductions proposal would have a very damaging effect. For one thing, allocation of deductions affects many more people than the House minimum tax. The latter is applicable only when total income from tax preference items exceeds $10,000 and regularly taxable income. The former is applicable to any amount of tax preference income in excess of $10,000. Moreover, allocation of deductions has particular relevance to banks - much the larger

33-758 O - 69 -- No. 9 -- 2

customers for state and local bonds. A banker might reason, if allocation of deductions is required of life insurance companies and of individuals and if the requirement with respect to banks were in the all-but-final House bill, can banks be far behind?

Mr. Chairman, those who purchase state and local bonds pay a "tax." It is not paid to the United States, but it is paid to state and local governments in the form of lower interest rates. True, investors may hope to gain more in federal income tax savings than in interest foregone. But have we not shown that the principal beneficiaries of low state and local bond interest rates are the issuing governments? Have we not shown that to correct on alleged inequity in federal income tax laws will cost state and local governments far more than the Treasury will realize in revenue? Should direct or indirect taxation be voted, what would be the result? Immediately there would ensue postponement, cancellation or reduction in scope of many public building projects - schools, hospitals, highways, water and sewer facilities and others vitally needed. Eventually, of course, these projects would be built. They would have to be paid for, however, out of increased sales and property taxes and utility fees. These are regressive in nature, but they would have to be relied on even more heavily than at present to supply the funds state and local governments could not afford to borrow or to pay the increased debt carrying costs on what they would have to borrow.

Other witnesses who appear for the states will cover aspects of taxation of state and local obligations that I have not covered. I have tried to show, and I believe I have shown, certain of the dire results that federal taxation would achieve. I do not believe that this Committee, its parent body or the Congress wishes to accomplish such results.

Mr. Chairman, Members of the Committee, I appreciate your giving me your time and attention. Thank you.

69/9/18 T-2

National Governors' Conference

OFFICE OF FEDERAL-STATE RELATIONS
1735 DeSALES STREET, N.W.
WASHINGTON, D. C. 20036

CHARLES A. BYRLEY,
DIRECTOR

TELEPHONE:
AREA CODE 202 293-2662

Statement of

The Honorable John A. Love
Governor of Colorado

Chairman, National Governors' Conference

on H. R. 13270,
The Tax Reform Act of 1969

Before the
Committee on Finance
United States Senate

September 23, 1969

Mr. Chairman, Members of the Committee:

I am John A. Love, Governor of Colorado and Chairman of the National Governors' Conference. I am pleased to have this opportunity to appear before you on behalf of the State of Colorado and the National Governors' Conference to testify on H. R. 13270, the Tax Reform Act of 1969. Appearing with me as representatives of the states are my colleagues, Governor Richard J. Hughes of New Jersey, Governor Daniel J. Evans of Washington, Governor Claude R. Kirk of Florida, Governor Norbert T. Tiemann of Nebraska, and Governor John J. McKeithen of Louisiana.

Mr. Chairman, it is no secret that we are seriously concerned about several sections of H. R. 13270, and substitute provisions for them suggested by the administration. At the most recent National Governors' Conference, 51 of the 52 Governors attending the Conference -- all who were present at the time -- sent a wire to the President expressing our concern. Copy of the telegram is attached, but I should like to quote part of it at this time.

We wired the President:

> One crucial matter which we did not have an opportunity to discuss with you is the taxation of state and municipal bonds. The infringement upon what we consider the constitutional prerogatives of state and local government would be a setback of major proportions to our mutual goal of governmental balance in the "Spirit of '76".
>
> The staggering blow of increased costs for all public construction would either add to the tax burden of the people or stop construction of much needed public facilities.
>
> Very simply, Mr. President, if the ability to market state and municipal bonds is jeopardized in any way, it will be a setback that for years to come will overshadow any positive proposals.

As citizens and taxpayers, we welcome the effort to reform our tax laws in which this Committee and the Congress are engaged. Inequities and

imperfections that have grown up over the years should be corrected. The task you have set for yourselves is a difficult and complex one. We are here to urge that in its accomplishment, however, you do nothing to disturb the market for state and local government bonds.

I am referring, of course, to the provisions of H.R. 13270 relating to a limit on tax preferences, allocation of deductions and the subsidization of interest payments if state and local bonds are issued as taxable obligations, Sections 301, 302 and 601 and 602 respectively. I should like also to refer to the administration proposals on these subjects.

In the main, I shall limit my remarks to the tax and fiscal consequences of what is proposed. Other aspects will be discussed by those appearing with me.

Mr. Chairman, as I know you know, the pressure is enormous on state and local governments to furnish more and better services and facilities. Our population and our expectations continue to grow. To build the schools, highways, hospitals, water and sewer facilities and all the other projects we want and need means that state and local governments must have a healthy, readily available capital market. We are a Nation that builds on credit, and few, if any, of our public or private institutions are more dependent on credit than states and localities. At the end of 1956 — only 13 years ago — state and local securities outstanding totaled less than $50 billion, according to Federal Reserve Board data. Today that total has reached $140 billion — an increase of 180 percent. The Federal Reserve Board estimates that the total outstanding in 1970 will be about $147 billion, and nearly $210 billion in 1975. Parenthetically, I assume that these estimates are based on there being no damage done to the market. In any event, the Federal Reserve Board estimate is that in 20 years — 1956 to 1975 — state and local government

bonds outstanding would increase by about 320 percent. If there were any question concerning the need of state and local governments for capital funds, these data should put it to rest.

H.R. 13270 proposes enactment of a minimum tax on individuals, a "limit on tax preferences", in the base of which would be state and local bond interest. Witnesses for the Department of the Treasury testified that it would produce $85 million a year when fully effective. Of that amount, revenue from taxation of state and local bonds was estimated to produce $35 million. Application of LTP to bonds would be at a gradual rate of 10 percent per year over 10 years.

The Treasury witnesses urged this Committee that it not include state and local bond interest in this minimum tax. They cited two reasons for not doing so: (1) it would raise a constitutional question, and (2) it would have an adverse effect on the market for such bonds.

With respect to allocation of deductions, the House bill would require that individuals allocate deductions between taxable income and tax preference amounts, including in the latter state and local bond interest. The provision would apply to bonds issued after July 12, 1969, and be phased in over a 10-year period.

The Administration similarly would include municipal bond interest in the allocation of deductions requirement, but would extend it to cover interest on outstanding issues as well as future issues, and make it fully effective immediately.

The House included in its bill a plan to provide a subsidy to state and local governments -- exercisable at their option -- if they chose to issue taxable bonds. The Treasury opposed this plan, promising to submit a substitute proposal.

Mr. Chairman, although the revenues that the proposed inclusion of state

and local bond interest in the limit on tax preferences — $35 million the Treasury estimated — and allocation of deductions — $45 million for the Treasury plan — would be small, the market impact of these provisions would be great.

Attached to my statement are certain graphs and tables. They illustrate the impact on the market that the threat of taxation has had. I wish to emphasize that what they represent is the market reaction to the possibility of taxation. Should that possibility be realized, the impact could be expected to be even more severe.

Historically, comparable municipal and corporate bonds have been considered to have a relationship as to yield in the vicinity of 70 percent. That is to say, municipal yields have run at about 70 percent of those on comparable corporates. To put it another way, if a corporate bond were to be sold at 8 percent, one would expect a comparable municipal to yield 5.6 percent.

Graph No. 1 illustrates the relationship over the past two years. Please note that the latest data indicate a yield relationship of 80 percent. Today, if a corporate bond were to be sold at 8 percent, a comparable municipal would bear an interest rate of 6.4 percent — not 5.6 percent. Note also the extent of the change in the relationship that occurred in 1969.

Graph No. 2 illustrates the same basic change. It is based on different indices.

Graphs No. 3 and 4 show the yields of tax exempt and taxable bonds over the past two years as indicated by representative indices. Again the closing of the gap can be seen.

Tables No. 1-3 show in tabular form the data shown on the several graphs. Please note on Table No. 1 the difference of 1.78 percent in August 1967 (4.06 and 5.84 percent), which remained about the same, 1.77 percent, in January 1969, had by July shrunk to 1.39 percent. On Table No. 2, a similar

change can be seen. The respective differences are 1.80, 1.87 and 1.51. Both Table No. 3 and Graph No. 4 indicate the yield relationship of one representative municipal bond index and U.S. Government 20-year bonds. Just to round out the story, a difference in interest rate of 0.93 percent in August 1967 (0.95 percent in January 1969) had shrunk in July 1969 to 0.19.

These data indicate a general increase in interest rates which may be ascribed to the tight money market. The time during which most of the change in yield relationship took place, i.e. when this bill was before the other body, make it abundantly clear that the threat of taxation of municipal bonds was the cause for that change.

Also attached to my statement are two schedules. If we may turn first to Schedule II, columns 1-4 reflect the issuances of tax exempt municipal securities for the years 1965-1968 on a state by state basis as reported in the IBA Statistical Bulletin. The figures shown for each state include issuances by local governmental units as well as those of the state itself.

The figures shown in columns 5 and 6 are projections of bond sales by state for 1969 and 1970. They assume a 10 percent per year increase over 1968, 5 percent due to inflation and 5 per cent in real governmental outlays. They assume further that nothing in the tax situation would disrupt the issuance of municipal securities.

I should observe that the latter assumption is unwarranted. The ominous tax situation and attendant high interest rates - interest rates in some instances high enough to exceed legal interest ceilings and in others to force issuers out of the market - reduced the annual rate of issuances to less than $11 billion based on first quarter statistics. That is a level 40 percent below what might reasonably have been expected for this year. The figures in columns

5 and 6, in other words, represent reasonable estimates of need for state and local government capital financing.

If we may turn back to Schedule I now, it shows estimates of the additional interest costs that would be incurred by state and local governments were the provisions relating to municipal bonds of HR 13270 enacted. Two estimates are made - one based on actual volume for 1968, the other on projected volume for 1970. Inclusion of the 1968 figures and estimates is justified on the grounds that they represent a year unaffected by the current market uncertainties due to the threat of taxation and, therefore, represent an actual expression of state and local financing needs. As discussed above, the volume for 1970 undoubtedly is overstated because of the taxation threat.

Column 2 of Schedule I represents calculations of the annual debt service on bonds issued in 1968. Inasmuch as it would be impossible to calculate the actual debt service on each of the over 5,400 separate issuances, a 20-year bond with equal annual payments of principal and interest was used for these computations. The interest rate used - 4.5 percent - was the approximate average of the Bond Buyer's Index for 1968. This well-known index consists of 20 municipal bonds picked for their representativeness of the overall market. As can be seen, debt service was $1.24 billion for the entire 50 states.

For purposes of computation, an increase of two percentage points of interest has been employed. If this appears to be too large an increase, please remember that the January through July 1969 increase based on the threat of taxation only was 0.96 or 0.85 percent, depending upon which index is used. In any case, a two percent increase would have resulted in an annual debt service of $1.46 billion (column 4) or an increase of $222 million over the tax exempt cost. The figures in

column 5 show that for debt issued in 1968 the additional interest cost over the life of the bonds would have amounted to the staggering sum of $4.45 billion. As appalling as these figures are, they relate to issuances of a single year.

Columns 6-10 contain information similar to that of columns 1-5, but based on projected issuances for 1970. Please note the assumed interest cost increase, approximately $270 million. If the same total in bonds were issued in 1971, the increase would be $540 million. By the tenth year, and making the unrealistic assumption that state and local financing would not grow from year to year, an additional $2.7 billion in interest costs would have to be paid that year from state and local government budgets.

Mr. Chairman, Members of the Committee, some may feel that we have overestimated the increase in interest costs that would result from enactment of H.R. 13270 as it came to you. Some may feel that the Treasury proposals would result in a smaller increase. If one reduces the estimated increase by one-half or even more, what remains is an undeniably additional heavy debt service burden that must be borne by state and local governments and their taxpayers.

Mr. Chairman, neither Governors nor their fiscal officers nor Members of Congress make the market. Investors do. In their wisdom or unwisdom they determine what interest rates will be. The Treasury estimates of the actual revenue impact of the limit on tax preferences provision of H.R. 13270 as only $35 million, and its own allocation of deductions proposal as $45 million are not controlling. Investors decide for themselves. They can decide that if Congress breaches the tax exemption dike or reduces the value to them of their deductions, they will bid on bonds at sharply increased interest rates. They can and they do as we have seen from studying

33-758 O - 69 -- No. 9 -- 3

what happened to state and local bond interest rates while the Ways and Means Committee and the House were considering H.R. 13270.

Secretary Kennedy testified that the market impact of the Treasury allocation of deductions proposal would be minimal. Neither he nor we know if his opinion is valid. We do know, however, that the Treasury estimates the revenue yield in the first full year of operation of the proposal to be $45 million. We know too that this estimate is based on a requirement that deductions be allocated with respect to all bonds, outstanding as well as prospective. We may assume for present purposes that it was based on the total of bonds outstanding at the end of 1969 -- $140 billion at the end of 1968 plus our assumed 10 percent increase for 1969 or $154 billion. Let us then assume an additional 10 percent increase in bonds outstanding at the end of 1970, or approximately $170 billion. The revenue accruing to the Treasury would than amount to $49.5 million.

Let us now look at what the increased debt service cost would be to states and localities for just one year, 1970. Assume the increase to be -- not two -- but one percent. That would be $135 million. Assume it would be one-half percent. That would be $67 million. And remember, that is for that year only. The additional debt service cost would continue for the life of the bonds.

No one can know until after the fact what the actual debt service cost increase would be. There is reason to believe, however, that it would be much greater than the increase in federal revenue would be. As we have pointed out, the threat of enactment of H.R. 13270 with its phasing in of both LTP and allocation of deductions and its application of the latter only to future issues pushed interest rates up nearly one percent. The Treasury proposal, if enacted, would have nearly the same -- possibly an even greater-- damaging impact. For one thing, allocation of deductions affects many more people than the minimum tax. The latter is operative only when the total

income from tax preference items exceeds both $10,000 and regularly taxable income. The former is applicable with respect to any amount of tax preference income in excess of $10,000. Moreover, and this seems to have been overlooked by both the House of Representatives and the Treasury, allocation of deductions can easily be made to apply to banks, by far the largest buyers of state and local bonds. As a matter of fact, in the all-but final House bill, banks were required to allocate deductions. If life insurance companies can be made to allocate, as Treasury witnesses pointed out the Supreme Court has held, and Congress chooses to require individuals to allocate, would bankers feel that they would be forever immune?

Mr. Chairman, another point overlooked or ignored is that those who buy state and local bonds pay a "tax" as long as they hold the securities. True, they do not pay it in the form of income tax to the United States, but they pay it to state and local governments by accepting a lower rate of interest than they would receive if they bought taxable securities. True, also, they expect to gain more in federal income taxes not paid than in interest foregone in many if not most instances.

But, have we not shown that the principal beneficiaries of low state and local government bond interest rates are the issuing governments? Have we not shown that to correct an alleged inequity in federal income tax laws will cost state and local governments in interest costs far more than the Treasury will realize in revenue?

If the Congress does not heed our warning, what will be the result? The immediate result will be the postponement, cancellation or reduction in scope of many public building projects -- schools, hospitals, highways, water and sewer facilities and others vitally needed. Eventually, of course, these projects will be built. They will have to be paid for, however, out of increased sales and property taxes and utility fees. These taxes and fees -- regressive

though they may be -- will have to be relied on even more heavily than at present to supply the funds state and local governments could not afford to borrow or to pay the increased debt carrying costs on what they would have to borrow.

Mr. Chairman, in my statement I have chosen not to speak on a number of aspects of what is involved in the direct or indirect taxation of state and local obligations by the Federal Government. Other witnesses appearing for the states will cover them. I have tried to show, and I believe I have shown, certain of the calamitous results that federal taxation would achieve. I do not believe that this Committee, its parent body or the Congress wishes to accomplish such results.

Mr. Chairman, Members of the Committee, I appreciate your giving me your time and attention. Thank you.

-- TELEGRAM --

SEPTEMBER 2, 1969

THE HONORABLE RICHARD NIXON
PRESIDENT OF THE UNITED STATES
THE WHITE HOUSE
WASHINGTON, D. C.

DEAR MR. PRESIDENT:

YOUR PRESENTATION TO THE NATION'S GOVERNORS MONDAY NIGHT WAS A TREMENDOUS CONTRIBUTION TO THE MEANINGFUL ESTABLISHMENT OF THE "NEW FEDERALISM." WE ARE CONVINCED, MR. PRESIDENT, THAT WE HAVE BEFORE US THE OPPORTUNITY FOR A MONUMENTAL BREAKTHROUGH TO A POSITIVE PARTNERSHIP IN GOVERNMENT. YOU VERY ABLY OUTLINED THE PARAMOUNT ISSUES WHICH ARE CHALLENGING OUR SYSTEM OF GOVERNMENT, AND LAID THE GROUNDWORK UPON WHICH ALL ELECTED OFFICIALS CAN JOIN TOGETHER IN A COMMON CAUSE. THAT CAUSE IS, OF COURSE, A GOVERNMENTAL SYSTEM THAT CAN EFFECTIVELY DELIVER SERVICES TO OUR PEOPLE.

YOU CAN BE ASSURED OF THE COMPLETE COOPERATION OF THE NATION'S GOVERNORS IN THESE VITAL ISSUES.

ONE CRUCIAL MATTER WHICH WE DID NOT HAVE AN OPPORTUNITY TO DISCUSS WITH YOU IS THE TAXATION OF STATE AND MUNICIPAL BONDS. THE INFRINGEMENT UPON WHAT WE CONSIDER THE CONSTITUTIONAL PREROGATIVES OF STATE AND LOCAL GOVERNMENT WOULD BE A SETBACK OF MAJOR PROPORTIONS TO OUR MUTUAL GOAL OF GOVERNMENTAL BALANCE IN THE "SPIRIT OF '76."

THE STAGGERING BLOW OF INCREASED COSTS FOR ALL PUBLIC CONSTRUCTION WOULD EITHER ADD TO THE TAX BURDEN OF THE PEOPLE OR STOP CONSTRUCTION OF MUCH NEEDED PUBLIC FACILITIES.

VERY SIMPLY, MR. PRESIDENT, IF THE ABILITY TO MARKET STATE AND MUNICIPAL BONDS IS JEOPARDIZED IN ANY WAY, IT WILL BE A SETBACK THAT FOR YEARS TO COME WILL OVERSHADOW ANY POSITIVE PROPOSALS.

..... continued .....

WE URGE YOUR CAREFUL CONSIDERATION OF THIS VITAL MATTER, AND BY COPY OF THIS TELEGRAM CALL ON THE CONGRESSIONAL LEADERSHIP FOR THEIR COOPERATION AND SUPPORT.

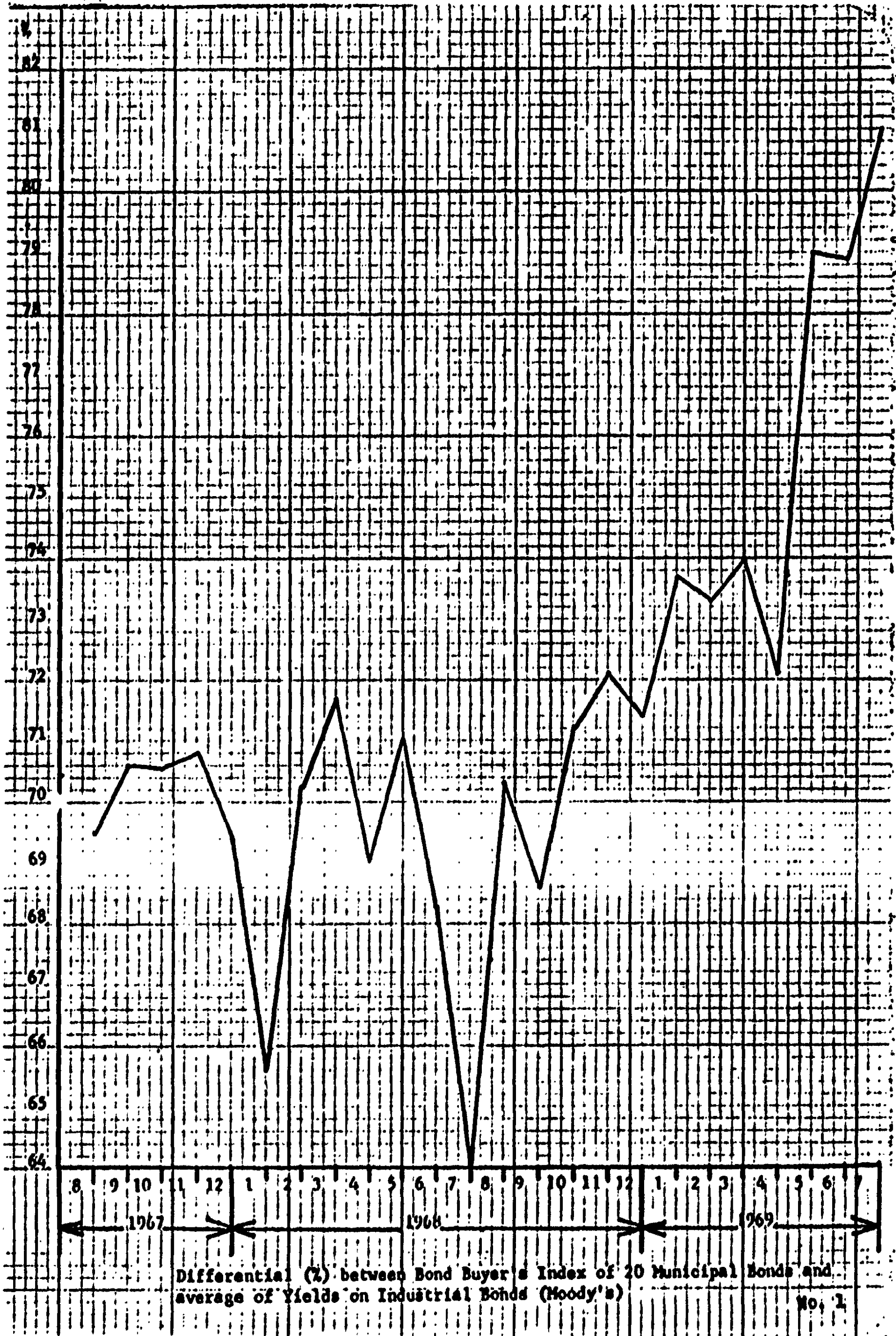
AGAIN, WE APPRECIATE SO MUCH YOUR PRESENCE AT OUR CONFERENCE, AND THE TREMENDOUS CONTRIBUTIONS YOU ARE MAKING TO PROVIDE ORDER AND BALANCE IN OUR FEDERAL SYSTEM.

/S/ GOVERNOR BUFORD ELLINGTON, TENNESSEE, CHAIRMAN OF THE NATIONAL GOVERNORS' CONFERENCE, JOINED BY ALL OTHER GOVERNORS PRESENT AT TODAY'S BUSINESS SESSION:

GOVERNOR ALBERT P. BREWER, ALABAMA
GOVERNOR KEITH H. MILLER, ALASKA
GOVERNOR JOHN M. HAYDON, AMERICAN SAMOA
GOVERNOR JACK WILLIAMS, ARIZONA
GOVERNOR WINTHROP ROCKEFELLER, ARKANSAS
GOVERNOR RONALD REAGAN, CALIFORNIA
GOVERNOR JOHN A. LOVE, COLORADO
GOVERNOR JOHN DEMPSEY, CONNECTICUT
GOVERNOR RUSSELL W. PETERSON, DELAWARE
GOVERNOR CLAUDE R. KIRK, JR., FLORIDA
GOVERNOR LESTER G. MADDOX, GEORGIA
GOVERNOR CARLOS G. CAMACHO, GUAM
GOVERNOR JOHN A. BURNS, HAWAII
GOVERNOR DON SAMUELSON, IDAHO
GOVERNOR RICHARD B. OGILVIE, ILLINOIS
GOVERNOR EDGAR D. WHITCOMB, INDIANA
GOVERNOR ROBERT D. RAY, IOWA
GOVERNOR ROBERT DOCKING, KANSAS
GOVERNOR LOUIE B. NUNN, KENTUCKY
GOVERNOR KENNETH M. CURTIS, MAINE
GOVERNOR MARVIN MANDEL, MARYLAND
GOVERNOR FRANCIS W. SARGENT, MASSACHUSETTS
GOVERNOR WILLIAM G. MILLIKEN, MICHIGAN
GOVERNOR HAROLD LEVANDER, MINNESOTA
GOVERNOR WARREN E. HEARNES, MISSOURI
GOVERNOR FORREST H. ANDERSON, MONTANA
GOVERNOR NORBERT T. TIEMANN, NEBRASKA
GOVERNOR PAUL LAXALT, NEVADA
GOVERNOR WALTER PETERSON, NEW HAMPSHIRE
GOVERNOR RICHARD J. HUGHES, NEW JERSEY
GOVERNOR DAVID F. CARGO, NEW MEXICO
GOVERNOR NELSON A. ROCKEFELLER, NEW YORK
GOVERNOR ROBERT W. SCOTT, NORTH CAROLINA
GOVERNOR WILLIAM L. GUY, NORTH DAKOTA
GOVERNOR JAMES A. RHODES, OHIO
GOVERNOR DEWEY F. BARTLETT, OKLAHOMA
GOVERNOR TOM MC CALL, OREGON
GOVERNOR RAYMOND P. SHAFER, PENNSYLVANIA
GOVERNOR LUIS A. FERRE, PUERTO RICO
GOVERNOR FRANK LICHT, RHODE ISLAND
GOVERNOR ROBERT E. MC NAIR, SOUTH CAROLINA
GOVERNOR FRANK L. FARRAR, SOUTH DAKOTA
GOVERNOR CALVIN L. RAMPTON, UTAH
GOVERNOR DEANE C. DAVIS, VERMONT
GOVERNOR MILLS E. GODWIN, JR., VIRGINIA
GOVERNOR MELVIN H. EVANS, VIRGIN ISLANDS
GOVERNOR DANIEL J. EVANS, WASHINGTON
GOVERNOR ARCH A. MOORE, JR., WEST VIRGINIA
GOVERNOR WARREN P. KNOWLES, WISCONSIN
GOVERNOR STANLEY K. HATHAWAY, WYOMING

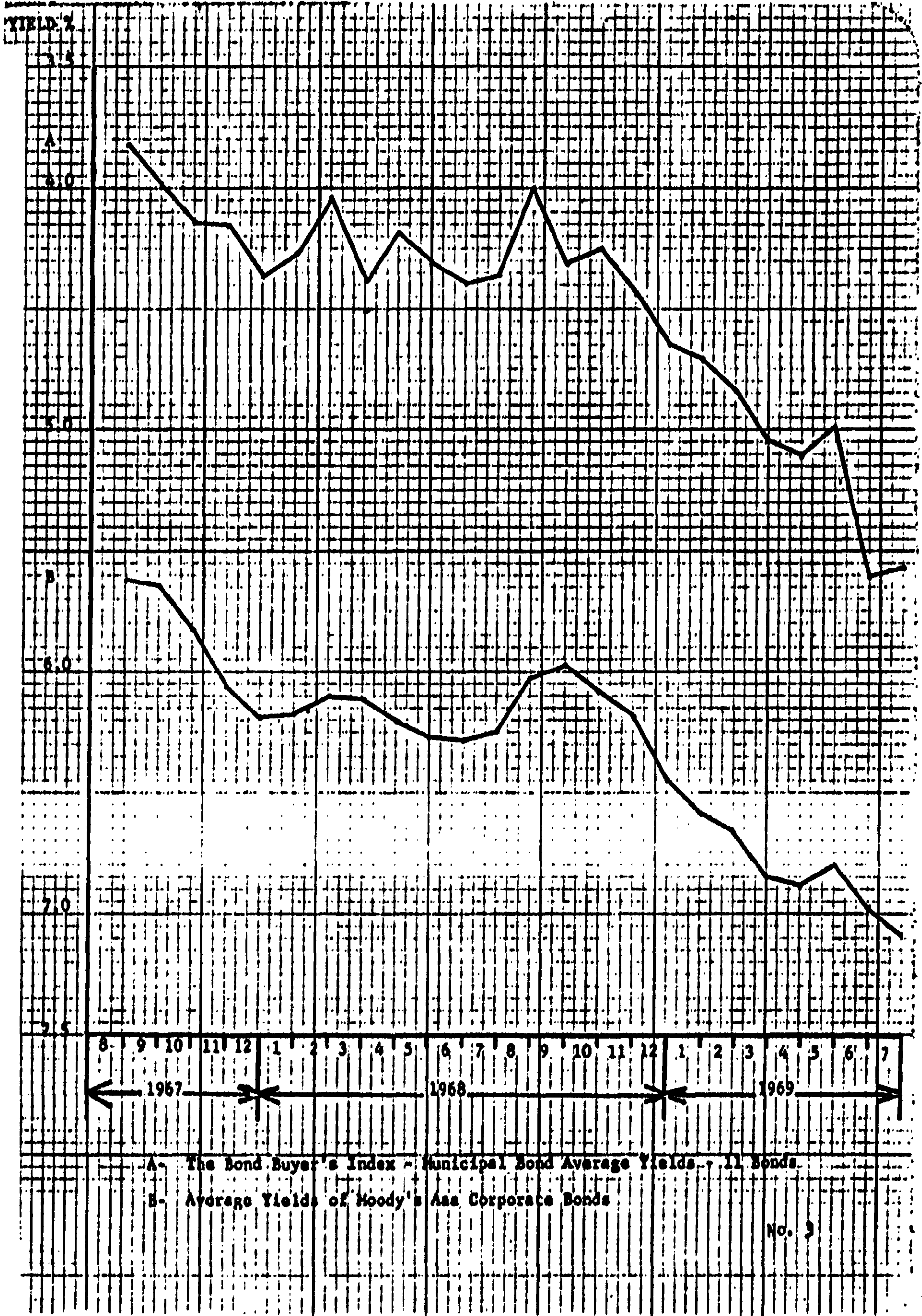
AND FURTHER JOINED BY:

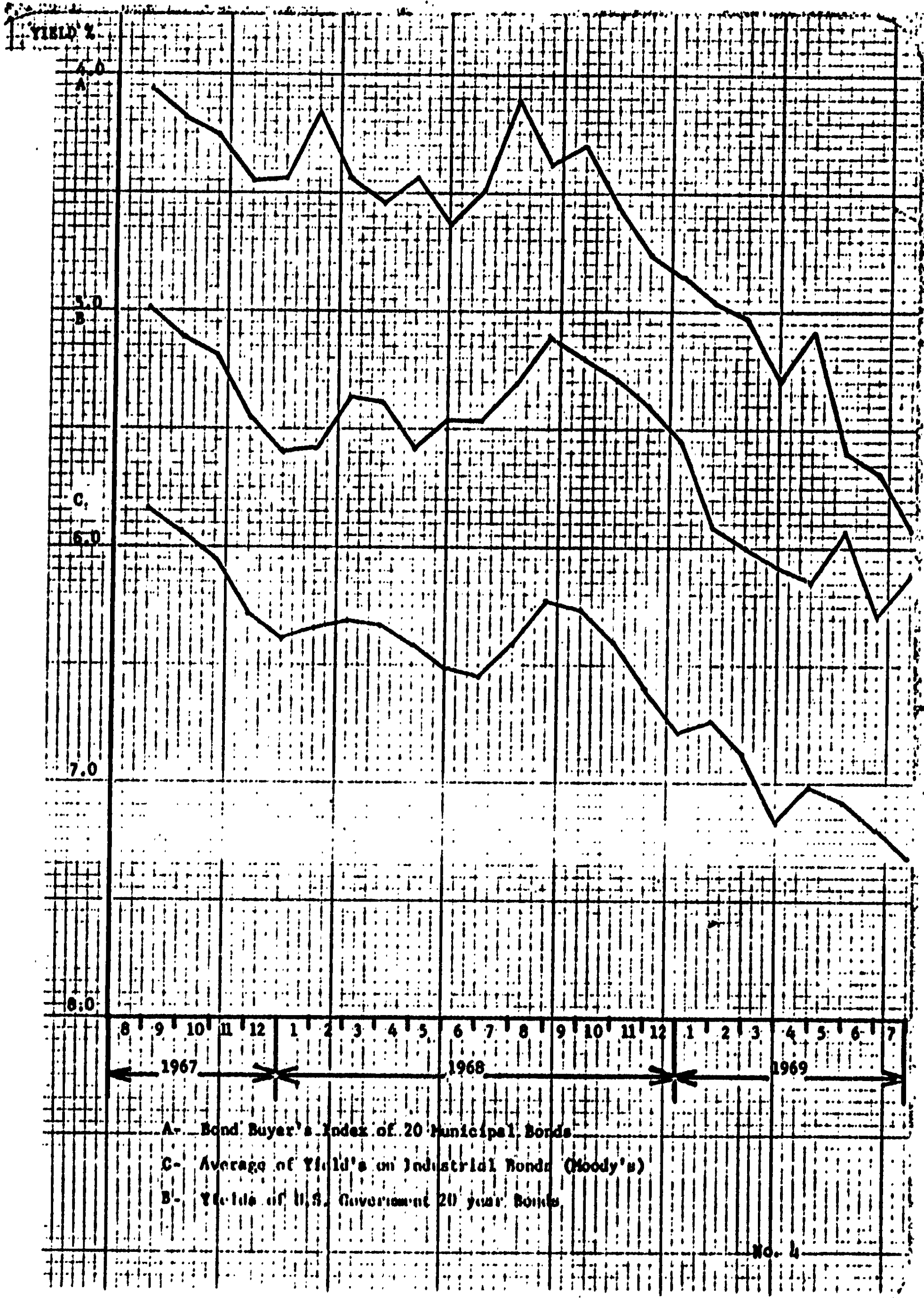
CONRAD FOWLER - PRESIDENT, NATIONAL ASSOCIATION OF COUNTIES
JACK D. MALTESTER - PRESIDENT, U. S. CONFERENCE OF MAYORS
BEVERLY BRILEY - PRESIDENT, NATIONAL LEAGUE OF CITIES


%
82
81
80
79
78
77
76
75
74
73
72
71
70
69
68
67
66
65
64
8 9 10 11 12 1 2 3 4 5 6 7 8 9 10 11 12 1 2 3 4 5 6 7
1967
1968
1969
Differential (%) between Bond Buyer's Index of 20 Municipal Bonds and average of Yields on Industrial Bonds (Moody's)
No. 1

Differential (%) between Moody's Average of Yields on Aaa Corporate Bonds and Bond Buyer's Index - 11 Bonds.

No. 2


YIELD %
4.5
A
5.0
5.5
B
6.0
7.0
7.5
8 9 10 11 12 1 2 3 4 5 6 7 8 9 10 11 12 1 2 3 4 5 6 7
1967
1968
1969
A- The Bond Buyer's Index - Municipal Bond Average Yields - 11 Bonds
B- Average Yields of Moody's Aaa Corporate Bonds
No. 3


YIELD %
4.0
A
5.0
B
C
6.0
7.0
8.0
8 9 10 11 12 1 2 3 4 5 6 7 8 9 10 11 12 1 2 3 4 5 6 7
1967
1968
1969
A- Bond Buyer's Index of 20 Municipal Bonds
C- Average of Yield's on Industrial Bonds (Moody's)
B- Yields of U.S. Government 20 year Bonds
No. 4

COMPARISON OF YIELDS
Municipal (Bond Buyer 20)
and
Industrial (Moody's Average)

		Bond Buyer's Index of 20 Municipal Bonds	Avg. of Yields On Industrial Bonds (Moody's)	Differential (%)
1967	Aug.	4.06%	5.84%	69.5%
	Sep.	4.19	5.93	70.6
	Oct.	4.27	6.05	70.5
	Nov.	4.45	6.28	70.8
	Dec.	4.44	6.39	69.4
1968	Jan.	4.16	6.34	65.6
	Feb.	4.44	6.31	70.3
	Mar.	4.54	6.33	71.7
	Apr.	4.43	6.42	69.0
	May	4.64	6.52	71.1
	Jun.	4.48	6.55	68.3
	Jul.	4.11	6.42	64.0
	Aug.	4.38	6.23	70.3
	Sep.	4.30	6.26	68.6
	Oct.	4.56	6.40	71.2
	Nov.	4.76	6.60	72.1
	Dec.	4.85	6.79	71.4
1969	Jan.	4.97	6.74	73.7
	Feb.	5.04	6.87	73.3
	Mar.	5.30	7.16	74.0
	Apr.	5.09	7.02	72.5
	May	5.60	7.08	79.0
	Jun.	5.68	7.20	78.8
	Jul.	5.93	7.32	81.0

EM:LO
8/28/69

No.1

COMPARISON OF YIELDS
Municipal (Bond Buyer 11)
and
Industrial (Moody's Aaa)

		Bond Buyer's Index - 11 Bonds	Moody's Average of Yields on AAA Corporate Bonds	Differential (%)
1967	Aug.	3.82%	5.62%	67.9%
	Sep.	3.99	5.65	70.6
	Oct.	4.15	5.82	71.3
	Nov.	4.16	6.07	68.5
	Dec.	4.37	6.19	70.5
1968	Jan.	4.27	6.17	69.2
	Feb.	4.04	6.10	66.2
	Mar.	4.38	6.11	71.6
	Apr.	4.19	6.21	67.4
	May	4.32	6.27	68.8
	Jun.	4.40	6.28	70.0
	Jul.	4.36	6.24	69.8
	Aug.	4.00	6.02	66.4
	Sep.	4.32	5.97	72.3
	Oct.	4.25	6.09	69.7
	Nov.	4.44	6.19	71.7
	Dec.	4.65	6.45	72.0
1969	Jan.	4.72	6.59	71.6
	Feb.	4.84	6.66	72.6
	Mar.	5.05	6.85	73.7
	Apr.	5.12	6.89	74.3
	May	4.99	6.79	73.4
	Jun.	5.61	6.98	80.3
	Jul.	5.57	7.08	78.6

EM:LO
8/28/69

No. 2

COMPARISON OF YIELDS
Municipal (Bond Buyer 20)
Industrial (Moody's Average) and
U. S. Governments (20 Years)

		BB's Index of 20 Mun. Bonds	Average Yields On Industrial Bonds (Moody's)	Yields of U.S.G.'s 20
1967	Aug.	4.06%	5.84%	4.99%
	Sep.	4.19	5.93	5.12
	Oct.	4.27	6.05	5.18
	Nov.	4.45	6.28	5.46
	Dec.	4.44	6.39	5.60
1968	Jan.	4.16	6.34	5.57
	Feb.	4.44	6.31	5.37
	Mar.	4.54	6.33	5.39
	Apr.	4.43	6.42	5.59
	May	4.64	6.52	5.47
	Jun.	4.48	6.55	5.47
	Jul.	4.11	6.42	5.31
	Aug.	4.38	6.23	5.12
	Sep.	4.30	6.26	5.20
	Oct.	4.56	6.40	5.29
	Nov.	4.76	6.60	5.40
	Dec.	4.85	6.79	5.55
1969	Jan.	4.97	6.74	5.92
	Feb.	5.04	6.87	6.00
	Mar.	5.30	7.16	6.08
	Apr.	5.09	7.02	6.20
	May	5.60	7.08	5.92
	Jun.	5.68	7.20	6.29
	Jul.	5.93	7.32	6.12

EM:LO
8/28/69

No. 3

SCHEDULE I

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT
H. R. 13270
MUNICIPAL BOND ISSUANCES BY STATE AND ESTIMATED DEBT SERVICE THEREON
TAX EXEMPT VS. TAXABLE
(MILLIONS)

State	(1) Issuances 1968 (Actual)	(2) Debt Service Tax Exempt Basis	(3) Debt Service Taxable Basis	(4) Additional Interest Cost Due To Tax Each Year	(5) Additional Interest Cost Due To Tax Life of Bond	(6) Issuances 1970 (Projected)	(7) Debt Service Tax Exempt Basis	(8) Debt Service Taxable Basis	(9) Additional Interest Cost Due To Tax Each Year	(10) Additional Interest Cost Due To Tax Life of Bond
Alabama	$ 299.0	$ 23.0	$ 27.1	$ 4.1	$ 82.0	$ 363.0	$ 27.9	$ 32.9	$ 5.0	$ 100.0
Alaska	69.0	5.3	6.3	1.0	20.0	84.0	6.5	7.6	1.1	22.0
Arizona	90.0	6.9	8.2	1.3	26.0	109.0	8.4	9.9	1.5	30.0
Arkansas	36.0	2.8	3.3	.5	10.0	44.0	3.4	4.0	.6	12.0
California	1,976.0	151.9	179.3	27.4	548.0	2,391.0	183.8	217.0	33.2	664.0
Colorado	72.0	5.5	6.5	1.0	20.0	87.0	6.7	7.9	1.2	24.0
Connecticut	266.0	20.4	24.1	3.7	74.0	322.0	24.8	29.2	4.4	88.0
Delaware	61.0	4.7	5.5	.8	16.0	74.0	5.7	6.7	1.0	20.0
Florida	585.0	45.0	53.0	8.0	160.0	708.0	54.4	64.3	9.9	198.0
Georgia	221.0	17.0	20.0	3.0	60.0	267.0	20.5	24.2	3.7	74.0
Hawaii	90.0	6.9	8.2	1.3	26.0	109.0	8.4	9.9	1.5	30.0
Idaho	15.0	1.2	1.4	.2	4.0	19.0	1.5	1.7	.2	4.0
Illinois	553.0	42.5	50.1	7.6	152.0	669.0	51.4	60.7	9.3	186.0
Indiana	216.0	16.6	19.6	3.0	60.0	262.0	20.1	23.8	3.7	74.0
Iowa	165.0	12.9	14.9	2.0	40.0	200.0	15.4	18.2	2.8	56.0
Kansas	108.0	8.3	9.8	1.5	30.0	131.0	10.1	11.9	1.8	36.0
Kentucky	367.0	28.2	33.3	5.1	102.0	444.0	34.1	40.3	6.2	124.0
Louisiana	531.0	40.8	48.2	7.4	148.0	642.0	49.4	58.3	8.9	178.0
Maine	64.0	4.9	5.8	.9	18.0	77.0	5.9	7.0	1.1	22.0
Maryland	512.0	39.4	46.4	7.0	140.0	619.0	47.6	56.2	8.6	172.0
Massachusetts	369.0	28.4	33.4	5.0	100.0	447.0	34.4	40.6	6.2	124.0
Michigan	694.0	53.3	62.3	9.0	180.0	839.0	64.5	76.1	11.6	232.0
Minnesota	299.0	23.0	27.1	4.1	82.0	362.0	27.8	32.3	4.5	90.0
Mississippi	141.0	10.8	12.8	2.0	40.0	171.0	13.1	15.5	2.4	48.0
Missouri	452.0	34.7	41.0	6.3	126.0	547.0	42.1	49.6	7.5	150.0
Montana	12.0	.9	1.1	.2	4.0	14.0	1.1	1.3	.2	4.0
Nebraska	372.0	28.6	33.8	5.2	104.0	450.0	34.6	40.8	6.2	124.0
Nevada	22.0	1.7	2.0	.3	6.0	26.0	2.0	2.4	.4	8.0
New Hampshire	34.0	2.6	3.1	.5	10.0	41.0	3.2	3.7	.5	10.0
New Jersey	472.0	36.3	42.8	6.5	130.0	571.0	43.9	51.8	7.9	158.0
New Mexico	50.0	3.8	4.5	.7	14.0	61.0	4.7	5.5	.8	16.0
New York	2,197.0	168.9	199.3	30.4	608.0	2,659.0	204.4	241.3	36.9	738.0
North Carolina	223.0	17.1	20.2	3.1	62.0	270.0	20.8	24.5	3.7	74.0
North Dakota	9.0	.7	.8	.1	2.0	11.0	.8	1.0	.2	4.0
Ohio	700.0	53.8	63.5	9.7	194.0	847.0	65.1	76.9	11.8	236.0
Oklahoma	212.0	16.3	19.2	2.9	58.0	256.0	19.7	23.2	3.5	70.0
Oregon	219.0	16.8	19.9	3.1	62.0	265.0	20.4	24.0	3.6	72.0
Pennsylvania	1,187.0	91.2	107.7	16.5	330.0	1,437.0	110.5	130.4	19.9	398.0
Rhode Island	95.0	7.3	8.6	1.3	26.0	116.0	8.9	10.5	1.6	32.0
South Carolina	146.0	11.2	13.3	2.1	42.0	177.0	13.6	16.1	2.5	50.0
South Dakota	13.0	1.0	1.2	.2	4.0	15.0	1.2	1.4	.2	4.0
Tennessee	212.0	16.3	19.2	2.9	58.0	256.0	19.7	23.2	3.5	70.0
Texas	775.0	59.6	70.3	10.7	214.0	938.0	72.1	85.1	13.0	260.0
Utah	22.0	1.7	2.0	.3	6.0	26.0	2.0	2.4	.4	8.0
Vermont	54.0	4.2	4.9	.7	14.0	65.0	5.0	5.9	.9	18.0
Virginia	202.0	15.5	18.3	2.8	56.0	244.0	18.8	22.1	3.3	66.0
Washington	320.0	24.6	29.0	4.4	88.0	387.0	29.8	35.1	5.3	106.0
West Virginia	52.0	4.0	4.7	.7	14.0	63.0	4.8	5.7	.9	18.0
Wisconsin	237.0	18.2	21.5	3.3	66.0	287.0	22.1	26.0	3.9	78.0
Wyoming	37.0	2.8	3.4	.6	12.0	45.0	3.5	4.1	.6	12.0
TOTALS	$16,125.0	$1,239.5	$1,461.9	$222.4	$4,448.0	$19,514.0	$1,500.6	$1,770.2	$269.6	$5,392.0

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT
H. R. 13270
Municipal Bond Issuances By State
(Millions)

SCHEDULE II

State	(1) Amount of Issuances 1965	(2) 1966	(3) 1967	(4) 1968	(5) 1969 (Projected)	(6) 1970 (Projected)
Alabama	$ 362	$ 261	$ 390	$ 299	$ 330	$ 363
Alaska	12	11	78	69	76	84
Arizona	103	93	49	90	99	109
Arkansas	49	79	147	36	40	44
California	1,642	1,584	1,719	1,976	2,174	2,391
Colorado	131	104	85	72	79	87
Connecticut	189	117	314	266	293	322
Delaware	59	96	68	61	67	74
Florida	364	274	219	585	644	708
Georgia	204	272	346	221	243	267
Hawaii	58	24	89	90	99	109
Idaho	11	11	7	15	17	19
Illinois	353	422	606	553	608	669
Indiana	186	209	193	216	238	262
Iowa	53	144	175	165	182	200
Kansas	103	70	113	108	119	131
Kentucky	153	414	351	367	404	444
Louisiana	299	246	442	531	584	642
Maine	16	22	40	64	70	77
Maryland	227	270	386	512	563	619
Massachusetts	250	262	446	369	406	447
Michigan	379	466	586	694	763	839
Minnesota	282	203	296	299	329	362
Mississippi	120	99	217	141	155	171
Missouri	136	146	270	452	497	547
Montana	22	24	21	12	13	14
Nebraska	45	100	55	372	409	450
Nevada	47	51	50	22	24	26
New Hampshire	55	22	52	34	37	41
New Jersey	265	343	348	472	519	571
New Mexico	81	73	36	50	55	61
New York	1,416	1,457	1,554	2,197	2,417	2,659
North Carolina	143	130	294	223	245	270
North Dakota	17	19	7	9	10	11
Ohio	414	332	608	700	770	847
Oklahoma	149	309	86	212	233	256
Oregon	56	141	122	219	241	265
Pennsylvania	673	639	998	1,187	1,306	1,437
Rhode Island	84	40	106	95	105	116
South Carolina	63	44	165	146	161	177
South Dakota	12	15	8	13	14	15
Tennessee	149	207	396	212	233	256
Texas	657	543	662	775	853	938
Utah	102	15	23	22	24	26
Vermont	22	39	5	54	59	65
Virginia	166	105	243	202	222	244
Washington	267	85	301	320	352	387
West Virginia	84	80	71	52	57	63
Wisconsin	222	202	225	237	261	287
Wyoming	16	10	51	37	41	45
TOTALS	$10,968	$10,924	$14,119	$16,125	$17,740	$19,516

STATEMENT OF GOVERNOR DANIEL J. EVANS, CHAIRMAN, NATIONAL GOVERNORS' CONFERENCE ON EXECUTIVE MANAGEMENT AND FISCAL AFFAIRS, TO SENATE COMMITTEE ON FINANCE, SEPTEMBER 23, 1969, OPPOSING PROVISIONS OF H. R. 13270 DEALING WITH TAX EXEMPTION OF STATE AND LOCAL BONDS

SUMMARY

1. The provisions of H. R. 13270 dealing with taxation of state and local bonds will result in a basic change in our governmental structure arising from immediate economic pressure.

2. The provisions insure a narrowing of the difference between the cost of taxable and non-taxable issues. The current chaotic condition of the market can, in specific part, be attributed to the proposed provisions, and has already resulted in serious financial problems in construction programs in the State of Washington and substantial increased cost of borrowing throughout the country.

3. The provisions do not represent tax reform, but shift to more regressive state and local tax burdens and utility charges.

4. The basis of exemption is constitutional, and enactment will result in legal challenge, with continuing chaos in the bond market and severe intergovernmental conflict.

5. The purchaser of municipal bonds now pays a minimum tax by accepting a lower interest rate.

6. There is no indication that tax exemption of municipal bonds was a significant factor in the failure by wealthy individuals cited by the Treasury Department to pay income taxes.

33-758 O - 69 -- No. 9 -- 4

7. Further study needs to be undertaken on the role of tax exempt securities in the tax system and on ways to broaden the market for municipal bonds before changes in the tax exempt status of municipal bonds should be considered. ACIR has suggested such a study in which the National Governors' Conference would be desirous of participating.

STATEMENT OF GOVERNOR DANIEL J. EVANS, CHAIRMAN, NATIONAL GOVERNORS' CONFERENCE ON EXECUTIVE MANAGEMENT AND FISCAL AFFAIRS, TO SENATE COMMITTEE ON FINANCE, SEPTEMBER 23, 1969, OPPOSING PROVISIONS OF H. R. 13270 DEALING WITH TAX EXEMPTION OF STATE AND LOCAL BONDS

I sincerely appreciate the decision of this Committee to hold public hearings on the provisions of H. R. 13270 which deal with taxation of state and local bonds. Seldom has an issue of such intergovernmental importance and sensitivity been before you. The decision by the House of Representatives without any public opportunity for Governors and local officials to express themselves is an unfortunate chapter in the history of the federal system.

Others who will appear before you in future hearings will deal with the technical features of the optional issuance of exempt or non exempt bonds, the allocation of deductions and the minimum tax provisions of H. R. 13270. I believe that taken separately or together, their result will be a change in the basic structure of government resulting from immediate economic pressure and demagogic appeals. Therefore, I urge the members of this Committee to weigh most carefully the effect of this issue.

The effect of the provisions of H. R. 13270 is, by gradual stages, to tax the interest on state and local bonds. The much discussed local choice to issue either tax exempt bonds or taxable bonds with an interest subsidy is an illusory choice. The requirement that the Secretary of the Treasury fix the interest subsidy for fully taxable bonds each quarter on the basis of the difference between the interest yield on such fully taxable bonds and the yield on "tax exempt" bonds as determined by the market at that time, makes it apparent that this difference would gradually decline and the cost of borrowing to state and local governments even under the subsidy option would substantially increase.

The effect on the municipal bond market of this legislation can be viewed dramatically today by each of us and can be separated from the general financial market instability. The Dow Jones municipal bond index rose from 6.02% to a record 6.23% in one week in September. Within the past month in the State of Washington we have increased the burden to our present taxpayers by markedly shortening the maturity period on one issue of bonds which must be sold by December 31 and has an interest rate limitation, and the timely construction of vitally needed vocational education and general educational facilities in our community colleges has been placed in jeopardy by rejecting all bids on a $22 million issue because they were based upon interest rates which the state could not accept. We can only hope that when we reissue a call for bids on this issue, some order will have returned to the market.

Financial experts in my state have stated that the interest rate differential between taxable and non taxable bonds has narrowed from 30% to 20% since this legislation came under consideration. Based on the supportable assumption of the issuance of $10 billion in state and local bonds throughout the country during the year, the portion of the increase in cost attributable to the potential effect of this legislation will cost

local taxpayers of the nation more than $1 billion over an average 25 year life of the bonds issued in one year alone. This cost will be compounded each year in which additional bonds must be issued under the present market conditions.

The net effect of the enactment of these provisions will be to increase slightly the tax yield to the federal government at the expense of substantially increasing the cost of borrowing by state and local government. It will increase the federal income tax yield at the expense of higher property taxes and higher utility charges for the local residents who pay the cost of municipal and state borrowing. It is not overall tax reform, but enforced local tax regression. It is a shift of the tax burden to the advantage of the federal treasury but the disadvantage of renters, home-owners, and utility users, regardless of their ability to pay. I cannot too strongly express my view that the result of these provisions are inimical both to the concepts of federal-state relations expressed by Presidents Nixon and Johnson, and to the views of those who most urgently desire real tax reform. The Federal Treasury cannot be viewed as the single entity in the nation's tax structure. When the entire tax system is viewed, these provisions will prove regressive in effect.

Tax deductions are generally permitted as a matter of Federal policy to encourage charity and investment and stimulate discovery of natural resources or similar worthwhile activities. But exemption of state and local bond interest does not derive from such Federal policy. It stems from the constitutionally mandated doctrine of inter-governmental immunity which is designed to permit the continued functioning of States and their political subdivisions. There is no doubt that litigation will ensue if this bill is enacted. By making this litigation inevitable, the Congress will doom the municipal bond market to several years of chaos which can only result in costing the public taxpayer hundreds of millions of dollars in additional interest cost. At a time when close intergovernmental relationships are being encouraged, a bitter and divisive battle will ensue, causing possibly irreparable harm to the Federal system.

It should be pointed out that the House of Representatives did not take cognizance of the fact that the buyer of State and local government bonds is now paying a "minimum tax" (in effect) to local government bonds by accepting a lower interest rate than he would demand if the bonds were taxable. Individuals with incomes in excess of $200,000 per year who pay no taxes are cited by the U.S. Treasury Department as examples of the need for reform. However, in the vast majority of cases cited by the Treasury Department this non-taxpaying status was achieved through depreciation, charitable contributions and other deductions and not through municipal bond holdings. The only study which has been conducted of which I am aware supports the conclusion that a minor portion of the income of most persons with large incomes is derived from this source. Action should be taken by this Committee to have timely information on this subject before it should consider accepting the provisions of H. R. 13270. The Advisory Commission on Intergovernmental relations has expressed interest in dealing with the subject of taxation of municipal bonds and I urge the Committee to utilize this prestigious body on which all levels of government are represented to bring more realistic recommendations before us. I assure you that the Nation's Governors will participate constructively in such a

study. Given the crippling condition of today's bond market, this Committee and the Treasury Department, in conjunction with ACIR and the National Governor's Conference Committee on Executive Mandgement and Fiscal Affairs should be reviewing ways to broaden the market for municipal bonds. The use of urban development bonds and the authority for investment of unemployment compensation trust funds in municipal bonds are among suggestions which deserve further study.

The recent National Governors' Conference unanimously adopted a policy statement originating in the Committee of which I was Chairman, affirming its support of the constitutional freedom from taxation of municipal bonds by the Federal Government and affirming its opposition to the provisions of H. R. 13270 which so obviously affect the marketability of state and local securities, and thereby the provision of needed public services and facilities. I appreciate the opportunity to share with you this view on behalf of the nation's Governors.

National Governors' Conference

OFFICE OF FEDERAL-STATE RELATIONS
1735 DESALES STREET, N.W.
WASHINGTON, D. C. 20036

CHARLES A. BYRLEY,
DIRECTOR

TELEPHONE:
AREA CODE 202 393-2662

Summary of

Statement of

The Honorable Norbert T. Tiemann

Governor of Nebraska

Before the

Committee on Finance
United States Senate

on

Tax Treatment of State and Local Government Bonds

September 23, 1969

Mr. Chairman, Members of the Committee, my name is Norbert T. Tiemann. I am Governor of Nebraska. I appreciate your permitting me to speak on the tax treatment of state and local bonds.

On March 11 of this year, I was afforded the opportunity to appear before the Ways and Means Committee on the subject of tax reform. As the representative of the National Governors' Conference, I urged strongly that the Committee not include in its bill provisions to tax state and local bonds. Other witnesses and I warned that the inevitable result of such provisions would be an escalation in bond interest rates. Unfortunately, we have been proved to be excellent prophets.

In February, before we testified, the Bond Buyers' Index of 20 representative municipal bonds was 5.04 percent. On August 21, the index breached 6 percent to reach 6.02. The Bond Buyers' Index of 11 bonds - more highly rated issues - showed yields in February to be 4.84 percent. On August 21, it hit 5.92. These are increases of 0.98 and 1.08 in the short space of six months. In the period, February-July, corporate issues (Moody's Average of Yields on Corporate Bonds) and 20-year U.S. Government bonds experienced interest rate increases of 0.44 and 0.12 respectively.

I am not here to assert a claim to be regarded as a seer. I am not here to argue that tight money has not caused interest rates to rise. I do assert, however, that the only thing that could have caused state and local bond interest rates to increase so much more greatly than those of these other long-term securities is the consideration the House gave to taxation of state and local bonds. I'll make one more prophecy. Should the Senate and then the entire Congress decide to tax our bonds - be the form minimum tax, allocation of deductions

or some other - our interest rates will continue their climb both absolutely and relatively.

You have heard, Mr. Chairman, testimony that the House provisions on a "limit on tax preferences" and allocation of deductions and the Treasury scheme with respect to the latter will have only minimal revenue consequences. We do not quarrel with this view. What we fear is that the market will react - as it has already- to a much greater degree than the revenue consequences would appear to justify.

One of the Treasury witnesses referred to the market reaction as being primarily "psychological." Of course it is. So labeling it does not make it any less severe, however. Whether the Congress, Governors, Mayors, the Treasury or anyone else feels the actual and potential reaction to be justified is beside the point. Investors make their own decisions. And their decisions determine what the state and local bonds interest rate will be.

They might decide that a minimum tax rate established by this Congress could be increased by a subsequent Congress. They might decide that an allocation of deductions requirement for individuals applicable only to future issues of bonds and phased in over 10 years, as provided by H.R. 13270, enacted by this Congress might be changed to be effective immediately with respect to both outstanding and future issues at the behest of a future Secretary of the Treasury. They might decide that once absolute immunity is abridged they must fear later additional abridgements.

Their fears might prove to be groundless, but personally I find it hard to criticize investors for entertaining such fears when they

contemplate investing their money for 10 or 20 or up to 50 years.

Mr. Chairman, if ultimately Congress decides not to include state and local bond interest in a minimum tax or an allocation of deductions requirement, the mere considerations of these items has already cost state and local governments and their taxpayers $13.8 million annually. This can be shown very easily.

Assume, if you will, that the yield relationship that existed last February between the Bond Buyers' Index and the Average of Yields on Industrial Bonds (Moody's) were to obtain today. The yield relationship then was (73.3). Today it is (81.0). Assume that municipals issued in the intervening period had an average date of maturity of 20 years.

The difference between what might have been and what will be - what will be, Members of the Committee - is $276 million.

That difference allows for the general increase in interest rates. It can be ascribed only to the consideration that the Congress has given to taxation of state and local bond interest. It represents the "hedge" that those who bought the bonds decided they needed to guard against the possibility of taxation.

Were the investors overcautious? Each one of us can judge for himself.

Commerical banks constitute the largest category of investors in state and local bonds, as I am sure you have been told repeatedly. A banker confronted with a choice among investments might conclude that he needed such a "hedge." His reasoning might be that since the Supreme Court has held that life insurance companies must allocate deductions, as Assistant Secretary Cohen testified, since the House determined that individuals must do so, and since the House Ways and

Means Committee announced shortly before it reported the tax reform measure a "tentative decision" to require banks to allocate, Congress might decide that banks must allocate deductions long before the bonds he bought would mature.

Mr. Chairman, in testifying before the Ways and Means Committee, I said, "In approaching this issue we do not intend to be merely negative or to defend the status quo simply because it is the status quo. Rather we seek - with you - a reexamination of the common objective and possible alternatives open to us....."

That was my attitude. That continues to be my attitude.

Following the hearing, I was given an opportunity to submit a supplementary statement. In it I outlined my views on what possible means might be found to satisfy the objective of the Committee while protecting the state and local bond market. With your permission, I shall file with you its complete text, and a memorandum outlining an alternative subsidy plan.

Mr. Chairman, Members of the Committee, to me it is ironic that serious consideration is being given to revenue sharing, a mass transit fund, reformation of our welfare system and other proposals that indicate an appreciation of the serious financial plight of state and local governments - and to taxing state and local bond interest. The last could cost us most or all of what we hope to receive from the others.

At the state and local level, we are aware of the difficult decisions you must make in order to reform our tax laws. We wish you well. Our only additional desire is that you understand that we are pleading the case for state and local governments - not industry, not

banks, not individuals, not any class of investors. The beneficiaries of the continued tax exemption of state and local bonds will be state and local government. Only marginal benefits will accrue to investors as testimony by witnesses for the Treasury has indicated.

Thank you, Mr. Chairman, Members of the Committee, for permitting me to testify.

69-9-12-T2

National Governors' Conference
OFFICE OF FEDERAL-STATE RELATIONS
1735 DESALES STREET, N.W.
WASHINGTON, D. C. 20036

CHARLES A. BYRLEY,
DIRECTOR

TELEPHONE:
AREA CODE 202 393-2662

Statement of

The Honorable Norbert T. Tiemann

Governor of Nebraska

Before the

Committee on Finance
United States Senate

on

Tax Treatment of State and Local Government Bonds

September 23, 1969

Mr. Chairman, Members of the Committee:

My name is Norbert T. Tiemann. I am Governor of Nebraska. I appreciate your permitting me to speak on the tax treatment of state and local bonds.

On very few issues, Mr. Chairman, would it be possible to find a greater measure of agreement among representatives of state and local governments than the one we are considering today. We are firmly opposed to any proposal to tax our bonds, be it minimum tax, allocation of deductions or some other scheme. I should be less than candid if I did not report that we are divided in our views on the efficacy or desirability of a plan embodying a federal subsidy of one kind or another in exchange for issuance of municipal bonds on a taxable basis. About that I shall have more to say later.

I am not here to argue the legal case for tax exemption of our securities, but I do wish to emphasize that we believe strongly that any federal tax on the bond interest of a state or its local governments without the state's consent is unconstitutional. The doctrine of reciprocal immunity from taxation was enunciated by the Supreme Court almost as many years ago as the Republic is old. In the intervening century and one-half, it has resisted successfully many assaults.

The Congress has complete discretion in determining what the tax treatment shall be for capital gains, charitable deductions, depletion allowances and other items. The tax immunity of state and local governments, however, is part of the warp and woof of our federal system. Be that as it may, my reasons for urging the continuing inviolability of reciprocal immunity will be cast solely in policy term.

33-758 O - 69 -- No. 9 -- 5

On March 11 of this year I was afforded the opportunity to appear before the Ways and Means Committee on the subject of tax reform. As the representative of the National Governors' Conference, I urged strongly that the Committee not include in its bill provisions to tax state and local bonds. Other witnesses and I warned that the inevitable result of such provisions would be an escalation in bond interest rates. Unfortunately, we have been proved to be excellent prophets.

In February, before we testified, the Bond Buyers' Index of 20 representative municipal bonds was 5.04 percent. On August 21, the index breached 6 percent to reach 6.02. The Bond Buyers' Index of 11 bonds - more highly rated issues - showed yields in February to be 4.84 percent. On August 21, it hit 5.92. These are increases of 0.98 and 1.08 in the short space of six months. In the period February-July, corporate issues (Moody's Average of Yields on Corporate Bonds) and 20-year U.S. Government bonds experienced interest rate increases of 0.44 and 0.12 respectively.

I am not here to assert a claim to be regarded as a seer. I am not here to argue that tight money has not caused interest rates to rise. I do assert, however, that the only thing that could have caused state and local bond interest rates to increase so much more greatly than those of these other long-term securities is the consideration the House gave to taxation of state and local bonds. I'll make one more prophecy. Should the Senate and then the entire Congress decide to tax our bonds - be the form minimum tax, allocation of deductions or some other - our interest rates will continue their climb both absolutely and relatively.

You have heard, Mr. Chairman, testimony that the House provisions on a "limit on tax preferences" and allocation of deductions and the Treasury scheme with respect to the latter will have only minimal revenue consequences. We do not quarrel with this view. What we fear is that the market will react - as it has already - to a much greater degree than the revenue consequences would appear to justify.

One of the Treasury witnesses referred to the market reaction as being primarily "psychological." Of course it is. So labeling it does not make it any less severe, however. Whether the Congress, Governors, Mayors, the Treasury or anyone else feels the actual and potential reaction to be justified is beside the point. Investors make their own decisions. And their decisions determine what the state and local bonds interest rate will be.

They might decide that a minimum tax rate established by this Congress could be increased by a subsequent Congress. They might decide that an allocation of deductions requirement for individuals applicable only to future issues of bonds and phased in over 10 years, as provided by H.R. 13270, enacted by this Congress might be changed to be effective immediately with respect to both outstanding and future issues at the behest of a future Secretary of the Treasury. They might decide that once absolute immunity is abridged they must fear later additional abridgements.

Their fears might prove to be groundless, but personally I find it hard to criticize investors for entertaining such fears when they contemplate investing their money for 10 or 20 or up to 50 years.

Mr. Chairman, if ultimately Congress decides not to include state and local bond interest in a minimum tax or an allocation of deductions requirement, the mere consideration of these items has already cost state and local governments and their taxpayers $13.8 million annually. This can be shown very easily.

Assume, if you will, that the yield relationship that existed last February between the Bond Buyers' Index and the Average of Yields on Industrial Bonds (Moody's) were to obtain today. The yield relationship then was (73.3). Today it is (81.0). Assume that municipals issued in the intervening period had an average date of maturity of 20 years.

The difference between what might have been and what will be - what will be, Members of the Committee - is $276 million.

That difference allows for the general increase in interest rates. It can be ascribed only to the consideration that the Congress has given to taxation of state and local bond interest. It represents the "hedge" that those who bought the bonds decided they needed to guard against the possibility of taxation.

Were these investors overcautious? Each one of us can judge for himself.

Commercial banks constitute the largest category of investors in state and local bonds, as I am sure you have been told repeatedly. A banker confronted with a choice among investments might conclude that he needed such a "hedge." His reasoning might be that since the Supreme Court has held that life insurance companies must allocate deductions, as Assistant Secretary Cohen testified, since the House determined that

individuals must do so, and since the House Ways and Means Committee announced shortly before it reported the tax reform measure a "tentative decision" to require banks to allocate, Congress might decide that banks must allocate deductions long before the bonds he bought would mature.

Mr. Chairman, in testifying before the Ways and Means Committee, I said, "In approaching this issue we do not intend to be merely negative or to defend the status quo simply because it is the status quo. Rather we seek - with you - a reexamination of the common objectives and possible alternatives open to us...."

That was my attitude. That continues to be my attitude.

Following the hearing, I was given an opportunity to submit a supplementary statement. In it I outlined my views on what possible means might be found to satisfy the objectives of the Committee while protecting the state and local bond market. With your permission, I shall indicate briefly what the statement contained and file with you its complete text.

First, I urged that, since the matter was both of enormous complexity and of vital concern to state and local governments, it be given sufficient study. I suggested that the Advisory Commission on Intergovernmental Relations might be asked to make the study. Incidentally, I understand it is doing so. I pledged the complete cooperation of state and local governments in such a study.

Second, I suggested that if the Committee felt impelled to act without further study, it consider:

1. A system employing a federal- state agreement in which the

Federal Government would agree to pay a percentage of the interest cost of future issues of state and local securities if they were issued as taxable obligations, and waive immunity from state and local taxation of income from future issues of its own securities. A state, in turn, would agree to waive tax immunity for its obligations and those of its political subdivisions if it or they chose to issue taxable securities; or

2. A Federal System of Urbanks. This would be a variation of the Urban Development Bank proposal introduced by a number of Members of Congress.

In the statement, I listed four specific criteria that I felt any plan must contain. They were:

1. State and local governments must be able to determine all policy questions relative to bonding free of federal control.
2. State and local governments must have the opportunity to choose between the alternative plan, whatever it might be, and reliance on the private market.
3. Reliability must be assured. If inaugurated, the scheme must be continued unless three years notice of its intended termination were given.
4. The plan must provide for a minimum processing time.

With your further permission, I am attaching to my statement an amplification of the proposal for federal-state agreements.

Mr. Chairman, Members of the Committee, to me it is ironic that serious consideration is being given to revenue sharing, a mass transit fund, reformation of our welfare system and other proposals that indicate an appreciation of the serious financial plight of state and local governments - and to taxing state and local bond interest. The last could cost us most or all of what we hope to receive from the others.

At the state and local level, we are aware of the difficult decisions you must make in order to reform our tax laws. We wish you well. Our only additional desire is that you understand that we are pleading the case for state and local governments - not industry, not banks, not individuals, not any class of investors. The beneficiaries of the continued tax exemption of state and local bonds will be state and local government. Only marginal benefits will accrue to investors as testimony by witnesses for the Treasury has indicated.

Thank you, Mr. Chairman, Members of the Committee, for permitting me to testify.

69-9-12-T1

National Governors' Conference

OFFICE OF FEDERAL-STATE RELATIONS

1735 DESALES STREET, N.W.

WASHINGTON, D. C. 20036

CHARLES A. BYRLEY, DIRECTOR

TELEPHONE: AREA CODE 202 393-2[illegible]

Supplementary Statement

of

The Honorable Norbert T. Tiemann
Governor of Nebraska
Member, Executive Committee
National Governors' Conference

Submitted to the

Committee on Ways and Means
U. S. House of Representatives

on

Tax Treatment of State and Municipal Bonds

April 25, 1969

This is a supplementary statement to that which I presented to the Committee on Ways and Means, March 11, 1969, on behalf of the National Governors' Conference. I thank the Chairman for giving me the opportunity to submit this more detailed statement.

Since March 11 representatives of State and local governments have met frequently to discuss ideas and proposals to further the objectives of the Committee on Ways and Means while protecting the market for municipal securities. I believe that several exciting proposals have been formulated that warrant further examination and refinement. These proposals are outlined later in this statement.

It is not necessary to enlarge on our belief that any Federal tax on the bond interest of a State or its local governments without that State's consent is unconstitutional. The doctrine of reciprocal immunity from taxation was enunciated by the Supreme Court almost as many years ago as the Republic is old. In the intervening century and one-half it has resisted successfully many assaults. It goes without saying that we could support no proposal that raises this constitutional issue.

We are convinced that the doctrine of reciprocal immunity extends to the inclusion of the interest paid on State and local obligations in the calculation of a minimum tax, allocation of deductions to such tax exempt income or any similar proposal the effect of which would be to levy a tax on such securities.

Eschewing the constitutional argument except to point out that tax treatment of capital gains, charitable deductions and depletion allowances are matters over which the Congress has complete discretion while the tax immunity of State and local governments is part of the warp and woof of our federal system, we shall state our reasons for the continuing inviolability of reciprocal immunity solely in policy terms.

Our reasons have to do largely with the marketability of State and local securities and consequences flowing therefrom. Investors in securities are sophisticated. They would not be confident that a minimum tax rate, for example, would not be increased or, if the interest paid on State and local securities were taxed as income to individuals, it would not be taxed as income to banks, other financial institutions and corporations. Not being confident, they would not buy or would buy only if interest rates were boosted sufficiently to safeguard their investment.

As a consequence, interest rates would have to be raised appreciably. Some capital improvements would be postponed, others limited in scope, still others abandoned. To take up some of the slack, State and local taxes -- particularly sales and property taxes, both regressive in nature -- would have to be raised. Additional pressure would be brought on the Congress to increase the range of programs supported by grants-in-aid, to raise authorizations for current grant-in-aid programs and to appropriate sums more nearly comparable in size to authorized amounts. Nor would there be much benefit to the United States Treasury from the much higher interest rates. As individuals and entities subject to tax moved out of the municipal bond market, tax exempt pension and welfare funds, foundations and other tax exempt institutions would move in.

It is particularly ironic that, at a time when State and local governments are under such intense financial pressure, the integrity of their securities -- the means by which they finance most of their capital expenditures -- should be threatened. The "urban crisis" is not an invention of city hall publicists. The urgings of some that the Federal government assume entire responsibility for welfare costs or States assume entire responsibility for elementary and secondary education costs are prompted by an awareness of the serious nature of the fiscal crisis faced by States and localities. In Congress similar recognition is represented by the

many bills to share Federal revenues with the States and local governments. We believe that the Committee on Ways and Means does not wish to bring about a marked increase in interest costs for State and local capital expenditures, to cause an increase in regressive taxes, and to benefit the United States Treasury only marginally -- all to tax more heavily an uncertain number of millionaire tax evaders. The proposals described below would avoid such dire consequences.

--Proposals Under Consideration

Study of Proposed Methods of Taxation:

The matter of taxation of State and local obligations is a complex one as the Committee on Ways and Means is aware. Equity is not to be achieved by the simple expedient of providing for taxation of such securities as if they were private obligations. Vying with this objective are constitutional and policy issues that must be resolved satisfactorily. Obviously this matter is of great interest to the Congress. Even more obvious is its interest to State and local governments. It is their capital improvements that would be jeopardized were an unwise Federal policy to be elected. The Federal interest is represented by an undetermined amount that may run into millions of dollars annually. To State and local governments, the annual stake is literally billions of dollars worth of capital improvements.

For these reasons, if it is not possible within a relatively brief period to find a satisfactory way to safeguard the integrity of State and local securities within a Federal tax system that is equitable to the generality of taxpayers, we believe that it would be wise to refer this matter to a study group. Should this prove necessary, we pledge our entire cooperation in the study.

We propose that such a study be concerned with devising alternative methods of financing capital needs of State and local governments which will expand available capital and reduce reliance on tax exempt bonds, but not imperil the Federal tax immunity of State and local bonds when their use is necessary. Possible expansion could include the purchase of State and local obligations by the Federal Reserve Board and the Unemployment Compensation Fund.

To make such a study we suggest the Advisory Commission on Intergovernmental Relations. It is unique in having as members representatives of Federal, State and local governments from both the Legislative and Executive Branches.

With respect to specific proposals below, obviously much work must be done if they are to be perfected. Others equally worthy or better might be developed. To this end, we shall devote as much time and energy as may be needed, and will be available for consultation with the Committee on Ways and Means or its staff.

Federal-State Agreements:

One proposal that is being considered would provide for a Federal-State agreement. The Federal government would agree to pay a percentage of the interest cost of future issues of State and local securities, if they were issued as taxable obligations, and waive immunity from State and local taxation of income from future issues of its own securities. A State, in turn, would agree to waive tax immunity for its obligations and those of its political subdivisions if it or they chose to issue taxable securities. The Federal percentage might be 50 percent. Since in effect corporate interest costs are subsidized by the Federal government in the amount of 50 percent, Federal participation in the interest

rate costs of State and local government bonds at this level appears not to be unreasonable.

The method of issuance would involve a dual set of coupons for each State-issued bond. The investor would clip the Federal coupon and present it for payment as if the bond were an issuance of the United States. The other coupon would be presented for payment to the disbursing agent of the State or political subdivision.

This proposal appears to offer several advantages. Since immunity would be waived, a confrontation would be avoided on the issue of the constitutional basis for immunity of Federal obligations from taxation by States and State obligations from taxation by the Federal government. Since there would be taxation of future issuances only, there would be no question of equity to purchasers of earlier issues who assumed in good faith that income from Federal, State and local obligations was not subject to taxation. Finally, were such securities made taxable, the allegation of tax avoidance could not be raised.

Federal System of Urbanks:

Another suggestion that has been advanced involves the establishment of a Federal System of Urban Development Banks. As the name implies, this is a variation of the Urban Development Bank proposal that has been introduced in the Congress. It would require each State to establish a bank to purchase obligations issued by the State and its political subdivisions. Obligations of the State Urbanks would be sold to private purchasers as taxable securities with a Federal coupon as proposed above or as tax exempt securities. If the demand on a given State Urbank were too great, it could call on a Federal Development Bank to serve as a secondary market. An additional responsibility of the Federal Urbank would be to act as the insuring agent for State and local bonds in return for a premium to be paid on each issue.

Possible advantages of this suggested arrangement are several. First, in having a series of 50 State Urbanks, as opposed to only one Federal institution, there would be a minimum of delay in a bank's determining that the credit of the issuing government was adequate to support the issue of the securities in question. Second, by providing that the obligations would be insured, there would be no need for a Federal "guarantee" of payment with the consequent possible exposure of the Federal government to make good on its warranty. Third, by assigning to the several Urbanks responsibilities of banker and, in the case of the Federal Urbank, insurer, there would be no need or occasion for interference with the policy decisions of the issuing unit.

Elements of a Proposal

Any proposal that is adopted must meet constitutional limitations and provide for equity among taxpayers. In addition to these obvious requirements in our view it should meet certain other specifications. Some of them have been suggested or implied above. However, at the risk of repetition, we believe they should be stated explicitly.

Freedom from Federal Control:

It is a mark of our system of government that power is widely dispersed. Decisions with respect to public policy are made at each of the several levels of government. Means to insure that the electorate is heard are familiar at all levels. By such means we insure both an optimum measure of popular participation and an optimum responsibility to popular control. Both are impossible of realization, however, if decisions which should be made at the State or local level are made at the Federal level. The decision to build a court house or a school, where to build it, what size it should be and how to raise the money for its construction are not qustions that can be answered properly by a Federal official. Any scheme

that may be developed must permit such basic policy decisions to be made by responsible State or local officials and legislators.

Alternative Markets:

To this point in time State and local governments have been able to borrow from the private bond market the funds they need for capital expenditure requirements. Of late interest rates on municipal securities have risen markedly, but so have they for housing mortgages, corporate bonds and United States Government bonds. Assuming that the credit "squeeze" does not become appreciably tighter, there is no reason to suppose that State and local governments will not be able to continue to place their primary reliance on the private bond market.

On the other hand, an alternative market, particularly one that might offer preferential rates, would be a welcome additional source to satisfy the continually growing State and local capital needs. It must be an alternative, however. State and local governments must retain the option to go to the private market if they choose.

Reliability:

Assuming a method can be devised that meets other expectations, it also must be reliable. Credit cannot be turned on and off like a faucet. Any scheme that depends for its funds on annual appropriations cannot be relied upon. If the Congress proposes to make a commitment, it must be met in full and it must be continued for at least three years after notice of termination is given. Should a satisfactory alternative capital market plan be developed State and local governments will expect to utilize it. They would be unable to do so -- or would do so at their peril -- if they could not anticipate that money would be available when they needed it. If the alternative were to be established and then abruptly discontinued

33-758 O - 69 -- No. 9 -- 6

or radically reduced in scope, the effect would be disastrous. Private markets would have to be reestablished -- a process that would require time. State and local governments would have lost valuable time at a minimum and possibly all chance to sell their securities.

Freedom from Delay:

The next requirement is one which more properly might be addressed to the agency made responsible for administering any of the alternative plans. Nevertheless, it is an important element in the successful operation of any plan that might be adopted. Provision must be made for a minimum processing time. Delay can add to interest costs at a time when rates are climbing. Inevitably it adds to building, land acquisition and other costs. Even at favorable interest rates an appreciable delay in processing could offset completely any savings in interest rate reduction.

Conclusion

In discussing our position regarding taxation of state and local bonds I mentioned -- and I now underscore -- the irony of proposals to subvert the tax exempt status of said bonds while at the same time the recognition of State and local fiscal crises is being expressed in proposals and actual legislation to provide for block grants, revenue sharing, and grant consolidation. The National Governors' Conference has stated its firm support of these varying means of relieving the fiscal crises, as I indicated in answer to questions from Committee members at the hearings of March 11. At that time Chairman Mills inquired whether the States would exchange the tax-exempt status of their bonds in return for some form of revenue sharing and block grants. In reply I indicated that I would submit this question to the Executive Committee of the National Governors' Conference. This matter will be on the Executive Committee's agenda when it meets in mid-May.

But I do not anticipate any specific action by the Executive Committee at its forthcoming meeting. It should be noted that the National Governors' Conference has a Standing Committee on Executive Management and Fiscal Affairs. That Committee is now at work on revenue sharing, block grants, grant consolidation and related matters. Specifically that Committee is gathering data from the states regarding their capital improvement programs and the effect of the tight money market on the marketing of State bonds and State programs. The survey results will be made known to the House Committee. Thus it is my view that the Executive Committee will request that the Committee on Executive Management and Fiscal Affairs give careful attention to this important question raised by the distinguished Chairman of the Committee on Ways and Means.

FEDERAL-STATE AGREEMENTS

The Problem: To avoid inequities from the exemption of state and local government bond interest in a manner which is constitutional, fair and not harmful to state and local governments and local taxpayers.

The Solution: An optional double coupon plan, can accomplish a voluntary termination of the issuance of exempt bonds. With such termination the inequities would become impossible for future issues and would come to an end as outstanding issues are paid off. Elements of amplification are set forth below.

A Workable Double Coupon Plan

(a) To be constitutional the plan must be completely optional with the affected states. Therefore the technique of a federal-state agreement is recommended, authorized by legislation of both the Congress and the affected state legislature. The agreement should prohibit withdrawal by either the federal government or the state except on five years notice.

(b) In the agreement the state would authorize its local governments to elect to issue taxable bonds and would also authorize taxable bonds at the state level. The United States would authorize each such issuer of taxable bonds to attach coupons for the federal share of the interest.

(c) The United States coupons would be the direct obligation of the United States and not of the issuer. This is necessary because:

(i) It avoids conflict with innumerable constitutional and statutory limits on the interest rate a local government can pay.

(ii) It avoids the problems of local government having to pay more interest and waiting to get the excess back from Washington.

(iii) It will give investors in a new kind of security, more confidence.

(d) The United States coupons would be for half the interest payable. Fifty percent is fully justified because:

(i) A private corporation can cost the United States 52.8 percent of the interest paid on private bonds. This results from the deductibility of the interest payments from the base for corporate income tax at the present 52.8 percent rate.

(ii) The Treasury estimates the United States will recover 42 percent of the interest payment on taxable state and municipal bonds. Since the purpose is reform, all this should be returned to the issuers. The additional 8 percent is well justified as a needed contribution to the local government crisis.

(iii) Since the plan must be optional to be constitutional, the federal percentage should be large enough to make sure that all issuers will opt for taxability to assure that the reform will be accomplished.

The cost to the local issuers in recent years has been around 33 percent. A substantial increment above the figure is required for the option to work.

(iv) Adding municipal bonds to the taxable market will probably raise all taxable interest rates, so that just to break even requires more than the present 33 1/3 percent.

(e) The Federal Government would reaffirm that state and local issuance would be subjected to no controls. The federal coupon authorization would not be withheld from any true state or municipal bond regardless of the purpose of issuance, interest rate or any other factor.

Industrial development bonds, properly defined, and arbitrage bonds are not true exercises of the state or municipal borrowing power and would be ineligible for the federal coupon.

National Governors' Conference

OFFICE OF FEDERAL-STATE RELATIONS

1735 DeSALES STREET, N.W.

WASHINGTON, D. C. 20036

CHARLES A. BYRLEY
DIRECTOR

TELEPHONE:
AREA CODE 202 393-2662

Summary of

Statement of

Honorable John J. McKeithen

Governor of Louisiana

Before the

Committee on Finance
United States Senate

on

H. R. 13270

The Tax Reform Act of 1969

September 23, 1969

Mr. Chairman, Members of the Committee, I am John J. McKeithen, Governor of Louisiana. I appreciate your hearing me on the subject of the tax treatment of state and local bonds -- a subject of intense interest and concern to our state and its local governments.

We appreciate the difficulty and complexity of what you are trying to accomplish. As taxpayers and citizens, we wish you well in this undertaking.

Mr. Chairman, state and local governments from their own resources support services in such areas as education, highways and highway safety, crime prevention and control, health, water and natural resources, and a host of others. In all these program areas, they receive federal grants-in-aid. Major federal construction grants include those for highways, airports, hospitals, water pollution abatement, urban renewal and others. They represent national policy decisions relative to national goals. Total grants-in-aid approximate $25 billion. Grants for capital purposes total $6.457 billion (estimated) for fiscal year 1970.

These grants must be matched by state and local governments. If capital expenditure is involved, almost always bond financing is used.

Many bills have been introduced providing for sharing federal revenue with states and localities. The administration is about ready to offer its plan. Other aid programs have been proposed. Their proponents are undoubtedly sincere in arguing that they are necessary to ease the severe financial pressure on state and local governments.

You may imagine then how astonished we were when H. R. 13270 included state and local bond interest in its provisions for a limit on tax preferences and allocation of deductions. Our wonderment was increased by the administration's "instant" allocation of deduction plan, and its proposal that it be applied to both future and outstanding issues.

Are you surprised that we rub our eyes or shake our heads in wonder?

On the one hand, we see national policies to give aid to state and local governments to achieve national goals. Additional programs are proposed -- some with the avowed purpose of relieving the fiscal crisis of these governments. On the other hand, we see provisions in the House bill that would impair the ability of state and local governments to raise needed capital. Then the administration proposes an even harsher allocation of deductions plan.

Mr. Chairman, there are many reasons to oppose these provisions, but I shall limit my remarks to policy considerations.

The genius of the federal system lies in its mutual forbearance from taxation of instrumentalities, property, revenue or income derived from securities. We have a system of parallel governments. It is no more right that the Federal Government interfere with or impede the states in the performance of their governmental functions than it is for a state to interfere with or impede the Federal Government in the attainment of its governmental aims.

Governments raise money by various means. Taxation is the largest revenue producer, but borrowing is of great significance. In 1968, state and local governments issued more than $16 billion in debt instruments. Such a sum supports the assertion that the power to borrow is as essential to government as the power to tax.

If the Congress takes action to impair state and local capacity to borrow, how shall we raise capital funds, including those required to match federal grants? Shall we raise taxes to build schools and hospitals? Shall we accommodate to increased debt service costs by reducing our contributions toward the building of highways and airports?

If it is felt that these questions represent an overreaction, I should like

to call your attention to certain information from the tables presented by Governor Love.

INTEREST RATES, SEVERAL INDICES, SELECTED DATES

	20 Municipals	Industrials	11 Bonds	AAA Corporates	U. S. Govt. 20
Aug. 1967	4.06%	5.84%	3.82%	5.62%	4.99%
Jan. 1969	4.97 (.91)	6.74 (.90)	4.72 (.90)	6.59 (.97)	5.92 (.93)
July 1969	5.93 (.96)	7.32 (.58)	5.57 (.85)	7.08 (.49)	6.12 (.20)
Aug. 21	6.02		5.92		

Please note that between August 1967 and January 1969, the figures in parentheses indicate the range of rate increases was very narrow -- .90 to .97. Note, however, that from January to July this year, the municipal bond indices rose by .96 and .85. Private issues rose .58 and .49, U. S. Government obligations .20. Note, too, from the August 21 data that municipal bond interest rates continue to rise.

The change in market behavior can be explained only by the consideration that has been given to taxing state and local obligations. If the decision to tax is affirmed, even higher rates will result.

Necessarily taxes ultimately will be relied upon to pay these increased rates. Who are the taxpayers? They are those who pay federal taxes - those who anticipate relief from enactment of the tax reform bill.

Does that sound like we are chasing our tail? We are.

We are, that is, except for two reasons.

One reason is that the cost to state and local taxpayers will be far greater than will be realized in revenue if these provisions are enacted.

The second is that the bill would reduce income tax rates -- a progressive tax. By far the largest part of local government revenue comes from real property taxes. States rely primarily on sales taxes. Both are regressive taxes.

To enact these provisions would achieve a modest increase in federal revenue. This would be achieved at the expense of higher state and local taxes -- taxes far larger in total than the revenue realized. Enactment may help to reduce a progressive tax -- but would raise regressive taxes.

Mr. Chairman, tampering with the tax exempt status of state and local bonds is justified on the grounds that wealthy persons escape their fair burden of taxation by their owning municipal bonds. Sometimes it is stated that the revenue loss exceeds state and local savings.

As to the former, this has not been proven. Possibly wealthy persons have large holdings. Neither they nor other taxpayers report income derived from such ownership. As a matter of fact, one might wonder why they should. The Ways and Means Committee reported that the 154 individuals with adjusted gross incomes of $200,000 or more in 1966 did very well under other provisions. They claimed as deductions, the Committee showed, large charitable deductions, interest payments, real estate depreciation and farm losses. That half of capital gains not taxed was another bonanza. Why should these people invest heavily in what were until recently low-yield securities?

Gentlemen, do those who buy state and local bonds realize savings in taxes? One may assume some do. Is the aim to make a profitable investment different from that of other investors? Or are they attracted to our bonds because they are a safe investment? Some do. State and local governments honor their obligations. Who knows why investors pick particular securities? Some local banks buy their local government bonds from a sense of civic duty.

Mr. Chairman, the so-called "taxpayers' revolt" is not confined to the national level. Despite it, however, reasonably and logically, we must point out that tax dollars are required to rebuild our cities, protect our environment, improve our transportation system, and assure our people adequate diets,

health care and educational opportunities. These and other domestic programs are supported primarily by state and local governments. To endanger them by endangering our capacity to borrow would be folly. We need your help -- help you have already determined is in the national interest. We trust you will serve your real, long-term interests and ours by rejecting these proposals.

Mr. Chairman, Members of the Committee, I thank you.

#69915T2

National Governors' Conference

OFFICE OF FEDERAL-STATE RELATIONS

1735 DeSALES STREET, N.W.

WASHINGTON, D. C. 20036

CHARLES A. BYRLEY,
DIRECTOR

TELEPHONE:
AREA CODE 202 393-2662

Statement of

Honorable John J. McKeithen

Governor of Louisiana

Before the

Committee on Finance
United States Senate

on

H. R. 13270

The Tax Reform Act of 1969

September 23, 1969

33-758 O - 69 -- No. 9 -- 7

Mr. Chairman, Members of the Committee, I am John J. McKeithen, Governor of Louisiana. I appreciate your hearing me on the subject of the tax treatment of state and local bonds -- a subject of intense interest and concern to our state and its local governments.

We appreciate that the Committee on Finance in considering means to reform our tax laws is endeavoring to accomplish a difficult and tremendously complex assignment. We are aware that current national policy may dictate your recommending certain changes. We understand your desire to remove or minimize certain inequities. As taxpayers and citizens, we wish you well in this undertaking.

What you decide -- what the Congress decides -- will have very far-reaching effects. Among those that will be affected will be state and local governments.

Mr. Chairman, state and local governments from their own revenues support services in such areas as education, highways and highway safety, crime prevention and control, health, water and natural resources and a host of others. In all these broad categories they administer programs for which they receive federal grants-in-aid. Major federal construction grant programs include those for highways, airports, hospitals, water pollution abatement, urban renewal and others. These programs represent policy decisions by the National Government in the attainment of national goals. Total grants-in-aid approximate $25 billion. Grants for capital purposes total $6.457 billion (estimated) for fiscal year 1970.

Formulas vary, but these grants must be matched by the recipient state and local governments. If captial expenditure is involved, almost always bonds are issued to raise the necessary funds.

Many Members of Congress have introduced bills to share federal income tax revenue with state and local governments. The administration is about ready to offer its plan, we are told. Proposals have been made for a mass transit fund. The President has asked that welfare laws be reformed to

increase aid to the states. Many other financial assistance schemes have been advanced. Their proponents are obviously sincere in their support of these measures as being necessary to ease the severe financial pressure on states and localities.

Perhaps you can imagine our astonishment when the Ways and Means Committee and then the House of Representatives approved the inclusion of state and local bond interest in the limit on tax preference and allocation of deductions provisions of H. R. 13270. Those feelings were compounded when the administration unveiled its "instant" allocation of deductions plan and proposed it be applied to both future and outstanding issues.

Are you surprised that we rub our eyes or shake our heads in wonder?

On the one hand, we view declared national policies to give aid to state and local governments to achieve national goals. In addition, other aid programs are urged - some with the avowed purpose of relieving the fiscal crisis of these governments. On the other hand, we are witness to House passage of LTP and allocation of deductions formulas that would impair the ability of state and local governments to raise needed capital. Then the administration proposes an even harsher allocation of deductions plan.

The situation appears to be another illustration of the left hand's not knowing what the right hand is doing.

Mr. Chairman, I do not propose to argue that the consideration of these provisions has had a severe impact on municipal bond interest rates. If the material submitted by Governor Love does not prove that point, no words of mine will do so. Nor shall I show that the administration's allocation of deductions formula will be even more damaging than the one in H. R. 13270. Its specifications make that clear. It is not my intention to argue the constitutional issue. Presumably that will be done by others. I shall

limit my remarks to policy matters.

The genius of the Federal system is in its mutual forbearance from taxation of instrumentalities, property revenue or income derived from securities. No specific provision in the Constitution forbids such taxation. It is inherent in the concept of federalism. We have a system of parallel governments in other words. It is no more right or appropriate that the Federal Government interfere with or impede the states in the performance of their governmental functions than it is for a state to interfere with or impede the Federal Government in the attainment of its governmental aims.

Governments raise money by various means - taxes, borrowing, fees for services, licenses, various enterprises and others. Taxation is the largest revenue producer, but borrowing is of great significance. As has been pointed out, in 1968 state and local governments issued more than $16 billion in debt instruments. This is no small sum. It supports the assertion that the power to borrow is as essential to government as the power to tax.

If the Congress takes action to impair the capacity to borrow of state and localities, how shall we secure the capital funds we need, including what is required to match federal grants? Shall we raise taxes to build schools and hospitals? Shall we accommodate to increased debt service costs by reducing our contributions toward the building of highways and airports?

If it is felt that these questions represent an overreaction, I should like to call your attention to certain information from the tables presented by Governor Love.

INTEREST RATES, SEVERAL INDICES, SELECTED DATES

	20 Municipals	Industrials	11 Bonds	AAA Corporates	U. S. Govt. 20
Aug. 1967	4.06%	5.84%	3.82%	5.62%	4.99%
Jan. 1969	4.97 (.91)	6.74 (.90)	4.72 (.90)	6.59 (.97)	5.92 (.93)
July 1969	5.93 (.96)	7.32 (.58)	5.57 (.85)	7.08 (.49)	6.12 (.20)
Aug. 21	6.02		5.92		

Please note that in the period August 1967-January 1969, the range in interest rate increases was very narrow - .90 to .97, the figures shown in parentheses. Note, on the other hand, that between January and July of this year, the municipal bond indices rose by .96 and .85. The indices showed that rates for private issues rose .58 and .49, for U. S. Government obligations .20. I have added the reports on municipal bond interest rates for August 21, 1969, to show that they are continuing to rise.

The change in the behavior of the market must be ascribed to the consideration that has been given to taxing state and local obligations. Should the decision the House has made be affirmed by the entire Congress, even higher rates must be expected.

How will state and local governments secure the revenue to pay these increased rates? Ultimately, it would be raised by taxes.

Who are the taxpayers? They are those who pay federal taxes - those who anticipate relief from the enactment of the tax reform bill.

Does that sound like we are chasing our tail? We are.

That is, we are except for two reasons.

One reason is that the cost to state and local governments and their taxpayers will be far greater than the Federal Government will realize in revenue if the provisions you are considering are enacted.

The second is that you are comtemplating rate reductions in the income

tax - a progressive tax. By far the greatest portion of local government revenue is raised by taxes on real property. States rely primarily on sales taxes. These are regressive taxes.

To enact these provisions would achieve a modest increase in federal revenue. This achievement would be at the expense of higher state and local taxes - taxes far larger in total than the revenue realized. In other words, enactment may help to reduce a progressive tax - but raise regressive taxes.

Is this achievement in line with what most people regard as wise tax policy? Do we feel that to cause regressive taxes to be raised by a reduction in a progressive tax serves our social purposes?

Criticism may be leveled at state and local governments because their tax structures are not more progressive. Even so, they cannot be changed overnight. Nor will the situation be improved by their being forced to bear the burden of increased bond interest rates.

Mr. Chairman, tampering with the tax exempt status of state and local bonds is justified on the grounds that wealthy persons escape taxation by having large investments in such bonds. Sometimes it is stated that the cost to the Treasury from income not taxed is greater than the savings realized by state and local governments in the lower interest rates they pay.

As to the former - large municipal bond holdings by the wealthy - this has not been proven. (Possibly they have such holdings, but we just don't know.) Neither they nor other taxpayers report income derived from such ownership. As a matter of fact, from the information contained in the Report of the Ways and Means Committee, one might wonder why they should. The 154 individuals with adjusted gross incomes of $200,000 or more who paid no federal income tax in 1966 seem to have done all right by claiming as deductions large charitable contributions, interest payments, real estate

depreciation and farm losses. The excluded half of capital gains was another bonanza, the Committee stated. Why should those so skilled in minimizing their taxes invest heavily in what were until recently investments with low yields?

Incidentally, the Ways and Means Committee in justifying the bill made its first reference to municipals on page 9 of the Report. It stated, "It is believed that still other high-income individuals paid no tax and did not even file tax returns since virtually their entire income was from tax-exempt State and municipal bonds."

By page 11, what the Committee "believed" had become a "fact." There it said, "Also, despite the fact that tax-exempt State and municipal bond interest is a prime way for well-to-do individuals to escape the burdens of taxation,..."

What the Committee "believed" had become a "fact" and a "prime way" - in the short space of two pages.

In fairness, I should point out that thereafter the actions and statements of the Committee were consistent. It acted and justified its actions on the basis of the "facts."

Gentlemen, is it true that those who buy state and local obligations realize or hope to realize, savings in taxes? One may assume some do. Is their aim to make a profitable investment different from that of any investor? Or are they attracted to our bonds because they are a safe investment? Again one may assume this to be a motivating factor. The record of state and local governments is that they honor their obligations. Who know why investors pick particular securities? Some local banks, for example, buy the bonds of their city or county - or in Louisiana, parish - out of a sense of civic duty.

Members of the Committee, you have heard much about the "taxpayers' revolt." No doubt your correspondence has been heavy on this subject. Let

me assure you that it is not confined to the national level. State and local tax rates have been rising. Except for the surtax, Congress has been able to reduce tax rates several times in the past 15 years. We have not been so fortunate. We have been increasing rates and instituting new taxes.

We may deplore the restiveness of the taxpayer. We may be aware that governmental expenditure can be supported only by comparable taxation. We may agree with Justice Holmes that taxes are the price we pay for civilization. Reason and logic may sustain our position. Unfortunately, taxpayers in revolt have little time for reason and logic.

About a year ago, Governor Rockefeller of New York said that states and localities supported from their own revenues 64 per cent of the governmental expenditures for domestic programs. It is these expenditures that we need to make to rebuild our cities, protect our environment, improve our transportation system and assure that our people have adequate diets, health care and educational opportunities.

Gentlemen, to endanger even to a minor degree our capacity to sustain these programs is folly. To do so to raise the paltry sums -- $35 million from LTP and $45 million from allocation of deductions -- would compound the folly. We need your help -- help you have already determined is in the national interest. We trust yours will serve your real, long-term interests and ours by rejecting these proposals.

Mr. Chairman, Members of the Committee, I thank you.

#69915T1

SUMMARY OF PRINCIPLE POINTS

Changing the historic tax exempt status of municipal bonds will reflect on the integrity of our government.

Proposal to subsidize a portion of interest costs would lead to Federal control over state and local borrowing and would be in conflict with President Nixon's goal of decentralizing authority and responsibility.

Proposals would increase the cost of borrowing to communities and would result in increased taxes at state and local levels.

The effect on growth states would be particularly harmful due to their critical need for financing.

If doctrine of reciprocal immunity from taxes is violated by Federal Government, it will lead to similar action by states to tax United States Treasury obligations.

NATIONAL GOVERNORS' CONFERENCE PANEL ON TAXATION
OF STATE AND MUNICIPAL BOND INTEREST
STATEMENT
GOVERNOR CLAUDE R. KIRK, JR., FLORIDA

Gentlemen, we are all here today to consider a matter far more basic than the details of a proposed tax bill. Changing the historic tax exempt status of municipal bonds would have a deep and penetrating consequence which we should recognize, and that is loss of faith in the integrity of our government.

Even while Congress has been discussing the enactment of a law to tax interest on state and local security, we have seen the steady deterioration of the investing public's confidence in their value.

It is time, once and for all, to lay this matter to rest, by deciding to abide by the assurances given all states over fifty years ago when the Income Tax Constitutional Amendment was submitted to the states. That assurance was that the Federal Government could not and would not directly or indirectly tax this income source, and we now find ourselves faced with the very thing the states were assured would never happen.

This is a breach of faith which, if permitted, would destroy the very foundation of our Federal system; that is, sovereign status but mutual trust in each other.

Another trust which is even more important than that between governments is the trust of the people in their government at all levels, Federal, state, and local. All too frequently this trust has been violated and this proposal flies in the face of assurances, given time and time again, that the Federal Government will not tax the interest on local and state bonds. Credibility of the Federal Government has too frequently been successfully attacked, and I am sure you do not want to add to this credibility gap.

If you now take the back door approach by indirectly taxing state and local bonds, the investing public will be forewarned that the fiscal integrity of the states no longer exists. The results will be chaotic.

The proposal to "subsidize" a portion of the interest costs accruing to the states and local governments, if they agree to issue taxable bonds, would give the Federal Government in Washington control over all such state and local borrowing for capital outlay programs. The effect of this proposal would be increased Federal control rather than increased Federal revenues, although offered under the guise of "tax equity." Federal regulations and the necessity for prior Federal approval will inevitably result.

President Nixon has emphasized the importance of the "New Federalism" under which the states will be called upon to assume an increasing share of the responsibility for providing the public

services citizens have come to expect from their government. These tax proposals, by shifting authority and control of capital outlay borrowing to Washington, and by making it more difficult and costly for state and local governments to do their job of building needed public facilities, are in conflict with the goal of decentralizing authority and responsibility as urged by the President.

The minimum income tax and the allocation of deduction proposals, as they relate to the interest on state and municipal bonds, would increase the cost of borrowing for the needed improvements for which state and local governments are responsible and would, therefore, necessarily increase state and local taxes. These higher taxes would have to be paid by the same taxpayers supposedly being benefited by the so-called tax reform package. Every taxpayer in America would have to pay more taxes to his state, county, school district, and city if these proposals become law, thus increasing tax inequity in the name of tax equity. The increased cost which would have to be paid by the taxpayers under these proposals would be in excess of the amount of additional revenue to be collected by the Federal Government under these indirect forms of taxation of presently tax exempt bonds. The total cost of government to the taxpayer would thereby be increased.

The effect upon growth states, such as Florida, would be particularly harmful, because of the great need for financing education, anti-pollution, transportation, health and rehabilitative facilities for which state and local governments are responsible. Such growth

states have critical needs for such facilities and would therefore suffer disproportionately the consequences of the increased cost of borrowing. These needs cannot be ignored if the states are to assume their proper responsibilities. These proposals would impose unfair burdens upon those states which have the greatest needs and make the greatest efforts to solve them. The impact of this burden would be even greater at the local level with smaller communities which are not as well established as credits in the bond market. Every local taxpayer in states with rapidly growing populations would pay the price of these attempts at "tax reform" in increased property and excise taxes.

There is one other inevitable consequence of the proposed legislation about which you should be forewarned. The Constitutional doctrine of reciprocal immunity from taxes has been held sacred by both the states and the Federal Government since the drafting of our Constitution. If the Federal Government chooses to unilaterally circumvent or abort this doctrine by legislation such as this, so then should the states be free and anxious to tax the instruments of the Federal Government. This would open a Pandora's box of incalculable proportions. The negative effect on the desirability and marketability of United States Treasury obligations would impose the same burden on the Federal Government which this legislation would place on the states. Let us not break this delicate balance of powers which has been so wisely cherished and maintained by our forefathers.

NATIONAL LEAGUE OF CITIES

City Building, 1612 K Street, N.W.
Washington, D. C. 20006

Representing 14,600 Municipalities in 50 states

PATRICK HEALY
Executive Director

Phone: (202) 628-3440
Cable: AMERMUN

Testimony of

C. Beverly Briley
Mayor of Nashville, Tennessee
President, National League of Cities

before the

Senate Finance Committee

on

Tax Treatment of State and Local Bond Interest

September 23, 1969

33-758 O - 69 -- No. 9 -- 8

SUMMARY OF STATEMENT OF C. BEVERLY BRILEY

on behalf of

THE NATIONAL LEAGUE OF CITIES

The cities of the nation are vitally concerned with the provisions of H.R. 13270 which affect municipal bond interest because they would increase the cost of city government and threaten the physical rejuvenation of our cities. Tax exemption is important to cities because it protects the integrity and independence of fiscal policy-making by cities, it provides a stable, adequate independent source of capital and saves states and cities billions of dollars in interest costs and tax dollars.

The market impact of mere House passage of H.R. 13270 has been great; increasing interest costs an average of 1/2 to 1 percentage point which in turn has added millions of extra dollars to local debt service costs. The actual and the psychological impact of the ADR and LTP will very severely curtail the market for municipal bonds.

The large extra cost of this action to local taxpayers and the very small return to the Federal government, coupled with the fact that extra costs must be paid through regressive property taxes hardly is equitable. Congress must take full responsibility for any increase in local property taxes. This action would really cause a taxpayers revolt.

The interest subsidy provisions do not meet certain criteria of acceptability established by bond issuers and would pose critical problems for both the federal and the local governments.

The cities call upon this Senate Finance Committee to delete provisions which include bond interest in the Limit on Tax Preferences and the Allocation of Deductions rule. They urge deletion of the interest subsidy program from the bill for consideration at a future time.

I am C. Beverly Briley, Mayor of Nashville, Tennessee and President of the National League of Citi^s. I am speaking on behalf of more than 14,600 cities of all sizes throughout the nation.

REASON FOR CONCERN

In early August, the House of Representatives passed H.R. 13270 which contained provisions to tax directly and indirectly the interest from municipal bonds. This action has increased interest rates significantly on all state and local government bonds and will cost state and local taxpayors millions of additional tax dollars over the next ten to twenty years. If the Senate concurs with the House action, the effect on municipal capital financing will be devastating.

Surely no other issue has concerned city officials over the past several months to the degree that this has. The reason is simple. This action strikes at the very fiscal stability of our cities. This is an insidious threat because the provisions of H.R. 13270 could increase taxes and add additional strain to already tight budgets. It will delay or perhaps halt altogether public works projects which are vital to the physical rejuvenation of our cities -- in fact our entire physical environment. We thus attach the greatest importance to these hearings for the Senate must undo the damage contained in H.R. 13270. The alternative is to face a taxpayers' revolt of mammouth proportions that would put the current "revolt" to shame.

IMPORTANCE OF TAX EXEMPTION

Tax exemption of municipal bonds is important for these reasons. First, it represents a clear determination on the part of those who designed our federal system and of succeeding governmental officials to protect

the fiscal policy integrity and independence of each level of government. It is a hands-off policy which enables local officials to be fully responsive to local conditions and needs, not to the policies of another level of government. Second, the principle of tax exemption has created a special, independent source of capital upon which cities can rely without concern for competitive capital demands from the private sector or from the federal government. Third, and perhaps most important, tax exemption has kept the cost of capital relatively low, saving states and local governments billions of dollars in interest costs and tax dollars. The legislation before you jeopardizes all of these benefits.

It is obvious that the actions of one level of government are not isolated from or unaffected by another in our "marble cake system." But the integrity of local policymaking must be respected and maintained in order that state and local governments can fulfill these primary responsibilities to the needs and demands of local citizens. Interjecting the Federal government into local fiscal decisions through Federal taxation or any other form of influence on local debt management, the both of which are almost answered by H.R. 13270, interferes with the independence of judgement that local officials now exercise in the important area of capital financing.

Abandoning or severely constricting the tax exempt money market as envisioned through the interest subsidy provisions of the bill suggest serious political implications. When we consider that taxable local government bonds would have to compete with corporate securities and securities of the Federal government for available funds, we must ask, under such conditions, would local government bonds be well received by the investor? The clear answer is that the private sector

competition could well place the collective needs of our communities , as determined by governmental processes, secondary to the interest of a corporate board of directors or the motivation of economic gain of an individual investor.

The economic return from the construction of a school or sewer project may not be as great as that from a steel mill or automobile plant, but the social importance is another matter. To require needed public projects to compete for the investor's dollar on equal economic terms with say, General Motors and AT&T is fiscal folly.

MARKET IMPACT

I will return to the interest subsidy plan later. What has been and will be the specific market impact of the inclusion of bond interest in the Limit on Tax Preferences and Allocation of Deduction rules?

The tax exempt bond market, like all other segments of the economy, has felt the effects of inflation and tight monetary policies applied by the Federal government to cool off inflation. Commercial banks, the largest single investor group in the market, have curbed their municipal bond investment programs and in fact have been liquidating portions of their bond holdings to maintain reserves and lending capacity. However, extrapolating the effects of tight monetary policy, based roughly on bond price trends in periods prior to the House action and comparison to the effects of the 1966 credit crunch on municipal bonds, shows that the prospective action of Congress has had a noticeable effect on interest rates. This effect has been estimated conservatively at at least an average 1/2 of one percent increase in bond yields and is more likely on the order of one percentage point . We can only conclude from this that the investors faith in the traditional security of municipal bond tax exemption has been breached and he is reacting to it.

If Congress enacts the specific provisions of H.R. 13270 which affect bonds (i.e. inclusion of bond interest in the allocation of deductions and the limit on tax preferences) it would probably remove individual investors from the market for tax exempt bonds altogether. Moreover, this action could have an irreparable psychological effect on institutional investors, namely the banks and fire and casualty insurance companies. Once the principle of tax exemption is breached, these investors in making long term investments in municipal bonds, would have to anticipate the day when some future Congress might apply the rules of H.R. 13270 against the bond investment practices.

The situation is made more difficult by the threat of litigation to test the constitutionality of bond interest inclusion in the Limit on Tax Preferences. Lengthy litigation all the way through the Supreme Court, taking as much as three years, would leave the status of tax exemption in total doubt and could very well discourage investment in municipal bonds altogether.

COST IMPACT

In dollars, the cost of the House action is immense. Assuming that final action on this bill did not occur until next year and that the effect on interest rates of House passage of H.R. 13270 is indeed an average of one percentage point increase, the additional cost on an annual volume of $15 billion of bonds is $150 million. The effect of actual enactment over the life of future bonds would be more and of course, cumulative. These figures are particularly striking when one considers that the Treasury Department will receive less than $80 million a year in tax revenue as a result of applying "ADR" and "LTP" to municipal bond interest. This is indeed a sad price to have to pay for very little accomplishment in either tax revenue or making the Federal

income tax system more "equitable."

WHERE IS THE REAL EQUITY?

This equity question rises continuously. Our studies show that based on the best estimates, interest from municipal bonds rates a very poor fourth or fifth in terms of all factions contributing to tax avoidance. In percentage terms, based on Treasury Department figures, it accounts for only 6.6% of all such factors and only 12% of the largest factor -- capital gains.

Moreover, we have found from conversations with market experts that those few individuals now buying municipal bonds (less than 2% of new bond issues have been bought by individuals in recent years) are more likely to be in lower tax brackets --older persons seeking retirement investments, school teachers and so forth--not high tax bracket individuals who are naturally more interested in growth for their investments. Thus, your action would tax "the forgotten American" as he has been called, who may own 5 or 10 bonds.

On the other hand local agencies would have to increase already strained tax rates on the regressive property tax to meet the additional costs. The diversion of additional scarce local funds to debt service would further aggravate the shortage of funds needed to finance other essential local services. Moreover, further aggravating an already regressive tax system is hardly equitable.

To tax a very few rich individuals, most of whom do not now view municipal bonds as good investments anyway,

---risks complicating the structural problems of the Federal system itself.

---risks unbalancing highly complex economic market relationships in the entire capital market,

---raises important legal and constitutional questions which would lead to protracted litigation,

---and makes more difficult the problems of making the total tax structure --federal, state and local--function equitably and effectively while not further depressing local resources.

To us, it is unthinkable to take these risks which will boomerang against hundreds of thousands of local property taxpayers and users of municipal services who will have to bear the burden of increased debt service costs and whose governments will have to suffer the other consequences. This is not equity and we who are the first to feel the taxpayers revolt will be hard put to explain why the Congress of the United States took action which causes us to increase taxes.

THE INTEREST SUBSIDY PLAN

The House has proposed in H.R. 13270 that the Federal government undertake to subsidize municipal bond interest in turn for a waiver of tax exemption on the part of the local bond issuer.

Alternatives to capital financing need not be viewed unconstructively. States and localities have enjoyed a relatively stable source of capital funds in the past and will continue to depend upon the tax exempt bond market in the future for an adequate supply of capital funds. While strong evidence shows that this source will continue to meet the foreseeable needs of states and localities, it is the only source of capital financing available aside from the luxurious pay-as-you-go method and, of course, is dependent largely upon future activity of institutional investors and the expectation that Congress will not

attempt to tamper with the principle of tax exemption. To this end, the "alternative" adopted by the House is not really an alternative in that the other applicable provisions of the bill do much to curtail the tax exempt status of bonds.

CRITERIA FOR ALTERNATIVES

Any proposed alternative system of capital financing would have to meet the following criteria:

1. First, it must preserve the present Federal system and protect the state and local governments from Federal domination.
2. The state and local governments must preserve their freedom to act, independent of Federal control, on matters of purely state and local concern.
3. Any Federal subsidy must be at least as generous as the present financing advantage which the states and municipalities enjoy by virtue of tax-exemption.
4. The Federal government's obligation to provide a subsidy in lieu of tax-exemption must be automatic and irrevocable.
5. The states and municipalities must have unrestricted access, at their own option, to both tax-exempt and taxable markets.
6. Financing procedures must not be subject to delay by Federal red tape which might make state and local governments miss their best markets or involve them in increased capital costs as construction costs keep rising.

We feel the interest subsidy program falls short of meeting these criteria and agree with the Administration in recommending that it not be enacted. This provision of the bill, we believe, was hastily constructed without consultation with public issuers, bond attorneys and market

experts and presents problems for both the Federal government and states and localities. Among its more serious question marks are:

-- strong evidence that the program will cost the Federal government substantial amounts of money rather than add any profit to the Treasury.

-- the marketability of taxable municipal securities.

-- the fact that taxable municipal bonds will be directly competitive with Federal securities and corporate securities and will not bear the guarantee of the Federal government or the magic name of a powerful corporation.

-- an impact of a large volume of taxable securities on the taxable bond market in terms of interest costs.

-- state legal barriers.

I include for the record at this point an article written by Patrick Healy, Executive Director of the National League of Cities, entitled "The Assault on Tax Exempt Bonds," appearing in the July/August issue of TAX POLICY. The article deals extensively with the so-called capital financing alternatives and will serve as detailed explanation for our opposition.

Allow me to expand on a subject I also referred to earlier when I used the word "manipulation" in connection with the subsidy arrangement embodied in H.R. 13270. As stated in the bill, the purpose of the subsidy is "...to encourage states and their political subdivisions voluntarily to relinquish the privilege of tax exemption..." In other words, the Secretary of the Treasury is empowered to offer an interest subsidy great enough to entice municipal issuers to sell taxable securities. Obviously, if no, or very few, tax exempt bonds

were issued -- as would probably be the case in the event of a 40% subsidy -- the tax exempt market would soon shrink and perhaps dry-up completely. After that came to pass, would the Secretary of the Treasury still feel obliged to continue offering a 40% subsidy? Unlikely! If there were no genuine tax exempt market against which to gauge a true yield differential -- and therefore the size of an equitable subsidy -- it is unlikely that the Secretary would feel obliged to offer more than the minimum subsidy of 25%. Carrying this to the next logical step, a case could be made in some future Congress that there is no need for any subsidy, inasmuch as there would no longer be any visible difference in tax exempt and taxable yields. But, even if the present subsidy arrangement were left unchanged and the proposed minimum of 25% left in effect, state and local governments would still have lost a goodly portion of their present "market" subsidy of 30-35%. This seems ironic when one considers that the Federal government is talking about "revenue sharing" at this same time. Perhaps even more harmful than the economic penalty which can be perpetrated under the present bill, is the very real prospect that the Federal government, through its ability to set the subsidy rate and the power that any such discretion inherently carries with it, would be in a position to exert real influence over policy matters heretofore considered the domain of local government.

The answer to the problem lies not in dismissing the subject of alternatives outright but in postponing its consideration until this committee and its House counterpart can fully study and understand its ramifications.

Prior to closing, I should like to address myself briefly to the question of "arbitrage." The House bill contains a provision designed to bar state and local governments from issuing bonds and investing the proceeds in U.S. obligations. In those few cases where such investment was attempted for the purpose of obtaining revenue from the difference in interest cost between municipal and United States bonds, the legal officers of the states concerned have stepped in and halted the process. The provision is unnecessary and dangerous, particularly because it contains no definitions of or standards relating to arbitrage. Rather, it leaves this whole question to the discretion of the Secretary of the Treasury. We recommend its deletion.

To summarize, we are convinced that the inclusion of any of the provisions affecting municipal bond interest will have a disastrous effect on the fiscal well-being of our states and cities and will serve to seriously impair the physical development of our cities. It is truly incrediblo how much damage so little a stroke of the legislative pen will wrought. This must not come to pass. The interest from municipal bonds should be deleted from the Limit on Tax Preferences Rule and from the Allocation of Deductions Rule. The interest subsidy program should be deleted and deferred to future hearings.

STATEMENT

OF

MAYOR JAMES H. J. TATE

Mayor of Philadelphia, Pennsylvania

ON BEHALF OF THE

UNITED STATES CONFERENCE OF MAYORS

before the

Senate Subcommittee
Senate Finance Committee

September 23, 1969

My name is James H.J. Tate. I am mayor of the City of Philadelphia. I appear here today on behalf of the United States Conference of Mayors. The Conference is an organization of chief executives of cities located in every part of the United States. I am here specifically to express their firm opposition to the proposals to tax the interest on municipal bonds which are contained both in H.R. 13270 and in the Treasury Department's plan which has recently been outlined to this Committee. The effectuation of either or any part of these proposals, or indeed of any federal attempt to subject the financial obligations of our cities to federal taxation would be, in the view of the Conference of Mayors, unconstitutional and impolitic, and, from a fiscal standpoint, irresponsible and regressive.

These proposals would fatally undermine the doctrine of reciprocal inter-governmental immunity which has heretofore protected both the national government, and the sovereign states and their political subdivisions, from unwarranted and obstructive intrusion by either into the other's essential governmental affairs. They would permit the federal government to begin to exercise the most coercive form of dominion over state and local governmental functions, by subjecting them to financial controls

33-758 O - 69 -- No. 9 -- 9

through the use of the taxing power.

In thus contributing to the further consolidation of authority in the federal bureaucracy at the expense of state and local government independence and initiative, they move in the opposite direction from the Administration's announced concept of the "new federalism". That concept calls upon states and local government to assume full responsibility for regional and local affairs, with federal assistance, to be provided through such programs as revenue sharing and the funding of minimum welfare standards. We can only regard as self-contradictory a federal policy which proposes distribution of federal revenues to state and local government on the one hand while saddling them with new and tremendous financial obligations on the other.

The fiscal irresponsibility of these new tax proposals with respect to municipal bond interest is conclusively demonstrated by their economic effect. The financial liabilities they would impose upon state and local government would overwhelmingly exceed any gross return to the Treasury in the form of income taxes, and, in fact, the clear effect of these proposals would be to cause a net <u>loss</u> in tax revenues to the federal government. To achieve this dubious result it would, nevertheless, be necessary for state and local government to impose additional taxes in annual cumulative amounts which would reach a total of

one billion dollars a year just a few years after the enactment of any of these new proposals. In other words, state and local government would be taxing an additional one billion dollars a year just so the Treasury can suffer a net loss.

Unfortunately, the additional revenues needed to pay the higher borrowing costs compelled by these new proposals must be derived primarily from real property and sales taxes which fall most heavily, and most regressively, upon the middle and poorer classes. Yet, both the House bill and the Treasury's proposal are characterized as "tax reform" measures with the professed objective of providing tax relief for these very same classes of citizens.

I emphasize that I cannot avoid overstating the effect of the enactment of these proposals on the fiscal condition of our states and cities. In fact, even the threat of federal taxation has thrown the municipal bond market into a state of chaos. No municipality can now market even the most highly rated and secured bond without paying an interest rate so excessive as to be punitive. On July 1st of this year my own City of Philadelphia incurred interest costs ranging from 6.352% to 6.431% on issues aggregating $60,625,000. This was the highest interest cost paid by the City of Philadelphia on record, and there is no question that the primary cause was uncertainty in the market as to the future tax

exempt status of our bonds. Yet, this borrowing took place even before H.R. 13270 was reported out by the Ways and Means Committee and passed by the House.

The City of Philadelphia's current program for the development of its airport, seaport, and mass transit system as well as the development of its traditional health, recreation and public safety facilities will cost $903 million. The interest on tax exempt debts to finance that program would be $43.2 million annually.

If the present exempt status of the bonds intended to be issued were jeopardized in the manner recommended by the House Ways and Means Committee, the interest on these bonds would increase at least 2% more than we are currently paying. On the $903 million capital program the extra 2% interest would add $15.7 million to our annual interest cost. To absorb a cost increase of that magnitude it would be necessary to raise the city's real estate tax by 16%.

In addition the school board of Philadelphia has a capital program in excess of $500 million. If the bonds to be sold to finance that program became taxable, the additional interest rate would require another 8% increase in the present real estate tax. In other words, the net increase to the real estate taxpayers of

Philadelphia, if municipal bonds are taxed in any form, would be a whopping 24% increase.

And the market has continued to deteriorate. We were more fortunate than the City of Newark, which as recently as September 9th was obliged to accept a net interest rate of 7.684% on a $20,461,000 issue of general obligation bonds. Yet earlier, on July 29th, city officials rejected as excessive a bid for that same issue which would have resulted in a lower interest cost of 7.439%. The basis for the earlier rejection was the unsettled state of the market resulting from this threatened tax legislation. The situation since has obviously gone from bad to worse.

Newark was only able to borrow this money because the State of New Jersey had temporarily suspended statutory limits on municipal borrowing interest rates. The existence of constitutional and statutory interest rate limits (which exist in 38 states), coupled with the unwillingness or economic inability of issuers not subject to such limitations to pay punitive interest costs, have resulted in a wholesale cancellation or postponement of borrowings. The consequence will inevitably be severe cutbacks in public works programs on the state and local level which will not only deprive the average citizen of much needed services but will also afflict workers in the construction trades and allied industries. In all, since September, 1968, there have been a total of 316 bond issues

valued at well over $1.9 billion which have been rejected or postponed throughout the nation thus depriving many communities work for their building and roads and construction workers. In those cases where borrowings have been consummated during this period, the issuers will have no alternative but to increase local taxes in order to meet the additional interest costs.

The passage of any legislation which would result, directly or indirectly, in taxing the interest on municipal bonds would only insure the continuing chaotic state of the bond market for years to come. Litigation challenging the constitutionality of any such legislation must inevitably follow and until a final and conclusive opinion is rendered by the U. S. Supreme Court, the marketability of municipal bonds will depend entirely upon the ability and the willingness of issuers to pay outrageous interest rates. While I am confident that the unconstitutionality of such taxes would ultimately be confirmed, the additional cost to state and local government in the interim would be staggering. These additional costs soon would reach one billion dollars.

While both H.R. 13270 and the Treasury proposal possess a superficial attractiveness, they cannot survive even a cursory analysis. Both proposals have the laudable objective of preventing

affluent persons from escaping income taxation, although there has been no showing of the extent to which these or any persons may have reduced or escaped income tax liability by investing in municipal bonds. The proponents of so-called tax reform would nevertheless require the holders of such bonds to pay a minimum tax to the Treasury. This would be achieved by including a portion of bond interest in taxable income and/or by reducing otherwise available deductions because such income has been received.

What the proponents of these measures fail to realize or fully appreciate is that the purchaser of municipal bonds is paying a very real and a very substantial tax now, and he is paying it to levels of government which most urgently require it. The holder of municipal bonds has accepted an interest rate some 30% or more lower than the rate on comparable taxable investments. This foregone income represents a substantial net gain to state and local government and is the equivalent of the minimum tax so piously sought by proponents of tax reform.

State and local governments have issued bonds now outstanding in the amount of $130 billion. With the owners of those bonds accepting at least 2% less, which is the differential if the exemption is lost, state and local government will in effect lose over $2 1/2 billion annually. If state and local

governments are to lose this real income, they will have no recourse but to tax locally to obtain it, and to tax in such formidable amounts as to precipitate public outrage at the grassroots level.

The economics of the new tax proposals make them even more incomprehensible. Under the allocation-of-deduction plan, the Treasury expects to realize a relatively meager $45 million annually. The adoption of the minimum tax proposal would produce in addition only $35 million more. There is no question that the effect of these proposals which would breach the historic immunity of state and local government from federal taxation and shatter the confidence of investors in municipals, could result in at least a 1% increase in the interest rates on the bonds. Assuming no growth in the $16 billion aggregate of new annual municipal bond issues, this means that the Treasury is willing to require state and local government to levy, at a minimum, an additional $160 million in taxes in the first year the legislation is effective to produce income to the Treasury which can only be characterized as negligible. With each additional year, the amounts required to be levied could rise correspondingly and cumulatively. After post 1969 issues outstanding reached only

the present level of $130 billion the state and municipal cost would be $1.3 billion a year.

However, the analysis does not end here. All of these taxes required to be levied by state and local government would, of course, be deductible on federal income tax returns. The amounts received by the Treasury as a result of these proposals will thus quite clearly be more than offset by the loss of revenue resulting from increased federal tax deductions. In other words, the Treasury will lose revenue by virtue of these proposals but, nevertheless, would impose crushing local tax burdens on our states and cities, burdens which must fall most heavily on the middle- and lower-income classes.

On the basis solely of economics, and that must be the overriding consideration for our cities, these new tax proposals must not emerge in any form from this Committee. We simply cannot afford them.

H.R. 13270 and the Treasury proposal, both by commission and omission, would lull us into a false sense of security. Directing myself to the omission first, I note that only individuals, and not corporations and institutions which hold most outstanding municipals, are subject to the minimum tax and allocation-of-deduction provisions. But we are not taken in and neither are the corporations and institutions. If the Treasury

and the proponents of the House bill believe that they can now tax individuals on their interest on outstanding municipal bonds, there is no question but that investors will assume that the same fate ultimately lies in store for corporations and institutions. The current state of the bond market clearly reflects this judgment.

Nor can we find any solace in the bond-interest subsidy provisions included in H.R. 13270. Not only is the Secretary of the Treasury given wide latitude in determining the amount of the subsidy, but the subsidy is completely at the mercy of Congress and may be curtailed and indeed eliminated at any time. The end result will be a debilitating loss of independence by state and local governments over their financial affairs, and ultimate fiscal subservience to the vagaries of an over-centralized federal bureaucracy concerned only incidentally with matters of vital local concern.

APPEARANCE OF W. W. DUMAS, MAYOR-PRESIDENT
PARISH OF EAST BATON ROUGE, CITY OF BATON ROUGE
BEFORE
THE SENATE FINANCE COMMITTEE
2227 New Senate Office Building
Washington, D. C.
February 23, 1969

HONORABLE RUSSELL B. LONG, CHAIRMAN, AND
DISTINGUISHED MEMBERS OF THE SENATE FINANCE COMMITTEE:

The Senate of the United States, represented by this Committee, deserves an expression of appreciation for its patience and adherence to democratic principles in affording the present public hearing--a procedure not allowed by the House Ways and Means Committee. If such a hearing had been conducted and more time taken in the study of H.R. 13270, the shattering damage to the ability of local governments to finance capital improvements which has occurred since the middle of August of this year might have been avoided.

As a consequence of the precipitous and extremely ill advised action of attempting to impose taxation indirectly on municipal bonds, irreparable harm has already occurred to an increasing number of municipalities in the state of Louisiana. Passage of H.R. 13270 by the House of Representatives has compounded the difficulties in the Louisiana bond market. Within the past few days in order to sell a twenty-year "A" rated bond it has been necessary for the governing authority to accept a requirement that the bond proceeds be deposited for a period of time of from six to eighteen months

before the bond proceeds may be expended. Such deposits are interest free to the issuing authority, and the investment of the idle funds inures to the benefit of the initial bond buyers.

The chaos and confusion generated by H.R. 13270 in the bond market has prevented many cities, including Baton Rouge, from proceeding with vital works of public improvement. For example, street paving certificates, secured by local or special assessments and additionally by a pledge of the full faith and credit of the Parish of East Baton Rouge, have not been successfully sold within the maximum six percent interest limit since public advertisement several weeks ago. Having a maturity of only ten years, this short-term debt would ordinarily bring in the bond market prior to H.R. 13270 a sale price within six percent per annum. The delay in this particular project prevents the paving of a section of a gravelled dirt street running between a large, new motel complex near the LSU campus known as the "Prince Murat House" and a large public housing project recently completed. Blowing dust from the traffic makes life almost unbearable in that portion of the public housing and motel properties facing the street. The public health, welfare and safety is directly and adversely affected.

The East Cameron Harbor and Terminal District offered its twenty-year full faith and credit secured bonds for sale on November 1, 1969, and a copy of the official prospectus is offered for filing in the minutes of this hearing. The purpose of the project is to dig a barge canal from the navigable portions of the Mermentau River to a navigable depth in the Gulf of Mexico to

permit shrimp and other fishing boats and offshore oil boats to utilize the natural harbor facilities of the Mermentau River. The mouth of the River has never been navigable, and the opening up of this new territory holds untold potential for the development of natural and human resources. This project, like many others in Louisiana, is denied to the people because bonds cannot be sold within the lawful rate of interest of six percent per annum, and the bond market of the United States will not purchase any more so-called tax exempt bonds until the Congress has made it very plain that such bonds are, in fact, tax exempt for all times.

The Government of the Parish of East Baton Rouge which I represent has in progress large building programs costing many millions of dollars requiring the continued borrowing of money. On an open and free market, this could be accomplished. On a government controlled market, functioning through an urban development bank or some other similar scheme, it is not at all certain what could be accomplished.

The ability of East Baton Rouge Parish to borrow money is predicated on years of good fiscal management, development of an excellent credit repution, the winning of outstanding ratings by national bond rating firms, prompt payment of debts when due. The advantage of such hard-earned good rating and the consequent ability to borrow money at advantageous interest rates in a private market should not be taken away by government planners who seek to substitute or superimpose the judgment of an all-central agency or bank to determine priorities between states and local issuing authorities.

The elimination of the tax exempt status in whole or in part, directly or indirectly, immediately or step-by-step, is nothing more or less than an attempt by the planners to destroy the ability of local government as we know it today to finance improvements and thereby render such government substantially impotent. Such an impotent government would then be replaced by the central planning and financing agency.

Local government officials throughout Louisiana are of the opinion that the blatant grab for power, disguised under the cover of "tax reform", is really an attempt to finally, once and for all, establish the central government as supreme, even on the level of local government. The effort should be turned back here in the Senate Finance Committee and by the thinking members of both Houses of Congress. The damage--already done--irreparable in some places--can only be stopped by the strongest possible pronouncement by this Committee and by your Senate colleagues that any attempt to tax municipal bonds to any degree will not be allowed now or at any time in the future. The loss and chaos generated by the precipitous action of H.R. 13270 can be repaired only if all bond buyers for all time are given unconditional and unqualified assurance that the promise of the United States that such obligations are tax exempt will be honored, and that future years will not see a repetition of the debacle of 1969.

The officials in Louisiana are not confused as to who really benefits from the tax exemption advantage afforded local government. The real benefit is not to the few millionaires held up as the target. The real beneficiary is the little man, the poor man, the

middle class, the average American taxpayer who carries the primary burden for essential cost of improvements.

The thinking citizens and public officials of Louisiana are not confused by the suggestion that a Federal Subsidy Plan will be more efficient than the present free and open market system. The volume of activity necessary to support the demands of modern innovative and creative local government would require the development of a federal agency so large as would absorb any theoretical increase in federal income tax savings. The cumbersome effort of the central bureau proposed to be created could not possibly match the private money market in its ability to promptly and efficiently meet almost any demand, as is judged on the basis of the honest law of supply and demand in a free enterprise system. There is nothing that cannot be accomplished in such a free society. There is much that cannot be accomplished in the controlled central government bureau.

Many projects in the State of Louisiana would simply not be subject to financing if it were not for the advantage of tax exemption. If these projects were required to compete on the open market without the tax exempt advantage, the burden of increased interest rates would be so great as to delay financing for years or perhaps prevent it forever. The states of the Deep South, including Louisiana and other lower population areas, would not fare well in competition for the interest of the central bureau planners.

The Government which I represent has issued and has outstanding millions of dollars of bonds represented to be "tax exempt". The "tax exempt" representations were printed in newspapers, in official

documents, in contracts including the bonds and coupons. The representation of tax exemption was predicated on the fundamental concept of the inviolability of contract--on the historic constitutional principle of full faith and credit to the sanctity of contract.

Purchasers throughout the United States have acquired obligations of this local government in reliance upon such representations. At the time of their respective purchases, there was a sharp disadvantage between the interest rates offered on one hand for the "A" rated bonds of my local government and the much higher interest rates available otherwise in the open market. To suggest now that these obligations are taxable is to violate every concept of the obligation of contract which, in the Civil Law State of Louisiana, is an unconscionable and an indefensible act.

The breach of good faith with the holders of these obligations presents such an outrageous departure from the practice of civilized western man in adhering to the law of written contract, that the local government which I represent would feel constrained, if not legally obligated, to bring suit resisting in every possible lawful manner the unconscionable and unconstitutional encroachment here.

Litigation of this type by many parties in interest and the consequent publicity will have the effect of destroying the reputation -- reliability of the tax exempt promise for a long period of time, if not permanently. In the meantime, chaos will result in unheard of high interest rates and discounts, as is now occurring in Louisiana.

If the historic concept of intergovernmental immunity is violated by H.R. 13270, it logically and ethically follows that the obligations of the United States Government should similarly be subject to tax and assessment by state and local government. In examples too numerous to enunciate, local government does not collect from the United States local or special assessments for street paving and other improvements levied on an abutting property front foot or square foot basis. Street paving or other local improvements directly benefiting United States property is simply donated, in deference to the long-standing and supposedly immutable doctrine of intergovernmental immunity.

This Committee is urged to complete these hearings at the earliest possible time and to recommend to the Senate that conclusive action be taken to defeat the entire package of H.R. 13270; that the Congress undertake and adopt at the earliest possible date a reaffirmation and confirmation of the doctrine of intergovernmental immunity, of the inviolate status of the tax exemption on state and local bonds, and that such action be couched in such terms as shall stand out as an unconditional assurance and guarantee that the fiasco of 1969 will not be repeated at any time in the future.

Respectfully submitted,

W. W. Dumas, Mayor-President
Parish of East Baton Rouge
City of Baton Rouge
State of Louisiana

33-758 O - 69 -- No. 9 -- 10

TESTIMONY OF

LOUIE WELCH, MAYOR

CITY OF HOUSTON, TEXAS

Presented before the Finance Committee of the
United States Senate - September 23, 1969

Senator Long and Gentlemen:

Thank you for the opportunity to appear before your committee. I shall attempt to be as brief as possible here, taking the time which you have granted to emphasize the significance of the legislation which you are considering. For your later contemplation I also am providing copies of detailed statistical and analytical studies which support these points.

Gentlemen, the proposals now before you will directly and seriously increase the cost of living of your constituents. They will do this by adding measurably to the cost of public education in every state. They will do this by increasing significantly the cost of local government in every community of every state. Furthermore, they will irreparably damage the traditions of state and local government independence from federal control.

These effects, lest you hear in your minds the cry of "Wolf" from the imaginative shepherd, already have been felt. They are demonstrated currently by the serious problems of the bond market under only the threat of this bill.

Now, we are referring here specifically to the provisions which include interest from state and local bonds in the limited tax preference and the allocation of deductions rule.

To the taxpayer, the costs of these proposals will add up to some $1.32 billion per year. Details on this staggering impact are shown in Exhibits A and B to this presentation. What is not shown in these figures are the unpleasant facts which this must involve, as these unnecessary costs are incurred by cities and school systems in every state.

Reflect for a moment, if you will, on the problem to be faced by mayors and school system leaders each time they place new bonds on the market under this proposed system. It will be incumbent upon them to explain to their constituents-- who are your constituents, too--the reason why local government is costing more. And that reason, as the public will be told time and time again, will be because this Congress passed the law which costs them more to borrow money for their school buildings, for their sewers, for their water, for their streets... for every essential item of local government.

Make no mistake about it. There will be no choice for local officials, for they must tell the public the facts. And in this case, they will find it necessary to tell them the facts often, for when $1.32 billion dollars are incurred in extra costs each year, scarcely a day will go by that does not see some community being reminded of the cause for its rising cost of living.

I refer you again to Exhibits A and B, the sources of this estimate. You will see that it is a low estimate, not a high one. It is based on facts already established. In particular, Exhibt B shows that since this legislation was proposed, the interest rates on state and local bonds---which are the cost to the public---have increased more than one-half of one percent beyond increases on comparable, taxable bonds. This one-half percent, translated into the extra dollars which this is costing the public, amounts to $1.32 billion per year. And this, I remind you again, is the impact from the mere threat of the law. Passage undoubtedly would make it more severe.

The interest subsidy proposal would have further dire effects. The tradition of our nation since its founding has preserved for the people the right to determine their own destiny in local matters. Imposing this new thinking on local governments now would severely restrict the right of a community to meet its own challenges on such strictly local matters as construction of school buildings and paving of streets. This, with the cities of the nation so much larger and so much more complex, with the tremendous shift of population to urban centers, would be a crippling blow to the very system of life which has made the United States what it is today.

And for what? What will really have been accomplished by this measure, intended for the much-needed purpose of tax reform?

The Committee already has received testimony which shows the answer. From the office of the Secretary of the Treasury you have been given the facts and figures which show that, at best, this bill would recapture some $80 million annually. And that "best" will not be achieved for ten full years -- years during which the cost to local government and to the taxpayer will be more than 16 times as much <u>each year</u>.

Of course, it also should be recognized that the buyers of municipal bonds, from whom this money is to be taken, already have paid their taxes when they buy the bonds. This, after all, is the simple effect of accepting a lower return on their investments than would be available in fully taxable securities. They are, in effect, to be penalized by this legislation for supporting their local governments, and the psychological impact of this punishment can only further damage the market for municipal bonds.

Local governments have been pleased at the concern of this Congress with the need for lower, not higher, costs for local government. Attachments 1, 2 and 3 to this testimony, which have been prepared by the Urban Institute, Washington, D. C., are submitted as a more effective and acceptable alternative to the interest subsidy proposals thus far put forth.

The proposals of the Urban Institute should prove most attractive to this Committee because they accomplish the desirable purpose of broadening the market for state and local bonds through inducing new types of investors to purchase these securities. This approach, by offering a subsidy to state and local retirement funds for example, would lower local government borrowing costs by opening the door to a substantial, new and rapidly increasing source of funds. It would preserve the integrity of tax exempt bonds and the independence of local governments to finance capital improvements.

I urge the Committee to examine the Urban Institute proposals thoroughly, for they provide a method which will not require federal permission for state and local borrowing and will thereby preserve rather than diminish local autonomy.

I further urge this Committee to provide itself with adequate time to examine other alternate proposals which you will receive. In particular, we are told that the Treasury Department during these hearings will present an alternative plan and I am sure that you will agree that there is not adequate time for you to make an informed judgment prior to the end of your hearings in October.

Gentlemen, the discussions now under way before you in regard to HR 13270 cover far-reaching and decisive matters. Your actions can permanently alter the traditional sovereignty of the states and their political subdivisions. Indeed, it is within your power in these measures to make virtually every local government dependent upon the federal government for its capital improvements programs and, thereby, for its economic health and its very future.

As the representative of the citizens of Houston, and with the concurrence of the Governor of Texas, the Honorable Preston Smith, we urge you on behalf of all citizens of our state to drop all references to state and local bonds from this legislation.

Specifically, we urge the following changes in HR 13270:

Deletion of income from state and local bonds in:

Section 301 - Limit on tax preferences for individuals, estates and trusts;

Section 302 - Allocation of Deduction;

Deletion in entirety:

Section 601 - Interest on certain governmental obligations;

Section 602 - United States to pay fixed percentage on yield on taxable issues.

We further urge you to permit this subject to receive the proper time, attention and consideration which it deserves. We pledge to you our cooperation in this essential study.

An Analysis of the Tax Reform Bill of 1969 (H.R.13270) as passed by the House of Representatives of the United States on August 8, 1969, as it pertains to Local Government Financing.

By Louie Welch, Mayor, City of Houston, Texas

Tax reform is vital and badly needed in our Nation today. Many facets of this legislation are important and necessary to the equality of taxation in our system of government. Portions of this legislation deal with State and Local government financing of capital improvements through municipal bonds.

As the Mayor of Houston, I have examined these portions of the legislation which affect our city (and all local government throughout the United States) and find some of them to be so costly to the average taxpayer that I feel that I must speak out in an effort to warn members of Congress and the people themselves of the consequences of this little understood portion of this legislation.

The portions of the legislation to which this paper is addressed will be discussed as two separate matters:

First Discussion

Section 301 - Limit on tax preferences for individuals, estates and trusts

Section 302 - Allocation of deductions

It is the inclusion of interest from local government bonds in these two sections to which these comments are directed.

Second Discussion

Section 601 - Interest on certain governmental obligations

Section 602 - United States to pay fixed percentage of yield on taxable issues

I advocate total elimination of these provisions as being costly to taxpayers of both the Federal government and local governments,

and because it adversely changes the traditional relationships between Federal, State and Local governments.

FIRST DISCUSSION

Section 301 - Limit on tax preferences for individuals, estates and trusts (hereafter referred to as LTP)

Section 302 - Allocation of deductions

Both of these sections place a tax on previously tax-exempt obligations of local governments.

The bais for the inclusion of interest from state and local bonds in LTP and allocation of deductions is set forth on page 9 of The Report of the Committee on Ways and Means dated August 2, 1969. The Committee reported that it had examined 154 tax returns from the year 1966 of individuals who had adjusted gross income in excess of $200,000 and who paid no income tax. It continued:

> "Your Committee examined these 154 returns (along with other tax cases involving low effective rates) in detail in order to find out the reasons for their nontaxable status.
>
> The analysis showed that in most cases the nontaxable status arose from a combination of several factors. The most important single cause of nontaxability for this group was itemized deductions which totaled over $130 million or 116 percent of adjusted gross income. Another group of these taxpayers benefited most from the unlimited charitable contribution deduction (49 cases). In fact the single most important itemized deduction for the nontaxable group was the charitable contribution deduction, amounting to nearly $79 million, of which $55 million or 70 percent was property, the bulk of which represented untaxed appreciation. Another group benefited primarily from the deduction of interest paid (72 cases), which was the second most important itemized deduction for the group as a whole. Most of this interest paid was on loans which were presumably for the purpose of acquiring appreciating investment assets held for capital gain purposes and was frequently deducted from earned income. Others benefited from such items as real estate depreciation, the excess of percentage over cost depletion and

> intangible drilling and development expenses, and farm losses. Many were nontaxable because they were able to exclude one-half of capital gains from their income and offset all their itemized deduction against the remaining income subject to tax.
>
> Your committee also examined the returns of taxpayers who were taxable but paid low effective rates of tax. The most important reason for the low effective tax rate paid by these taxpayers was the combination of the excluded half of capital gains and itemized deductions which were offset against their income subject to tax."

Note that no mention is made of interest from state and local government bonds. In fact, there would be no economic justification for ownership of tax-exempt securities by those taxpayers because tax-exempt income does not have maximum net after tax benefit when a taxpayer's tax rate is 0%.

The next paragraph of the report continues:

> "It is believed that still other high-income individuals paid no tax and did not even file tax returns since virtually their entire income was from tax-exempt State and municipal bonds."

No evidence is found in the report to support this statement. In fact, the word "believed" seems to speak for itself. We would support legislation that would require the reporting of interest on state and local bonds on federal income tax returns so that the Congress could know whether or not his statement is correct.

WHAT WILL BE TAXED UNDER LTP AND ALLOCATION OF DEDUCTIONS?

The only municipal bonds to be taxed as a result of this legislation would be those held by individuals, estates and trusts. The distribution of ownership of state and local bonds is set forth below.

Ownership of Municipal Bonds

Individuals, estates and trusts.......	32%
Banks.................................	38%
Insurance companies...................	17%
Pension funds, sinking funds and all others......................	13%

Further, only those obligations held by individuals whose tax preferences are an amount greater than one-half of their adjusted gross income would be taxed in any manner by LTP.

The allocation of deductions formulas apply only to interest on local government bonds issued after July 12, 1969.

Under the transition rule, only one-tenth of such interest would be taken into consideration for allocation purposes in the first year, two-tenths in the second year and so on, until after 10 years, 100% of the interest on only new issues of tax-exempt bonds would be included.

It must be apparent to even the casual observer that the federal government is not in a position to tax any more than a minimal percentage of outstanding bonds as a result of these proposals. Indeed, under the formula it will be many years before any significant percentage of bonds can be affected.

It is my opinion that much of the damage which has occurred to the market for municipal bonds over the past sixty days is a result of fear--the fear of a subsequent extension of this formula.

I understand the attitude of those Senators on this Committee who commented in these hearings on September 4, 1969 to the effect that the impact of this legislation on the market for tax-exempt bonds over recent weeks is difficult to understand.

EFFECT ON U.S. TREASURY AND LOCAL GOVERNMENT

The Assistant Secretary of the Treasury, the Honorable Edwin S. Cohen, testified on September 4, 1969, to the effect that the total annual tax collected after the 10-year phase-in period as a result of State and Local Bond interest would be only $80,000,000. He estimated revenue of only $45,000,000 as a result of the inclusion of municipal bond interest in the Allocations of Deductions rule and only $35,000,000 as a result of the inclusion of this interest in LTP.

Exhibit A at the conclusion of this report demonstrates the additional cost to state and local government as a result of higher interest rates on their securities. The study reflects that an increase in local government borrowing next year, 1970, in the amount of 1/2% would cost states and local governments $1.32 billion over the life of those bonds.

Since Secretary Cohen has testified that the return of taxes to the U.S. Treasury after 1979 would only be $80 million, the vast difference in these two figures is difficult to understand.

However, fear, sentiment, opinion and attitudes are all important factors in a free market. Although it seems to be far out of proportion to reality, the facts are that average yields on state and local bonds have risen in excess of 1/2% more than yields on comparable Government and Corporate Bonds during the past sixty days. Exhibit B demonstrates these facts.

Stated in another manner, if the increased yields on state and local bonds remain at the higher level (1/2%) that has recently been attained, and the ultimate (1979) tax return to the U.S. Treasury is considered as a constant figure, a significant net loss to all taxpayers is the result.

Cost to local governments of 1/2% higher interest rates	$ 1,320,000,000
Return to Treasury from LTP and Allocation of Deductions	80,000,000
NET ANNUAL LOSS TO ALL TAXPAYERS	$ 1,240,000,000

It is apparent from these calculations that the taxpayers would still suffer even if the increase in interest rate to local governments was reduced to as little as 1/20th of 1%.

Cost to local governments of 1/20% higher interest rates	$ 132,000,000
Return to Treasury from LTP and Allocation of Deductions	80,000,000
NET ANNUAL LOSS TO ALL TAXPAYERS	$ 52,000,000

33-758 O - 69 -- No. 9 -- 11

DOLLARS LOST TO STATE AND LOCAL GOVERNMENT AS A RESULT OF HIGHER INTEREST RATES ON MUNICIPAL BONDS

	VOLUME OF NEW DEBT ISSUED (1)	1/2% INCREASE RESULTS IN LOSS OF	1% INCREASE RESULTS IN LOSS OF
1970	$ 17,600,000,000	$ 1,320,000,000	$ 2,640,000,000
1971	$ 18,600,000,000	$ 1,385,000,000	$ 2,790,000,000
1972	$ 19,500,000,000	$ 1,462,500,000	$ 2,925,000,000
1973	$ 20,000,000,000	$ 1,560,000,000	$ 3,120,000,000

Average Maturity: 15 Years

1. Source: JEC Study

EXHIBIT A

RELATIVE CHANGES IN BOND MARKETS

YIELD COMPARISON - JULY 2, 1969 AS RELATED TO SEPTEMBER 4, 1969

	Moody's Corporate Bond Index	U.S. Treasury[1]	BOND BUYER AVERAGES STATE AND LOCAL BONDS[2]
September 4, 1969	7.44%	6.21%	6.37%
July 2, 1969	7.33%	6.17%	5.68%
NET INCREASE IN YIELD	+ .11%	+ .04%	+ .69%

SOURCE: DAILY BOND BUYER

(1) 20 year maturity used for illustration.

(2) 20 bond average as compiled by the DAILY BOND BUYER using representative yields on tax exempt bonds of 20 year maturity.

EXHIBIT B

Second Discussion

Section 601 - Interest on certain governmental obligations

Section 602 - United States to pay fixed percentage of yield on taxable issues

The Treasury Department in its testimony of September 4, 1969, before the Senate Finance Committee did not recommend the interest subsidy provisions set forth above and we presume that this decision was based upon an analysis of the cost of these provisions to the United States Treasury, and therefore, to all taxpayers. Several important considerations in this matter are discussed below.

The impact upon markets for taxable securities - The Investment Bankers Association reports that in 1968 their members underwrote and distributed approximately $33 billion in corporate, state and local bonds. Approximately one-half or $16 billion was in tax-exempt state and local bonds. It would seem that any substantial infusion of more taxable securities into that market would trend interest rates on taxable securities higher thus increasing corporate and federal government interest rates on its direct borrowing as well as on Federal agency borrowing higher than those relative levels presently attained by taxable debt securities.

Changing ownership patterns of state and local bonds as a result of taxable interest rather than tax exempt interest - Taxable securities over the period 1966-67-68 (see Exhibits 3 and 4) were held by investors whose aggregate tax rate was only 13.4%. It is logical to conclude that this percentage would be reached

on taxable federally subsidized local government bonds. In fact, purchase of their own securities by local governments at higher taxable yields would be a natural result and could easily cause the tax return to the federal government to drop below the 13.4% level which exists for other taxable securities.

Obviously, any federal interest subsidy of the magnitude of 30% to 40% would create a substantial drain on the United States Treasury and a heavier federal tax burden on all taxpayers.

Statistical Analysis of Optional Taxable State and Local Bonds

40% Interest Subsidy

	Annual Increment	Interest Rate	Annual Interest Cost In Dollars
A.	$16,000,000,000	8% (Taxable)	$1,280,000,000
B.	16,000,000,000	3.2% (Federal Subsidy)	512,000,000
C.	16,000,000,000	4.8% (Local Participation)	768,000,000
D.	16,000,000,000	5.6% (Tax Exempt)	896,000,000

Savings to local government (D-C)

$896,000,000
768,000,000
$128,000,000

Federal Government Revenue Gain (or Loss)

Taxable Income (A)	$1,280,000,000
Tax Recovery @ 13.4%	171,520,000
Less Federal Interest Subsidy (B)	(512,000,000)
Loss to U. S. Treasury	(340,480,000)
Savings to local government	128,000,000
Annual Net gain (loss) to all taxpayers	($212,480,000)

__30% Interest Subsidy__

	Annual Increment	Interest Rate	Annual Interest Cost In Dollars
A	$16,000,000,000	8% (Taxable)	$1,280,000,000
B	16,000,000,000	2.4% (Federal Subsidy)	384,000,000
C	16,000,000,000	5.6% (Local Part.)	896,000,000
D	16,000,000,000	5.6% (Tax exempt)	896,000,000

__Savings to local government (D-C)__

$896,000,000
__896,000,000__
NONE

Federal Government Revenue Gain (or loss)

Taxable Income (A)	$1,280,000,000
Tax Recovery @ 13.4%	171,520,000
Less Federal Interest Subsidy (B)	384,000,000
Gain (loss) to U. S. Treas.	(212,480,000)
Savings to local government	-0-
Annual Net gain (loss) to all taxpayers	($212,480,000)

Keep in mind that these figures are for one year only. The average life of state and local bond issues approximates 15 years. The total cost on this basis for using this device, for just one year could thus approximate $3,187,200,000. In addition to the above figures one can mentally add the unestimated cost of administering such an undertaking. The basic principle underlying this discussion rests on the foundation that the Federal Government is likely to have a net drain on the Treasury as a result of this approach.

Since local citizens are also Federal Taxpayers it is the citizen who will suffer. The wealthy will merely seek another investment which will offer a better "after tax" return on investment dollars, than taxable state and local government securities.

Investor Group	Net Purchases of Corporate & Foreign Bonds ($ Billion) 1966	1967	1968 E	Three Year Total		Per Cent Contributions		Effective Federal Tax Rate	Effective Taxable Contributions	
State & Local Government	4.4	6.7	7.0	18.1		44.7		0	0	
Private Pension Funds	1.9	1.0	1.5	4.4		10.9		0	0	
Subtotal # 1					22.5		55.6			0
Mutual Savings Bank	0.3	2.0	0.2	2.5		6.2		18	1.1	
Life Insurance Co.	2.2	3.7	3.2	9.1		22.5		20	4.5	
Subtotal # 2					11.6		28.7			5.6
Other Insurance Cos.	0.1	0.8	0.4	1.3		3.2		48	1.5	
Commercial Banks	0.1	0.8	0.0	0.9		2.2		48	1.1	
Other Finance	0.4	-0.6	0.3	0.1		0.2		48	0.1	
Households	1.2	1.8	-0.9	2.1		5.2		50	2.6	
Rest of World	1.2	0.8	0.0	2.0		4.9		50	2.5	
Subtotal # 3					6.4		15.7			7.8
Grand Total	11.8	17.0	11.7		40.5		100.0			13.4

Source: 1966 and 1967 net purchases are from Board of Governors, Federal Reserve System; "Flow-of-Funds" January 31, 1968, Page 16. 1968 Estimate is SB & H projection.

EXHIBIT 3

NET FUNDS INVESTED IN CORPORATE AND FOREIGN BONDS BY INVESTOR GROUP ARRANGED BY TAX BRACKET

	Net Volume of Purchases of Corporate & Foreign Bonds ($ Billions) Total: 1966, 1967 & 1968		Per Cent Contribution
ZERO TAX BRACKET			
State & Local Governments	18.1		
Private Pension Funds	4.4		
Total in Zero Tax Bracket		22.5	56
1-20% TAX BRACKET			
Mutual Savings Banks	2.5		
Life Insurance Companies	9.1		
Total 1-20% Tax Bracket		11.6	29
21-50% TAX BRACKET			
Other Insurance Companies	1.3		
Commercial Banks	0.9		
Other Finance	0.1		
Households	2.1		
Rest of World	2.0		
Total 21-50% Tax Bracket		6.4	16
GRAND TOTAL		40.5	100

Average Tax Bracket: 13.4%

EXHIBIT 4

NOTES ON THE URBAN INSTITUTE MUNICIPAL MARKET EXPANSION PROPOSALS.

Briefly stated, the Urban Institute plans to seek to expand the supply of funds available to municipal borrowers by opening up State and local savings to support that sector's investment programs. To do this, the proposals circumvent the obstacle of tax-exemption that makes these investments now unprofitable for state and local pension funds by paying them a subsidy to neutralize the pre-tax yield differential between taxable and nontaxable securities. In the case of the Unemployment Trust Fund, it is proposed that State and local securities be made legal investments and also that this fund be paid a subsidy. These subsidies should be largely self-supporting since the taxable security incomes given up by these non taxpaying investors will be held by taxpaying investors. That is, the diminished supply of tax-exempts to taxpaying investors will channel their holdings into taxable investments and the tax revenues from these would approximate the subsidy required to induce the State and local pension funds to hold tax-exempts.

Altogether, the State and local funds could supply from $4 to $8 billion a year to the municipal bond new issue market. Moreover, these inflows would be largest in times of stringent monetary conditions when municipal yields soar above their traditional relationship to those on taxable instruments. The cost of such a subsidy scheme would be, for $4 billion in State and local securities with 5 percent coupons, $80 million dollars with a 40 per cent coupon subsidy. This compares to the $7.5 billion that the Federal government dispenses in grants to State and local facilities alone.

Some specific notes on the proposals:

1. The UI proposals do no violence to the principle of tax-exemption. They rather expand the supply of funds in such a way as (1) to increase the efficiency of tax-exemption qua-subsidy to State and local borrowers and (2) to reduce the extent of tax shelter available to high income-tax bracket investors.

2. Communities and states would continue to issue bonds in the same manner. Underwriting would still be in the hands of private investment bankers. The Federal government or any agency of it would have no interest in a control over the amount or timing or nature of any state and local borrowing. The market mechanism would remain the same in all mechanical details.

3. But a new investor group, that of the State and Local Pension Funds, would now be purchasing State and local bond issues. For example, if the subsidy rate were 40 per cent, pension funds would acquire municipals on the basis of a 40 per cent markup on coupon yields to be covered by a Federal government subsidy. Thus, if municipal bonds were selling at 6 per cent, a pension fund buying this bond

Attachment 1 to testimony of Louie Welch, Mayor
City of Houston, Texas

would receive a post-subsidy yield of 8.40 per cent. Today, that would be above the yield available on the highest grade corporate issue.

4. The pension fund would recive the subsidy routinely on the presentation of a copy of the coupon to the Treasury. Although there might need to be some provisions to protect the Treasury against intra-governmental transactions and to insure "arms length" tranactions, there would be no restriction as to the nature or maturity or purpose of the municipal bond. The buying decision is left strictly up to the pension fund.

5. State and local pension funds are growing at a rate of about 10 per cent or $4 billion a year. Their total assets are $45 billion, the majority of which are invested in corporate bonds. Given that the average investment life of their fixed income securities (93 per cent of the total) is 10 years, they have a rollover of $4 billion as well as net new funds of $4 billion to invest each year. If roughly one half (or $4 billion) of this were to be invested in State and local securities, it would be sufficient to absorb about 40 per cent of the $10 billion annual net increase in State and local securities. A 40 per cent expansion in net available funds would not only allow for more borrowing but would lower the cost of the borrowing done. And the market would be greatly stabilized. Addition of just the net growth in the Unemployment Trust Fund would add another $1.0 billion of support to the market. The selection process of which bond to buy for the Federally administered fund could be solved by tying their purchases to Federally guaranteed tax-exempt notes and bonds such as those emitted by HAA and UAA.

6. How does the subsidy pay for itself? The subsidy pays for itself by (1) keeping tax-paying investors from holding tax-exempt securities, and (2) keeping non taxpaying investors from holding taxable securities. Of course, this rearrangement is not brought about by fiat or purposeful exclusion, but is an outcome of removing the barrier which tax-exemption forms to the investment flow of certain non-taxpaying institutions - in this case, the State and local pension funds - into the tax-exempt market.

   While the final outcome is a complicated thing, the essential idea can be expressed as follows: Given a fixed supply of tax-exempt bonds and investor resources, the pension funds would absorb part of the supply of tax-exempt bonds. High taxable income investors, that now demand a high discount to hold municipals, would acquire taxable investments instead. (A simple way of looking at it is that they would purchase the corporate bonds that otherwise would have been held by the pension funds.) Taxable investors would pay taxes where now taxes are avoided -- both by their holding of tax-exempts

and by the pension funds holding potentially taxable securities. These taxes would probably cover most if not all of the subsidy since the average marginal rate on tax-exempt investors is approximately 40 per cent.

There are other costs and savings to consider. Federal government borrowing costs might go up somewhat, but is is primarily a short-term market and State and local pension funds make only a small contribution in support. On the other hand - and this is very important - the broadened municipal market would be able to absorb a greater volume of financing and at a lower cost. This type of support would cheapen the borrowing of governments, especially in times of tightness when the taxable to non-taxable yield ratio drops off precipitously.

THE URBAN INSTITUTE
2100 M STREET, N.W.
WASHINGTON, D. C. 20037

A PROPOSAL TO ALLOW THE UNEMPLOYMENT TRUST FUND TO INVEST IN STATE AND LOCAL SECURITIES

Over the past 12 years, the total volume of state and local obligations outstanding has grown by over 250% (Table 1). Yet, despite the substantial growth in this source of financing capital outlays, our society has not been able to keep pace with the increasing needs for educational facilities, sewage disposal plants, hospitals, and the like so as to maintain, let alone improve, the quality of public services in these areas. Therefore, we may reasonably expect the demand for capital funds to continue to grow at least as rapidly over the next decade, and the question arises: Who will be the lenders of these funds?

To provide a perspective, Table 2 presents the stocks of state and local securities held by various institutions for the years 1960 and 1965-68 as well as the percentage distributions in those years. Several facts emerge from this table. First, over the 8-year period, commercial banks have become the mainstay of the state and local securities market and have increased their holdings of the total stock from 26% in 1960 to 45% in 1968. (As will be seen below, this proportion is projected to rise to over 50% in 1975.) This development has been accompanied by a decline in the proportion of municipals held by households, which in 1960 were the most important suppliers of funds to states and localities. Fire and casualty insurance companies classified in Table 2 as "other insurance" are the other major lenders to state and local governments. State and local government holdings of their own securities through pension funds have fallen both relatively and absolutely since 1960. The expanding role of commercial banks in the municipal market may be demonstrated by the fact that 68% of the change in stocks from 1960 to 1968 were absorbed by these institutions.

The dependence of municipalities upon commercial banks as a source of funds has at least two consequences. On the one hand, the considerable resources of commercial banks are increasingly available for financing much needed capital facilities in our urban areas. On the other hand, when financial markets tighten, commercial bank resources become severely squeezed, forcing states and municipalities either to look elsewhere for funds (usually to individual investors) at considerably higher interest rates or to revise their borrowing plans. Thus, commercial banks, while at times quite a large source of financing, are also an exceedingly volatile source. It is not coincidental that 1966 was both a year during which the net increase of municipals fell by about 20% relative to 1965, and also a year during which commercial banks absorbed only 40% of the net increase. We should be quite concerned, then, about the near-term outlook for the municipal market in view

Table 1

STATE AND LOCAL SECURITIES OUTSTANDING
(billions of dollars)

End of Year	Stock Outstanding
1956	49.4
1960	68.7
1965	101.2
1966	107.2
1967	117.3
1968	128.5

Page 2
Attachment 2 to testimony of Louie Welch, Mayor
City of Houston, Texas

Table 2

HOLDERS OF STATE AND LOCAL SECURITIES
(in billions of dollars)
AND PERCENTAGE DISTRIBUTIONS

	1960		1965		1966		1967		1968	
		%		%		%		%		%
Total	68.7	100.0	101.2	100.0	107.2	100.0	117.3	100.0	128.5	100.0
State and Local Governments	7.2	10.5	4.8	4.8	4.5	4.2	4.0	3.4	3.6	2.8
Other	61.5	89.5	96.4	95.2	102.7	95.8	113.3	96.6	124.8	97.1
Households	28.7	41.8	38.4	37.9	40.6	37.9	40.6	34.6	42.0	32.7
Corporate Business	2.4	3.5	3.6	3.6	4.4	4.1	5.1	4.3	5.2	4.0
Commercial Banks	17.6	25.6	38.6	38.1	41.0	38.2	50.0	42.6	58.1	45.2
Mutual Savings Banks	.7	1.0	.3	.3	.3	.3	.3	.3	.4	.3
Life Insurance	3.6	5.2	3.5	3.5	3.1	2.9	2.9	2.5	3.0	2.3
Other Insurance	8.1	11.8	11.3	11.2	12.7	11.8	13.7	11.7	15.6	12.1
Other Institutions	.4	.6	.5	.5	.5	.5	.6	.5	.6	.5

of the preliminary data for the first quarter of 1969 which shows commercial banks adding municipals to their portfolios at an annual rate of only $1.5 billion after averaging $8.5 billion the previous two years.

In terms of the longer-term prospects, unpublished financial forecasts at the Federal Reserve Board assume that commercial banks will be in a position to continue to absorb the bulk of future state and local borrowings. Table 3, which is based on these forecasts, shows estimated holdings of the stocks of municipals and the percentage distributions for the years 1970 and 1975. The 1975 estimates of total stocks are quite close to those of Diamond in State and Local Public Facility Needs and Financing (U.S. Congress, Joint Economic Committee, 89th Cong., 2nd Sess., December 1966, p. 50). It should be noted that this is an equilibrium projection in the sense that the stocks represent a balancing of demands for and supplies of funds. The public facility needs of state and local governments are not projected to be completely satisfied in this projection. Rather, the estimates represent what may be reasonably borrowed, given present institutions. Inasmuch as the 70% growth in the outstanding stock over the 8-year period 1961-1968 failed to raise the quality of public services, it is unlikely that a 63% increase from 1968-1975 will do much more. Hence, it is desirable to broaden the market for state and local securities from two points of view:

(1) to develop new sources of financing beyond what present financial institutions can provide so as to allow a faster growth in the rate of public facility construction;

(2) to move away from the present heavy reliance on commercial bank resources which display a high volatility in response to changes in financial market conditions.

One possible source of additional financing has already been referred to -- state and local pension funds -- and they will be the subject of a later memorandum. Suffice it to say that the tax-exemption feature is of no value whatever to the pension funds, and the lower returns which result are the major reason for their declining role in the municipal market.

Our interest in this memorandum is in the federal trust funds of the original Social Security legislation, and specifically the Unemployment Trust Fund, which recommends itself as a possible source of state and local government financing on several grounds.

(1) The Unemployment Trust Fund (UTF) holds primarily the states' own funds. The federal government is merely the trustee on behalf of the beneficiaries within the individual states. Over the period fiscal 1960-68, 76% of the total receipts of the UTF (net of interest and profits on investments) consisted of deposits by the states. Therefore, the case can reasonably be made that what are essentially the state funds should be used for purchasing their own obligations.

Table 3

ESTIMATES OF STATE AND LOCAL GOVERNMENT SECURITY HOLDINGS

	1970		1975	
		%		%
Total	146.9	100.0	209.3	100.0
State and Local Governments	3.1	2.1	2.3	1.1
Other	143.8	97.9	207.0	98.9
Households	44.7	30.4	59.9	28.6
Corporate Business	6.6	4.5	11.5	5.5
Commercial Banks	70.7	48.1	106.4	50.8
Mutual Savings Banks	.1	.1	.3	.1
Life Insurance	2.8	1.9	2.0	1.0
Other Insurance	18.0	12.2	25.4	12.1
Other Financial Institutions	.8	.5	1.4	.7

Page 5
Attachment 2 to testimony of Louie Welch, Mayor
City of Houston, Texas

33-758 O - 69 -- No. 9 -- 12

(2) The UTF represents a large and growing source of investible funds. At the end of calendar 1968, its portfolio was over $12 billion and, if invested in state and local securities, it would have just equalled the combined holdings of state and local pension funds, business corporations, life insurance companies, and mutual savings banks. Furthermore, this portfolio has doubled from fiscal 1961-68 and may be expected to continue to grow.

(3) The rate of return on state and local obligations is not greatly different from that currently earned in the UTF portfolio. At the end of 1968, 78% of the UTF portfolio was invested in special issues at the average interest rate of 4.397%. These special issues are non-negotiable obligations of the U.S. Treasury which are required to yield a return to the fund equal to the current average rate of interest on all interest-bearing securities of the United States (rounded to the nearest .125%).

Table 4 shows, for six-month intervals over the period 1960-68, the rate of return on the U.S. interest-bearing debt and the state and local rate as given by the Bond Buyer 20-bond index. The average divergence in rates over the period was only 6 basis points, and the maximum was 52 basis points in December 1964. In the last few years, the state and local rate has exceeded the rate on the debt and, in fact, as interest rates in general rise over time, the average rate on the debt tends to lag behind other market rates. Thus, investing in state and local securities rather than special issues will not significantly affect the return on the UTF portfolio.

We should not ignore the issues that are likely to arise in connection with a proposal to allow the UTF to invest its portfolio in state and local securities:

(1) The legal provisions governing the UTF's investments must be changed to make municipal securities eligible. Although the eligibility question has been a subject of some controversy (see Temporary Income in Debt Ceiling, Hearings, U.S. Congress, House of Representatives, Committee on Ways and Means, 90th Cong., 1st Sess., January 1967, pp. 31ff.), eligible investments are currently defined as direct obligations of the United States or securities which are guaranteed by the United States as to principal and interest. We would recommend a broadening of these provisions to include state and local obligations explicitly.

(2) Given the volume of municipal securities issued each year -- $10-$11 billion in recent years -- the UTF would face a decision as to which particular municipal securities to purchase. There are two ways out of this situation. First, if the proposal of this memorandum were adopted in connection with the pending URBANK proposal, the UTF could purchase URBANK obligations and pass the selection problem on to the bank. Secondly, and this would also satisfy the logic of the present eligibility requirements, the UTF could purchase PHA and URA securities which are now guaranteed by the federal government. The gross issues of these securities in 1968 were $5.4 billion. Also with the new federal guaranteed programs in the areas

of college housing and water pollution, this type of security is likely to show substantial growth. Furthermore, if liquidity is still a consideration in the investment decisions of the UTF, there is available for purchase an outstanding stock of 6-month to one-year PHA and URA notes of $3.9 billion. It should be noted, however, that the guaranteed obligations are likely to carry yields somewhat below the Bond Buyer series of Table 4, perhaps by 25 basis points or more.

(3) This proposal is likely to have some impact on the present interest rate structure. Assuming in the first instance that the total volume of securities held by the public is unchanged, this proposal will result in more Treasury securities and fewer municipals in individual and institutional portfolios. This change in relative supplies would cause Government rates to rise somewhat and municipal rates to fall. The major impact on the Treasury, however, will result from the fact that the greater quantity of Governments held by the public (rather than the UTF) will be at market rates and not at the substantially lower special issue rates. Furthermore, if we drop our original assumption of no change in the volume of securities held by the public in favor of the more likely and desirable occurrance of some significant increase in municipal issues under this proposal, then the general level of interest rates will be forced up somewhat for all borrowers.

Table 4

RATES OF RETURN ON THE INTEREST-BEARING DEBT AND STATE AND LOCAL SECURITIES

Period	Interest Rate on Debt	State and Local Rate
June 1960	3.30	3.52
December 1960	3.14	3.39
June 1961	3.07	3.54
December 1961	3.14	3.37
June 1962	3.24	3.24
December 1962	3.30	3.05
June 1963	3.36	3.22
December 1963	3.49	3.26
June 1964	3.56	3.20
December 1964	3.59	3.07
June 1965	3.68	3.30
December 1965	3.76	3.53
June 1966	3.99	3.90
December 1966	4.22	3.76
June 1967	4.04	4.07
December 1967	4.29	4.38
June 1968	4.50	4.48
December 1968	4.63	4.85

Page 8
Attachment 2 to testimony of Louie Welch, Mayor
City of Houston, Texas

THE URBAN INSTITUTE
2100 M STREET, N.W.
WASHINGTON, D. C. 20037

SUBSIDY PROPOSAL TO INDUCE STATE AND LOCAL RETIREMENT FUNDS TO INVEST IN STATE AND LOCAL SECURITIES

In our other memorandum on the Unemployment Trust Fund, we demonstrated the need for broadening the market for state and local securities in order to finance the large and growing demands for public facilities. Under present arrangements, the character of this market is determined by the tax-exempt status of municipal securities. Participants in the market are confined to those individuals and institutions for which the tax exemption privilege represents an economic gain relative to taxable securities. Thus, high-income individuals, fire and casualty insurance companies, and especially commercial banks constitute the principal lenders, and by year-end 1968, they together held 90 percent of the total stock of municipal securities outstanding. This situation affects the municipal market adversely in two respects. First, the market is unnecessarily narrow, and secondly, municipal borrowers, as residual claimants on commercial bank resources, and extremely vulnerable to changes in both monetary policy and business demands for funds.

It is against this backdrop that a series of proposals have been put forth which are designed to open up new sources of capital funds to state and local governments -- proposals such as the Patman-Proxmire subsidy plan, URBANK, and the like. Our approach to the problems of municipal financing is of a somewhat less general nature and is based on the premise that, as a minimum, state and local own funds should become available to the state and local security market. This consideration led to our earlier recommendation that the state reserves in the unemployment trust fund be authorized to purchase municipal securities. In this present memorandum, the state and local retirement funds (SLRF's) will be examined.

In both cases, the issue of the determinants of the portfolio investment decision is paramount. Inasmuch as the returns on municipal securities are below those on taxable securities, institutions which are not subject to taxation themselves derive no benefit from the tax exemption feature of municipals. In the case of the unemployment trust fund, the rate of return on U. S. Treasury special issues, which compose the bulk of the portfolio, is sufficiently low that little or no net loss to the trust fund would result from investment

Page 1
Attachment 3 to testimony of Louie Welch, Mayor
City of Houston, Texas

in state and local securities. In the case of the SLRF's this is not the case. Some form of subsidy is, therefore, required to induce these retirement funds to acquire securities of state or local governments.

The dimensions of this potential source of demand for municipal issues are shown in Table 1. In June, 1968, the latest date for which these data are available, total asset holdings of SLRF's were $44.5 billion. Of this total, $38.0 billion (85 percent) was composed of U. S. Government securities, corporate bonds, and mortgages. Although corporate stock holdings are growing both ablsolutely and relatively, fixed interest market securities are clearly the major assets of these funds.

The rate of growth of the SLRF's has been substantial. Their portfolios have doubled since 1961 and have increased almost sevenfold since 1952. In recent years, the increment to their asset holdings have amounted to about $4.5 billion per year and have been increasing. Thus, the SLRF's seem ideally suited as a potential source of investment in public facility financing.

Moreover, these funds historically have held state and local securities, and through the late 1950's municipals consisted of over 25 percent of their total asset holdings. Since then, a combination of more flexible investment regulations and the desire of SLRF managers for higher yields has led to the declining position of municipals in SLRF portfolios. By June 1968, only 5.3 percent of total asset holdings consisted of state and local securities.

Table 2 demonstrates the extent to which an increase in earnings has paralleled the decline in state and local security holdings of the SLRF's. Since 1959 when the proportion of municipal security holdings fell below 25 percent of the total portfolio, the increment in portfolio earnings as a percentage of the increment in portfolio size has almost always been above 4.5 percent.

There is an obvious lack of economic incentive for the SLRF's to invest in municipal issues. The remainder of this memorandum is devoted to the persentation of a subsidy device which would provide this incentive.

A subsidy mechanism ideally should possess the following characteristics:

1) It should provide a clear incentive for SLRF's to invest in municipal securities as opposed to their present asset holdings.

2) It should be simple to administer and free from federal regulation and control.

3) It should be relatively inexpensive in terms of cost to the U. S. Treasury.

The subsidy plan which we are proposing satisfies these criteria.

Table 1

STATE AND LOCAL PENSION FUND ASSET HOLDINGS, YEAR END

(Billions of Dollars)

	1952		1957		1960		1963		1964		1965		1966		1967		1968-a/	
	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Total asset holdings	6.9	100.0	13.7	100.0	19.7	100.0	27.2	100.0	30.2	100.0	33.5	100.0	37.2	100.0	41.9	100.0	44.5	100.0
U.S. government securities	3.4	49.4	5.2	37.7	5.9	30.0	6.9	25.2	7.4	24.6	7.8	23.3	8.0	21.5	8.2	19.5	8.6	19.2
State-local securities	1.9	27.4	3.5	25.9	4.4	22.4	3.3	12.1	2.9	9.6	2.6	7.8	2.5	6.7	2.4	5.7	2.4	5.3
Corporate bonds	.9	13.3	3.8	27.9	6.7	34.1	12.3	45.2	14.2	47.0	16.3	48.7	18.9	50.8	22.3	53.2	24.3	54.5
Corporate stock	.1	.8	.2	1.5	.4	2.2	1.0	3.6	1.3	4.2	1.6	4.8	2.1	5.7	2.8	6.6	3.1	7.1
Mortgages	.1	2.1	.5	3.9	1.4	7.4	2.6	9.6	3.1	10.2	3.7	11.2	4.5	12.2	5.0	11.9	5.2	11.6
Other	.5	7.1	.4	3.0	.8	3.9	1.2	4.3	1.3	4.5	1.4	4.1	1.2	3.1	1.2	3.0	1.0	2.2

a/ As of June, 1968

Source: Federal Reserve Board

Page 3

Attachment 3 to testimony of Louie Welch, Mayor
City of Houston, Texas

Table 2

INCREMENT IN PORTFOLIO EARNINGS AS A PERCENTAGE
OF THE INCREMENT IN PORTFOLIO SIZE

Year a/	Percent
1954	2.68
1955	3.19
1956	2.85
1957	3.27
1958	3.49
1959	4.54
1960	4.61
1961	4.96
1962	4.55
1963	4.67
1964	4.24
1965	4.76
1966	4.45
1967	4.89
1968	5.16

a/ From 1953-1963 - calendar years;
From 1964-1968 - fiscal years

Source: Bureau of the Census

Page 4
Attachment 3 to testimony of Louie Welch, Mayor
City of Houston, Texas

It is similar to suggestions that have been put forth for subsidizing the entire municipal market although we are applying it here only to SLRF's (and also to the unemployment trust fund as will be considered later). Our proposal is that a subsidy be given to holdings of municipal securities by SLRF's on all such securities -- general obligation bonds, revenue bonds, and short-term notes -- issued after a predetermined date. The subsidy would be a fixed percentage of the coupon rate on the municipal securities issued after that date and would be paid by the U. S. Treasury upon receipt from the state and local retirement funds of a copy of the coupon. As a precaution against misuse of this subsidy, the individual state and local governments would certify to the Treasury that their respective retirement funds are bona fide institutions established for the purpose of providing retirement benefits to their employees. The Treasury would maintain a list of such certified funds. Under this plan, administrative work would be kept to a minimum. The subsidy would be paid automatically and would require no federal supervision.

To make the plan operational, decisions must be made concerning (1) the issuance date after which municipal securities acquired by the SLRF's would be eligible for the subsidy and (2) the amount of the subsidy as a percentage of the state and local interest rate.

To aid in this latter determination, Table 3 has been prepared. This table presents quarterly data on the municipal rate, the U. S. long term rate, and the corporate rate from 1960 to mid 1969 along with the ratios of the two other rates to the municipal rate. The table indicates that for much of the period, a subsidy equal to 25 percent of the municipal rate would be a sufficient incentive to retirement funds to acquire municipal as opposed to long term government securities, and a subsidy of 50 percent of the municipal rate would induce retirment funds to prefer municipals to corporate issues as well. Therefore, in this memorandum, we shall examine the consequences of four alternative subsidy percentages between these ranges -- 25 percent, 33 1/3 percent, 40 percent, and 50 percent of the state and local rate. The higher the subsidy, of course, the greater the incentive to acquire municipal securities.

The cost to the Treasury will also vary with the subsidy percentage. This subsidy cost is a product of the percentage subsidy, the municipal interest rate, and the dollar volume of municipal securities acquired by the SLRF's. If S = the subsidy cost, s = the percentage of the municipal rate subsidized, r_m = the municipal rate, and D = the dollar volume of securities held, $S = s\, r_m\, D$.

The net cost to the Treasury is less than this subsidy outlay, however, since taxable securities that would otherwise be acquired by the SLRF's will, for the most part, now find a taxable investor and will, therefore, generate tax receipts for the Treasury. These receipts will be a product of the marginal income tax rate of the new holders of these securities, the interest rate on these securities, and the dollar volume involved. If R = tax recipts, t =

Table 3

QUARTERLY INTEREST RATES

		(1) Municipal Rate[1]	(2) U. S. Long Term Rate[2]	(3) Corporate Rate[3]	(4) U.S. Rate/ Municipal Rate (2)/(1)	(5) Corporate Rate/ Municipal Rate (3)/(1)
1960	I	3.65	4.22	4.87	1.1562	1.3342
	II	3.43	4.11	4.78	1.1983	1.3936
	III	3.58	3.83	4.64	1.0698	1.2961
	IV	3.44	3.91	4.64	1.1366	1.3488
1961	I	3.39	3.83	4.59	1.1298	1.3540
	II	3.47	3.80	4.59	1.0951	1.3228
	III	3.51	3.97	4.72	1.1311	1.3447
	IV	3.43	4.01	4.71	1.1691	1.3732
1962	I	3.22	4.06	4.69	1.2609	1.4565
	II	3.14	3.89	4.60	1.2389	1.4650
	III	3.21	3.98	4.63	1.2399	1.4424
	IV	3.06	3.88	4.55	1.2680	1.4869
1963	I	3.10	3.91	4.48	1.2613	1.4452
	II	3.15	3.98	4.47	1.2635	1.4190
	III	3.16	4.01	4.50	1.2690	1.4241
	IV	3.27	4.11	4.54	1.2569	1.3884
1964	I	3.22	4.16	4.56	1.2919	1.4161
	II	3.23	4.16	4.59	1.2879	1.4211
	III	3.20	4.14	4.57	1.2938	1.4281
	IV	3.18	4.14	4.58	1.3019	1.4403
1965	I	3.12	4.15	4.56	1.3301	1.4615
	II	3.19	4.14	4.58	1.2978	1.4357
	III	3.30	4.20	4.66	1.2727	1.4121
	IV	3.47	4.35	4.77	1.2536	1.3746
1966	I	3.64	4.56	4.98	1.2527	1.3681
	II	3.71	4.58	5.21	1.2345	1.4043
	III	4.06	4.78	5.52	1.1773	1.3596
	IV	3.88	4.70	5.67	1.2113	1.4613
1967	I	3.55	4.44	5.43	1.2507	1.5296
	II	3.85	4.71	5.58	1.2234	1.4494
	III	4.05	4.93	5.92	1.2173	1.4617
	IV	4.34	5.33	6.34	1.2281	1.4608
1968	I	4.33	5.24	6.42	1.2102	1.4827
	II	4.45	5.30	6.59	1.1910	1.4809
	III	4.32	5.07	6.43	1.1736	1.4884
	IV	4.64	5.42	6.60	1.1681	1.4224
1969	I	5.07	5.88	6.98	1.1598	1.3767
	II	5.43	5.92	7.18	1.0902	1.3223
Averages 1960-1969 II					1.2124	1.4138

[1] Bond Buyer 20-Bond Index

[2] Federal Reserve Bulletin, various issues

[3] Moody's Investors Services; includes all classes of bond ratings

Page 6 - Attachment 3 to testimony of Louie Welch, Mayor, City of Houston, Texas

the marginal income tax rate of the new holders, r_o = the interest rate on these securities, and D = the dollar volume,

$R = t\ r_o\ D.$

The net cost (NC) to the Treasury is $S - R = s\ r_m\ D - t\ r_o\ D.$

$NC = D(s\ r_m - t\ r_o) = D\ [s - t\ (r_o/r_m)].$

Thus, the net cost varies directly with the dollar volume, D, and the subsidy percentage, s, and inversely with the marginal tax rate of the new holders, t, and the ratio of the rates on the securities sold by the SLRF's to the municipal rate, (r_o/r_m).

For the Treasury to break even under this plan, S = R, or $s\ r_m\ D = t\ r_o\ D$, or $t = s/(r_o/r_m)$.

Thus, the higher the subsidy percentage and lower the ratio of the alternative interest rates to the municipal rate, the higher the marginal tax rate required for the subsidy to yield no net loss to the Treasury.

This information is summarized in Table 4. The left hand column lists the four alternative subsidies as a percentage of the municipal rate. The top row presents five r_o/r_m ratios which may be compared with those calculated in Table 3 for the U. S. long term rate and the corporate rate. Moving along a row for a given subsidy percentage, we see that the higher the r_o/r_m ratio, the lower the break-even tax rate. Similarly, for a given interest rate ratio, the higher the subsidy percentage, the higher the break-even tax rate.

The entries in the table marked with an asterisk are those combinations of subsidy and interest rate which would put the portfolio manager on the margin of indifference between acquiring the subsidized municipal securities and buying alternative assets such as corporate or Treasury bonds. Thus, if the subsidy is 40 percent of the municipal rate, retirement fund managers would be indifferent between buying municipals and another asset yielding 1.4 times as much as the current municipal rate. For this reason, all space to the right of the entries marked with an asterisk are left blank since they represent combinations that would be unattractive to the retirment funds. A subsidy of 40 percent of the municipal rate, for example, will not induce the retirement fund investors to buy state and local securities if rates on alternative forms of investment are 50 percent above the municipal rate.

As Table 3 indicates, from 1960 mid-1969 Treasury long term rates, on average, were approximately 20 percent above the municipal rate, and corporate rates were about 40 percent above the municipal rate. If a subsidy of 40 percent were put into effect, then a marginal tax rate of 33 1/3 percent would be required from the new holders of Treasury long term securities and 28.6 percent from the new holders of corporates for the Treasury to break even. Since the insurance companies, that are the largest holders of corporate bonds, and the commercial banks and other financial institutions, that are the main holders of U. S. securities, pay tax rates above those levels, a 40 percent subsidy would not involve much if any net cost to the Treasury.

Table 4

BREAK-EVEN MARGINAL TAX RATES, t (in percent)

Subsidy as % of municipal rate (r_m) \ Alternative interest rate/municipal rate (r_o/r_m) ratios	1.1	1.25	1.33	1.4	1.5
25%	22.73	20.00*	--	--	--
33-1/3%	30.30	26.67	25.00*	--	--
40%	36.36	32.00	30.00	28.57*	--
50%	45.45	40.00	37.50	35.71	33.33*

* Subsidy puts investor on margin of indifference between acquiring subsidized municipal securities and acquiring alternative asset.

Page 8
Attachment 3 to testimony of Louie Welch, Mayor
City of Houston, Texas

Therefore, we would make the following recommendation as a minimum position:

1) A subsidy of 40 percent of the municipal coupon rate should be paid to state and local retirement funds on their holdings of such state and local securities issued after a specified date, e.g., January 1, 1970.

2) This subsidy would be paid automatically by the U. S. Treasury to public retirement funds established and managed by public officials upon receipt from them of a copy of their coupons.

In this way, SLRF reserves could be made available to state and local governments for the financing of needed public facilities. As in the case of the unemployment trust fund proposal, benefits will accrue to the state and local governments in three important respects:

1) To the extent that credit availability limits municipal borrowing, opening up an additional source of funds can ease this constraint somewhat.

2) As a stable and growing source of funds, SLRF's can partially insulate state and local governments from the effects of changes in the available resources of commercial banks.

3) Municipal rates may be expected to decline to some degree. This would occur because a smaller volume of municipal securities would have to be held by individual investors to absorb the total supply, and the municipal rate would no longer have to induce individuals in lower tax brackets to enter the market.

Several additional points should be made concerning the above analysis. First, the calculations of Table 3 on the ratios of municipal interest rates to the rates on alternative assets are only suggestive and do not reflect the relative returns on a specific municipal security as compared to a specific corporate or Treasury issue. The subsidy we have proposed would apply to all categories of state and local securities--short-term notes and revenue bonds as well as general obligations--and SLRF asset holdings also include a variety of Treasury and corporate obligations. Hence, after the subsidy had been put into effect, SLRF managers would still have to make portfolio decisions among competing assets to achieve their investment objectives.

Secondly, in addition to the gross subsidy cost (which as mentioned may be completely offset by additional tax receipts) the Treasury may incur somewhat higher interest cost to the extent that the subsidy succeeds in causing SLRF's to acquire municipal rather than federal government securities. A higher interest rate on governments would then be required to induce other investors to hold more of these issues.

On the other hand, this proposal could go some way towards achieving another Treasury objective, that of distributing more equitably the income tax burden. By reducing the volume of tax-exempt securities in the hands of the taxable public, this proposal would narrow this avenue of tax avoidance.

In terms of the administration of this subsidy plan, it may be desirable to restrict the subsidy to SLRF holdings of securities issued by governments other than their own. Enforcing an arm's length transaction in this manner would avoid conflicts which may arise between the state or local government and its employee retirement system and would allow portfolio managers to make investment decisions solely on the basis of liquidity, yield, and other objectives.

One final matter remains for consideration. In the earlier memorandum on the unemployment trust fund (UTF) the point was made that the return on the trust fund portfolio was sufficiently low that trust fund investment in the tax-exempt state and local securities would not impair its earning position. It is, none-theless, still true that investment of UTF reserves in municipal securities would not carry out the trust type obligation of the Treasury to the states whose funds are held in the UTF. Higher yielding market instruments consistent with the liquidity re-quirements of the UTF would appear more appropriate. Thus, in terms of the responsibility of the Treasury to the state, we would recommend consideration of a subsidy on state and local securities acquired, and that the plan outlined above be applied to UTF inv-estments in municipal obligations.

The resluts of such a program would be the following:

1) The Treasury would not be able to borrow from the UTF at below market rates and would borrow more from the general public instead.

2) A smaller volume of state and local securities would be available to the public.

3) The UTF would hold the state and local(subsidized) securities rather then the special Treasury issues.

The subsidy would involve some net cost to the Treasury. The increased tax receipts resulting from the public holdings of governments rather than tax-exempt municipals will not cover both the higher rates that the Treasury must pay for its own borrowing and subsidy on UTF holdings of municipals. But this situation results only from the fact that the states through the UTF have historically been subsidizing the Treasury. There appears little justification for continuing this practice.

SUMMARY OF PRINCIPAL POINTS of Statement of Mayor Ilus W. Davis, Kansas City, Missouri, to the Finance Committee, U.S. Senate, Washington, D.C., September 23, 1969

1. I appear in opposition to the levying of a tax on income of municipal bonds on behalf of the City Council and the Board of Directors of Missouri Municipal League.

2. In hour of greatest financial need, this legislation could destroy ability of local government to finance capital programs.

3. This proposed legislation has now almost destroyed the municipal bond market. If municipal bond interest becomes taxable, there must be a complete reappraisal of these bonds as an instrument of financing.

4. The cost of debt financing for city government would exceed the cost of debt financing of private corporations, municipal interest costs would increase roughly 2 to 2-1/2% resulting in 6 - 8% increase in real estate taxes and about 10% increase in water and sewer rates.

5. Instead of putting taxation on the rich (an appealing but unrealistic political basis), it would substantially increase taxes and water and sewer rates of the poor and the rich.

6. The proposed federal subsidy of a portion of interest costs provides opportunity for Federal Government to exercise control over amount, purpose, and type of debt issued by local government.

7. The subsidy would provide division of responsibility for payment of interest on these bonds creating much additional expense in administration.

8. The Federal Government has in recent months pursued policy of decentralization. This legislation flies in the face of such a policy.

9. This legislation levies taxes on income of local government bonds at substantial cost to those governments but is silent about letting local government levy real estate taxes on facilities of Federal Government to meet local financial burdens.

10. This proposed legislation would be immediately challenged in the Courts constitutionally and on basis of case law now existing. This would take time, thus further contributing to the state of limbo in the municipal bond market.

11. At peak of urban crisis, the Federal Government proposes to step in and completely disrupt capacity for local government to undertake capital financing.

STATEMENT OF MAYOR ILUS W. DAVIS, KANSAS CITY, MO.
TO THE FINANCE COMMITTEE, U.S. SENATE
WASHINGTON, D.C. SEPTEMBER 23, 1969

Gentlemen:

I appear here today as Mayor of Kansas City, Missouri and as President of the Missouri Municipal League. I have been authorized to appear here on behalf of the City of Kansas City by the City Council, and on behalf of the Missouri Municipal League by the Board of Directors of that organization. I am here to register a strong protest to any effort by the Congress of the United States to levy a tax on the income of municipal bonds.

At a time when local government is confronted with its hour of greatest financial need to provide not only essential public services but capital needs for various essential areas of local government responsibility, we are confronted with this proposed legislation, which in our opinion could destroy our ability to proceed with and plan any bond financed capital programs. The people of our areas are looking to local government for the development of streets, sewers and airports, the financing of urban renewal, development of pollution control facilities, as well as the construction of schools, hospitals, parks, water works and other basic facilities for expanding urban areas.

There is no doubt, as has been indicated by the bond market for the past several weeks, that due to the threat of taxation of municipal bonds, coupled with high interest rates, and the uncertainty which surrounds the purchase of those securities, the capital market for municipal facilities has almost been destroyed. If the interest from municipal bonds becomes taxable, there must be a complete reappraisal of the municipal bond as an instrument of financing by the market. There is little question that municipal bonds would then be competing directly with the vast requirements of private enterprise in its financing of corporate expansion. In view of the small size of most municipalities of this country, there is little question that the cost of debt financing for city government would exceed the cost of debt financing of private corporations. This is especially true when we are in the period of history where the cities are confronted with monumental social, economic and political problems. The best estimate we can get in this area is that municipal bonds of good quality would require roughly 2% more interest rate than is being paid now, which if extended over a period of time to include all debts of Kansas City, would bring about a real estate tax increase of six to eight percent to finance the additional interest cost. In the field of revenue bond financing, which is the basic means of financing water works and pollution control facilities, there would be little doubt the net interest increase would amount to about 2-½%. Over a period of time, if this increase were extended to the present debt of Kansas City for water and sewer facilities, the water and sewer rates of this City would need to be increased by 10% to accommodate additional interest costs. It is quite apparent that instead of putting the burden of taxation onto the rich (which is the appealing but unrealistic political basis for this change) the ultimate result would be that real estate taxes and water rates and sewer rates of the poor and rich alike would undergo a substantial increase.

We are aware that a proposal has been made to temper this result by giving a subsidy by the federal government for the additional interest costs which would result from the taxation of municipal bond interest. This proposal does not appear to be sound. We feel that if the federal government starts paying some substantial share of the interest on municipal debt that the next step would be for the federal government to exercise control over the issuance of that debt. History tells us that the man who pays the fiddler calls the tune, and certainly it should not be unexpected for

33-758 O - 69 -- No. 9 -- 13

the federal government to step in and attempt to exercise some control over the amount, the purpose, and the type of debt instrument that might be issued by local government if the federal government were paying part of the interest cost. In addition, there is a question as to what the financial market might think of a debt instrument which had an interest coupon that was payable by two governments. A division of responsibility for the payment of interest on a debt instrument could create much additional expense in the administration in the issuance of the debt instrument and could create market confusion concerning the value of that interest.

At a time when the federal government has announced publicly that it is going to pursue a policy of decentralization, as has been evidenced by its action in establishing regional centers in various areas; and at a time when the federal government has announced that it is going to rely more and more on our federal policies of separating responsibility for various areas of governmental action, it would appear that this proposal to bring all of the interest of local debt instruments into the purview of the federal government flies in the face of these policies. This country has enjoyed a long tradition of a division of labor and responsibility, as between the national government and local government. This tradition has led to well-defined areas of responsibility in the construction of capital facilities and has promoted well the financial markets in the sale of debt instruments. This proposed legislation would immediately place the federal government in a stance to exercise control over the issuance of any local debt instrument in the United States and would reduce the capacity of local government to meet its obligations in the construction of capital facilities.

It is with considerable irony that I note that while the federal government is ready to step in and levy taxes on the income of the debt instruments of local government and thereby increase substantially the cost of local government, that the national government has said nothing about letting local government levy real estate taxes on facilities of the federal government so that additional money could be raised to meet the additional financial burdens. If we are to abandon the principal of separation of responsibility in the field of taxation, I say that it should be done on both sides and that local government should be permitted to levy the ordinary real estate taxes on the market value of the federal government property that enjoys all of the services now provided by local government without making any contribution therefore. Indeed the Congress might well consider the net financial results of such a breakdown in the laws and traditions that now exist before it proceeds further with this proposal.

No one has questioned the fact that if such legislation, as is proposed, were to be adopted, it would be immediately challenged in the Courts on the basis of the Constitution and the case law that now exists on the books. Certainly, such litigation would take time to be considered and resolved, and in the meantime, there is no question but that the municipal bond market would be in a state of limbo due to the uncertainty of both the legal and the financial aspects of the taxation of municipal bond interest. This litigation would continue for many months at a period when there has never been a greater need for municipal and school facilities than there is today. It is incredible that local government work which is suffering from lack of understanding and operational support at the State level, should now find itself battered by the national government in the field of its capital financing, to the point where such financing is now almost impossible. Here at the peak of the urban crisis, when the major population centers of this country are seething with unrest, part of which can be attributed to a lack of facilities to meet the needs of the times, the Congress has stepped in with a proposal which has completely disrupted the capacity of local government to undertake capital financing. This lack of understanding by the national government on the practical functioning of local government at a time of crisis reflects no credit on this proposal. The continuation of discussions and hearings on this proposal will effect a moratorium on the construction of badly needed capital facilities by local government across this country. An immediate decision should be made to abandon the efforts to levy federal income taxes on the interest of local government debt instruments so that local government from coast-to-coast can continue to meet and carry out its obligations.

SENATE FINANCE COMMITTEE

Statement of
Austin J. Tobin, Executive Director,
The Port of New York Authority

September 23, 1969

SUMMARY OF PRINCIPAL POINTS

I. The Port of New York Authority could not have developed its complex of terminal and transportation facilities in the Port of New York, in which it has invested $2 billion, if its bonds had been subject to federal taxation. And the Authority's contribution to current and future transportation requirements would, because of punitive borrowing costs, be substantially curtailed if the House or Treasury proposals were enacted.

II. These proposals squarely present a fundamental constitutional issue, for their effectuation would permit ultimate federal control of the powers reserved to the States under the Constitution.

III. Capital expenditures throughout the nation for essential transportation services and facilities, which are developed and financed primarily by state and local government, would be sharply cut back as a result of these new tax proposals.

IV. Based on future annual issuances for transportation purposes equal to the $2.8 billion borrowed by state and local government in 1968, these proposals would generate additional costs which would total $3.8 billion after ten years.

V. The States of New York and New Jersey have committed themselves by referendum to issue $3.1 billion in bonds for transportation. Their additional interest costs would total $420 million. These costs must be passed on principally in the form of regressive property, sales and other taxes.

VI. Even with increased federal assistance, state and local government must spend some $10 billion for airport capital requirements over the next 10 years. These new tax proposals would generate additional interest costs of more than $1.3 billion.

VII. The construction of the vitally-needed $600 million fourth jet airport for the New York/New Jersey metropolitan area on a self-supporting basis would be critically jeopardized if additional financing costs were to be added to the obstacles already delaying it.

VIII. State and local government also must contribute $10 billion in capital funds for mass transit in the next decade. An additional $1.3 billion in borrowing costs would be incurred should any of the new proposals be effectuated.

IX. Even the threat of impaired tax exemption has thrown the bond market into chaos. Many state and local governments have not been able to borrow at all, or have done so at punitive interest rates.

X. The enactment of any form of these proposals would ensure the continued disarray of the market for years to come, until their constitutionality was reviewed and conclusively determined by the U.S. Supreme Court.

XI. There is no reform in tax proposals that would impose staggering burdens on state and local government solely to capture a meager $45 or $80 billion annually from wealthy taxpayers. Five years after the enactment of these proposals, state and local governments would be taxing in amounts of $540 million annually to pay increased borrowing costs.

XII. Inasmuch as these taxes are deductible from federal income tax returns, the Treasury will probably suffer a net loss if any of the new proposals are effectuated.

XIII. Municipal bond holders have in fact paid substantial taxes to state and local government by accepting interest rates 30 to 35% less than those available on comparable

corporate obligations. Based on the 1968 issuances of $16 billion alone, this represents "tax" income to state and local government averaging more than $200 million annually.

XIV. The provision in the House bill for a federal payment to recompense state and local bond issuers for additional interest costs is unacceptable both to the Treasury and to our states and cities. The Treasury is given too wide a discretion to fix the size of the payment, and the statutes authorizing this payment would be subject to amendment or repeal at any time.

XV. Banks, corporations and other institutional investors in municipals, although exempted from the operation of the present tax proposals, are on notice that they may be taxed in the future on their current holdings. The dismal state of the bond market now is attributable largely to the substantially higher returns demanded by those investors.

XVI. The Committee on Finance should therefore reject those provisions of H.R. 13270 and of the Treasury plan, and any other proposal which would tax, directly or indirectly, the interest on municipal bonds.

SENATE FINANCE COMMITTEE

Statement of

Austin J. Tobin, Executive Director
The Port of New York Authority
on
H.R. 13270

September 23, 1969

I am Austin Tobin, Executive Director of The Port of New York Authority. I appreciate the courtesy of this Committee in affording me the opportunity today to submit my views on the proposals to tax municipal bond interest recommended in H.R. 13270 and again in the Treasury Department plan which was outlined to this Committee at the commencement of your hearings.

The Port of New York Authority is the bi-state instrumentality of the States of New York and New Jersey, created in 1921 to develop public terminal and transportation facilities in the Port of New York and to promote the commerce of the Port. It has no power to levy taxes or to pledge the credit of either State to finance its capital programs. Yet, over the past half century, it has been able to finance, construct and develop, at a cost of $2 billion, a comprehensive network of public airports, piers and docks, public bus and truck terminals, a commuter railroad and vehicular bridge and tunnel facilities, almost exclusively on the basis of its own credit, with Federal and state grants representing less than 3% of its total investment. Its outstanding bonded indebtedness at the end of 1968 was $1,180,000,000.

This complex of New York and New Jersey's public transportation facilities includes, among others, Kennedy, LaGuardia and Newark Airports, the modern docks and containership terminals at Ports Newark and Elizabeth and along the Brooklyn waterfront, the George Washington Bridge and the Holland and Lincoln Tunnels, the Manhattan Bus Terminal, and a trans-Hudson commuter railroad linking the Cities of New York and Newark.

It would have been quite impossible for us to have financed this complex of public terminal and transportation facilities if our bonds had been subject to federal taxation. Even with this advantage, we were practically bankrupt in the early 1930's. Practically every one of our facilities, in their very nature, go through a developmental period of annual losses for from five to ten years after they are opened. During this time they are rather marginal credit risks. This is the reason that under the laws of our two States, we are allowed to pool our revenues from all Port Authority projects and pledge these pooled revenues in support of our bonds. But we could never have financed these terminal and transportation facilities at interest rates which were economically practicable if our bonds had been taxable, which would have imposed a 40 per cent increase in our interest costs.

In other words, many of the public works which are so important to the basic economy of our region would not exist today if their financing had required the payment of interest rates which had to compete with those offered in the private sector. Not only would the residents of New York and Northern New Jersey be unable to construct the piers and docks, the airports, the terminals and other transportation services we have been able to provide over the past

fifty years on a self-supporting basis (i.e., through revenue bond financing), but the prospects for financing the current and future transportation needs of the people of the Port of New York District would be gloomy indeed.

But the issue precipitated by these attempts to tax state and municipal bonds is not one of economics alone. The constitutional issue squarely raised by these proposals is of even greater consequence and importance, for these proposals are an attack on the basic structure of our government. When a similar proposal was advanced many year ago, Senator William E. Borah said that it would "wrench the Constitution from its harmonious proportions." Without any question, if the central government has the power to tax the financial operations of the states, it has the power to control every exercise of the governmental powers that were expressly reserved to the states under the Constitution. That would mean that the future form of our federal system of government will have been radically changed.

You have already heard extensive testimony from representatives of state and local government describing the destructive consequences of these proposals to the fiscal condition of our states, counties and cities. I understand that the Governors of some forty of our great states asked your Committee to be heard in opposition to the House bill and the Treasury's proposals, as did also some 200 elected and appointed state and local officials. While I fully share their shock and their forebodings of the incredible fiscal consequences of these proposals, I will try to avoid reiterating the points they have made. Rather, in my capacity as the Executive Director of a

bi-state transportation agency, I would like to address myself to the consequences of the House bill and the Treasury recommendations to our national and regional transportation programs.

Under our federal system of government, our transportation services and facilities are in the main developed by our State, county and municipal governments. They are financed -- for the most part -- through those State, county and municipal governments. They are designed and financed and built to meet local and regional, as well as inter-regional transportation requirements. Yet the sum total of these locally and regionally developed facilities is a vast national transportation network that is not only vital to each region of our country, but also to the nation's whole economy, its defense, and its standing among nations.

The Port of New York typifies the dual stake which the people of the United States have in their transportation system. The primary purpose of the transportation facilities of the Port of New York is to meet the transportation needs of the civilian population during times of peace. At the same time, the existence of these facilities is an inherent part of our defense structure. And in time of war, their existence and operational efficiency is critical. During World War I, three-quarters of our overseas troop movements were through the Port of New York. And during World War II, one-half of all our armies overseas and one-third of all our material moved through New York.

As you may now be aware, state and local governments in 1968 issued more than $16 billion in municipal bonds. Of this total, some $2.8 billion were issued solely for transportation purposes. It has, I think, been amply demonstrated that the enactment of any of the tax

proposals recommended in the House bill or by the Treasury Department would generate at the very least an average one per cent increase in the interest rate on municipal bonds, which is to say an increase of from 20 to 25 per over the historic levels of state and municipal interest rates. Even assuming no increase in the $2.8 billion of future annual financing for transportation purposes, the effect of the proposals under consideration by this Committee would be to increase interest payments by state and local government by a total of $380 million for the life of each year's borrowings for transportation purposes. In other words, after a ten-year period, the total liability for additional interest costs imposed by these Treasury proposals will have reached the staggering total of $3.8 billion and this final impact on state and local borrowing would relate only to public financing for transportation purposes.

Only recently, the Port Authority's parent States of New York and New Jersey have by referendum committed themselves to the issuance in the next few years of $3.1 billion in state bonds for the development and improvement of transportation facilities in both states. A one per cent increase in interest rates on these transportation bond issues alone would require the two states to levy an additional $420 million in taxes to pay increased borrowing costs.

The amounts the States of New York and New Jersey are committed to expend in capital funds for their transportation requirements, together with the Port Authority's capital requirements over the next few years, reach the formidable total of $4.85 billion. All of the projects on the drawing boards for which these funds are allocated are in some measure jeopardized by the new tax proposals. The

financing and construction of these projects depend entirely upon the fiscal and political ability of the two States and their public transportation agencies to pay these tremendous increases in the cost of their financing. Unfortunately, these increased costs would have to be derived primarily from relatively regressive property, sales, and other taxes or charges assessed without respect to the ability to pay.

Turning to the problem of capital financing requirements for aviation development, it is estimated that more than $14 billion of public funds will be needed in the next ten years to finance the absolutely essential expansion of our national airport system. Historically, 80 per cent of the funds expended on our nation's airports have been derived from state and local sources. In the case of New York-New Jersey metropolitan airports, 96 per cent of the cost has been borne by the two States through their agency, the Port Authority. Even assuming increased federal assistance in the future, it probably will still be necessary for as much as $10 billion to be expended by the states and local government for essential airport construction; and this would involve more than $1.3 billion in additional interest costs if these planned and necessary aviation programs are to be carried out.

I am sure you are all aware of the critical necessity to upgrade the nation's air transportation system. In 1968, the American aviation industry transported over 150 million air passengers, representing an increase of 110 per cent over passenger volume just five years earlier. Those of you who regularly fly in and out of the New York metropolitan area have more reason than most to appreciate how essential it is that we provide additional airport capacity and reconstruct our existing

airports. The new 360-passenger jumbo jets will be coming into service in a few months, and in New York, as in other urban areas, we are at work on the formidable problem of providing adequate mass transit (rail) connections between Kennedy Airport and Manhattan. The financing of these vital airport programs will be severely disrupted by these proposals -- even by their consideration by the Congress.

One of the most critical needs of the metropolitan region of New York and Northern New Jersey is the provision of a fourth airport to meet the demands for air service to and from our area. Such an airport is not just a regional necessity; it is essential to the flow of air traffic across the nation. The cost of such an airport is now estimated at $600 million, and the assumption has validly been made that such an airport could, nevertheless, be developed on a self-supporting basis. However, the massive additional interest costs which would be incurred as a result of these proposals would most certainly jeopardize the prospect of constructing such an airport on a self-supporting basis. Itwould be nothing less than a tragedy, not only to New York and New Jersey, but also to our national air transport system, if these additional costs were to be piled on top of the formidable obstacles which are already delaying the construction of this vital facility.

The needs of the nation's mass transportation systems are equally impressive. These systems, which transport more than 8 billion passengers a year in our metropolitan areas, have projected capital needs of $20 billion over the next ten years.

Adequate mass transportation, by itself, will not solve the urban problem. However, without good public transportation, the urban problem cannot be solved. Workers must get to their jobs

and back. Poverty pockets must have access to employment. Children must be able to get to school and people of all ages must have a means to get about.

With most urban rapid transit systems operating at heavy deficits even before considering capital costs, it is apparent that the $20 billion of capital needs must come from government sources. As you know, President Nixon has proposed a $10 billion federal aid program for mass transportation. If we assume that the proposal is enacted, there will still be the need of local and state governments to provide an additional $10 billion.

The proposal to tax state and municipal bond interest would increase the total borrowing cost of these bonds by another $1.3 billion. This increased cost would, of course, be reflected in higher fares to the users and increased taxes to the residents of the metropolitan areas. More importantly, the increased costs could very well cause the deferral or absolute abandonment of many urgently needed mass transit projects.

To recapitulate, just in these two vital areas alone -- airports and mass transit -- the additional fiscal burdens which these new tax proposals would impose on our states and cities would amount to the enormous total of $2.6 billion.

Lest I be accused of viewing with undue alarm, I need point only to the chaos that exists in the municipal bond market today. Even the threat of this attack on the immunity of municipal bonds has brought in its wake a market reaction which has required state and local governments in many cases to pay the highest borrowing costs in their history. Many units of government have been unable, because of constitutional

and statutory interest rate limitations, to borrow at all. Many municipalities have deferred borrowings, although the futility of postponements in anticipation of better days was demonstrated most forcefully on September 9th when the City of Newark was obliged to accept a 7.68 per cent interest rate on its general obligation bonds after it had earlier rejected a 7.43 per cent rate. Ironically, the earlier bid was rejected as excessive due to the uncertainty of the market attributable to these proposals to tax municipal bonds. In the past few weeks, the State of Hawaii and the Cities of Chicago, Houston and Jacksonville, among others, could not find a market for bonds valued in total at over $100 million.

There is no sign that the deterioration in the market is slackening. If these new proposals are enacted in any form, the result will be to insure the continuance of chaotic market conditions for years to come, until the constitutionality of these proposals is reviewed by the Supreme Court. In the meantime, a market which has been developed over the years to the point where it can now readily absorb the capital requirements of our states, cities and counties approaching $20 billion annually is crumbling, and its rehabilitation -- even if the Congress of the United States rejects these proposals -- will be achieved only at great cost to the taxpayers of the nation.

I can perceive absolutely no "reform" in tax proposals designed to capture a few dollars from the rich which have as their primary consequence the imposition of debilitating economic burdens on state and local government -- burdens which must be passed on to our already over-taxed middle-class and poorer people. Actually a large majority of outstanding municipal bonds are held by public and institutional

investors and only a fraction are in the hands of the very wealthy. Moreover, the recovery by the Treasury of even the $45 million, which the Secretary of the Treasury estimated in his testimony a week or so ago before this Committee, is comparatively a very small sum when placed against the loss of hundreds of millions of dollars in increased interest costs that would be sustained by the states and cities. The ultimate fact is, however, that these proposals would probably result in a net loss for the Treasury itself. The municipalities' increased borrowing costs could only be met by increasing municipal real estate taxes or state income or sales taxes. These are deductible items on the federal tax returns of state and local taxpayers.

Assuming that the level of state and local borrowing remains constant at $16 billion a year, in but five years it would be necessary for state and local government to raise an additional $540 million annually. With deductions from federal income tax returns, it is apparent that the $45 million return to the Treasury estimated here by the Secretary of the Treasury from the allocation of deduction proposal, or the $35 million return estimated by the Treasury from the limited tax preference proposal, would be offset by the loss in revenues due to increased deductions. Just on the basis of economics alone, these proposals should be rejected.

Moreover, the Treasury and the proponents of the House bill apparently refuse to recognize that the holders of municipal bonds are now paying very substantial taxes indeed. Those taxes are being paid not to the federal government, but to state and local government

whose financial situation is so desperate that the Administration is, under its "New Federalism" policy, now proposing to share federal revenues with them.

The holder of municipals has historically agreed to take an interest rate of 30 to 35 per cent lower than the rate he could obtain by investing in comparable private obligations. The difference in interest rates between these two types of obligations -- municipal and corporate -- now represents real "taxes" for the benefit of state and local government. For example, using the $16 billion issuances in 1968 alone, these "taxes" average well over $200 million a year. The new tax proposals would serve only to deprive state and local government of a very significant financial advantage and, instead, divert negligible gross revenues to the Treasury. The rather amazing result of these proposals will ultimately be to produce losses for everyone concerned: for the Treasury, for state and local government, and for taxpayers generally.

Also badly hurt would be workers in the building and construction trades and in the industries which support them. Higher borrowing costs must inevitably result in a sharp deceleration of public works programs, causing layoffs, reduced work opportunities and consequent economic hardship. In the last year alone, more than 300 bond issues valued close to $2 billion were cancelled or postponed in the face of soaring interest rates.

The House bill includes a provision for federal payments which would allegedly save state and local governments harmless from increases in interest costs if their bonds were to become fully taxable.

33-758 O - 69 -- No. 9 -- 14

The Secretary of the Treasury opposed this provision of the House bill when he appeared before your Committee. I also oppose it. The wide discretion afforded the Secretary of the Treasury in fixing the size of the payments would in itself make this proposal unacceptable to the states and cities. Moreover, the payment provisions may be amended or indeed repealed by any future Congress. The confidence of investors in municipals will be restored only as the result of a clear indication by this Congress that the immunity of state and local bond interest from federal taxation will not be invaded.

Although both the House bill and the Treasury would exempt banks and other corporate and institutional holders of municipal bonds from taxation, these corporations and institutions realize full well the implications of the proposals now before you. Both the Ways and Means Committee and the Treasury have put all investors on notice that the holders of municipals may be subject to some form of taxation even with respect to investments they have made prior to the enactment of new tax legislation. If this can happen to individual investors, corporate buyers would be apprehensive that it might happen to them. In fact, the amount of return corporate and institutional investors demand in the present market from investment in municipals clearly reflects their apprehension and concern.

Therefore, I respectfully urge rejection by this Committee of all the provisions of the House bill and the Treasury plan and of any other proposal which would, directly or indirectly, tax the interest on municipal bonds.

Thank you.

SUMMARY STATEMENT

CALIFORNIA'S VIEWS REGARDING H.R. 13270's PROPOSALS TO TAX MUNICIPAL BONDS*

The State of California, which I have the honor to represent before this committee, opposes those provisions of H.R. 13270 which, as presently written, would tamper with the existing federal-state relationship concerning tax-exempt municipal bonds. We contend that the so-called tax reform law would cause far more harm than good in attempting to solve some of the existing inequities, would jeopardize federal-state relationships of all kinds and touch off bitter rounds of litigation. In this summary statement we seek to point out as concisely as possible what we believe would be some of the adverse effects on California of this proposed legislation. These, together with some of our views on the principles involved, are as follows:

1. We believe the proposal to tax state and local bonds, commonly referred to as "municipals", is unconstitutional, regardless of whether the federal government subsidizes all or only part of the increased interest costs resulting from state or local issuance of taxable bonds instead of the traditional non-taxable bonds.

2. Federal taxation of "municipals" will immediately and automatically increase market interest rates to compensate investors for the altered status of such bonds. The inevitable

*Presented by California State Treasurer Ivy Baker Priest before The Senate Committee on Finance, September 23, 1969, Washington, D.C.

result must be increased state and local taxes to pay for the increased interest costs. The low and middle income taxpayer thus would bear an even larger share of the burden than he now does.

3. Once the principle is breached, there would be no fixed stopping point. Once Congress takes the first step away from tax exemption on municipal bonds, it can always take another step whenever circumstances make it expedient to do so. Federal subsidy of the extra interest costs involved in issuing taxable municipals can be withdrawn just as easily as it was first offered.

4. The very fact that Congress has been seriously considering legislation of this type already has had adverse effects upon the bond market. The fears and uncertainties surrounding current proposals to tax these bonds have led to (a) a shrinking of available money supply and demand for investments of this type because many would-be investors shy away entirely from the municipal bond market until congressional intentions solidify, and (b) further increase in interest rates on those municipal bonds which do manage to attract bidders in these unsettled times. Selling prices of stocks and bonds are affected by such intangibles as investor confidence and optimism, or the lack thereof, fully as much as they are by earnings records, credit ratings and the caliber of management. This is as true with municipal bonds as with corporate bonds. Investor buying patterns are influenced very markedly by any threat or suspicion of threat such as presented by current congressional actions toward state and local bonds.

5. Greater dependence upon the federal government as the source of major public works funding for state and local needs will be the inevitable result of any tampering with the historic status of tax-exempt bonds. If the states and their political subdivisions no longer can sell their bonds without having to pay extremely high interest, cannot find buyers at all because of federal interference with the orderly marketing processes of the past, or can't raise taxes enough to fund a "pay-as-you-go" policy, then the only other major source of funds for state and local capital outlay projects has to be the federal government itself. That would be in direct contradiction to current efforts to bring about better working relationships between the national and state governments and would force the states to rely almost completely on Washington to solve their fiscal problems involving capital outlay projects. I doubt that any of us want that to occur!

6. California is unable to sell general obligation bonds in the normal manner or volume at the present time because inflation has boosted interest rates above the state's legal limit (five percent). In June, 1970, with voter approval, the limit on interest may rise to seven percent. However, even if this does occur, the entire matter may become moot if, through federal taxation, national bond interest rates are forced to remain above the new ceiling. Administration efforts to curb inflation's effects on the bond market may be nullified if the Congress, through action which we consider most unwise, brings about a

condition of permanent fear and uncertainty regarding investments of all types, including municipal bonds.

7. Those who will be most hurt in California if our bonds are made taxable will be the young people now reaching college age who will be denied the new buildings and facilities they need for their education. It will be the youngsters now in school or about to be enrolled in our public school system who will lack the classrooms they need. It will be the California veterans who depend on bond funds to provide the loans they deserve for buying farms and homes. It will be the growing millions of people who use and enjoy our state parks and historical sites made possible by bond financing. Perhaps most urgent of all at this point in time, those millions of Californians who are depending on the State Water project to deliver to them the surplus waters of the north, as promised. In short, most of our 20 million population would be adversely affected by the taxation of state and local bonds as proposed under H.R. 13270.

All of these are strong reasons for our belief that taxation of state and municipal bonds not only is undesirable but perhaps even tragic for California, which is second only to the United States government itself in the volume of annual bond sales. We urge you to take these adverse effects into account most seriously in your deliberations on this bill.

Thank you for this opportunity to present our views to you.

CALIFORNIA'S VIEWS REGARDING H.R. 13270's PROPOSALS TO TAX MUNICIPAL BONDS*

The State of California, which I have the honor to represent before this committee, opposes those provisions of H.R. 13270 which, as presently written, would tamper with the existing federal-state relationship concerning tax-exempt municipal bonds.

We oppose also any changes in charitable trust provisions of tax law which would cause unintended but seriously adverse effects on California's and the entire nation's educational institutions. Any action which shuts off or diminishes the flow of gift funds to private schools will yield only added burdens to the public tax structure.

It is our contention that H.R. 13270, the so-called tax reform law, would cause far more harm than good in attempting to solve some of the existing inequities. It would open a Pandora's box of horrors, jeopardizing federal-state relationships of all kinds and touching off bitter rounds of litigation. For the most part, however, we will restrict our testimony to the proposed taxation of state and municipal bonds.

From this nation's earliest days these bonds have been considered as tax-exempt without serious question. We have not attempted here to present the full weight of data and expert opinion available to support our views, but instead seek to point out as concisely as possible what we believe would be some of the adverse effects of this proposed legislation.

---

*Presented by California State Treasurer Ivy Baker Priest before the Senate Committee on Finance, September 23, 1969, Washington, D.C.

This committee's goal of tax reform is a most desirable one. However, because California would be so seriously affected we must oppose H.R. 13270 in its present form on the following grounds:

1. We believe the proposal to tax state and local bonds, commonly referred to as "municipals", is unconstitutional, regardless of whether the federal government subsidizes all or any part of the increased interest costs resulting from state or local issuance of taxable bonds instead of the traditional non-taxable bonds. We believe that it really makes no difference whether the interference is direct or indirect on this point.

2. Federal taxation of municipals will immediately and automatically increase market interest rates to compensate investors for the altered status of such bonds. The inevitable result must be increased state and local taxes to pay for the increased interest costs. The low and middle income taxpayer thus would bear an even larger share of the burden than he now does.

3. Once the principle is breached, there would be no fixed stopping point. Once Congress takes the first step away from tax exemption on municipal bonds, it can always take another step and yet another whenever circumstances make it expedient to do so. Thus, a federal subsidy of the extra interest costs involved in issuing taxable municipals can be withdrawn just as easily as it was first offered.

4. The very fact that Congress has been seriously considering legislation of this type already has had adverse effects upon the bond market. The fears and uncertainties surrounding current

proposals to tax these bonds have led to (a) a shrinking of available money supply and demand for investments of this type because many would-be investors shy away entirely from the municipal bond market until congressional intentions solidify, and (b) further increase in interest rates on those municipal bonds which do manage to attract bidders in these unsettled times. It must be recognized that selling prices of stocks and bonds are affected by such intangible factors as investor confidence and optimism, or the lack thereof, fully as much as they are by earnings records, credit ratings and the caliber of management. This is as true with municipal bonds as with corporate bonds. Investor buying patterns are influenced very markedly by any threat or suspicion of threat such as presented by current congressional actions toward state and local bonds.

5. Greater dependence upon the federal government as the source of major public works funding for state and local needs will be the inevitable result of any tampering with the historic status of tax-exempt bonds. If the states and their political subdivisions no longer can sell their bonds without having to pay extremely high interest, or cannot find buyers at all because of federal interference with the orderly marketing processes of the past, then the only other major source of funds for state and local capital outlay projects has to be the federal government itself. That would be in direct contradiction to current efforts to bring about better working relationships between the national and state governments and would force the states to rely almost completely on Washington to solve their fiscal problems involving capital outlay projects. I doubt that any of us want that to occur!

6. California, along with other states, finds herself unable to sell general obligation bonds in the normal manner or volume at the present time because inflation has boosted interest rates above the state legal limit -- in our case, five percent. Steps are under way to alleviate this situation through referendum in June, 1970, so that, with voter approval, the state's legal limit on interest may rise to seven percent. However, if and when this does occur, the entire matter may already be or soon afterward become moot if, through federal taxation of our bonds, interest rates are forced to remain above even the new ceiling. Administration efforts to curb inflation's effects on the bond market may be nullified if the Congress, through action which we consider most unwise, brings about a condition of permanent fear and uncertainty regarding investments of all types, including municipal bonds.

7. Those who will be most hurt in California if our bonds are made taxable to investors will be the young people now reaching college age who will be denied the new buildings and facilities they need for their education. It will be the youngsters now in school or about to be enrolled in our public school system who will lack the classrooms they need through 12 years of schooling. It will be the California veterans who depend on funds from the sale of state bonds to provide the loans they deserve for the purchase of farms and homes. It will be the growing millions of people who use and enjoy our state parks and historical sites made possible by bond financing. Perhaps most urgent of all at this point in time, those who will be hurt will

be the farmers and cities of California who are depending on the State Water Project to deliver the surplus waters of the north, as promised, two years from now. All of these groups of people -- probably most of our 20 million population -- would be adversely affected by the taxation of state and local bonds as proposed under H.R. 13270.

-- At this point, I would like to present some specifics about California's population, geography, economy and state financing policies. These are germane to your understanding of why we believe so strongly that taxation of municipal bonds would be not only undesirable but perhaps even tragic in its effects on California.

FACTS ABOUT CALIFORNIA SCHOOLS AND COLLEGES

According to a researched feature article in the San Francisco Examiner and Chronicle for September 7, 1969, approximately six million of a population totaling approximately 20 million were expected to be in California schools this month. That's a school enrollment equal to an entire nation the size of Switzerland. Add to these students some 600,000 school employees and you have more Californians involved in some phase of education than in all other jobs and professions combined. As a state, we spend $4.5 billion a year to run our schools, about what it costs each year to put men on the moon. We are the most college-oriented political entity on earth: nearly one million of us, 50 out of every 1,000, now attend college, which is half again as many as in New York and three times as many as in Illinois.

Our investment in school property is more than $17 billion, according to a study by Crocker-Citizens National Bank economists. The biggest part of our tax dollar goes for education, a large share, of course, paying for the three million youngsters in elementary school and the 1.3 million in high school. We have had to build 150 new classrooms each week to house our growing public school population. We have the largest and most extensive adult education program in the nation; each year 1.8 million adult Californians take courses in some 500 locations around the state. Our extensive junior or community college system at last count totaled some 89 two-year colleges throughout California.

Between 1955-1967, California's population increased 47 percent -- but at the same time, enrollment in all colleges and universities increased 160 percent and in the state college system 222 percent. The increase in college enrollment in our state has been averaging about 50,000 a year.

These facts and figures are cited to stress that education in California is, indeed, big business. To guarantee good schools for all of its people wherever they happen to live, the state provides its share of school support according to district need. For many years a state program of loan-grants has assisted local school districts with their building needs. These state funds are provided through the sale of bonds authorized by popular vote. In turn, local matching funds also are usually provided through local bond issues.

The University of California has an enrollment of about 100,000 on its nine campuses and the State College system has an enrollment of about 200,000. Buildings for these college and university campuses are financed largely through state general obligation bonds. Any action which would disturb California's ability to sell such bonds, or which would greatly increase the interest which state taxpayers would have to pay on such bonds, can only work to the detriment of higher education in California.

FACTS ON STATE WATER PROJECT

Planner, builder and operator of a $2.8-$3 billion project which will transfer surplus waters from northern California to thirsty lands and cities throughout the state, the State Department of Water Resources is at a crucial stage of construction in its timetable. Water already is flowing through the aqueduct system as far south as the Tehachapi Mountains, which separate the great San Joaquin Valley from southern California. Contract deliveries are being made to northern California, the San Francisco Bay area and to the San Joaquin Valley. However, getting the rest of the contracted supplies through and over the mountains to southern California by means of the world's greatest pump lift and difficult tunneling across earthquake faults still presents a challenge before the end of the 600-mile water route is reached in 1972. Water is scheduled to reach Los Angeles County in 1971 and nearly to the Mexican border the following year.

Contracts for water service provide that costs of construction, operation and maintenance of the facilities will be paid for by the users, with interest. Until completion of the project, however, the largest proportion of the revenue cannot start flowing back into the state treasury to meet principal and interest payments on the general obligation bonds which have been issued in series as needed to finance construction. Thus, it is imperative that no unnecessary and controllable factor intervene to disrupt the sale of California water bonds or to cause extra interest charges to be assessed against all contracting parties.

Approximately $600 million of the initial $1.75 billion in water bonds remain to be sold to complete the project as presently planned. Taking a long-range look, however, the project will have to be extended to tap new sources of surplus water from California's north coastal rivers, making further bond financing a necessity. It would be an unnecessary burden to carry on the backs of California water users who pay for these projects if the federal government were to enact tax legislation which would increase the cost of bond financing, as would H.R. 13270 or any other similar bill.

FACTS ABOUT CALIFORNIA'S BOND SELLING PROGRAM

At the end of fiscal 1968-69, California's bonded indebtedness (general obligation bonds only) totaled $4.7 billion. Bonds already authorized by the voters but still unissued as of September 1, 1969, totaled $1.34 billion. The state ranks second only to the United

States government itself in the dollar volume of bond sales. Under normal market conditions, our bond sales in recent years have been totaling $500-600 million per year.

There is a direct link between California's unusually rapid population growth and the need for public works on a large scale. There is no letup in sight. Because the need is so great (the population increase each year being comparable to adding a city of 500,000) bond financing has been the only feasible means of keeping up reasonably well. It is the fastest way to obtain large sums of money for capital outlay beyond the scope of pay-as-you-go financing. It also is a matter of principle and fiscal common sense that long range benefits should be paid for by future beneficiaries and future taxpayers as well as present ones.

California's general obligation bonds are used, for example, to finance capital outlay needs for:

1. The Cal-Vet farm and home loan program. This has been successfully funded for decades in this manner. A total of $2.285 billion in bonds has been authorized during that period. Ending of the Viet Nam involvement will result in increased requests for loans from returning veterans.

2. Public school construction. The public school system's building needs are aided by the state through bond sales. State aid is of a loan-grant type, partly repaid with interest. Since 1946 the state has approved applications for approximately $2 billion in state funds to help in constructing facilities for approximately two million students.

3. Junior college construction. Authorized in 1968, the $65 million in bonds for this purpose is another type of bonding program in California which is directly affected by national bond market conditions. At the beginning of this year, there were 89 community colleges operated by 69 separate junior college districts. These are required to match state building construction funds. Last November, the first series of these bonds was sold; no more have been sold since then because of prevailing high interest rates.

4. Park, recreational and historical site facilities. In 1964, California voters approved a $150 million bond issue for expanding the state park system, for local parks and for additions to Wildlife Conservation Board hunting and fishing improvement facilities. In a state of 20 million population, agumented in the summer by visitors numbering in the hundreds of thousands, at least, it has become imperative to provide more parks and recreational facilities. Bonds meet these capital outlay needs.

It should be noted that these have been examples, not an all-inclusive list.

Authorized but unissued state bonds as of September 1, 1969, include: $600 million for the water project, $60 million for construction of state buildings, $80 million for university and state college construction, $75 million for the state park system, $275 million for public school system building aid, and $50 million for junior college construction.

VIEWS ON TAX IMMUNITY UNDER THE CONSTITUTION

The question of tax exemption of municipal bonds may be phrased as follows:

Does the right of states and their political subdivisions to borrow by means of bonds whose interest is exempt from federal taxation stem from the permissiveness of a beneficent central government, or is this right a part of the very nature of our republic's political partnership?

California contends that Congress by itself cannot abolish by statutory enactment that which has been recognized as a constitutional right by the U.S. Supreme Court and which, therefore, can be changed only by amending the Constitution. This principle has been reiterated by the Supreme Court since adoption of the Sixteenth Amendment (the income tax amendment). Since California's presentation here today is not intended to be a legal brief, we will not set forth the citations in case history which substantiate our position. In our view, they are solidly based.

We contend that the federal government has no right to tax municipal bonds even indirectly, or by offsetting such taxes through the device of interest subsidy. To extend this point, if the states are to be required to yield <u>their</u> immunity in this matter, the <u>federal government should reciprocally give up its own immunity</u>, thus opening the way for counter taxation of its bonds by the states. It should work both ways if it is going to be brought into the picture at all. No one would gain by such a chaotic scheme. We merely suggest that a cutting sword usually has two edges!

33-758 O - 69 -- No. 9 -- 15

California contends that any alteration of the principle of reciprocal immunity from taxation could pull down the entire framework of federal-state relationships and would destroy the principal means open to the states to finance their major capital outlay projects. Once any exception is made to the principle of immunity, immunity no longer exists!

VIEWS ON CHARITABLE CONTRIBUTIONS

The proposed changes in the treatment of charitable contributions suffer from the same weaknesses as those dealing with tax-exempt bonds. The House Ways and Means Committee, in trying to eliminate abuses of present regulations, has proposed changes which in our opinion will lessen the flow of charitable contributions.

Although California would not be affected as much as her sister states by such changes because our private institutions carry only about 11 percent of the total enrollment in higher education, we nevertheless are concerned about the negative impact that this proposal would have on gifts to private educational institutions. They already are at a competitive disadvantage relative to public institutions. This move to tighten regulations on charitable contributions would heighten that disadvantage at a time when private schools need all the help they can get if they are to remain a viable part of our educational framework.

Every enrollment gain by private institutions lessens the burden which otherwise would fall on our taxpayers. Moreover, we feel that the increased competition between public and private schools helps to achieve our goal of excellence in higher education.

For these reasons, therefore, only summarized here, the State of California respectfully urges the Congress to take no action in developing a tax reform bill which would tend to diminish the ability and willingness of contributors to support private colleges as in the past.

NEWS CLIPS: LOCAL COMMENTS ON AND EFFECTS OF TAXING MUNICIPAL BONDS

Sacramento Bee, Sept. 4, 1969

From a story describing a meeting of the Los Rios Junior College District board of education:

"The board rescinded its action of two weeks earlier, awarding a $1,875,400 contract to Harbison and Mahoney for construction of the American River College library. Assistant Superintendent George Rice explained the district had been unable, in the current confused bond market, to sell the bonds needed to finance the project. Rice said proposals in Congress, to remove the tax-exempt status from such bonds and to alter the capital gains tax, have combined with high interest rates to dry up the bond market ..." (emphasis added).

Sacramento Bee, Sept. 5, 1969

From a story reporting proceedings of a Sacramento City Council meeting:

" ... Christensen (City Councilman Walter Christensen, former Mayor) warned that 'the community center is down the drain' if Congress passes a tax reform bill which eliminates or reduces the tax-free status of municipal bonds, thus making some or all interest on such bonds taxable to investors."

<u>San Francisco Chronicle, Sept. 4, 1969
Financial Editor Sidney P. Allen's column</u>

" ... Bonds go begging, more than ever.

"Here's fresh evidence of it. The Bond Buyer Index, the major gauge for the tax-exempt bond sector, topped six per cent 10 days ago, and currently has shot up to a new high record at 6.26 per cent.

"Right here at home, to be more specific, the California Municipal Bond Index of Glore Forgan, Wm. R. Staats Inc. topped 6.21 per cent. That, too, was up a whopping 21-100ths in one week!

"Obviously investor confusion and fear regarding possible tax reform that might eliminate or reduce state and municipal bond tax exemption has knocked the final prop from that sector. It's a punch to the solar-plexis (sic) for California ..."

<u>Sacramento Bee, Sept. 7, 1969</u>

"DAVIS--Failure of the Davis Joint Unified School District to market $330,000 in bonds has prompted a warning that taxpayers may face increased taxes because of the current condition of the money market.

"The Davis bonds, authorized by voters in 1963, failed to attract any bidders at the legal maximum interest rate of 5 per cent.

"The business manager of Davis district, Melvin H. Keuhnhold, said, 'The money market is like a yo-yo at the moment. No one's buying bonds -- particularly at the interest rate of 5 per cent.

'<u>One of the major problems is the tax reform discussions in Washington</u> (emphasis added). At present interest earnings on bonds

are tax-free. But the indications are that they will become taxable -- with taxes being applied retroactively. So no one is buying.'

"... The Davis bonds were to finance a new gymnasium and shop at Holmes Junior High School, a project considered 'top priority' by officials."

PART B—ADDITIONAL STATEMENTS

September 18, 1969

Mr. Tom Vail, Chief Counsel
Senate Finance Committee
2227 New Senate Office Building
Washington, D. C.

Re: Tax on Interest from Municipal Bonds

Dear Mr. Vail:

As Mayor of the City of Providence, I am deeply concerned with the effects of the proposed tax on the interest received from holders of municipal bonds. I had our finance department do a preliminary study of the impact such a tax would have upon the tax rate in the City of Providence. On the basis of this study the following conclusions were arrived at:

The City of Providence currently has authorized but not yet bonded 80 million dollars in new issues.

On the basis of projection of these figures over the next five year period ending in 1975, the tax rate increase to the Providence tax payer resulting solely from the effect of the tax on interest from municipal bonds would be approximately $.63 the first year, $1.86 the second year, $3.02 the third year, $4.11 the fourth year, $5.15 the fifth year and $6.00 by the end of the fifth year.

These figures were derived at simply by considering the 80 million dollars already authorized and not yet issued. This does not take into consideration any new future issues. We allowed merely for the differential in the interest payments which would have to be made up to holders of these bonds. Therefore, by using an interest rate of 10% rather than the present 5% return, the net result would be to raise the tax rate in the City of Providence by the amounts listed above. Such a tax increase

to the residents of the City of Providence would come at a most inopportune time when additional and increasing demands are being made by the teachers, police and fire and the municipal employees; and the costs of municipal services as a whole are increasing. Since most cities are experiencing the same demands for increased services at higher costs, the added burden of additional interest payments to holders of municipal bonds would cause our local tax rates to sky rocket. This in turn would most likely affect the low income and middle income tax payer. Also, the City would have to turn more and more to the federal government for alternative means of financing which would mean shifting more local control to the federal level.

I urge you to carefully consider the potentially dire effects such a tax would have on local governments before approval is given.

Very truly yours,

Joseph A. Doorley, Jr.
Mayor of Providence

JAD:mmh

STATEMENT OF
HONORABLE JOHN A. KERVICK
TREASURER, STATE OF NEW JERSEY
BEFORE
UNITED STATES SENATE COMMITTEE ON FINANCE
ON
H.R. 13270
SEPTEMBER 23, 1969

I wish to express my thanks for the opportunity to testify concerning the tax reform proposals that have been submitted to the Senate Finance Committee for consideration and, in particular, to the provisions of H.R. 13270 which will affect the ability of the State and its municipalities to obtain the capital needed to finance the construction of schools, hospitals, highways and similar essential facilities. I have read the explanation given by Mr. Mills, Mr. Kleppe, and Mr. Byrnes of the effect of H.R. 13270 as it pertains to State and municipal bonds, reported in the Congressional Record (House) on August 7, 1969, and with due respect for these gentlemen wish to suggest to you that there is a lack of understanding concerning the mechanics of the bond market and the manner in which the capital required by the State and municipalities is obtained.

The theory of public finance suggests that State and local governments should employ issues of bonds for one basic purpose: to finance capital projects. In fact, in New Jersey the State

Constitution and State Laws limit the issuance of bonds to that purpose and require that State and school district bond issues must be submitted to referendum and approved by the voters.

On February 5, 1968 Governor Richard J. Hughes convened a Commission composed of citizens of the State of New Jersey to study and evaluate the capital needs of the State. The introduction to the report of this Commission contains the following statement:

> "New Jersey has not been as progressive in its capital expenditures as have been its sister urbanized states. There has been no capital program because there has been little or no long term capital financing. Given the opportunity to provide for sufficient capital construction to keep New Jersey a first class State, the choice was made to keep State levied taxes at a minimum.
>
> The price of these years of inactivity in capital appropriations is now very large. But it must be paid if we are to prevent further atrophy and create a viable and progressive State.
>
> Everywhere that this Commission looked, it saw the tragic results of years of neglect. Passenger rolling stock is on the verge of collapse. Railroad stations are dark and dilapidated. Highways are choked. A severe drought brought us to the brink of real peril. Prisons and mental health institutions are patched and worn, with many positively inhumane facilities. Secondary and elementary schools are overcrowded and many of the older ones are sadly in need of repair or replacement. Our colleges and universities can accommodate only a fraction of our applicants, forcing most of them to go out of state. Our rivers are polluted and our cities are pockmarked with crumbling ghettos.

These conditions are all very serious in themselves, but they are also serious beyond themselves. Lack of adequate capital funds has undoubtedly contributed heavily to our racial problems and to the decline of our cities as centers of industry and culture.

Our Commission foresees a serious weakening of the economic and social stature of New Jersey if this regressive fiscal philosophy continues. We are deeply disturbed to see one of the wealthiest states in the nation apparently condoning conditions which could ultimately destroy it.

The people of New Jersey have two great responsibilities to fulfill now. First, we must eliminate the enormous backlog of capital deficiencies. Second, we must build toward the future. We must guarantee for ourselves a growth which will keep pace with our future obligations. Prudent expansion and preventive maintenance must be substituted for virtual stagnation in new construction and a massive accumulation of deferred maintenance."

The Commission reported that the immediate capital requirements for State projects alone amounted to $1,948.9 million itemized as follows:

Recognized Capital Requirements

(Financing required in addition to projected Federal aid and State appropriations)

	Millions
Education (Elementary & Secondary, including Vocational)	$ 227.5
Education (Higher)	492.4
Educational Broadcasting Network	17.4
Institutions	100.0
Water Pollution Control	190.6
Conservation	121.0
Transportation	800.0
Total	$1,948.9

On November 5, 1968, the voters of the State approved the sale of $990 million of bonds to finance the construction of facilities recommended by the Commission in the areas of transportation and school and hospital buildings construction. In November 1969, the voters will be asked to approve the sale of $271 million of bonds to finance water pollution*control and the development of additional water supplies. The construction of the above facilities will take place over the next five years and it is expected that the State will sell approximately $250 million of bonds each year to pay for the construction cost. State tax dedicated to repayment of the principal amount of the bonds and the interest on the bonds are the motor fuels, emergency transportation, and sales taxes.

There is no report available concerning the capital requirements of the municipalities and school districts within the State. It is probable that some municipalities have been more progressive than the State in the construction of schools and other necessary municipal facilities; however, many others have not. There are a total of 1,363 jurisdictions within the State, each with its own capital needs and each able to issue bonds to finance its needs.

These jurisdictions are classified as follows:

Counties	21
Municipalities	335
Townships	232
School Districts	593
Special Districts (Garbage, Fire, Light, Sewer and Water)	71
Authorities	111
	1,363

Gross Local Debt, including authorized, issued and unissued obligations, totals $2,369.9 million as shown hereunder:

As of December 31	General Obligations Only: General Municipal	School	County	Total
	(In Millions)			
1968	$585.4	$1,393.4	$391.2	$2,370.0
1967	530.4	1,291.6	336.8	2,158.8
1966	466.0	1,196.3	291.4	1,953.7

The typical debt instrument is a serial bond with an approximately equal principal amount maturing each year for 25 to 30 years.

During the twelve months period, August 1, 1968 to August 1, 1969, hampered by rising interest costs and poor market conditions, a total of 131 issues were sold in the total amount of $195,117,000. The average size of each issue was $1,489,000 and, by actual count, there were 97 issues below $3,000,000 in size, and only 4 issues

exceeding $10,000,000 in size. The credit rating of the issues sold is summarized as follows:

	No. of Issues
No rating	51
Ba	15
Baa	35
A	19
Aa	11
	131

It will be seen that the average New Jersey municipal issue is approximately $1,500,000 in size and carries a credit rating below Baa in quality. Also, it will be seen that gross local debt has been increasing at the rate of approximately $200 million per year and the probability is that this rate of increase will continue for some time into the future. Revenues needed for the repayment of this debt and the interest on the debt are derived from local property taxes.

The combined capital needs of the State and its municipalities require the sale of $450 to $500 million of bonds each year. In marketing such a supply of bonds it is in the State's best interest for the Congress to consider legislation which will stimulate investment in tax exempt bonds rather than to propose changes in the tax laws which remove the incentive for such investment. In

considering the manner in which the tax changes incorporated in H.R. 13270 remove the incentive for such investment, it is helpful to keep in mind the various types of investors in tax exempt securities and the proportions of the total supply which each has purchased in the past. The following analysis published on August 29, 1969 by Salomon Brothers & Hutzler shows the net purchases of State and local securities during the first half of each year for the period 1966 through 1969.

	(Billions of Dollars)			
	1966	1967	1968	1969E
Non Bank Financial Institutions				
Savings Banks	0.0	0.0	0.0	0.0
Life Insurance Companies	-0.3	-0.1	0.0	0.2
Fire and Casualty Companies	0.1	0.6	0.9	1.0
Public Retirement Plans	-0.1	-0.1	-0.1	-0.1
Subtotal	-0.3	0.4	0.8	1.1
Commercial Banks	2.9	5.7	3.0	0.1
Business Corporations	0.4	0.4	0.0	0.1
Residual: Individuals & Other	0.4	-0.9	0.6	3.9
Net Increase Publicly Held*	3.4	5.6	4.4	5.2

*Excludes Small Amounts Purchased by Sinking Funds and U. S. Government Accounts.

This table shows that during the years 1966, 1967, and 1968, over 80% of all tax exempt issues were purchased by commercial banks. In 1969, due to credit restrictions, the commercial banks were unable to purchase tax exempt securities and it was necessary for interest rates to be raised sufficiently to induce individuals to

33-758 O - 69 -- No. 9 -- 16

return to the tax exempt market and absorb the available supply. Sales of State of New Jersey obligations are in sufficient size so that the effort required on the part of the underwriters to achieve distribution to individuals can be accomplished without great difficulty. The interest cost on State issues did rise from 4.49% on Jan. 7, 1969 to 5.70% on August 19, 1969, but the marketability of the bonds was never in question. However, the situation with respect to the bond issues of the municipalities is quite different. The size of the average issue, $1.5 million, and the relatively poor credit rating tends to restrict the sale of such obligations to local banks and individuals within the State who are acquainted with the community. In fact, many local banks purchase the obligations of the local community or school district as a service to the community.

One provision of H.R. 13270, and one which I consider harmful, is the proposal to make both the profit and loss transactions of commercial bank investment portfolios answerable to the same tax liability -- the corporate income tax rate. It is my belief that if this provision is enacted and becomes law, the commercial banks will limit investments to short-term securities on which no loss need be sustained and avoid the purchase of long-term

obligations of the local community. I wish to express my strong opposition to any change in the tax laws which will have that effect.

There is general agreement that the limit on Tax Preferences and allocation of deductions provisions of H.R. 13270 have added a minimum of 1/2 of 1% to the interest cost of State and municipal borrowing. This estimate is based upon the sale of bonds of excellent quality such as the recent State of Oregon issue. The fact is that the borrowing cost of municipalities of relatively poor quality has probably increased more than 1/2 of 1%. For example, an interest cost of 7.20% was incurred by the Piscataway School District in selling $6,000,000 of school bonds rated Baa on September 3, 1969. An interest cost of 5.35% was incurred by the Cherry Hill School District in selling $3.5 million of similarly rated bonds on May 5, 1967. This represents an interest rate increase of 1.85% whereas the Bond Buyer Index of 20 bonds increased 1.20% during the same period.

This increase in interest cost is not related in any way to the amount of additional tax which will be paid by the purchaser of municipal obligations if the two provisions become law. On the contrary, it is a premium required by the purchaser to compensate

for the new element of risk concerning the future value of his purchase. Obviously, if the present Congress can alter the value of tax exempt income, some future Congress can alter the value further. Typical of the reaction of individuals to this new risk factor is the following letter received in connection with the recent sale of State bonds:

"675 Red Oak Lane
Smoke Rise Butler
N J 07405
August 21 1969

Treasurer
State of N J Trenton N J
Dear Mr. Treasurer

I live in New Jersey. My capital is invested in state and municipal bonds, mostly of New Jersey. I would have subscribed for this new issue of 37½ m.d. except that I fear being whipsawed - i.e., buy the bonds at relatively low interest rate, because they are said to be tax-free, then find the Feds. taxing them anyhow. Can you not make Senators Case & Williams see this?

(signed) Lyle T. Alverson"

An increase of 1/2 of 1% in tax exempt interest rates will add $6,250,000 per year to the cost of financing the State's present construction program. On the basis of an average life of 15 years this will add $93,750,000 to the debt service charges which must be paid by New Jersey taxpayers.

An increase of 1/2 of 1% in interest cost will add $1,000,000 per year to the cost of municipal financing. Assuming that

New Jersey municipalities will continue to sell $200,000,000 of bonds each year, the additional interest cost will build up to $15,000,000 per year before new bond sales and old bond maturities reach equilibrium. Revenues to cover this additional cost must be obtained by increasing real estate taxes through the State. In other words, the impact of H.R. 13270, if it should become law, upon the taxpayers of New Jersey will be to increase motor fuels, sales and real estate taxes by at least $21,000,000 per year and some experts predict the increase will be double that amount.

The option, provided by H.R. 13270, to issue a taxable bond and receive a compensating interest subsidy payment from the Federal Government is illusory and without real substance. The fact is that:

1. The acts authorizing the sale of State bonds which were approved by the voters in November 1968 limit the interest rate to 6%. It may be necessary to hold a new referendum before bonds can be sold at the higher rates applicable to taxable issues.
2. There is no present market for taxable bond issues of the size and credit rating offered for sale by the average

New Jersey municipality. There are only five or six municipalities within the State than can offer bonds for sale in sufficient size to compete with corporations in the taxable bond market. For the average New Jersey municipality the option provided by H.R. 13270 is meaningless.

I wish to reaffirm my contention that the capital requirements of the State and its municipalities are so great that new devices and new incentives for investment in State and municipal securities are needed and that the Congress should consider constructive measures as opposed to the destructive provisions of H.R. 13270.

One constructive measure which might be considered by the Congress is revenue sharing so conceived that the total amount of municipal financing is reduced. The present volume of municipal financing is approximately $16 billion per year. A reduction of $5 billion in this amount would provide a powerful stimulous, reducing interest costs and enabling the average municipality to market its bonds with far less difficulty. This could be accomplished by channeling the shared revenues through the State Departments of Education for the construction

of schools in those communities demonstrating the greatest need, with the proviso that the entire cost of construction must be paid and bond indebtedness avoided.

The State of New Jersey is attempting to assist the smaller municipalities within the State in marketing bond issues by the creation of a State operated Municipal Bond Bank. Legislation providing for the establishment of such a bank has been introduced in the Senate with the expectation that it will be acted upon favorably when the Legislature reconvenes in November. The purpose of the bank would be to combine a number of small municipal issues in one package so that an issue of sufficient size to attract wide interest can be marketed with a consequent reduction in the interest cost paid by each municipality.

Also, the State is considering a proposal for the sale of State and Local bonds in small denominations through payroll deduction plans. At the present time, such bonds can be offered for sale at interest rates which would be competitive with the rates paid on the Series E bonds offered by the U. S. Treasury. The market for any substantial quantity of small denomination bonds is problematical. However, there is evidence to support the contention that many residents of the State would welcome an opportunity

to invest in the obligations of the State or of their municipality if a small denomination bond was offered to them.

In conclusion, I wish to restate my opposition to all of those provisions in H.R. 13270 which affect either directly or indirectly the tax exempt status of State and municipal obligations. The effect of the provisions will be to increase State taxes and local property taxes. This is not a desirable result.

STATEMENT BY THE STATE ASSOCIATION OF COUNTY COMMISSIONERS OF FLORIDA RELATIVE TO HR 13270 - SEPTEMBER 17, 1969 - TO THE UNITED STATES SENATE FINANCE COMMITTEE

The State Association of County Commissioners of the State of Florida is grateful for the opportunity to present its views to the Senate Finance Committee with respect to the provisions of HR 13270 that change the current status of tax exempt bonds. The State Association of County Commissioners is unalterably opposed to any change in the law with respect to tax exempt bonds. In support of this position, the following should be noted:

In growth states, such as Florida, the competition for investment capital for public purposes is extremely keen. The monies required to build schools, water and sewage systems, roads, dormitories for higher education and plants to attract industry are dependent upon the issuance of governmental bonds that offer attractiveness in addition to the interest rate.

The State has only recently taken advantage of some of the provisions for tax exempt bonds to meet the needs of our local government. In 1968, a new Florida Constitution was adopted, which permits the issuance of industrial revenue bonds. Many counties in Florida are preparing to take advantage of this to obtain a necessary capital to attract desirable industry and thereby reduce unemployment. During the 1969 Legislature, a bill was enacted to permit counties to establish authorities and issue revenue bonds for the construction of much needed private dormitories and educational facilities. Also during 1969, provisions were adopted for counties to issue short term bonds to build needed secondary roads, pledging as security therefor the county's portion of the state gasoline tax. Prior to these important changes being made, public needs were largely met through the issuance by state, municipal and other local government entities of tax exempt securities.

The public purposes served by obtaining these critical needs far outweigh any benefit which might accrue in the form of tax shelter to the investor. The only feasible alternative to the issuance of tax exempt obligations is to raise interest rates to exorbitant levels, thereby increasing the threat of inflation and penalizing the public, not only in the reduction in construction of needed public facilities, but in reduced buying power of the dollar.

The experience of those states which have utilized tax exempt securities to a greater extent than Florida, has proven its wisdom. It was for this reason that Florida's new Constitution contains a provision for pledging the credit of the state and for issuing additional types of these securities. Continuation of the tax exempt feature of theso securities is deemed essential to every segment of local government in the State of Florida.

It is respectfully urged that no change in the present tax exempt bond law be effected.

THE CITY OF COUNCIL BLUFFS *Iowa*

FINANCE DEPARTMENT
CHAS. L. CAMPBELL, Director
LUCILLE M. MORRIS, Treasurer

September 15, 1969

Senator Russell B. Long, Chairman
Senate Finance Committee
New Senate Office Building
Washington, D.C.

Dear Senator:

Availing ourselves of the opportunity offered in Mr. Vail's telegram of September 10, 1969, we wish to make the following statement on behalf of the City of Council Bluffs, Iowa:

> The City Council, August 4, 1969, unanimously adopted a resolution opposing any legislation which would tax income on State and Local government securities.

The municipal bond market is presently demoralized, partly as a result of the proposed legislation. Passage of this legislation will result in continued demoralization of this market pending anticipated litigation.

Increased interest rates will result in higher property taxes, as property taxes still represent the largest share of municipal income. Every home owner or renter will be penalized. The people have not asked for reforms which raise property taxes.

The Attorney General has grave doubts as to the constitionality of the Federal Government taxing States and their governmental subdivisions.

Taxing existing municipal bonds penalizes the holder, unfairly, who in effect has already paid a tax when accepting interest rates amounting to 65% to 70% of rates on private securities.

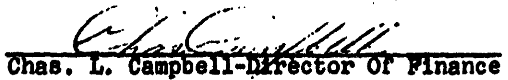
No showing has been made that municipal bond interest entered into the 154 cases cited by the Treasury Department of taxpayers who paid no income tax, even though their adjusted gross income was at least $200,000.00.

The tax subsidy proposed will not equal existing benefits to states and their governmental subdivisions. The City of Council Bluffs, Iowa in 1968 paid $239,961.55 interest. H.R. 13270 could increase this cost one-third or $80,000.00 annually. Should funds appropriated for the Federal Subsidy fall short, the Secretary of the Treasury would in effect be the judge of which governmental subdivision would receive a subsidy and for which purposes debt might be issued.

The City of Council Bluffs, Iowa does not oppose correcting inequities in the present federal income tax laws, but does oppose the creation of new inequities in planning to tax interest on local government securities.

The government of the City of Council Bluffs, Iowa wishes to preserve a benefit created by the Constitution and to retain it's ability to serve it's people without federal domination and control.

M. Don Harmon City Manager



Chas. L. Campbell-Director Of Finance

STATEMENT TO THE

SENATE COMMITTEE ON FINANCE

BY

PAUL A. AMUNDSEN
EXECUTIVE DIRECTOR

AMERICAN ASSOCIATION OF PORT AUTHORITIES

ON

H.R. 13270

Public marine terminals have never been attractive to private capital. With a few exceptions they have been developed by city or state governments or agencies thereof.

Local government has been able to provide such facilities at low investment rates because of the marketability of fully tax exempt general obligation or revenue bonds.

Historically, the total local public investment in marine terminals had reached $861,000,000 by 1941.

As attachments show, investment by city and state port agencies for 1946-65 has been $2,127,464,000. An additional $692,789,000 is being spent in the 1966-70 period, bringing all-time expenditures to almost $3.7 billion.

While minor portions of this total investment stem from direct appropriations by state and city governments, and from direct reinvestment of operating revenues, almost the entire dependency of the U.S. public port system is upon the fully tax exempt revenue bond or the general obligation bond for investment capital.

For this reason the member ports of The American Association of Port Authorities are opposed to any direct or indirect Federal taxation of interest on State and Municipal bonds. The effect of any such taxation on the bond market, already brought out by other witnesses, is, on the nation's seaport system, total and direct. Consider that system.

State port agencies apply in Maine, Massachusetts, New York and New Jersey (bi-state), Philadelphia, Pa.-Camden, N.J. (bi-state), Maryland, Virginia, North and South Carolina and Georgia as well as in Alabama. New York, Philadelphia, Norfolk, Savannah and others also have City agencies. Wilmington, Delaware is a city Port Commission. The Louisiana ports of New Orleans, Lake Charles and Baton Rouge are administered by agencies deriving their powers from the State. The Port Commissions of Mississippi are agencies of the State's Board of Agriculture and Industry. In Florida, a system of county port agencies applies (not unlike Navigation Districts). Well defined and more autonomous port authorities exist in Jacksonville and Tampa.

As the United States developed westward, from the Mississippi River, it is notable that port development began in local public hands and then remained so, there being very little private operation of commercial waterfront facilities in the West Gulf, and almost none in the states

of California, Oregon, Washington. Texas ports are governed by Navigation Districts deriving their powers from the State. The port cities of California were given "commerce and navigation" responsibilities by the State and hence the California pattern has been one of City development primarily. San Diego has within the last several years changed from a City agency to a regional Port Authority. San Francisco, long the lone State agency, within recent months has become a City agency.

Oregon has City agencies generally and a State agency identified with the Columbia River and airport structure. Washington has a system much like that of Florida, involving districts and elected commissioners, emanating from State powers.

Turning to the Great Lakes, the City harbor departments there in many cases have been replaced by port authorities including Duluth, Toledo, Cleveland and Buffalo. In Chicago there is both a City port department and a Chicago Regional Port District under State auspices. Milwaukee remains a City department whereas Detroit is a port commission under County auspices.

Every one of the port agencies has developed in an atmosphere of local self-determination. As each port area evolved, protection of the public interest of that area,

from the standpoint of waterborne commerce and harbor development has resulted in a port agency particularly tailored to that area's needs. As a result, no two of the agencies are alike as political structures. Nor are they alike as business entities.

Competing for a fair share of the nation's export-import tonnage is a large part of the job of protecting the local public interest, and this competition is very keen among ports in the cargo producing centers here and abroad.

Competing for industrial locations is likewise very keen, for this is "captive cargo" which is built into the port physical plant.

Seaport competition for cargo, given equal freight rates and frequency of sailings, really boils down to the provision of port facilities which offer efficiencies to the shipper and steamship line. This competition has resulted in the finest national port system on the globe.

It consists of 2,121 deepwater cargo terminals of all types (bulk as well as general cargo) of which 1254 were constructed since 1940. The average age of the total plant is 24.6 years, well under the typical amortization period of 35 years.

In general cargo terminals, where the competition is

very keen, 720 of the above terminals were built since 1946, their average age being 11 years.

Of these, 49 are container terminals built since 1965, average/age 4 years. Another 24 container terminals are under construction and another 45 are in the planning stage.

Almost the total investment in this system has been by local public agencies through fully tax exempt bond issues.

The Federal investment in ports has been mainly in the form of deepwater channels, the U.S. Engineers being responsible for navigable waterways.

The all-time Federal investment in channels since 1824 totals almost $1.5 billion, including maintenance. Comparing this to the historic local public investment in marine terminals ($3.7 billion) means that port authorities have invested more than $2.00 for every Federal dollar.

Customs collections at marine terminals for fiscal 1969 totalled $3 billion (excluding air cargo). The Federal deep channel appropriation for fiscal 1970 will probably be $35.5 million.

Thus on ports alone, the Federal Government has a very advantageous arrangement here. A 10,000% annual cash flow return on its dollar of annual investment as the minor partner in the joint venture.

33-758 O - 69 -- No. 9 -- 17

The technology of world shipping is undergoing rapid change. Thanks to the competitive public port system of the Unitwd States, the nation's world gateways are keeping pace and indeed assumed an early leadership position in urging new technology.

The Senate Finance Committee should very carefully consider that a major national asset, totally dependent upon local tax exempt issues for its progress, is being destructively dealt with by those provisions of H.R. 13270 which directly or indirectly hamper marketability through taxation.

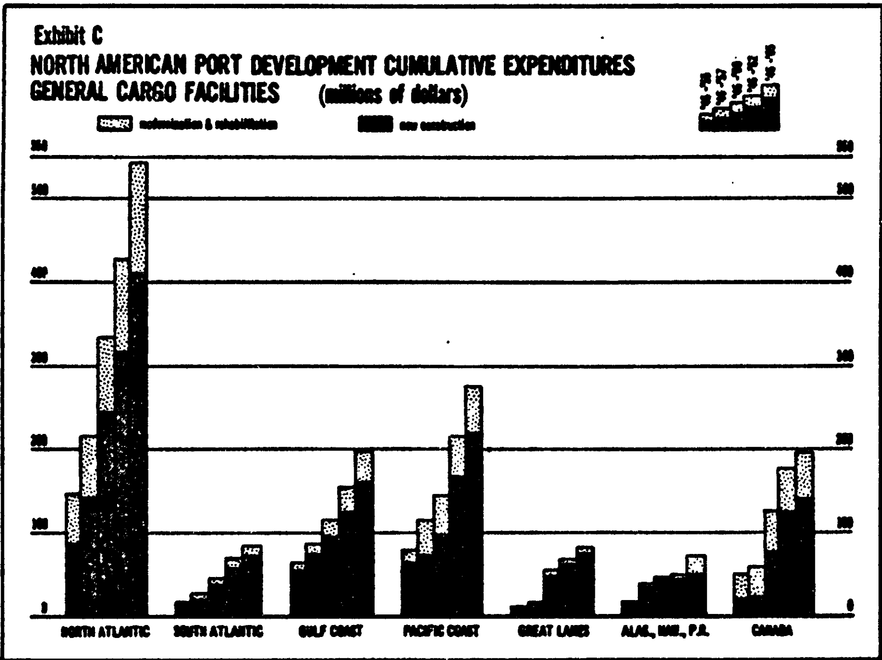


Exhibit C
NORTH AMERICAN PORT DEVELOPMENT CUMULATIVE EXPENDITURES
GENERAL CARGO FACILITIES (millions of dollars)
NORTH ATLANTIC
SOUTH ATLANTIC
GULF COAST
PACIFIC COAST
GREAT LAKES
ALAS., HAW., P.R.
CANADA

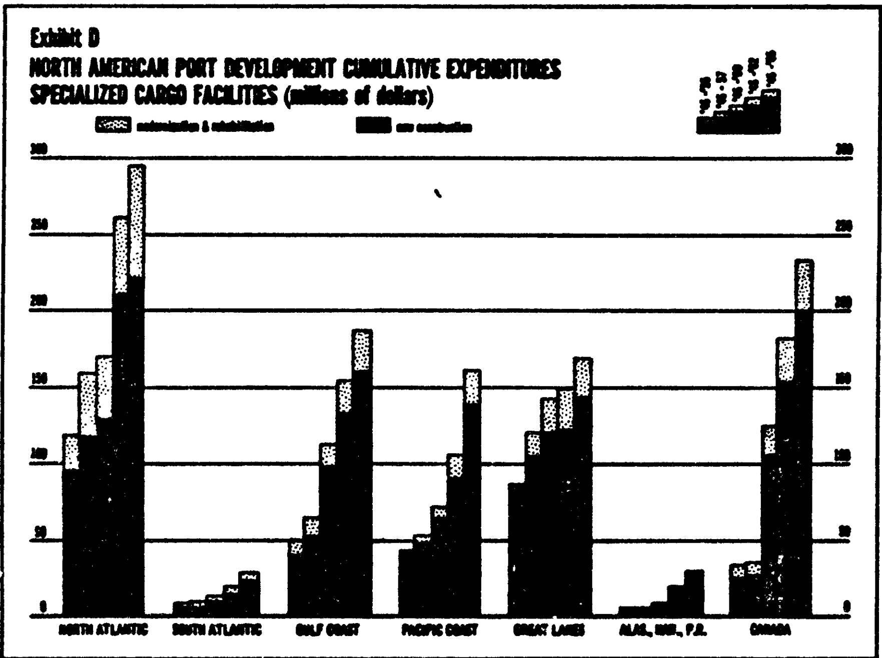


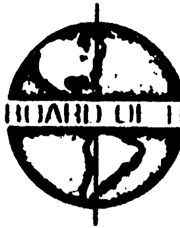
Exhibit D
NORTH AMERICAN PORT DEVELOPMENT CUMULATIVE EXPENDITURES
SPECIALIZED CARGO FACILITIES (millions of dollars)
NORTH ATLANTIC
SOUTH ATLANTIC
GULF COAST
PACIFIC COAST
GREAT LAKES
ALAS., HAW., P.R.
CANADA

TABLE XI

PORT DEVELOPMENT EXPENDITURES
JANUARY 1, 1961 - DECEMBER 31, 1965; JANUARY 1, 1966 - DECEMBER 31, 1970
(Thousands of Dollars)

Area	1966-1970 New	1966-1970 M-R	1966-1970 Total	1961-1965 New	1961-1965 M-R	1961-1965 Total
North Atlantic						
Authorized	94,131	27,466	121,597			
Planned	74,000	2,278	76,278			
Total	168,131	29,744	197,875	258,130	76,332	334,462
South Atlantic						
Authorized	43,031	15,906	58,937			
Planned	25,450	675	26,125			
Total	68,481	16,581	85,062	47,867	5,384	53,251
Gulf Coast						
Authorized	62,061	14,573	76,634			
Planned	24,321	1,439	25,760			
Total	86,382	16,012	102,394	126,453	30,647	157,100
Pacific Coast						
Authorized	269,933	41,560	311,493			
Planned	58,833	5,013	63,846			
Total	328,766	46,573	375,339	194,947	25,389	220,336
Great Lakes						
Authorized	10,000	-	10,000			
Planned	500	1,000	1,500			
Total	10,500	1,000	11,500	48,554	5,049	53,603
Alaska, Hawaii, Puerto Rico						
Authorized	13,366	250	13,616			
Planned	17,163	3,130	20,293			
Total	30,529	3,380	33,909	26,099	20,800	46,899
Canada						
Authorized	63,873	15,555	79,428			
Planned	43,160	9,512	52,672			
Total	107,033	25,067	132,100	155,950	21,711	177,661
TOTAL						
Authorized	556,395	115,310	671,705			
Planned	243,427	23,047	266,474			
Total	799,822	138,357	938,179	858,000	185,312	1,043,312

THE NEW ORLEANS BOARD OF TRADE



NEW ORLEANS, LA., U.S.A. 70130

September 12, 1969

Senator Russell B. Long, Chairman
Senate Finance Committee
217 Old Senate Office Building
Washington, D.C. 20510

Dear Senator Long:

For as long as we can remember, our communities have been building schools, roads, hospitals, sewers, bridges, waterworks, and port improvements by issuing long-term, low interest municipal bonds. The interest on these bonds (and, therefore, the cost to the tax-payer) is lower than on other securities because historically, traditionally and constitutionally it is exempt from all Federal income taxes.

In the so-called tax reform bill passed by the House of Representatives, and now being considered by your Finance Committee, most important among the proposals, we understand, is taxation of municipal bonds. In our opinion and that of bond experts such a plan would be most inimical to our State, particularly with reference to Parish and City school bonds and the proposed bond issue for the Port of New Orleans which is a must if our port is to maintain its position as the second major port of the nation.

If the House Bill was enacted into law in its present form, it is our feeling that the market for tax-exempt securities would be significantly and lastingly damaged; municipal bond purchases by individuals would be substantially reduced; interest rates on municipal bonds would materially rise, the excess costs thereby resulting on the community at large for the sake of punishing the few who might buy large quantities of such bonds; the preferential position of municipal securities in the capital markets relative to taxable issues would be impaired.

Established 1880

Senator Russell B. Long, Chairman
Senate Finance Committee

Page Two
September 12, 1969

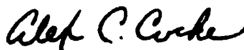
Only several days ago the Parish of Jefferson proposed a school bond issue for $10,000,000. for the purpose of building much needed schools and not a single bid was received.

We strongly urge that you oppose any legislation that might jeopardize the long-standing, highly successful and economical system of tax-exempt municipal bond financing. Unfortunately and with much regret we will not be able to appear before your committee, however, we are sending you under separate cover twenty copies of this letter and kindly ask that it be made a part of the record of your Committee's hearing.

Sincerely yours,

New Orleans Board of Trade, Ltd.

Kent Satterlee, President



Alex C. Cocke, Consultant

KS:ACC:mlm

cc: Senator Allen J. Ellender
245 Old Senate Office Building
Washington, D. C. 20510

Senator John C. Stennis
209 Old Senate Office Building
Washington, D. C. 20510

Senator James O. Eastland
2241 New Senate Office Building
Washington, D. C. 20510

STATEMENT OF J. ELDON OPHEIM, GENERAL MANAGER, PORT OF SEATTLE, SEATTLE, WASHINGTON, BEFORE THE SENATE FINANCE COMMITTEE, SEPTEMBER 22, 1969, ROOM 2227 NEW SENATE OFFICE BUILDING, ON H.R. 13270, AND OPPOSING PROVISIONS REMOVING TAX EXEMPT STATUS OF LOCAL BONDS ISSUED IN DEVELOPMENT OF PORT FACILITIES, WHICH WOULD RESULT IN GREATLY INCREASED AND POSSIBLY PROHIBITIVE INTEREST COSTS, HONORABLE RUSSELL B. LONG, CHAIRMAN OF THE SENATE FINANCE COMMITTEE, PRESIDING.

The Port of Seattle is a special purpose municipal corporation of the State of Washington established for the purpose of owning and operating marine and air terminals within the area of Seattle and King County. The Port founded in 1911 is under the management of a five-member non-partisan, non-salaried Port Commission elected by the voters of King County. The Port owns 15 working ocean terminals, a grain elevator, special facilities for container vessels, related warehousing, three small boat harbors for pleasure and fishing craft and the Seattle-Tacoma International Airport. Current book value of the Port of Seattle facilities after depreciation exceeds $150 million and gross operations in 1968 were in excess of $12 million.

Currently, the Port has under way an airport expansion program which will require expenditures in excess of $100 million during the next three years. This program includes the construction of the second parallel runway, major terminal enlargements and highway improvements.

The Port also has under construction a new grain elevator, estimated to cost in excess of $13 million, several new marine terminals and additional warehousing and other improvements

related to its water front operations.

The Port of Seattle wishes to register its protest to the enactment of H.R. 13270 as approved by the House of Representatives. It is our considered opinion that the measure which is now before the Senate destroys the independence of states and municipalities. No amount of argument by Treasury officials nor committee members can change the fact that this measure is aimed at destroying the municipal bond market, and has already had a serious impact on that market and made exceptionally more difficult the problem of financing important local public works.

The principal argument presented by the Treasury officials and by others supporting this measure is that certain citizens have used the tax exempt municipal bond to avoid paying their fair share of taxes. It should be noted, however, that for the privilege of buying municipal bonds these individuals have received materially lower interest rates. Presumably the market place has reflected only the saving in tax to the individual and that individual always had the option to purchase the more lucrative securities of the taxable market which would as a practical matter yield him approximately the same net return.

The effect of the Treasury's proposal which is contained within H.R. 13270 is to enrich the Federal Treasury at the expense of local property taxpayers who underwrite the majority of the municipal bonds sold in the United States. In the long haul, these property taxpayers will be the ones who will pay the added burden, the wealthy will simply receive a higher interest

rate. It is clear, therefore, that this legislation, so far as municipal bonds are concerned, does not tax the wealthy. Instead, it taxes the average citizen. The average home owner will end up paying higher taxes to support his schools, roads, public hospitals, ports et cetera, and the wealthy will receive a higher interest rate to compensate them for the added tax. If the wealthy do not get the higher rate, they simply will not enter the municipal market at all. They will invest their money as they have always been able to do in premium corporate securities which pay substantially higher rates of interest.

GRAFTON, FERGUSON, FLEISCHER & HARPER
ATTORNEYS AT LAW
310 WEST LIBERTY STREET-TELEPHONE 582-3871
LOUISVILLE, KENTUCKY 40202

CORNELIUS W. GRAFTON
JO M. FERGUSON
LILLIAN M. FLEISCHER
SPENCER E. HARPER, JR.

BEFORE THE FINANCE COMMITTEE

OF THE SENATE OF THE UNITED STATES

IN THE MATTER OF:

THE TAX REFORM ACT OF 1969 (H.R. 12370), IN SO FAR AS THE ACT UNDERMINES AND VIRTUALLY DESTROYS (WHILE GIVING SOME APPEARANCE OF NOT DOING SO), THE EXEMPTION OF INTEREST ON STATE AND LOCAL BONDS ISSUED FOR SUCH ESSENTIAL PROJECTS AS SCHOOLS, WATER SYSTEMS, SEWER SYSTEMS, RELIEF FROM WATER POLLUTION, HOSPITALS, COURT HOUSES, CITY HALLS, ROADS, AND THE LIKE.

MAY IT PLEASE THE COMMITTEE:

As a Municipal Bond Lawyer with more than 30 years' experience, largely in working with the smaller communities of Kentucky, I wish to be heard on the point that these smaller communities simply cannot survive this legislation in its present form.

Sections 601 and 602, with an appearance of innocence which assumes naivete and downright stupidity, seem to offer a harmless and deceptive new choice on a voluntary basis, while leaving undisturbed the privilege of issuing tax-exempt bonds as in the past.

But quite obviously, the provisions in Sections 301 and 302, providing for such euphonious "reforms" as Limited Tax Preference and Allocation of Deductions, will so destroy the marketability of tax-exempt bonds as clearly to indicate that there is really no choice at all.

The smaller communities, for which I am undertaking to speak, will be unable to market tax-exempt bonds; and when effectively forced by this legislation to seek the federal interest subsidy which is supposed to be just as good, they will learn that this is not an acceptable or workable substitute. Then it will be too late.

The essential and tragic fallacy lies in the assumption, which is false, that an interest subsidy, even in the maximum amount of 40% which is permitted, will make taxable bonds as marketable and effective as tax-exempt bonds, at the same cost to the small community, and with the federal government making up the difference.

Somebody is engaging in spinning out a self-pleasing but very foolish day-dream. I have a mental picture of so-called experts in the Treasury Department who entertain a theory that there is no difference between a taxable bond and a tax-exempt bond that cannot be made up, in any and all events, by a 40% interest subsidy. And I have no doubt that they prove their case by producing the published averages of Dow Jones, The Daily Bond Buyer, and others. These averages have little or no significance in the cases of bonds offered for sale by little communities -- they are openly published as being averages of bonds offered and sold by the biggest issuers, the household names, and the credits which have long and reassuring histories.

The same averages and theories are wholly without any realistic relation to bonds offered by little issuers, names unfamiliar to the investing public, and credits which venture into the market-place for the first time. If these are effectively deprived of the historic tax-exemption which gives them the only break they have ever had; then, subsidy or no subsidy, they will be obliged to go out in open competition with the gold-plated names of the great corporations which are listed on the Exchanges and deal in terms of millions and billions of dollars.

This can be called "competition," if you like, but only in the cynical sense in which it might be suggested that the local high school football team may fairly "compete" with the New York Jets, the Baltimore Colts, or the Green Bay Packers; the argument apparently being that the hospital and surgical bills will be paid by the government, so everything will be equal.

In high school football in Kentucky, as I believe to be the case in many other states, schools are put in different classes

according to size; so that the big ones play the big ones, the mediums play the mediums, and the little ones play the other little ones. Each has a chance to become a champion -- but among equals, and not with the odds rigged against them. So also in boxing, where featherweights are not put in the ring with heavyweights.

I carry no torch, nor shed tears of sympathy, for certain persons of great wealth who are shown to have avoided payment of federal income taxes, in whole or in part, by investing substantially in state and local tax-exempt bonds. Nor am I qualified by education or experience to weigh the right and the wrong of avoiding taxes by making charitable contributions. These practices are held up as deplorable "loopholes" which make people very angry and are said to threaten a "taxpayers' revolt."

But it seems to me there is a certain amount of blindness or at least myopia about all this, in terms of perspective. Out of perhaps 200 million people in the United States, it appears from statements by proponents of this "Tax Reform Bill," as found in the Congressional Record (August 7, 1969, page H7075) that there are 155 persons worthy of being held up to the rest of us in horror on this account.

The idea of curing 155 cases of this sort at the cost of destroying what little ability small communities may have to finance essential local improvements (if they can do it at all), seems to me to be like drowning the faithful family dog in order to drown his fleas at the same time. No doubt the fleas will be drowned, and then we will adjourn to the back yard and bury Old Rover. This makes sense only if you hate dogs; not just because you hate fleas.

I assume that if I were testifying before this Committee in person, instead of submitting this written statement, -- I would be interrupted at this point (if not considerably earlier), with a suggestion that I justify my essential premise by explaining just why it is that an interest subsidy of up to 40% will not, in fact, serve as the equivalent of exemption of interest from federal income taxation in the first place.

There is no trouble at all in making such an explanation -- and to the experts who may still be doubters, I can only suggest that they come down to Kentucky, prepare bond issues for little communities, and see what happens to them. They have a hard time getting

noticed. Even with the benefits of tax exemption, the best of engineering service, and competent and vigorous sponsorship and financial assistance from licensed underwriters, they sometimes fail to receive a purchase bid. In many instances they can obtain no encouragement from dealers and investors, and have no choice but to look for grants and low-interest loans from the federal government, which virtually monopolizes the readiest sources of tax revenues and therefore has all the money. If government grant and loan resources have been exhausted (which is as often the case as not), they wait in line for the next fiscal year's appropriations -- or give up and do without.

The principal bond-purchasing officer of one of the big New York banks told me one day that he could give consideration to bonds of the Commonwealth of Kentucky, the City of Louisville, and perhaps seven other cities and the counties in which they are situated. The other cities, counties and public bodies of Kentucky could not be considered because they were not covered in published, official source material, generally could not obtain ratings from the standard rating agencies, had no credit history, and were offering bond issues too small to warrant the expense of an independent study of his own.

A high-ranking officer in a nationally-known underwriting firm explained to me that during the average week his staff has opportunities to participate in 50 to 100 bond syndicates -- that it was impossible to give thoughtful consideration to more than 20, and that the rest simply had to be passed up, regardless of the fact that they might very well have merit. The ones that are passed up are naturally the little ones that need help the most. I am not complaining. These are the facts of life.

Our small communities, having no impact in the national markets, owe their successful financial ventures, when they happen, to a combination of two factors -- the tax-exempt status of the bonds they can offer, and the loyal and vigorous support they get, in meritorious cases, from investment banking firms operating out of Louisville and Lexington, Kentucky, Cincinnati, Ohio, and Nashville, Tennessee. These fine firms, well acquainted as they are with local conditions and neighborhood customers for bonds in small lots, constitute the only available market for those bond issues that cannot survive in the national market, yet have merit enough to warrant distribution, with help. Otherwise there is no

place to go, except to governmental agencies for grants and what amount to sub-marginal loans.

But all of these nearby dealers will tell you, I believe, that without the feature of tax exemption working in their favor, the small bond issues they can otherwise manage to distribute with persistent effort might as well be forgotten in the face of the Tax Reform Bill of 1969. The little communities will be reformed out of existence. If a purchase bid cannot be obtained -- a subsidy of 40% of nothing is nothing. Letcher County, Kentucky, cannot compete with General Motors.

Even the small local investors are already alarmed and their faith in their national government has been shaken. The doctrine that the sovereign governments of the States may not tax the sovereign government or agencies of the United States was originally enunciated by the Supreme Court in a case where it was the United States that was the party seeking protection, and which obtained it. It is scarcely imaginable that the doctrine does not apply in the converse, when the idea is advanced that it is somehow permissible for the United States to tax the governments, agencies, and subdivisions of the several States. The Supreme Court has so held.

Exemption of interest received on bonds of the States, their municipalities, agencies and subdivisions has been in the income tax laws, and in the regulations implementing the income tax laws, as long as such laws and regulations have been in existence. The basis has always been Justice John Marshall's truism that "the power to tax is the power to destroy."

It has been upon the faith of these long-standing laws, regulations, and repeated interpretations of them, that investors large and small have purchased state and local bonds upon terms favorable to public issuing bodies -- terms which could not otherwise have been justified. Now these investors are confronted by legislative proposals that seek to obtain by indirection and circuity what the Congress obviously knows it cannot achieve by a direct and frontal constitutional attack.

It is disconcerting to be confronted with a rather sly and pleased suggestion of one's own government that a way may have been discovered to accomplish what cannot be done forthrightly, by

simply wiggling around the end and back of it. The States, their governments, and large public bodies such as the New York Port Authority appear to be big enough, and possessed of sufficient means, to be heard -- and we are confident that they will speak up -- hopefully on behalf of small investors as well as in their own defense.

The small investor, and the small public issuing bodies, can only sit still and be bewildered. A course of action in the direction now suggested may be constitutional, while at the same time constituting a crashing breach of faith. The present administration even suggests publicly that the underground erosion of the historic and traditional tax-exempt status of state and local bonds be applied in retrospect to bonds which were issued when the law was clearly otherwise. It would be bad enough to be given warning of the future so that one might avoid getting into a trap. It is not in accord with ordinary standards of good faith and morality to have the trap sprung on what has already been done under different ground rules.

It is a cause for legitimate wonder when government acts toward its citizens in a manner which, if used by citizens against their government, would doubtless cause speeches to be made in high places, and perhaps investigations to be ordered and indictments to be sought.

And all this seems stranger still, when one observes that although the government long ago abandoned exemption of interest on its own bonds from its own income taxation -- yet when it felt the necessity to obtain from private sources the most inexpensive possible money for its vast housing program, it (a) by law made the bonds incontestable, (b) by law pledged the full faith and credit of the United States to their payment, and (c) by law exempted interest thereon from "all taxation now or hereafter imposed by the United States." (The United States Housing Act of 1937, as amended.)

H.R. 12370 is some 368 pages in length, and I cannot pretend to have read and understood all of it, or indeed any very substantial part of it. But I have read published summaries and analyses, and I have yet to find any suggestion that the government proposes to subject the housing bonds which it has thus guaranteed and exempted from "all taxation now or hereafter imposed by the United States" to the destructive proposals which are directed

toward state and local municipal bonds by the legislation here under consideration.

I am reminded of the long-protracted litigation between the Dollar Steamship Line and the United States; wherein the United States, shamefully but obviously without any sense of shame, refused to obey a final judgment of its own Supreme Court, and our Supreme Court. After the case was decided against it, the United States persisted in attempts to litigate, in the District Court for the Northern District of California, issues which had already been litigated to final conclusion.

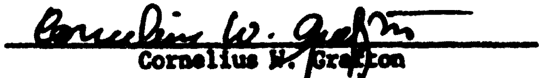
In United States v. Dollar et al. (1951), 100 F.Supp. 881, there is to be found a long and indignant discourse by Judge Murphy on the subject of the government's behavior. It is, we think, appropriately brought to a climax in this passage (see p. 889):

> "The government should not be permitted to avoid liability by tactics that would never be countenanced between private parties. The government should be an example to its citizens, and by that is meant a good example and not a bad one." (Emphasis supplied.)

Someone has said what somebody ought to have had the courage to say.

I agree.

Submitted by:



Cornelius W. Grafton

GRAFTON, FERGUSON, FLEISCHER & HARPER
Room 403 - 310 West Liberty Street
Louisville, Kentucky 40202

September 16, 1969

33-758 O - 69 -- No. 9 -- 18

Bellevue Public Schools

Box 458
Bellevue, Nebraska 68005

September 15, 1969

Honorable Senator Russell B. Long
Chairman, Senate Finance Committee
New Senate Office Building
Washington, D. C. 20000

Mr. Chairman:

The Bellevue School District of Bellevue, Nebraska wishes to file testimony in opposition to section 301 of H.R. 13270.

We oppose this section of the bill for the following reasons: (1) We believe that those individuals who are buying municipal bonds are already indirectly taxed by accepting a lower return on their money. (2) We are of the opinion that if this section of the bill becomes law the inevitable litigation to follow will make the municipal bond market an uncertainty for many years. (3) Any attempt to eliminate or curtail the issuance of tax-free municipal bonds can only weaken local self-government and place greater power in the federal bureaucracy in Washington. The citizens of our community are qualified to determine the needs of our school and the ability of this community to meet those needs.

As a federally impacted school district we have experienced a government program for building. The conclusion we have reached based on this experience is that the time lapse in appropriation does not allow this district to meet its immediate needs.

Our district is attempting to sell bonds at the present time. We have been unable to sell the bonds because of this proposal under consideration by the Congress. Because of rapid growth our district must sell bonds to meet the need for additional facilities. We urge this Committee to reject the proposal to tax municipal bonds.

Sincerely,

Richard L. Triplett

RICHARD L. TRIPLETT
Superintendent

RLT(FL)/jlg

QUALITY EDUCATION IN NEBRASKA'S FASTEST GROWING COMMUNITY

Tax Reform and the Market for Municipal Bonds*

by

Edward F. Renshaw and Donald J. Reeb
Graduate School of Public Affairs and Department of Economics
State University of New York at Albany

Summary

1. The debt of state and local government is now in excess of $140 billion and has been projected to grow at a faster rate than the aggregate economy through 1975. The market for tax exempt bonds is largely limited to commercial banks and a few wealthy individuals whose assets are not likely to grow as rapidly as the economy. Many states are now paying over six percent interest on new issues of municipal securities and at these historic rates are unable to find buyers for about half of the normal volume of new issues.

2. The current crisis is likely to continue owing to:

(a) a much slower growth in the money supply which will force banks to ration credit more carefully,

(b) a preference on the part of banks for business loans as opposed to investment in municipal bonds,

(c) possible changes in our tax laws which will reduce the cash flow of corporations and financial institutions, and

(d) a tremendous pent up demand for credit to provide housing, automobiles and consumer durables a maturing baby boom and the returning G.I.'s from Vietnam.

3. Recognizing that state and local governments will face a continuing problem in finding financing for needed public construction, the members of the House of Representatives have included in their tax reform bill a provision which would permit the Treasury to provide state and local governments with a direct interest subsidy if they elect to issue taxable bonds. This provision would:

(a) provide the Treasury with a clear mandate to gradually eliminate one of the most glaring inequities in our federal tax system, and

(b) make it reasonable for the financial officers and managers of the trust funds of state and local governments, who now administer over $100 billion in financial assets, to help solve the current crisis.

4. No Urban development bank would be large enough or possess enough local appeal to accomplish these ends. Congress and the Treasury can afford to be generous in encouraging state and local governments to abandon tax exempt securities in favor of a more equitable system of public finance. The increase in taxes which would accrue to the US Treasury can be expected to offset even the maximum subsidy of 40 percent which would be permitted in the House bill.

5. The lack of basic data on which to assess the effects on the market of other provisions in the House bill which might tax some of the interest on tax exempt bonds is unfortunate. It and problems related to credit ratings and other ways state and local governments can reduce the cost of borrowing high light a need for a major study of the municipal bond market.

*Statement prepared for Senate Finance Committee Hearings on Tax Reform, September 1969.

1. TAX EXEMPT BONDS

The debt of state and local governments—now in excess of $140 billions—has grown at about eight percent per year since the end of World War II and has been projected to grow an average rate of about seven percent per year through 1975.[1] The market for this debt has been constrained by the implicit form of the subsidy and its dependence on the federal personal and corporate income tax rates. That is, the size of the subsidy varies directly with the marginal tax bracket of the holder of the bond. The result has been that nearly seventy-five percent of the state and local debt is owned by commercial banks and high income individuals.

Household demand for municipal securities grew at a fairly steady rate in the early post war period and then reached a state of near saturation in 1955 when additions to total holdings amounted to more than three billion dollars. Between 1955 and 1966 household demand declined to an average increase of less than two billion dollars. In 1967 and 1968 demand for new issues was not sufficient to replace retirements. It became increasingly clear from the periods of monetary restraint such as 1966 and 1969 that a very high interest premium must be paid to induce a significant number of new individual investors to enter the market for municipal securities.

Commercial banks absorbed about 75 percent of the net increase in municipal securities in the seven year period from 1962-68. Dominance in this market appears to have been related to a high marginal tax rate and an unusual growth in the money supply (8 percent).

---

[1] The Joint Economic Committee, State and Local Public Facility Needs and Financing, December 1966, Volume 2, p. 35.

See columns (3) and (4) of Table 1. In the preceding fifteen year period (1947-1961) when the money supply, was growing at a much slower rate (3 percent), commercial banks were willing to absorb only 27 percent of the increase in municipal debt.

Table 1

The Composition of Commercial Bank Assets in Relation to Interest Incentives and Changes in the Money Supply Including Time Deposits The United States 1947-68

Year	Other Securities (which are mainly Municipals) as a Percent of Bank Loans	S&P's High Grade Municipal Bond Rate as a Percent of the Average Short Term Bank Rate	Percentage Growth in the Money Supply Including Time Deposits	Increase in Bank Holdings of Municipals as a Percent of the Total Increase in Municipals
	(1)	(2)	(3)	(4)
1947	23.6	95.7		64.3
48	22.2	96.0	-.7	20.0
49	24.5	82.5	.0	29.6
50	24.3	73.6	3.7	53.3
51	23.7	64.3	5.3	44.0
52	22.6	62.8	4.8	37.0
53	22.2	73.7	2.7	14.0
54	23.7	65.6	4.1	32.7
55	20.8	68.4	2.5	2.0
56	18.5	69.8	1.9	4.3
57	19.6	77.9	2.2	22.2
58	21.4	82.0	6.8	53.1
59	19.1	79.0	1.4	10.2
60	18.3	72.3	2.2	12.0
61	19.8	69.6	6.6	39.7
62	21.8	63.6	7.4	64.3
63	23.4	64.5	8.0	94.5
64	23.1	64.5	7.8	59.3
65	23.3	64.6	9.7	82.0
66	23.4	63.7	4.8	40.0
67	27.0	66.0	11.0	89.1
68	28.1	67.5	10.9	81.4[a]

Source: Economic Report of the President and Flow of Funds Statistics of the Federal Reserve.

a. Estimated by the Investment Bankers Association

In the second half of 1966 and in the first eight months of 1969 commercial banks sold more municipals than they purchased. While one would expect bank demand to improve somewhat as inflationary pressures begin to ease, there are several reasons for supposing that the total value of municipals held by commercial banks might not grow at all in the next few years. If this rather pessimistic view is warranted, state and local governments will either have to find new sources of financing for from eight to ten billion of public improvements each year or cut back on their capital accumulation drastically.

2. THE FUTURE MARKET

Five reasons can be advanced in support of a pessimistic view of bank demand for municipals. The first reason is the monetary outlook. The percentage growth in the money supply including time deposits has already declined sharply from the eleven percent growth rate which prevailed in 1967 and 1968 and will probably not be permitted to grow at an average rate of more than five percent per year in the next few years. If past relationships were to hold, this would mean that bank demand should fall to less than half of all net new issues of municipal debt.

Secondly, the unprecedented demand for credit that is likely to result when the baby boom reaches maturity and the economy strives to provide more consumer durables could cause bank demand for state-local bonds to fall even lower than would be indicated by past history. In addition, it should be remembered that commercial banks have always tended to give first priority to the needs of business and to only invest their "excess funds" in other securities such as municipal bonds. In his book on the Management Policies for Commercial Banks, Howard Crosse, Vice-President of the Federal Reserve Bank of New York, has stated this preference in the following way:

> The policy approach advanced in this book has stressed the primary obligation of a commercial bank to serve the credit needs of the community. It has emphasized, also, the need for protective liquidity and has advocated the provision of sufficient additional liquid assets to meet any foreseeable local demand for loans. Banks in some areas, however, or at some times, will have provided adequate liquidity, granted all the sound loans they can, and still have excess funds to invest. Funds so employed represent the bank's "investment portfolio" as distinguished from its liquidity position and its loan account.[2]

State and local bonds are generally considered to be part of a bank's investment portfolio.

Corporate demand for bank loans surged from a net increase of less than 3 billion dollars in the early 1960's to over nine billion in 1965 and has since held at about twice the average level of the earlier period. The impact of this demand on the portfolios of commercial banks has been especially marked in the case of the large New York City Banks. The five largest NYC banks had about 10.3 percent of their assets invested in municipal bonds at the end of 1964; by the end of 1968 this figure had dropped to 7.3 percent--a decline of three percentage points.[3] While other banks did tend to increase the share of municipals in their portfolio during this period of time, none of larger NYC banks were inclined to do so.

As large corporations turn increasingly to banks in other cities and force unincorporated businesses to pay for goods received more quickly, it is likely that many more banks will feel compelled to make a permanent reduction in the share of assets invested in municipal securities.

---

[2] Howard Grosse, Management Policies for Commercial Banks, Englewood Cliffs, New Jersey: Prentice Hall, 1962, p. 231.

[3] These percentages are based on simple averages that were not weighted for differences in total assets. A weighted average decline in the proportion of municipals would be smaller since the two largest banks only decreased the share of assets invested in municipals by a little over one and one-half percentage points.

A third factor to consider is the House of Representatives tax reform bill.[4] Section 703 proposes the repeal of the seven per cent investment credit and the extension of the corporate surcharge tax (Section 701). The amount of funds that are available to businesses will be reduced by nearly 4.0 billions by 1971 if these two provisions are enacted.[5] This would force large corporations to relie more heavily on the credit obtained from large banks and be less generous in supplying credit to retail establishments, inturn forcing the latter to be more dependent on loans from local banks.

Fourthly, the market for municipal bonds will be decreased if Congress adopts the Treasury's proposal to grant banks a special tax deduction when they invest in residential construction, make loans to college students and accept SBA guaranteed loans. The Treasury proposal not only provides a direct incentive for banks to discriminate against municipal bonds in favor of other kinds of investments but also contains an "allocation of deductions" feature which would include tax exempt interest. Since over 50 percent of the net income of many commercial banks is from tax bonds, it seems likely that some banks would have to sell municipal obligations to take advantage of the new subsidy.[6] Most individuals, on the other hand, do not invest a very high proportion of their assets in municipal bonds. It stands to reason, therefore, that an allocation of deductions principle applied to financial institutions could have a decidely more negative impact on the municipal bond market than the allocation of deductions formula applied to individuals which the Treasury would like to see retained in the House bill.

---

[4] U.S. Congress, H.R. 13270, "An Act to Reform the Income Tax Laws," August 8, 1969.

[5] U.S. Congress, Tax Reform Act of 1969, Report of the Committee on Ways and Means, August 2, 1969, p. 19.

[6] Benjamin A. Okner, Income Distribution and the Federal Income Tax, (Ann Arbor: Institute of Public Administration, the University of Michigan, 1966), Table A-1, p. 83. It is estimated that only 1.1 percent of all investors in municipal bonds invest more than 25 percent of their assets in municipals.

Another important consideration, from the point of view of these hearings, is that an effective housing program is almost certain to divert thrift deposits from commercial banks to savings and loan associations which do not provide a significant market for municipal bonds.

Since 1947 commercial banks have maintained a remarkedly constant proportion of their total loan portfolio in mortgages. The average ratio for the period 1947-68 was about 26 percent and has actually trended down slightly since 1963. The Comparable proportion for savings and loan associations is nearly 100 percent. New deposits in savings and loan associations increased from a little over one billion in 1947 to more than eleven billion in 1963. Large portions of this flow of potential mortgage money have been diverted to commercial banks in recent years, however, as a consequence of changes in regulation which permit banks to pay higher rates on some time deposits and restrictions which have been placed on the rates that savings and loan associations may pay on their deposits. The result, of course, is that housing starts are now significantly lower than in 1963 when family formation was considerably less than it is today. The most effective way to increase the flow of savings going into residential construction would be to permit savings and loan associations to again pay somewhat higher rates of interest on time deposits than commercial banks. This has been the traditional way of diverting savings into housing and is almost certain to be resorted to again if a proper balance is to be struck between residential and business investment. Thus would result in a relative decline in commercial banks time deposits--and a lesser demand for municipal bonds.

In our testimony before the Committee on Ways and Means on March 11, 1969 we estimated that there now exists a permanent shortage of municipal financing amounting to at least five billion dollars per year and that the shortage this year could be even greater if commercial banks abandon the municipal bond market as was the case in the second half of 1966.

More than twice as many new issues of municipal bonds have been withdrawn from the market this year than in 1966. The slowness of the economy to respond to monetary and fiscal policy, the tremendous pent up demand for housing and other types of consumer credit, and the prospect that Congress will enact major tax reforms makes us even more convinced that the present market for municipal securities cannot be relied upon to provide adequate financing for public facilities.

3. A New Market

Recognizing that state and local governments will face a continuing problem in finding financing for needed public facilities, the members of the House of Representatives have included in their tax reform bill a provision which would permit the Treasury to provide state and local governments with a direct interest subsidy if they elect to issue taxable bonds rather than tax exempt obligations. This provision has several advantages over other proposals which would broaden the market for municipal securities.

The most significant advantage of the House bill is that it would provide the U.S. Treasury with a clear mandate to gradually eliminate one of the most glaring inequities in our Federal tax system without reducing the amount of capital available to finance state and local facilities.[6] No Urbank would be large enough to accomplish this objective.

A Federal Urban Development Bank could not be considered a financial success unless its securities sold at a rate of interest almost equal to Treasury obligations. This would make U.S. government bonds and the Urbank debt very close substitutes. Since the Treasury is responsible for keeping

[6] The law reads..."The Secretary of the Treasury...shall pay a fixed percentage of the interest yield...in order to encourage the states and political subdivisions...to make elections [to issue taxable bonds]. U.S. Congress, HR 13270, An Act to Reform the Income Tax Laws, August 8, 1969, p. 320-1.

interest on the U.S. debt as low as possible, it would tend to oppose large increases in the amount of Urbank debt for fear that these obligations will drive up the rates of U.S. government bonds and destroy much of the yield advantage that the Federal government has traditionally had in competing for funds in the private market. A small Urbank operation would mean added delays to state and local borrowing, an onerous rationing mechanism, and an extra layer of administrative costs in the financing of public facilities.

A direct interest subsidy to taxable local bonds would permit these obligations to compete more directly with high grade corporate bonds, which are now the most preferred investment in the cash and security holdings of state and local governments. These holdings amount to over $100 billion dollars. In 1956 when interest rates were lower and the yield differences between municipals and high grade corporate bonds were fairly negligible, state and local governments held about 12 percent of their assets in municipal bonds. This figure has declined to less than three percent of total assets in 1969. Corporate bonds during the same period of time increase from 10.4 to about 40 percent of total assets.

While state and local governments would not have a very compelling reason to support a market for securities of a Federal Urbank---U.S. government securities in state and local retirement funds declined from 50 to 20 percent of total assets between 1954-68---there is reason to believe that the managers of these funds would feel a very strong obligation to support a fair and orderly market for the taxable securities of their respective governments. It seems likely, therefore, that a system of direct interest subsidies to state and local governments that issue taxable bonds would provide a broader and more competitive market for municipal securities than an urban development bank.

The severe fiscal problems of state and local governments make it both proper and desirable that Congress adopt a tax reform bill which persuades, rather than coerses states and local governments into issuing taxable bonds.

Since the increased taxes which would accure to the US Treasury can be expected to offset even the maximum subsidy of 40 percent which would be permitted in the House bill,[7] it is clear that Congress and the Treasury can afford to be generous in encouraging state and local governments to abandon tax exempt securities in favor of a more equitable system of public finance.

Those attacking the exemption feature have generally recognized that state and local governments benefit from tax exemption but have argued that exemption is an inefficient subsidy. If income taxes are progressive and if the volume of bonds is too large to be absorbed by persons in the highest tax bracket, tax exempt rates must be raised enough to attract capital from persons in lower brackets, giving bond holders with higher incomes a windfall gain. Estimates suggest that the interest saving to state and local governments in the postwar period has ranged from about one-third to less than two-thirds of the revenue loss to the federal government.

There is one feature in the present bill which we feel should be deleted. That is the provision which would lower the minimum subsidy that the Treasury is permitted to pay state and local governments from 30 to 25 percent in 1975. No rationale is provided for this reduction. It might be considered breach of faith which increases the uncertainty as to whether Congress really intends to phase out tax exempt bonds by offering a more attractive substitute.

If the intention is to gradually eliminate the supply of outstanding tax exempt bonds, the subsidy to state and local bonds will have to be increased over time instead of lowered. This follows from the fact that fewer tax exempt issues will create a scarcity condition that will enable the outstanding issues to be absorbed almost entirely by persons and institutions in the very highest tax brackets. Its these groups which now obtain the largest

---

[7] David J. Ott and Allan H. Meltzer, Federal Tax Treatment of Local Securities (Washington, D.C.: The Brookings Institution, 1963), p. 1. Lucille Derrick, "Exemption of Security Interests from Income Taxes in the United States," Journal of Business, Vol. 19 (Oct. 1946), Part 1, App., listed 114 resolutions introduced between 1920-1943 to reduce the subsidy. Cited in Ott and Meltzer.

amount of windfall gain from the excess supply of municipals that is now depressing bond prices and raising yields to historical highs.

The most important point to note in connection with other features of the House bill which might tax some of the interest on municipal bonds is that we really have little or no information on the possible effect of these measures on the market for municipal bonds. Individual tax payers are not required to report interest on municipal securities. This lack of basic data on which frame an important public policy highlights a need for major study of the municipal bond market. In the remainder of this paper we will cite some additional reasons for undertaking such a study.

4. Some Notes on the Need for a Major Study of the Municipal Bond Market

That portion of the Federal debt which was not held by the Federal Reserve or agencies of the U.S. government was about 18 times as large as the debt of state and local governments at the end of World War II and has actually declined somewhat since 1945. The debt of state and local governments, on the other hand, has grown at about 8 percent per year and is now more than half as large as the net Federal debt. If past trends continue, it will be only about five years before state and local governments will place in the hands of private investors more debt than is (now) obtained from the Federal Government.[9]

[9] This projection subtracts U.S. Government securities that are owned by state and local governments from the net Federal debt. About seven years would be required for the debt of state and local governments to exceed the total net Federal debt, if past trends continue. Data are from the Economic Report of the President, p. 303 and the Joint Committee Print on State and Local Public Facility Needs and Financing, Dec. 1966, Vol. 2, p. 40.

While many volumes have been written on the "burden of the national debt," comparatively little attention has been paid to the management of state and local debt.[10] Two of the most prestigious college texts devote only one paragraph to problems connected with the municipal bond market.[11]

It has become increasingly clear in the last 2 years that the present market for municipal securities is too narrow to provide the facilities that will be needed by state and local governments in the decade ahead.[12] Rising concern on the part of public officials has inspired a large number of alternative arrangements which are now being given serious consideration within the broader context of tax reform. It is to be hoped that a method will soon be worked out to provide state and local governments with an attractive direct interest subsidy that will not only broaden the market for municipal securities but also end the stigma of an inequitable tax system.

If Congress does enact something along the lines of the 'dual coupon' proposal which was recently suggested by the National Governors' Conference[13]

---

10 The new SEC investigation which was presumed to imply a broad based study of the security markets will not devote much effort, as near as we can determine, to problems connected with the municipal bond market.

11 Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, 1959), p. 575. Less than half a page is devoted to borrowing by local governments. John F. Due, Government Finance (Homewood, Illinois: Richard Irwin, Fourth Edition, 1968), p. 400. One paragraph is used to summarize the conclusions of Ott and Meltzer in their monograph, Federal Tax Treatment of State and Local Securities (Washington, D.C.: Brookings Institution, 1963). The only other major work in this area by an academic economist is the now out-of-date book by Roland I. Robinson, Post-war Market for State and Local Government Securities (New York: National Bureau of Economic Research, 1960).

12 In the seven year period from 1962-68 commercial banks absorbed about 75 percent of the net increase in municipal bonds. This was made possible by an unusual growth in bank deposits. In the preceding 15 year period when the money supply, including time deposits, was growing at a more normal rate, commercial banks were willing to absorb only 27 percent of the increase in municipal debt.

13 The Wall Street Journal, May 5, 1969, p. 3.

there will still be a need for a follow-up study to determine whether the yields on taxable municipal securities compare favorably with other interest rates and to consider the benefits and costs that might be associated with various arrangements to improve financial information[14] and further reduce the cost of state and local borrowing.

Options such as permitting the Federal trust funds to hold state and local bonds and the creation of a Federal system of state urbanks are particularly worthy of study. It would also be interesting to know whether the same objectives could be obtained by simply creating a new type of Federal Deposit Insurance Corporation to insure the interest and principal due on state and local bonds. Of even greater concern to some public officials is the fairness of the existing municipal security rating system.

Are Bond Ratings Meaningful?

In July, 1965, Moody's Investors Service lowered New York City's credit rating from A to Baa. The reaction of finance administrator Roy M. Goodman "touched off a national debate on bond ratings" which eventually resulted in two hearings on the subject before the subcommittee on Economic Progress of the Joint Economic Committee in December 1967, and July 1968.

In March, 1968, Senator Proxmire and Representative Patman introduced identical bills to establish a government corporation patterned on the Federal Deposit Insurance Corporation to guarantee the payment of interest and principal on state and local bonds. The preamble to this bill contends that states and local governments are being forced to pay excessive interest

---

[14] Some states such as North Carolina have actively supervised the information and procedures used to issue local bonds. It would be interesting to study whether this effort has been successful at improving the bids received by localities.

33-758 O - 69 -- No. 9 -- 19

owing in part to "the failings of the existent municipal securities rating system."[15]

One of the best ways to indicate a need for an independent study of the municipal bond rating system is to observe the pattern of ratings which emerges when states are ranked on the basis of total personal income divided by the amount of debt outstanding which pledges the state's full faith and credit to guarantee both interest and principal. Total personal income is surely the best single measure of the taxable revenue base that is available to most states. One would expect such coverage to be an important determinant of credit ratings. It is clear from Table II, however, that Moody's ratings give little weight to income coverage. Twenty-one states, with lower credit ratings, have higher personal income coverage than either Vermont or Connecticut, both of which enjoy a triple-A rating.

The lack of relation between income coverage and credit ratings raises a serious question as to whether Moody's ratings are sufficiently objective to provide a fair and reasonable standard of investment quality. An in-depth study of available information and factors that might be used to establish a more objective rating system is not only in order but would seem necessary if states are to be encouraged to make maximum use of their general borrowing power in support of needed state and local facilities.

State Assistance to Local Governments

In 1966, 17 states had credit assistance programs to aid local governments in financing public facilities.[16] The majority of these programs use the state's borrowing power to make direct loans to local governments for such purposes as educational facilities, public housing, road construction, sewage

---

[15] The two bills were re-introduced into the 91st Congress as Senate Bill S.398 and H.R. 2115.

[16] Carol Krotzki and George A. Bell, "State Credit Aid for Public Facilities," State and Local Public Facility Needs and Financing (Washington, D.C.: Government Printing Office, December, 1966) Vol. 2, p. 92-101.

and airport facilities. The trend toward greater use of state borrowing power to finance local facilities would be greatly accelerated if Congress and/or the several states develop a system of state urbanks.[17]

This modification to the concept of a single urban development bank would seem to imply that states and local governments might be able to reduce their borrowing costs significantly without resort to Federal intervention.[18] It would seem desirable, however, to determine how successful existing programs have been before plunging into a national system of 50 different urbanks.

An Antequated System of Debt Limitations

Movement in the direction of a more rational pattern of state-local borrowing has been impeded in many instances by an out-dated system of debt limitations. A number of states have constitutional provisions which either prohibit the use of general obligation bonds or limit the amount that may be issued to a small proportion of the tax revenues that are now available to meet interest and repay principal. The recent rise in interest rates has forced some of these states to raise interest ceilings and also consider other changes which would make debt limits more realistic and avoid the necessity of elaborate subterfuges which increase the cost of state and

---

[17] In the revised statement of the National Governors' Conference at the Hearings of the Committee on Ways and Means on the tax treatment of state and municipal bonds, March 11, 1969, it was suggested that serious consideration be given to a Federal System of 50 State Urbanks which would purchase local bond and re-issue taxable obligations which would be subsidized by the U.S. Treasury through the Federal Urbank. The Federal Urbank might also act as a secondary market for state urbank obligations and as an insuring agent for state and local bonds in return for a premium to be paid on each issue.

[18] Other alternatives that should be considered in this context include the possibility of creating either a state savings bond program or the sponsorship of a state municipal mutual bond fund that would be sold to individuals that lack the $5,000 of savings that is usually required to purchase just one municipal bond.

local borrowing.[19] An up-to-date report on the progress which has been made in the last few years would be quite helpful to those public officials who are still laboring to modernize debt limitation practices which sometimes date back to the Civil War period.

---

[19] Paul Hefferman, "The Changing Notions of Debt Limit Borrowings," The Bond Buyer, Special Conference Issue No. 1, May 26, 1969, p. 41-61.

Table II

States With General Obligation Bonds
Ranked in Order of Personal Income Coverage and
Compared With Moodys' Credit Ratings

		General Obligation Bonds[a] (millions of dollars) (1)	State Personal Income Divided by General Obligations Bonds[b] (2)	Moodys' Rating[c] (3)
1.	Idaho	.8	2,130.0	Aa
2.	North Dakota	1.8	851.7	Aa
3.	Michigan	44.8	618.0	Aa
4.	Iowa	16.5	500.5	Aaa
5.	Missouri	45.4	283.2	Aaa
6.	Pennsylvania	130.3	264.3	Aa
7.	Washington	48.0	204.1	Aa
8.	Alabama	51.8	140.0	A
9.	Arkansas	31.2	126.0	Aa
10.	Nevada	12.5	120.6	A
11.	Illinois	344.6	110.5	Aaa
12.	Texas	315.5	86.6	Aaa
13.	Montana	22.5	81.9	Aa
14.	New Jersey	292.7	81.2	Aaa
15.	Ohio	575.6	55.0	Aaa
16.	Oklahoma	114.0	53.5	Aa
17.	New Mexico	48.8	49.0	Aa
18.	New York	1,323.2	48.1	Aa
19.	Minnesota	256.1	40.5	Aa
20.	Louisiana	207.3	39.7	A
21.	Tennessee	226.8	38.0	Aa
22.	West Virginia	104.7	37.6	A
23.	Utah	67.0	37.3	Aaa
24.	South Carolina	160.3	33.1	Aaa
25.	North Carolina	377.3	30.0	Aaa
26.	Maine	89.5	27.1	Aaa
27.	Maryland	442.2	26.2	Aaa
28.	Kentucky	362.1	19.7	Aa
29.	Massachusetts	1,085.7	16.3	Aa
30.	California	4,265.2	15.2	Aa
31.	Mississippi	279.5	14.9	Aa
32.	New Hampshire	131.6	14.4	Aaa
33.	Rhode Island	202.7	13.5	A
34.	Vermont	82.0	13.0	Aaa
35.	Connecticut	839.9	12.9	Aaa
36.	Oregon	482.9	11.9	Aa
37.	Alaska	76.4	11.9	Baa
38.	Hawaii	217.4	10.3	A
39.	Delaware	270.2	6.7	Aa

a. The figures are for mid 1967. An effort was made to deduct sinking funds and to include all issues where both the interest and the principal were backed by the full faith and credit of the state.
b. The personal income figures are for 1966.
c. The credit ratings were obtained from Moodys' 1968 Manual on Municipal Securities. A few of the ratings refer to the most typical issue that was rated in Moodys' Manual.

DANIEL STONE
BENJAMIN J. BAUM
RICHARD P. GROSS
EDWARD W. BURNETT
DAVID E. HARTLEY
EVERETT D. WILLIAMS
JAMES S. SAFFRAN
HERMAN B. ZELLES

STONE & YOUNGBERG
MUNICIPAL FINANCING CONSULTANTS
1314 RUSS BUILDING
SAN FRANCISCO 94104
(415) 981-1314

RICHARD A. SCIBIRD
EDWARD C. KERN
ROBERT G. BULOT
PAUL G. DINKELSPIEL
RONALD D. GOODMAN
MORRIS GREEN
EDWARD J. HYLAND

September 17, 1969

Senate Finance Committee
C/o Mr. Tom Vail, Chief Counsel
2227 New Senate Office Building
Washington, D. C.

Gentlemen:

As municipal financing consultants representing over 350 public entities, we wish to oppose those sections of H.R. 13270 which would subject municipal bond interest to Federal taxes. We have carefully reviewed the House Bill which is before you and wish to make the following observations regarding its content and the impact on municipalities if this bill is passed into law in its present form.

Since House passage of H.R. 13270, the proposed tax reform act, the Bond Buyer's 20 Bond Index declined from 5.86 percent on July 31 (a record low in itself) to a new low of 6.37 percent on September 4. Without question, the primary reasons for the drastically declining bond market centered around those sections of H.R. 13270 which would have the effect of subjecting the interest earned on municipal bonds to Federal income tax.

Large numbers of bond buyers all over the country have stopped buying municipal securities, and many bond dealers will tell you that there is just no municipal market. Unfortunately, the most serious threat to municipal financing as we have known it in the past is not contained in the specific provisions of the minimum income tax or allocations of deductions sections of H.R. 13270, but in the real threat that if this act becomes law (and is upheld by the Supreme Court), any future Congress could effect further erosion (or elimination) of the tax exemption. This appears to be the main reason that many potential bond buyers are refusing to speculate further in low yield tax exempts. They are fearful that if they act in good faith a future Congress could pull the rug out from under them.

The victims most seriously hurt by this proposed legislation are not the bond buyers but the voters and taxpayers of those public entities forced to issue bonds at record interest rates. Equally hurt are the voters and taxpayers residing in those entities which cannot sell their bonds to finance schools, sanitary systems, or other vitally needed public improvements. The situation is especially tragic because these people are the victims of an irresponsible proposal and they will suffer (many for the next twenty to thirty years) even if the proposed legislation never becomes law.

It is our belief that if the tax reform bill is passed as it is presently written, the following ramifications, in varying degrees, are likely:

1. General obligation bonds of many entities would be unsaleable. For most large taxpayers, municipal bonds would fall into substantially the same categories as corporate bonds or other taxable investments. High grade corporate bonds (AA and better) are presently yielding interest rates of 8 percent or more. It is likely, for example, that general obligation bonds of the State of California would be competitive with high grade corporates, but what about the bonds of smaller cities, counties, and special districts which have no rating or a rating less than the minimum requirements for corporate investment? It is our opinion that the market for these bonds may dry up completely.

2. Many revenue bonds, assessment bonds, and other limited obligation securities would be unsaleable. Obligations not secured by the full faith and credit of the issuing entity traditionally, with the tax exemption, sell at higher interest rates than general obligation bonds. Since many institutional investors only purchase general obligation bonds, a larger percentage of the limited obligations are placed with individuals. If interest becomes taxable, individuals would probably seek other investments or demand such high returns that project financing with limited obligation securities would be unfeasible.

3. Interest rates on all municipal securities would increase. Interest rates on all municipal bonds would probably increase but not on a proportionate basis. Entities issuing bonds which do not fall into the higher categories of investment quality would unquestionably have to pay interest rates far exceeding even today's record levels. Investors could pick and choose between corporates and municipals and would have no special inducement to invest in municipal securities, especially since at any time congressional whim could possibly eliminate all advantages of investing in municipal bonds.

4. Property taxes would necessarily increase. One could anticipate property tax increases for two reasons. First, if bonds were sold, taxes would have to be higher to meet higher interest costs. Secondly, if bonds were unsaleable and a project were vital, it might have to be financed on a pay-as-you-go basis. In such an event, the cost would be met by present taxpayers and not spread over future beneficiaries of the project as would be the case if bonds were sold.

5. Charges for municipal services would increase. Water, sewer, and other service charges would have to be increased substantially in order to pay higher debt service on new issues of bonds secured by and payable from service charge revenues.

6. Expensive new Federal grant and/or loan programs would be required. To alleviate the infinitude of problems summarized above, a massive Federal grant and/or loan program would undoubtedly be required; and such a program has already been proposed by Chairman Mills of the Ways and Means Committee and others. Regardless of the value of the program, additional Federal spending coupled with Federal guarantees for billions of dollars of new debt would further dilute the value of the dollar, which is already under tremendous pressure.

7. Federal aid can mean costly delays in construction of local projects. Experiance has shown that even the most workable and efficient Federal grant and/or loan programs require approximately six months to process. To qualify for Federal money, local agencies must generally:

(a) Have Federal approval of the project and concurrence that said project complies with both community and areawide general plans.

(b) Have Federal approval of engineering plans and specifications to assure that construction conforms to uniform Federal standards.

(c) Have Federal approval of construction bid documents to assure compliance with such factors as Federal wage rates, hiring practices, etc.

(d) Have a Federally approved economic and financing plan to assure project desirability (based on Federally established criteria) and feasibility.

(e) If a loan program is involved, have Federal approval of bond terms and conditions. (Said terms and conditions may or may not be the most desirable from the standpoint of the local entity, but Federal requirements would have to be met to qualify for assistance.)

(f) Have Federal inspection and approval of all stages of construction.

(g) Have a special Federal audit at the completion of construction.

We are in no way being critical of these procedures. On the contrary, we feel strongly that if Federal monies are provided to a local agency, that agency should comply with conditions determined to be in the general public interest. However, it is a well established fact that Federal grant and/or loan programs take time to process, and resulting delays on project construction can be extremely costly. As an example,

due to inflation, construction costs increased by approximately 10 percent between July 1968 and July 1969. A six month delay during this period of time, therefore, could have resulted in an increased cost of about $50,000 per $1 million of construction.

If Federal aid is involved, additional costs are also incurred at the local level as a result of the time required for local officials to prepare and process applications for Federal aid. In addition, it is not infrequent that complying with Federal construction standards results in still further additional costs to the local agency.

8. Federal aid will mean higher costs to the Federal Government. At this time we have no way of estimating the amount it would cost the Federal Government to equip and staff an agency or agencies to administer a vast grant and/or loan program of the magnitude which would probably be required. However, in 1968 state and local agencies sold bonds in excess of $16 billion. Were the Federal Government to assume or guarantee a substantial portion of this amount of local financing, it would appear highly unlikely that the increased revenue from taxes on interest earned on municipal bonds would pay for the program, much less return a surplus.

9. Federal aid in future years cannot be guaranteed. At the outset, Congress could probably be expected to appropriate sufficient money to fund an adequate national loan and/or grant program during its first year or so of operation. However, bitter experience shows us that many Federal assistance programs start with a bright promise, but succeeding Congresses gradually reduce program effectiveness by appropriating less and less money each year, until finally the program is no longer viable. Consider, for example, the present status of the following Federal assistance programs that were once held to be so important to the well-being of our country:

(a) This fiscal year, funds allotted to the State of California under the Federal Water Pollution Control Act are not even sufficient to cover last year's deficiency. Grants for projects which qualified for assistance in 1968/69 exceed the 1969/70 allocation by approximately $3 million. Consequently, no money will be available for any of the 185 projects on the 1969/70 priority list.

(b) The demise of the Public Facility Loans Program is expected momentarily. To our knowledge, few if any applications were accepted last fiscal year and potential applicants are being discouraged because of the lack of funding.

(c) The Program of Advances for Public Works Planning is believed to be operating solely on repayments of previous

loans. (No new appropriations have been made for several years.) The waiting period for the few selected applicants now runs to a year or more.

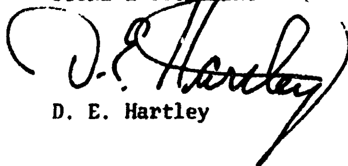
(d) Because of funding problems, the Program of Grants for Basic Sewer and Water Facilities is restricted to very low income communities and the maximum individual grant is limited.

It is our opinion that elimination of the tax exemption would destroy a workable system of local public financing and open a Pandora's box which would haunt local taxpayers for years to come. The threat of removal of tax exemption has already done irreparable harm, and has cost communities which have recently issued bonds many extra dollars in interest.

We urge your consideration of our comments above and your rejection of all proposals effectively subjecting interest on municipal bonds to Federal taxation. We further urge Congressional re-affirmation of the basic principle of keeping interest earned on municipal bonds free from Federal taxation to restore confidence of current and potential investors in this type of security. We attach a list of public entities that we have represented and are currently representing in matters relating to public finance. A majority of the public entities on the list have asked us to speak for them in objection to this current proposed legislation.

Respectfully submitted,

STONE & YOUNGBERG



D. E. Hartley

DEH:hs
Enc.

loans. (No new appropriations have been made for several years.) The waiting period for the few selected applicants now runs to a year or more.

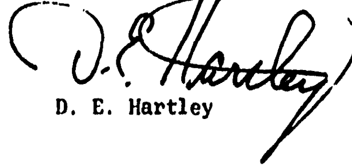
(d) Because of funding problems, the Program of Grants for Basic Sewer and Water Facilities is restricted to very low income communities and the maximum individual grant is limited.

It is our opinion that elimination of the tax exemption would destroy a workable system of local public financing and open a Pandora's box which would haunt local taxpayers for years to come. The threat of removal of tax exemption has already done irreparable harm, and has cost communities which have recently issued bonds many extra dollars in interest.

We urge your consideration of our comments above and your rejection of all proposals effectively subjecting interest on municipal bonds to Federal taxation. We further urge Congressional re-affirmation of the basic principle of keeping interest earned on municipal bonds free from Federal taxation to restore confidence of current and potential investors in this type of security. We attach a list of public entities that we have represented and are currently representing in matters relating to public finance. A majority of the public entities on the list have asked us to speak for them in objection to this current proposed legislation.

Respectfully submitted,

STONE & YOUNGBERG



D. E. Hartley

DEH:hs
Enc.

CITIES

Alameda
Alturas
Anderson
Antioch
Arroyo Grande
Atwater
Auburn
Bakersfield
Baldwin Park
Banning
Bellflower
Bell Gardens
Beverly Hills
Blythe
Brawley
Buena Park
Burbank
Calistoga
Carlsbad
Carmel-By-The-Sea
Ceres
Chico
Chino
Chula Vista
Claremont
Clovis
Coalinga
Corcoran
Costa Mesa
Crescent City
Cupertino
Cypress
Delano
Dinuba
Duarte
Dunsmuir
El Cajon
Fairfield
Fort Bragg
Fremont
Fresno
Garden Grove
Glendale
Glendora
Gridley
Grover City
Gustine
Hanford
Healdsburg
Hollister
Huntington Beach
Imperial Beach
Industry
Inglewood
King City
Lakeport
Lakewood
La Mesa
Las Vegas, Nevada
Lemoore
Lincoln
Livermore
Livingston
Lodi
Lompoc
Los Altos
Los Angeles
Los Banos
Los Gatos
Manteca
McFarland
Montclair
Montebello
Monterey
Monterey Park
Monterey Peninsula Cities
Napa
National City
Needles
Newman
Newport Beach
North Sacramento
Oakdale
Oceanside
Orange Cove
Oroville
Oxnard
Pacifica
Pacific Grove
Palm Springs
Petaluma
Pittsburg
Placerville
Pomona
Red Bluff
Redding
Redlands
Redwood City
Reedley
Richmond
Riverbank
Riverside
Sacramento
St. Helena
Salinas
San Anselmo
San Bernardino
San Bruno
San Carlos
San Diego
San Fernando
Sanger
San Jose
San Leandro
San Luis Obispo
San Rafael
Santa Ana
Santa Fe Springs
Santa Maria
Santa Monica
Santa Rosa
Selma
South San Francisco
Stanton
Stockton
Tiburon
Tracy
Turlock
Union City
Vacaville
Vallejo
West Covina
Westminster
Willits
Woodland
Yreka
Yuba City

DISTRICTS

Almonte Sanitary District
Alpine Springs County Water District
American Canyon County Water District
Antelope Plains Water District
Arcade County Water District
Arvin-Edison Water Storage District
Bellflower County Water District
Biggs-West Gridley Water District
Bolinas Harbor District
Burney County Water District
Calaveras County Water District
Cambria County Water District
Capitola Sanitation District
Carmichael Irrigation District
Cascade Community Services District
Central Contra Costa Sanitary District
Citrus Heights Irrigation District
Clark County School District, Nevada

Clearlake Oaks County Water District
Coastside County Water District
Contra Costa County Flood Control and
Water Conservation District
Contra Costa County Water District
Contra Costa Drainage District
Cordova Recreation and Park District
Corning Water District
Costa Mesa County Water District
Cotati Public Utility District
Cucamonga County Water District
Daggett Community Services District
Douglas County Sewer Improvement District No. 1, Nevada
East Bay Municipal Utility District
East Contra Costa Irrigation District
East Orange County Water District
East Quincy Services District
El Dorado County Sanitation District No. 2
El Dorado Irrigation District
El Toro Water District
Enterprise Public Utility District
Fair Oaks Irrigation District
Fallbrook Public Utility District
Florin Community Services District
Foresthill Public Utility District
Fulton-El Camino Recreation and Park District
Goleta County Water District
Goleta Sanitary District
Granada Sanitary District
Grover City County Water District
Hagginwood Sanitary District
Helix Irrigation District
Indio Sanitary District
Interlochen Sanitation District
June Lake Public Utility District
Jurupa Community Services District
Kootenai Hospital District, Idaho
Lamont Public Utility District
La Presa County Water District
Las Vegas Valley Water District, Nevada
Leucadia County Water District
Livermore Area Recreation and Park District
Los Alisos Water District
Lost Hills Water District
Mammoth County Water District
Marina County Water District
Mendocino County Flood Control and
Water Conservation Improvement District
Menlo Park Sanitary District
Merced Irrigation District*
Millview County Water District
Modesto Irrigation District*
Montara Sanitary District
Montecito Sanitary District
Monterey Peninsula Municipal Water District
Moulton-Niguel Water District
Mt. Diablo Unified School District
Murphys Sanitary District
Napa County Flood Control and
Water Conservation District
Napa Sanitation District
Nevada Irrigation District*
North Area Community Services District
North Coast County Water District
North Kern Water Storage District
North Marin County Water District
North Tahoe Public Utility District
Oakdale and South San Joaquin Irrigation Districts*
Oakley County Water District
Orange County Harbor District
Orange County Sanitation District No. 7
Orange County Sanitation District No. 12
Oroville-Wyandotte Irrigation District*
Palmdale Irrigation District
Palos Verdes Library District
Paradise Irrigation District
Pioneer, Pine Grove, Volcano County Water District
Placer County Assessment District
Placer County Waterworks District No. 1
Pleasant Valley Recreation and Park District
Purissima Hills County Water District
Richvale Irrigation District*
Rio Linda County Water District
Rocklin-Loomis Municipal Utility District
Rodeo Sanitary District
Rosedale-Rio Bravo Water Storage District
Russian River Sanitation District
Sacramento Municipal Utility District*
Sacramento-Yolo Port District
Salton Sea Water District
San Benito County High School and
Junior College District
San Diego Unified Port District
San Francisco Bay Area Rapid Transit District
San Juan Suburban Water District
San Luis Obispo County Flood Control and
Water Conservation District
San Pablo Sanitary District
Santa Ana Mountains County Water District
Santa Barbara County Flood Control and
Water Conservation District

*Co-consultants

Santa Clara County Sanitation District No. 4
Santa Clara County Flood Control and Water Conservation District
Santa Clara Valley Water Conservation District
Santa Cruz County Flood Control and Water Conservation District
Santa Nella County Water District
Santee County Water District
Santiago County Water District
Scotts Valley County Water District
Shasta Community Services District
Shasta Joint Junior College District
Solano Irrigation District
Sonoma County Flood Control and Water Conservation District
Sonoma Valley Sanitation District
Soquel Creek County Water District
South Bay Irrigation District
South San Luis Obispo County Sanitation District
South Sutter Water District
Stanton County Water District
Susanville Consolidated Sanitary District
Tehachapi-Cummings Water Conservation District
Terra Bella Irrigation District
Thermalito Irrigation District
Tuolumne County Water District No. 1
Tuolumne County Water District No. 2
Turlock Irrigation District*
Union Sanitary District
Upper San Gabriel Valley Municipal Water District
Vallejo Sanitation and Flood Control District
Valley of the Moon County Water District
Vista Irrigation District*
Vista Sanitation District
Walnut Valley Water District
Wasco County School District No. 9, Oregon
Weaverville Sanitary District
West Kern County Water District
West San Bernardino County Water District
Wildwood Sanitary District
Yolo County Flood Control and Water Conservation District
Yorba Linda County Water District
Yountville Sanitation District

*Co-consultants

OTHER AGENCIES

Bear Valley Development Company
California State Fair and Exposition*
California, State of (California Toll Bridge Authority)
Crescent City Harbor
Downey Community Hospital Foundation
El Dorado County
El Dorado County Water Agency
Garapito Creek Realty Investing Corporation
Kern County Water Agency
Lake County
Nez Perce County - Lewiston, City of, Idaho
Los Angeles County
Los Angeles Harbor Department
Malibu-Topanga Water Research, Inc.
Marin County
Mariposa County Water Agency
Metcalf & Eddy and Charles S. McCandless & Co.
Mojave Water Agency
Napa County
Orange County
Orangevale Mutual Water Company
Placer County
Placer County Water Agency*
Port of Oakland
Port of Redwood City
Redevelopment Agency of the City of Richmond
Rustic Ridge Realty Investing Corporation
San Bernardino County
San Diego County
San Diego Stadium Authority
San Mateo County
Santa Clara-Alameda-San Benito Water Authority
Santa Cruz County
Parking Authority of the City of Santa Monica
Redevelopment Agency of the City of Seaside
Shasta County
Solano County
Solano Water Users' Association
Sonoma County
State of California (Reclamation Board)
State Senate Interim Committee (Water)
Tahoe Southside Water Utility
Port of The Dalles, Oregon
Yuba County Water Agency*

*Co-consultants

METROPOLITAN UTILITIES DISTRICT
1723 HARNEY STREET
OMAHA, NEBRASKA 68102

CECIL S. BRUBAKER
GENERAL COUNSEL

WILLIS L. STRONG
ASSISTANT GENERAL COUNSEL

LESTER R. SEILER
ATTORNEY

341-5760
AREA CODE 402

Before Senate Finance Committee H.R. 13270

SUMMARY OF STATEMENT

1. The District recently built $16 million addition to water plant serving 100,000 patrons in Omaha and vicinity.

2. Sale of long-term bonds not possible because of excessive interest rates in early 1969, caused by general inflation plus threat of removal of tax exemption.

3. District able to get only one-year financing, and must sell these bonds in early 1970.

4. Provision for government subsidies in H.R. 13270 would be threat to sovereignty of states and subdivisions.

5. Need quick action striking out provisions of H.R. 13270 which in any way disturb the tax exemption of municipal bonds, so that District bonds can be sold without additional penalty of higher interest caused by present threat of loss of tax exemption.

6. Resolution of Board of Directors.

METROPOLITAN UTILITIES DISTRICT
1723 HARNEY STREET
OMAHA, NEBRASKA 68102

CECIL S. BRUBAKER
GENERAL COUNSEL

WILLIS L. STRONG
ASSISTANT GENERAL COUNSEL

LESTER R. SEILER
ATTORNEY

341-5760
AREA CODE 402

Statement of Cecil S. Brubaker

Representing

Metropolitan Utilities District of Omaha, Nebraska

H.R. 13270 "A Bill to Reform the Income Tax Laws"

Hearing Before The Senate Finance Committee

September 23, 1969

Mr. Chairman and Members of the Committee:

My name is Cecil S. Brubaker. This statement is made on behalf of Metropolitan Utilities District of Omaha, Nebraska, of which I am General Counsel. Metropolitan Utilities District of Omaha is a political subdivision and municipal corporation of the State of Nebraska, created under state law to operate, manage and control the water system and the gas system supplying residents of the City of Omaha and its environs. Under statutory authority the District issues bonds for major improvements to the gas and water systems.

The District has recently completed an addition to its water plant for which it was necessary to borrow Sixteen Million Dollars ($16,000,000.00). During attempts by the District representatives

33-758 O - 69 -- No. 9 -- 20

in the last year to find purchasers for long term bonds, it became increasingly evident that not only was it going to be impossible to find purchasers for long term bonds at an interest rate within our statutory limit of six percent (6%), but that possibilities were increasing that the bonds could not be sold at all. No buyers could be found for short term bonds or obligations in excess of one year, and the District was forced to accept one year financing. The story of what has happened to municipal bond sales since our fortunate sale in June, 1969, is familiar to all members of this Committee, I am sure, and demonstrates that our fear that bonds could not have been sold at all were well founded. Many issues from other municipalities have found no buyers at all.

In addition to the general inflation in the market place, our representatives were told that purchasers were not to be found because of the uncertainty of the situation with relation to tax exemption of municipal bond interest. The truth of these statements has been borne out by the market situation since the sale of bonds by our District.

The principal and interest on the bonds which we have issued, and which we must issue for a long term in the very near future, must be paid for by the users of water in our District. This includes all of the people, regardless of their economic status,

whether well-to-do or poverty stricken. These people must have water. Any increase in the cost of this necessity of life caused by taxation therefore has the ugliest result that any regressive tax can have. It penalizes even the very poor.

The passage of H.R. 13270 by the House of Representatives and the provisions of that proposed legislation relating to taxation of interest on municipal bonds has already had some effect upon the cost of money to the people of our District, and in the state of the market at the present time, it appears that the penalty our patrons will suffer will exceed that they are now paying by a considerable amount.

Just the consideration by Congress of the removal of tax exemption has been upsetting in the market place, and has made buyers hesitant and jittery, with the consequence that interest payments have necessarily gone far beyond traditional figures, and have added to the inflationary trend which the Congress and the administration appear to wish to end, and has raised the cost of necessary public improvements, to the injury of the taxpayers and voters whom the Congressmen and Senators represent.

This Committee will no doubt be furnished statistics by other opponents of the taxation of municipal bonds, which will demonstrate that the cost to the American public in general of the

removal of tax exemptions will far exceed the benefits of increased revenue to the Federal Government. The "evil" which is thus sought to be corrected by these provisions, would appear to be a political straw man, not worth the price.

The provisions of H.R. 13270 which relate to limited taxation and possible subsidy to the municipalities issuing bonds in exchange for a waiver of tax exemption have disturbed our Board of Directors because of the necessary intrusion into local affairs which would result from these provisions, and which would of necessity result in relinquishment of local control and would replace local decisions on local issues with nationally centralized decisions.

For those of us who are even slightly familiar with the doctrine of "reciprocal immunity" and the historical position of the Supreme Court of the United States holding that taxation of interest on municipal bonds is not permitted under the Constitution, it is puzzling why the Congress gives so much consideration to this seemingly indefensible legislation. The expectation is that this Committee will immediately and definitely strike from the "tax reform" bill H.R. 13270, the offensive sections which threaten the sovereignty of the states. The people of the United States do not need any more cause for unrest and uncertainty than other current events now supply in overabundance.

After its recent experience in the market place, the Board of Directors of our District adopted a resolution on August 6th, 1969, which protests and deplores any legislation by the Congress designed to eliminate or jeopardize the existing exemption from taxation of municipal bonds, including any proposal of a Federal subsidy. A copy of that resolution is attached to this statement.

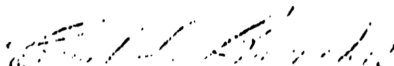
Gentlemen, the bond issues of the Metropolitan Utilities District of Omaha are small indeed compared to many, many others. We are convinced that the market needs all of the buyers it can possibly get for small bond issues, as well as large ones. Individual buyers should not be discouraged nor eliminated from the purchase of long term tax exempt bond issues, or the competition for such bonds will be seriously and dangerously impaired, with consequent increase of interest costs. Metropolitan Utilities District of Omaha is one of those unfortunate municipalities caught in the unrest and uncertainty caused by H.R. 13270. It is costing our 100,000 patrons money. The situation in the market can be brought back to a state of normalcy only by restoring the confidence of the buyers of municipal bonds in the continuing exemption from taxes.

There is some possibility that the debates and consideration

of H.R. 13270 will extend for some time, even into the next year. We hope, for the sake of the residents of the Omaha, Nebraska metropolitan area and for all others caught in this situation, that action of this Committee will come soon rejecting all of the provisions of H.R. 13270 which in any way infringe upon or compromise the traditional immunity from taxes of state and local securities.

Respectfully busmitted,

METROPOLITAN UTILITIES DISTRICT
OF OMAHA, NEBRASKA

By 
Cecil S. Brubaker,
General Counsel

CSB:mkp
#1500
attached

R E S O L U T I O N

WHEREAS, the Metropolitan Utilities District of Omaha, a political subdivision and municipal corporation of the State of Nebraska, has urgent need to issue $16,000,000 of Water Revenue Bonds for the improvement of water supply facilities serving Omaha and its immediate area, now being financed by a short term arrangement, and has been experiencing difficulties in marketing long-term bonds in the present climate surrounding such transactions, and

WHEREAS, it has recently come to the attention of the Board of Directors that traditional buyers of such bonds are hesitating to purchase such bonds because of the uncertainty and fear surrounding the bonds, and that the offering of very high interest payment is unable to develop a market for such bonds, because of the threat of the removal of such tax exemption, and

WHEREAS, the Board of Directors believes that the removal of tax exemption from interest payments on bonds of this District and any other municipal corporation will seriously affect the market for such bonds, and increase the costs of public improvements, to the injury of every tax-paying citizen and every customer of municipally-owned utilities, far in excess of any benefits to the Federal Government which might be realized by removal of such tax exemption; and

WHEREAS, any proposal of a Federal guarantee or subsidy of a local bond issue, in exchange for a waiver of tax exemption, would mean a relinquishment of authority by the local government body to a Federal Bureau, and would be a serious step toward the destruction of local government.

NOW, THEREFORE, BE IT RESOLVED, by the Board of Directors of Metropolitan Utilities District of Omaha, that this Body, acting in behalf of its more than 100,000 customers, protests and deplores any legislation by the Congress of the United States designed in any way to eliminate or jeopardize the traditional and constitutional exemption from Federal taxation of municipal bonds of State and local government, and urges each and every member of the Nebraska delegation in the 91st Congress to actively oppose any change in the existing tax exemptions of municipal bonds.

Adopted: August 6, 1969

EHLERS AND ASSOCIATES, INC.
FINANCIAL CONSULTANTS
FIRST NATIONAL-SOO LINE CONCOURSE 507 MARQUETTE AVE. MINNEAPOLIS, MINNESOTA 55402 339-8291 (AREA CODE 612)

September 15, 1969

The Senate Finance Committee
c/o Mr. Tom Vail, Chief Counsel
2227 New Senate Office Building
Washington, D. C. 20510

This communication is in lieu of an oral presentation to the committee on provisions of HR 13270 affecting taxation of interest on state and local bonds. In general this will be in opposition to these provisions in the proposed legislation.

By way of background, the writer is the principal of Ehlers and Associates, Inc., a government finance consulting firm which has been commissioned to assist the financing of some 500 capital improvement projects for over 300 local government in mostly, Minnesota, North Dakota, South Dakota and Wisconsin. The firm is not a bond dealer or broker.

Without going into constitutional questions of which members of Congress must be fully aware, this will discuss only some very serious and very practical objections to proposals to tax interest on these bonds and substitute federal financing either through a dual coupon arrangementor through a so-called "Urbank" or "Metro Bank".

1. Evasion of taxes - the fallacy.

   It is charged by Mortimer Caplin that while municipalities save $1 billion per year the federal government loses $2 billion per year. The House Committee estimates were $1.3 billion and $1.8 billion respectively and it has been admitted that, allowing for estimating errors and the cost of a new, massive federal agency, the saving and loss could just about wash.

   It is charged by Caplin and others that municipal bond investors pay no taxes. For example a midwest widow allegedly invested $57 million which has earned $1.5 million per year tax free (a yield of 2.8%) as though she made no social contribution. What is not recognized is that she could have elected to not invest in public works and, instead, invest in (taxable) securities which would have grossed some $1 million more annually. To be sure the federal government might have extracted more than $1 million higher yield (if her investment had yielded ordinary income), but it is simply not true that this investor gave up nothing. She did forego some $1 million in lieu of federal taxes.

2. Marginality of bond sales: minimum tax, allocation of deductions.

Under Paragraph I above the possibility of the federal government collecting $1.8 million added taxes was cited. However, it is not proposed to tax all interest on bonds and so this federal yield would not result under this bill proposed. However, because of the marginal nature of the tax exempt bond market only a minor impairment of the most prominent feature of such bonds would cause their interest rates to approach those of taxable securities for the following reasons.

As we learned in Econ. I the price of a commodity (wheat for example) will fall (interest rates rise in the case of bonds) to the level at which the entire supply can be sold. If, by taxing state and local government bonds, Congress destroys even a minor part of demand then the price of bonds must fall (interest rates rise) to the point where lower tax bracket investors can be induced to buy them. If some of the bond supply must be sold to someone already tax exempt (such as pension funds, retirement funds, etc.) then the whole price/yield structure of tax exempt securities will move to that level. Thus, though the proposals seem only directed at the very rich, the practical effect to local governments would be to raise their interest rates to the taxable yield level.

3. Subsidy, the federal teat, federal control.

In recognition of the above result it is proposed to provide a subsidy of 25% to 40% of municipalities' interest cost through a dual coupon arrangement or through a federally sponsored "Urbank" or "Metro Bank". And, it is said, there shall be no federal review of the advisability of a project or the community's ability to repay the bonds.

This is incredible. Congress has often deplored open end, back door, massive financing programs over which it has no control. Notwithstanding the language of the Bill, almost certainly some controls will be and should be imposed. For example, would Congress stand for federal financing of segregated schools, municipal liquor stores, ill advised medical facilities, a municipal or state owned and operated commercial enterprise? Would local government be able to finance projects not otherwise subject to the Davis-Bacon Act?

Ultimately there would have to be some federal control. This would mean the destiny of local government would fall to a federal dependency, that local initiative, which has accomplished so much, will degenerate into a begging for federal handouts.

4. Halt of public works construction.

The most immediate result of impairing the market for state and local government bonds and providing a federal pacifier would be the virtual halt of local public works construction. Even now, because of this tax threat, many communities are pressing their statutory interest rate limitations. Should the Bill pass, we expect that few if any bonds will be sold on the market thereafter.

If our experience with federal programs says anything, it says there will be something like a two year delay in effectively implementing a federal interest substitute. A whole new federal agency must be set up to process upwards of $15 billion of financing each year. An experienced staff must be recruited and educated. Rules and regulations must be formed and adopted after hearings. The investing public and public officials must be educated to a whole new concept of lending and borrowing, applications must be prepared, gotten into the handsof local officials, prepared, returned and processed and probably litigation must be resolved. It is impossible to see anything less than a 24 month time period for implementation of the federal subsidy. The questions then are: Can we afford to idle a large segment of the productive capacity of the heavy construction industry and its employees for two years? Can we afford a tax "reform" that will derive little or no net revenues to the federal government? Can we afford to delay needed sewers, water systems, schools, hospitals, highways and other needed local improvements for 24 months?

5. Litigation.

There is a real constitutional question as to the taxation of interest on municipal bonds, especially the retroactive features of HR 13270. Even though the Bill talks about "allocation of deductions" holders of large blocks of bonds can hardly be expected to let a large value of their holdings be confiscated by a measure which, in effect, tax that interest.

6. Other solutions.

Without question the spread between taxable and tax exempt yields has narrowed. One of the most serious reasons for this is the current congressional threat to tax, directly or indirectly, and retroactively, the interest on tax exempt bonds. At the moment the most appropriate remedy to restore the full value of tax exemption to state and local governments would be to decisively strike this proposal in HR 13270.

Beyond that, the most effective remedy to assure full value of the tax exemption would be to reduce the supply of tax exempt bonds.

As we noted, marketability of municipal bonds is marginal. That is, prices of all bonds will move down to the level required to market the last bond. As the supply of bonds grows the yields must increase (prices must fall) until buyers are found - probably buyers in lower income tax brackets.

One source of a large tax exempt bond supply has been federally sponsored housing and urban development issues which, if financed entirely by the federal government (non-tax exempt), would relieve much of the pressure on the market for other tax exempt bonds. Though these housing issues constitute only about $2 billion of a $16 billion tax annual exempt market, elimination of such bonds

would greatly improve the remaining market for other types of tax exempt bonds. Because of the marginal nature of the market, the resulting interest rates would then drop to more truly reflect the full value of the tax exemption as a saving to local governments. The spread between taxable and tax exempt bonds would widen considerably.

From our side, the local government side, we must recognize that, since almost all states and municipalities can offer tax exempt industrial revenue bond financing, and since the location of industrial plants is again determined by old economic factors, this type of financing should be done away with in all of the 50 states. No community can gain any special advantage over any other community by using this financing but its use has contributed substantially to the oversupply of tax exempt bonds, higher tax exempt interest rates, and probably, to the inclusion of this provision in HR 13270. We in municipal governments must recognize this and support congressional efforts to eliminate this abuse of tax exempt financing.

We must also recognize that so-called arbitrage or advance refunding bonds can only sour the tax exempt bond market as a source of fresh money for actual, new public inprovements. These two provisions, reducing the amounts of industrial revenue bonds and advance refunding, bonds would be supported by us and by most state and local officials.

<u>In Summary</u>:

Removal or impairment of tax exemption of interest on state and local bonds will raise little if any net revenues. It will, however, effectively and substantially increase interest rates on local borrowing. It is not just a tax "reform", it will result in a major restructuring of government. Those who own such bonds <u>do</u> make a substantial contribution "in lieu of" federal taxes.

If passed, this provision would cause about a two year halt in most local improvement construction.

Notwithstanding language in HR 13270, there would, ultimately, be federal control of local financing. In fact it would be unwise to not have control of a $15 billion per year program.

There are some less drastic measures that can be taken without setting up the new, massive and costly federal program provided in HR 13270.

Thank you for your attention.

Respectfully submitted,

EHLERS AND ASSOCIATES, INC.

By:

RLE:sz

Peck, Shaffer & Williams
Attorneys at Law
First National Bank Building
Cincinnati, Ohio 45202

AREA CODE 513
TELEPHONE 621-3394

FRANK H. SHAFFER, JR.
ANDREW J. CONROY
JOHN W. FISCHER
WALTER E. BECKJORD
JUDSON J. ALLGOOD
WILLIAM B. SHAFFER, JR.
STOCKTON LEHMANN
JOHN M. ANDERSON
CHARLES G. HEYD
RONAL R. NEWBANKS
FREDERICK O. KIEL
JOHN W. FISCHER III

HIRAM D. PECK
(1844-1914)
FRANK HOLMES SHAFFER
(1857-1936)
JOHN WELD PECK
(1874-1937)
FLOYD C. WILLIAMS
(1884-1963)
JOHN COLVILLE TAYLOR
(1904-1966)

September 17, 1969

Tom Vail, Esquire
Chief Counsel
Senate Finance Committee
2227 New Senate Office Building
Washington, D.C.

Dear Mr. Vail:

Taxation of Interest Income on Municipal Bonds

Tax-exempt bonds are historically the chief method of financing capital improvements in the State of Ohio and almost all other states. In Ohio, they are issued by the State itself, state and state-affiliated universities, counties, cities and villages, townships, and various special-purpose districts, including conservancy districts. Typically, these bonds (and the notes or other interim financing obligations issued in anticipation thereof) are sold either by negotiation or on the open market after public advertising, in competition with investment securities of many kinds. Until a few months ago, these bonds, together with a very few issues of Federal obligations, enjoyed a unique advantage in the eyes of institutional and individual investors, i.e., the unquestioned exemption of interest income received thereon from taxation by the Federal government. These bonds, of course, have always been subject to capital gains taxes. This exemption has meant that the issuers of the bonds -- and thus, in many instances, the taxpayers whose taxes or service charges secured and retired the bonds -- paid much lower interest rates than did the issuers of corporate bonds of comparable quality. Ignoring constitutional considerations for the moment, the fiscal effect of the tax exemption for these bonds was of course a federal subsidy to such issuers (and, indirectly, their taxpayers) for the public projects financed by issuance of the bonds.

Since the Ways and Means Committee of the House of Representatives began consideration of various tax reforms a few months ago, and it became known that that Committee proposed to have the interest income on these bonds be taxable in the hands of certain holders, the effect on the municipal bond market has been dramatic and nearly catastrophic. The bonds of many prospective issuers have become unsalable at rates within statutory

interest rate limitations. Bonds which would have sold at a net interest cost of 4% or 5% per annum as recently as six months ago sold last week at the 7% level. Differentials of this magnitude over the life of a 20 or 30 year bond issue of substantial size can amount to millions of dollars. To the taxpayer whose taxes are automatically increased or reallocated to cover the differential, or to the user of revenue-supported facilities such as sewer and water lines or state parks, the increased cost is very burdensome, especially in view of the heavy inflationary pressures now at work in the economy.

Although the bill as finally passed by the House of Representatives does not have the effect of taxing interest income from municipal bonds in the hands of corporate holders, the fact that these bonds may become taxable in the hands of certain individual holders of necessity limits the marketability of bonds held by corporations and banks, and thus conduces to higher interest rates for original issues.

As attorneys actively engaged in the practice of the law of public finance for more than eighty years, we have watched with dismay as the market reacted to the threat of taxation of municipal and other tax-exempt bonds, and are certain that any revenue gains to be derived by the Federal Treasury from the proposed modification of the present tax exemption for these bonds will be overborne by the higher interest costs which an uneasy market has demanded and will demand for bond issues for critical public improvements.

Passage of H. R. 13270 by the House of Representatives has by virtue of the bond market's near-collapse cost issuers across country hundreds of millions of dollars in increased interest costs on bonds sold during the last few months, and has caused postponement of many vital public projects with no concomitant federal benefit. Approval by the Senate of the United States or passage of a bill taxing the interest income on municipal bonds by the Congress would compound and perpetuate the damage.

Very truly yours,

Peck, Shaffer & Williams

ORIGINAL

STATEMENT OF HAROLD B. JUDELL
OF FOLEY JUDELL BECK MOREL & BEASLEY, ATTORNEYS AT LAW
NEW ORLEANS, LOUISIANA

Our firm's practice is devoted exclusively to municipal and corporate finance, and particularly the approval of municipal and corporate bonds. We represent a substantial number of municipalities, school boards, special service districts (waterworks, sewerage, drainage, road, hospital, recreation, etc.) and other political subdivisions and local units of government in the States of Louisiana and Mississippi in connection with the financing of their capital outlay requirements. Our clients are directly affected by the proposed tax legislation, which strikes at the heart of their method of raising money to construct essential governmental facilities to meet the needs of their constituents. Traditionally, these local entities have financed capital improvements through the issuance and sale of bonds or other debt obligations carrying an exemption under existing law from federal income taxation. Because the proposed legislation (insofar as it relates to the treatment of municipal bonds) will adversely affect and virtually cripple their financing powers, they have requested that we vigorously oppose, on their behalf, such legislation.

We will address ourselves to the matter of specific objections to the proposed tax reform bill. We object to (1) the minimum income tax plan, (2) the allocation of deductions, and (3) the federal subsidy plan on the grounds that (a) they raise serious constitutional questions involving the

immunity of states and their political subdivisions from taxation by the federal government which cannot be resolved except through lengthy and costly litigation, the effect of which will be to paralyze local finance until a final judicial determination of the issue; (b) they would prevent the orderly financing of public improvements in an established capital market in the private sector of the economy at a time when such improvements are needed to help overcome the tremendous socio-economic problems facing urban areas; and (c) they would result in a deterioration and destruction of the historic federal-state relationship in the field of public finance and centralize the control of local finance in the federal government at great cost to the citizens and taxpayers of the nation. The combined effect of the foregoing could be to fuel an economic recession of major proportions.

The foundation for the doctrine of reciprocal tax immunity between governmental entities has early foundations in constitutional law. The landmark case of McCulloch v. Maryland, 4 Wheat 316 (1819) one hundred fifty years ago established the basis for the principle that the federal government does not have the power to levy taxes which would interfere with the governmental functions of states or their political subdivisions and, in cases too numerous to cite, the principle has been upheld.

The successful imposition of the proposed taxes would require that the Supreme Court overrule this long-standing constitutional law. This will make litigation inevitable and doom the municipal bond market to several

years of disorder, which will cost the public taxpayers hundreds of millions of dollars in additional interest costs.

The inescapable fact is that even the threat of removal of the tax exempt feature from municipal bonds has resulted in a drastic increase in interest rates on such bonds in recent months, to the point where nearly two billion dollars of such bonds have not been sold. This results in the delay or postponement of a corresponding amount of construction of vitally needed public improvements. The taxation of interest on such bonds would permanently impair the ability of local governments to finance such construction, just at a time when the need for public facilities is at its peak. Then the so-called "taxpayer revolt" would become the "peoples' revolution" because the working man would be required to pay higher taxes to finance fewer improvements. Nor is the answer at this point a federal subsidy to "cover the difference" in the cost of issuing tax-free and taxable bonds. We already have a unique and time-tested subsidy program in the tax-free privilege accorded municipal bonds. This system has worked effectively for many years and should not be changed unless there is clear evidence of a better system, which is not provided for in the proposed legislation.

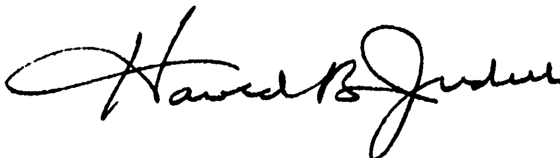
At a time when state-federal "revenue sharing" is being recognized as one solution to the many economic ills at the local level, a tax on bonds is proposed which would, in effect, shift revenue from the state to the federal level, resulting in a net loss to the states and local subdivisions. Inevitably this shift would bring federal control and weaken our entire system of federal-state relationships.

- 3 -

33-758 O - 69 -- No. 9 -- 21

One of the alleged reasons for the proposed tax is to levy a tax on the oft-cited 154 individuals in high income brackets who do not pay taxes; however, research indicates that their escape of taxes is not due to investment in tax-free bonds. In any event, it would seem to be the height of folly to enact a form of taxation admittedly designed to affect such a limited number when in reality its impact is far more severe on the small taxpayer.

In conclusion, the retention of our entire state-federal governmental structure and the preservation of a sound economy demands that any attempts to levy a tax on interest or municipal bonds be defeated.



Statement of

HAWKINS, DELAFIELD & WOOD
67 Wall Street
New York, N. Y.

Re: PROPOSED TAX REFORM ACT OF 1969 (H. R. 13270)

Submitted to Committee on Finance
United States Senate
Washington, D. C.

September 19, 1969

STATEMENT OF HAWKINS, DELAFIELD & WOOD

67 Wall Street, New York, New York 10005

Re: PROPOSED TAX REFORM ACT OF 1969 (H. R. 13270)

Preliminary Statement

This statement is submitted in accordance with press release of the Senate Committee on Finance and a telegram from the Chief Counsel of the Committee received on September 10, 1969.

The principal points presented in the statement are summarized as follows:

(1) The minimum tax on income including state and municipal bond interest levied by the House Bill is unconstitutional. The *Pollock* case holds that a tax on the interest from state and municipal bonds is unconstitutional. The Sixteenth Amendment did not change the decision in the *Pollock* case. The Congress has construed the Sixteenth Amendment consistently with the decision in the *Pollock* case. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning. To the extent that the minimum tax applies to interest on local housing authority obligations it also impairs the obligation of contract.

(2) The withdrawal from state and municipal bondholders of deductions allowed other taxpayers discriminates against individuals owning tax-exempt securities and by raising the cost of borrowing interferes with the borrowing power of states and municipalities. Although Congress may in some circumstances disallow deductions directly related to interest on state and municipal bonds or properly allocable to such interest, by disallowing deductions not reasonably related to the receipt of tax-exempt income, the House Bill violates the doctrine enunciated in the *National Life Insurance Company* case and is not supported by the *Atlas Life Insurance Company* case.

(3) The municipal bond subsidy provisions and the provisions relating to arbitrage obligations of state and local governments provide for unnecessary and undesirable federal control of state and local financing. Neither industrial development bonds as defined in Section 107 of the Revenue and Expenditure Control Act of 1968 or arbitrage obligations would be eligible for the subsidy program. Thus many bonds which would be issued to finance facilities for many acknowledged and traditional state and local functions would be ineligible. In addition the subsidy program is unworkable in certain respects. No political subdivision of any state has the power at the present to issue taxable bonds notwithstanding the possible passage of the Tax Reform Act of 1969. The payment of a percentage of interest yield on taxable state and local obligations is of no value. The dual coupon concept will not accomplish its intended purpose because state interest limitations will nonetheless apply. The administration of the subsidy program will involve substantial and undesirable federal involvement in state and local financing.

I

The minimum tax on income including State and Municipal bond interest levied by the House Bill is unconstitutional.

Section 301(a) of the House Bill adds a new Section 84 to the Internal Revenue Code of 1954. The new section includes in the gross income of a taxpayer other than a corporation the amount of so-called "disallowed tax preferences" and defines the so-called "items of tax preference." Among the items is any excess of interest on obligations which is excludible from gross income under section 103 of the Code, namely, the interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia."

The proposed section provides a transitional rule for including interest exempt under section 103 as an item of tax preference which is 10% multiplied by the number of taxable years beginning after December 31, 1969. When the new section is fully effective the limit on tax preferences will be an amount equal to (1) one-half of the sum of the items of tax preference and the taxpayer's adjusted gross income or (2) $10,000, whichever is greater.

The Report of the Committee on Ways and Means illustrates the application of the limit on tax preferences by the case of a taxpayer with a salary of $50,000 and tax preference items amounting to $150,000 and states that:

> "Under present law, such an individual is taxed only on his $50,000 of salary. Under the limit on tax preferences, he is to be required to pay tax on $100,000 of income (one-half of his total income of $200,000)." H. Rep. No. 91-413 (Pt. 1) (91st Cong., 1st Sess.) p. 79.

Thus, if the tax preference item comprises only interest on hitherto tax-exempt securities and 100% of the interest is taken into account at the end of the transitional period, the individual who receives a $50,000 salary and $150,000 in interest on tax-exempt securities will pay a tax on $100,000 of income. Obviously, since his salary amounts to $50,000 the remaining income of $50,000 on which he pays a tax can not consist of any income other than the interest received on his state and municipal bonds.

Law, as Mr. Justice Holmes has told us, is a "prophecy of what courts do in fact." In our opinion, the Supreme Court would hold that such a tax on the interest on state and municipal bonds is unconstitutional for the reasons stated below. From the time the income tax was imposed in 1913 until now both Congress and the Supreme Court have adhered steadfastly to the constitutional doctrine that state and municipal bond interest is exempt from federal income tax. It would be strange for Congress to abdicate its obligation to respect constitutional limitations upon its power by levying a tax on such interest without awaiting new constitutional authorization.

The doctrine of federal immunity from state interference, including interference by taxation, is a general principle of constitutional law with which this Committee is undoubtedly familiar. The converse immunity of the states from federal interference is equally well established. The doctrine was specifically applied to interest on bonds of states and municipalities and of state and municipal instrumentalities by the Supreme Court of the United States in the landmark case of *Pollock* v. *Farmers' Loan & Trust Company*, 157 U. S. 429 (1895) and on rehearing, 158 U. S. 601 (1895).

The cases decided by the Supreme Court under the Sixteenth Amendment as well as the legislative history of the amendment in Congress during the period it was being ratified by the state legislatures demonstrate that any claim that the amendment repudiated the rule of the *Pollock* case is unsupported by any judicial precedent, is unfounded in fact, and altogether spurious.

For the purpose of this statement it is not necessary or desirable to delve into the much repeated history of the constitutional doctrine of reciprocal immunity before August 15, 1894 when Congress enacted a statute which levied a tax upon net income, including income from all real property and from all personal property, both tangible and intangible, including the interest on state and municipal bonds.

At that time and until the Sixteenth Amendment became effective on February 25, 1913, Article I, Section 2, of the federal Constitution required the apportionment of "direct taxes" among the states according to population, as follows:

> "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole Number of free Persons, including those bound for Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons."

Article I Section 8, of the Constitution also requires that "Duties, Imposts and Excises" shall be uniform, as follows:

> "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; . . . "

A. *The Pollock Case holds that a tax on the interest from State and municipal bonds is unconstitutional.*

In the *Pollock* decision which considered the validity of the income tax law of 1894, the Supreme Court pointed out that the federal government had an unlimited power of taxation with a single exception and subject to two qualifications. The one exception was that "Congress cannot tax exports . . . " The two qualifications were that Congress "must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity." 157 U. S. at 557.

In the first *Pollock* case the Supreme Court held that a tax on the rents and other income from real estate was a direct tax and consequently violated the Constitution because the tax was not "apportioned among the several States . . . according to their respective numbers." The Court also unanimously held that the taxing power, like any and all other powers of the federal government, was impliedly subject to the constitutional limitation that it could not be so exercised that the instrumentalities of the states were taxed. 157 U. S. at 584.

Thus, the first decision in the *Pollock* case held the income tax act of 1894 invalid in respect of (1) the tax on rents and other income from real estate and (2) the tax on the interest from state and municipal bonds. The justices divided equally on the constitutionality of the income tax pertaining to personal property other than state and municipal bonds and on whether the 1894 act as a whole was unconstitutional.

On rehearing the Supreme Court decided (four of the justices dissenting) first, that the tax on income from personal property was a direct tax and hence was invalid because not apportioned and, second, that the 1894 Act was unconstitutional in its entirety.

The *Pollock* decision was unanimous as to municipal bond interest because in the words of Mr. Justice Fuller to tax the interest on municipal bonds "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract,"* and would be a "tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution." 157 U. S. at 586.

To the same effect was the separate opinion of Mr. Justice Field:

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States." 157 U. S. at 601

And Mr. Justice Brown who had concluded that "a tax upon rents or income of real estate is a tax upon the land itself" nevertheless said in the second *Pollock* decision:

> "The tax upon the income of municipal bonds falls obviously within the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of taxation, but of the power to subject the property to taxation in any form." 158 U. S. 692-693

* This is a prophecy found to be all too accurate and greatly understated by those state and municipal officials who have tried to borrow money since the introduction of the bill. The Monthly Economic Letter of the First National City Bank of New York says "the damage done by the proposals in the bill in terms of raising the cost of borrowing by States and municipalities this year cannot be underestimated. Those governments which have been penalized this year have no recourse to a Treasury subsidy."

Thus, all the justices in both *Pollock* decisions, whether they subscribed to the theory that a tax on income was a tax on the source of the income or considered that theory untenable, came to the identical conclusion that the interest on state and municipal bonds could not be included in federally taxable income. It is clear, therefore, that the decision in *Pollock* concerning the unconstitutionality of taxing state and municipal bond interest rests not on the economic premise that a tax on income is a tax on the source of the income but on the inviolability of the borrowing power of the states and their political subdivisions.*

B. *The Sixteenth Amendment did not change the decision in the Pollock Case.*

This, then, was the law when the Sixteenth Amendment was declared in full force and effect by the Secretary of State on February 25, 1913. The Amendment reads:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

1. *The Congress has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.*

Even before the Supreme Court decided that the phrase "from whatever source" in the Amendment relates not to the power to tax but to the requirement that certain federal taxes must be apportioned among the states according to their respective populations, Congress had also concluded that the object of the Amendment was to eliminate the necessity of *apportionment* irrespective of source in order that the income derived from the source of real and personal property could be taxed. Briefly stated, the Amendment means that a tax on income "from whatever source" is immune from the constitutional requirement of apportionment. 38 Stat. L. 168 (1913); 39 Stat. L. 758-59 (1916); 40 Stat. L. 329-30 (1917) and 1065-66 (1918).

When during World War I, a revenue act was drafted with a provision to include the interest on municipal bonds in gross income, the lack of power to tax such interest was expressed both in committee reports and congressional debate. It was recognized that lack of apportionment was not the objection to federal taxation of state and municipal bond interest but that the lack of power to tax such interest was absolute. The provision was omitted. H. Rep. No. 767, (65th Cong. 2nd Sess.) p. 9; Sen. R. No. 617, (65th Cong. 3rd Sess.) p. 6; 56 Cong. Rec. p. 10933-41, 10628-33, 11181-87.

Such a contemporaneous construction of the Sixteenth Amendment by Congress from the time it became effective through World War I is certainly an influential if not a controlling consideration in determining the meaning of the Amendment.

---

* The reluctance of the four justices in both *Pollock* cases to accept the theory that a tax on income is a tax on the source of the income was later shared by the Supreme Court in *New York ex rel Cohn v. Graves*, 300 U. S. 308 (1937) in which the New York State income tax on rents from real estate in New Jersey was upheld. Obviously, however, this was not the *ratio decidendi* of the *Pollock* case, because four of the justices who did not agree that a tax on income from personal property was a tax on the property itself joined with the other justices in invalidating the tax on municipal bond interest.

Later, in 1923, after the decision of the Supreme Court in *Evans* v. *Gore*, 253 U. S. 245 (1920), to be discussed below, Congress considered and the House of Representatives passed a constitutional amendment* to authorize the taxation of income derived from future issues of state and municipal bonds and to authorize states to tax the income of future issues of federal bonds. H. J. Res. 314, (67th Cong. 4th Sess.); H. Rep. No. 969, (67th Cong. 2d Sess.) The proposal failed to pass the Senate.

2. *The Supreme Court has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.*

In *Evans* v. *Gore*, 253 U. S. 245 (1920), the Supreme Court held (Justice Holmes and Brandeis dissenting) that the Sixteenth Amendment did not authorize an income tax on the salary of a federal judge in view of the fact that the Constitution provided that the compensation of judges "shall not be diminished during their continuance in office." Const. Art. III Sec. 1.

The Court then considered whether the constitutional inhibition against such diminution was modified by the Sixteenth Amendment. After an elaborate analysis of the Sixteenth Amendment the Court concluded that:

> "the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another." 253 U. S. at 261-2.

Although *Evans* v. *Gore* was overruled in *O'Malley* v. *Woodrough*, 307 U. S. 277 (1939), it is clear from the opinion of Mr. Justice Frankfurter in the latter case that the decision that federal judges could be taxed on their salaries was based on the premise that, as Justices Holmes and Brandeis had said in their dissenting opinion in *Evans* v. *Gore*, a tax on salaries was not a diminution of compensation. Only that portion of the majority opinion in *Evans* v. *Gore* was repudiated and not one word in the opinion in *O'Malley* v. *Woodrough* questions the above-quoted conclusion of the Court in *Evans* v. *Gore* concerning the Sixteenth Amendment.

* The proposed amendment read as follows:

"[H. J. Res. 314, Sixty-seventh Congress, fourth session.]

JOINT RESOLUTION Proposing an amendment to the Constitution of the United States.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled (two-thirds of each House concurring therein), That the following article is proposed as an amendment to the Constitution of the United States, which shall be valid to all intents and purposes as part of the Constitution when ratified by the legislatures of three-fourths of the several States:

'ARTICLE .

'SECTION 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other State.

'SEC. 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued, after the ratification of this article, by or under the authority of the United States, but without discrimination against income derived from such securities and in favor of income derived from securities issued after the ratification of this article, by or under the authority of such State.'"

In *Evans* v. *Gore* the Supreme Court had referred to previous cases in which the Court had considered the Sixteenth Amendment, beginning with the opinion of Chief Justice White in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1 (1916) which was the first case involving the scope and meaning of the Sixteenth Amendment. In that case, referring to the text of the Amendment the Chief Justice had declared (240 U. S. at 17-18):

> ". . . It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the *Pollock Case* and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock Case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

The *Brushaber* case was decided on January 24, 1916. On Feberuary 21, 1916, the Supreme Court handed down the decision in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103 (1916). The decision was unanimous and again the Court reiterated the rule

> ". . . that the provisions of the Sixteenth Amendment conferred no new power of taxation . . ." 240 U. S. at 112

In *Peck & Co.* v. *Lowe*, 247 U. S. 165 (1918), the Supreme Court decided that the net income of a corporation derived from exporting goods was not a tax on exports prohibited by the Constitution, the unanimous opinion of the Court stating:

> "The sixteenth amendment, although referred to in argument, has no real bearing and may be put out of view. As pointed out in recent decisions, it does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another." 247 U. S. at 172-3

Two years later, in *Eisner* v. *Macomber*, 252 U. S. 189, 206 (1920), the Court said:

> "As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which might otherwise exist for an apportionment among the States of taxes laid on income."

In 1926 in *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 521, Mr. Justice Stone flatly declared:

> ". . . the sixteenth amendment did not extend the taxing power to any new class of subjects."

Five years later, in *Willcuts* v. *Bunn*, Chief Justice Hughes, 282 U. S. 216, 226 (1931), speaking for a unanimous Court which held capital gains on the sale of public securities to be taxable, reiterated the rationale of the rule as follows:

> "In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & Trust Company, supra.* These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

Again in *James* v. *Dravo Contracting Co.*, 302 U. S. 134, 153 (1937) Chief Justice Hughes restated the reason for income tax immunity of state and municipal bond interest as follows:

> "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' *(Pollock* v. *Farmers Loan & Trust Co., supra)* and which would directly affect the Government's obligations as a continuing security. *Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,—considerations which are not found in connection with contracts made from time to time for the services of independent contractors.*" (italics supplied)

And again, in *Helvering* v. *Mountain Producers Corporation*, 303 U. S. 376, 386 (1938) the Chief Justice repeated that:

> "a tax on the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government (*Weston* v. *Charleston* * * *, *Pollock* v. *Farmers' Loan & Trust Co.* * * *)."

In the previous year Mr. Justice Cardozo had also pointed out in *Hale* v. *Iowa State Board*, 302 U. S. 95, 107 (1937):

> "By the teaching of the same *(Pollock)* case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland* * * * and *Collector* v. *Day* * * *."

And in *Helvering* v. *Gerhardt*, 304 U. S. 405 (1938), in upholding a federal income tax as applied to salaries of the employees of the Port Authority, Chief Justice Stone also referred to the hazard of impairing the borrowing power, stating that the immunity doctrine had been sustained

> "where * * * the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was * * * to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state, *Pollock* v. *Farmers' Loan & Trust Company*, 157 U. S. 429; cf. *Weston* v. *Charleston, supra*, 465-466."

The rationale of the *Helvering* v. *Gerhardt* case was followed in *Graves* v. *New York ex rel O'Keefe*, 306 U. S. 466 (1939) in which the Court held that the salary of an employee of the Home Owners Loan Corporation was not immune from state income tax. Both these cases relate to the same question whether intergovernmental immunities extend to the salaries of employees: *Gerhardt* to a federal income tax applicable to state employees and *O'Keefe* to a state income tax applicable to federal employees.

It is noteworthy that in the *Gerhardt* case Mr. Justice Stone pointed out that the *Pollock* case had no application because, as distinguished from the income taxation of public salaries, the income taxation of public securities would "threaten impairment of the borrowing power of the state." The *O'Keefe* case does not refer to the *Pollock* case, probably because of the Government's position that the income taxation of public securities was essentially different.

In his argument in *Graves* v. *O'Keefe* before the Supreme Court, Solicitor General Robert Jackson, later Justice of the Supreme Court, had explained that the Government accepted the distinction drawn by Chief Justice Stone in the *Gerhardt* case and had emphasized that where one deals with a debtor-creditor relationship, the borrower is the one who is burdened. The Solicitor General said that it was *the presence of an actual burden upon the public instrumentality which issues public securities which distinguished the taxation of the interest on public securities from the taxation of the salaries of public employees.*

The evidence is overwhelming that the views of Congress and the Supreme Court on the scope of the Sixteenth Amendment correctly express the purpose and meaning of the Amendment. That purpose was to permit Congress to levy and assess taxes on income without complying with the impracticable rule of apportionment according to population. Before the Amendment Congress had the power to lay income taxes but not without apportionment. After the Amendment Congress need not apportion. The history of the Amendment proves that it was never intended to repeal the constitutional doctrine of reciprocal immunity from taxation of state and federal instrumentalities and obligations.

3. *The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning.*

Sixty years ago President Taft sent a special message to Congress in which he urged a constitutional amendment which would confer upon the national government

> "the power to levy an income tax * * * without apportionment among the states in proportion to population."

The President urged Congress not to reenact the 1894 income tax law which had been declared unconstitutional, saying:

> "For the Congress to assume that the court will reverse itself, and to enact legislation on such an assumption, will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. (June 16, 1909) p. 3344

Previous to President Taft's special message, Senator Brown of Nebraska had offered a resolution for a constitutional amendment to the effect that "The Congress shall have power to lay and collect taxes on incomes and inheritances." Upon being informed in debate that Congress already had both of the powers in question and that only the rule of apportionment stood in the way of federal income taxation, Senator Brown offered, a few days later, a second resolution which read that "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population." 44 Cong. Rec. pp. 1548, 1568-9, 3377. The Senate Finance Committee soon reported a resolution for a constitutional amendment in which the words "direct taxes" were changed to "taxes" and after "income" the words "from whatever source derived" were inserted. The proposed amendment then read:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." 44 Cong. Rec. p. 3900

The Committee gave no explanation of the reason for these changes.* However, the reason for the two changes is clear. The words "direct taxes" in Senator Brown's proposal would require explanation because it was not obvious why the amendment should only provide that direct taxes need not be apportioned. Hence, to eliminate the ambiguity of "direct taxes" the committee provided that taxes on income "from whatever source derived" need not be apportioned. Senator Brown's proposed amendment as clarified by the Senate Finance Committee did not grant power to Congress to lay and collect a tax on incomes; Congress already had plenary power to levy income taxes under Article I, Section 8 of the Constitution (quoted *supra* at p. 3). The phrase "from whatever source derived" was simply another way of saying that Congress need no longer apportion any tax on incomes, irrespective of the source of the income; that was the sole purpose of the Amendment proposed by President Taft and introduced by Senator Brown.

* The only colloquy which took place when the revised resolution was reported to the Senate is found in 44 Cong. Rec. 3900.

The debate in Congress took one day in the Senate and one day in the House. The joint resolution proposing the amendment as redrafted by the Committee passed both houses and was immediately submitted to the states. No consideration was given at all to the question of the taxation of income from state and muncipal bonds. The matter simply was not discussed. There was no indication that anyone sought to overturn the doctrine that state and municipal bond interest was immune from federal taxation which had been unanimously established in the *Pollock* case.

On January 5, 1910, Governor Hughes of New York submitted the amendment to the Legislature with a message calling attention to the words "from whatever source derived," suggesting that this might permit the taxation of income from state and municipal bonds, and questioning whether the amendment should be ratified.

On February 10, 1910, Senator Borah spoke in the Senate in answer to Governor Hughes' objection, stating in substance that no such meaning could be attached to the amendment. 45 Cong. Rec. 1694-9. He was followed by Senator Brown who concurred with Senator Borah's interpretation. Later, Senator Brown pointedly suggested that Governor Hughes stood alone in his fear:

> "It is a very significant fact that this amendment which was pending in Congress for days and was the subject of discussion by Congress and the press, should never have met this criticism while it was pending. In its present form it had the support of a unanimous Senate and a practically unanimous House of Representatives, who were all, judged by their votes, in favor of conferring this power on Congress, and yet no one in Congress ever suggested any change in the language of the resolution or proposed an amendment thereto to cover the objection now made.
>
> "Nor did any distinguished Governor from any of the 46 States, all of whom are now very loud in their protestations that the Government should have the power to tax incomes without apportionment, ever suggest that the amendment should have been modified in form in any respect. In this body the State of New York enjoys representation of the very highest character and most eminent ability, and yet New York on the roll call, as shown in the Congressional Record, was in favor of this amendment as it passed Congress, and was silent as to any suggestion that the language was faulty.
>
> * * *
>
> "The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities." 45 Cong. Rec. 2245-6 (Feb. 23, 1910)

On February 17, 1910, Senator Elihu Root of New York, a strong advocate for the amendment, wrote to New York State Senator Davenport giving his reasoned

opinion that the amendment did not affect the immunity of state and municipal bonds. Senator Root wrote:

> "Much as I respect the opinion of the Governor of the State, I cannot agree with the view expressed in his special message on January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.
>
> * * *
>
> "The proposal followed the suggestion of the Supreme Court in the *Pollock case.*
>
> "The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal property, although it could be taxed when derived from business or occupation.
>
> "The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived." 45 Cong. Rec. p. 2539-40 (Mar. 1, 1910)

Thus, three United States Senators sought to allay any doubt held by Governor Hughes. No other member of Congress or any Governor* expressed any other view. That Governor Hughes' doubts were set at rest is shown by his opinions after he became Chief Justice, in *Willcuts* v. *Bunn* (*supra*, p. 8), *James* v. *Dravo Contracting Co.* (*supra*, p. 8) and *Helvering* v. *Mountain Producers Corporation* (*supra*, p. 8).

No one would doubt that if the states and their municipalities were to attempt to impose state or local taxes upon interest received by their residents from obligations of the Federal government, such a levy would be unconstitutional in the absence of consent by Congress to such taxation. *Weston* v. *City of Charleston*, 2 Pet. (U. S.) 449 (1829). And this is so even though it is universally accepted that the state legislatures possess plenary power to tax, subject only to the limitations of their state constitutions.

It is our opinion that the unanimous holding in the *Pollock* case, reaffirmed so many times after the Sixteenth Amendment, that interest on state and municipal securities is free from Federal income taxation under the Constitution would be again reaffirmed by the Supreme Court and that therefore the House Bill insofar as it seeks to lay a minimum tax applicable to such interest is unconstitutional.

---

* In a message to the New Jersey Legislature, dated February 7, 1910, John Franklin Fort, Governor of New Jersey, said:

> "* * * Nor am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power."

On February 23, Senator Brown, referring to the message of Governor Fort, of New Jersey, said:

> "It cheers our hearts to read in the press that President Taft agrees with the Governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." [45 Cong. Rec., p. 2245]

C. *To the extent the minimum tax applies to interest on local housing authority and agency obligations it is also unconstitutional under the Fifth Amendment.*

It is also our opinion that if the minimum tax in the House Bill applies to the interest on bonds of local public housing authorities issued to finance low rent housing, slum clearance and urban renewal projects, the bill violates the Fifth Amendment to the Constitution.

The United States Housing Act of 1937 [50 Stat. L. 888] provides in section 5(e) as follows:

> "Obligations, including interest thereon, issued by public housing agencies in connection with low-rent housing or slum-clearance projects, and the income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

The Housing Act of 1949 [63 Stat. L. 413] provides in section 102(g) as follows:

> "Obligations, including interest thereon, issued by local public agencies for projects assisted pursuant to this title, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

Since the interest on obligations issued by a local public housing authority or agency constitutes interest upon obligations of a political subdivision of a state, such interest is excluded from gross income under section 103 of the Internal Revenue Code. When interest is excluded from gross income under the Code, the provisions of the House Bill imposing the minimum tax become operative and apply to such exempt interest in excess of the $10,000 floor.

Each of the above-quoted provisions of the United States Housing Act of 1937 and the Housing Act of 1949 that the obligations of local housing authorities and agencies "including interest thereon" * * * shall be exempt from all taxation now or hereafter imposed by the United States constitutes a statutory contract between the federal government and the holders of such obligations. In our opinion, to deprive such holders to any extent of their immunity from federal taxation on the interest which they receive from such obligations impairs the obligation of the contract in violation of the Fifth Amendment which "protects rights against the United States arising out of a contract." *Lynch* v. *United States*, 292 U. S. 571 (1933). See also *Farmers and Mechanics Savings Bank* v. *Minnesota*, 232 U. S. 516, 528 (1913).

II

ADR by arbitrarily disallowing deductions unrelated to tax-exempt interest discriminates against state and municipal bondholders.

Section 302(a) of the House Bill which adds a new section 277 to the Code is inconsistent with established principles of judicial decisions concerning income tax deductions. The new section provides in effect that if a taxpayer other than a corporation

has so-called "allocable expenses" for a taxable year, the deductions otherwise allowable for such expenses are disallowed to the extent of an amount equal to (1) the aggregate of such expenses multiplied by a fraction, the numerator of which is the "allowable tax preferences" and the denominator of which is such preferences plus "modified adjusted" gross income, or (2) the "allowable tax preferences," whichever is lesser.

The deductions which the bill requires to be allocated are payments or losses not related to a business or to a transaction entered into for profit, including interest, state and local taxes, and personal theft and casualty losses, as well as charitable contributions, cooperative housing expenses, medical and dental expenses, and net operating losses attributable to nonbusiness casualty losses.

Among the "allowable tax preferences" which would cause the partial disallowance of allocable deductions is interest in excess of $10,000 received from state and municipal bonds issued on and after July 12, 1969.

The Secretary of the Treasury when he appeared before this Committee advocated the adoption of an even more stringent provision limiting deductions for individuals so far as interest on state and municipal obligations is concerned. Although the House Bill contains transitional provisions under which the interest on state and municipal bonds would be taken into account gradually over a ten-year transitional period, the Secretary of the Treasury proposed that 100% of the interest should be taken into account immediately. The respected Secretary referred to the section disallowing deductions as the "ADR" provision of the bill, meaning "Allocation of Deductions Rule."

The House Ways and Means Committee Report, which accompanied the bill, tries to give a simple example of the operation of sections 301 and 302 in a footnote which reads as follows:

> "For example, suppose the individual has as taxable income of $30,000, a tax-exempt income of $70,000, and $30,000 of personal deductions. Applying the limit on tax preference first results in adding $20,000 to the individual's taxable income increasing the latter to $50,000 and decreasing tax-free income to $50,000. Deductions are then allocated on the basis of a 50-50 split between taxable and nontaxable income, resulting in disallowing $15,000 of the total of $30,000 of deductions. For simplicity, this example omits the effect of the $10,000 floor." H. Rep. No. 91-413 (Part I), *supra*, p. 83, n. 3.

If, for example, the $30,000 of personal deductions consisted of contributions to charitable organizations (irrespective of whether the contributions consisted of cash or securities appreciated in value), the result would be that a substantial portion of the charitable contributions would be lost as a deduction.

First of all, the percentage limitation of 50% under the bill in the case of a cash contribution and 30% under the bill in case the contribution consisted of appreciated securities, would apply. Then the amount allowable as a deduction would be cut

by 50% regardless of the nature of the charitable contribution. Presumably under the House Bill the amount in excess of the percentage limitation (either $5,000 if the contribution were in cash or $15,000 if the contribution were in appreciated securities) could be carried over for the following five years and deducted as a charitable contribution. Nevertheless the 50% disallowed as a result of the application of the proposed allocation of deductions rule could not be carried forward and the donor would have no tax benefit from having given this amount.

Omitting "for simplicity" the $10,000 floor, if the $30,000 of personal deductions consisted of state and local taxes, or casualty losses, instead of charitable contributions, one-half of the deductions would be disallowed.

A. *There is no doubt Congress may disallow deductions directly related to interest on state and municipal bonds or properly allocable to such interest.*

In order to clarify an issue already beclouded by a fundamental discrepancy between the bill and the Committee Report, we wish to emphasize that in our view, Congress has plenary power to disallow any deduction directly related to tax-exempt interest on state and municipal bonds. This principle is illustrated by the provision of the Revenue Act of 1921 [now Code §265(2)] which forbids the deduction of interest paid on loans used to carry tax-exempt securities. In *Denman* v. *Slayton*, 282 U. S. 514 (1931) the constitutionality of this disallowance was upheld by a unanimous Supreme Court. The Court distinguished *National Insurance Company* v. *United States*, 277 U. S. 508 (1928) on the ground that Slayton, a municipal bond dealer, was not required to pay more taxes because he owned exempt securities.

Nor do we have any doubt regarding the constitutionality of section 265(1) of the Code which provides that no deduction shall be allowed for any

> "amount otherwise allowable as a deduction under section 212 (relating to expenses for production of income) which is allocable to interest * * * wholly exempt from taxes * * *."

For example, if an individual taxpayer receives one-half of his income from tax-exempt securities and one-half his income from taxable securities, all such securities being in a custody account of a bank, the custodian fees paid to the bank can constitutionally be allocated between the income from the tax-exempt securities and from the taxable securities. The statutory inhibition against the deduction of one-half of those fees and expenses is in our opinion constitutional because there is a meaningful basis for the allocation.

B. *By disallowing deductions not reasonably related to the receipt of tax-exempt income, ADR violates the rule of law in the National Life Insurance Company case.*

The House Ways and Means Committee Report gives lip service to the principle that allocation should be required "only for those expenses which can reasonably be assumed to be met in part out of tax-free income." H. Rep. 91-413 (Part 1), p. 82.

However, this assertion in the Committee Report finds no counterpart or expression in the House Bill which contains no clause confining the ADR to deductions having a reasonable relationship to the tax-exempt income.

Any attempt to include such a limitation on ADR would indeed be contradictory of the other provisions of the bill which apply ADR even when the deductions are wholly unrelated to the receipt of interest on state and municipal securities, such as, for example, the inclusion in so-called "allocable deductions" of casualty losses, charitable contributions, or state and local taxes.

Under ADR an individual with tax-exempt securities who also has deductions for casualty losses, charitable contributions or state and local taxes will be forced to pay a higher federal income tax simply by reason of the ownership of such securities. A simple example omitting the $10,000 floor should suffice to show that the ADR requires this result. Assume two taxpayers, each married and under 65 but with no dependents. Taxpayer A receives $50,000 in income from municipal bonds and has an adjusted gross income of $50,000 and deductions of $25,000. Taxpayer B has the same adjusted gross income and deductions but receives no tax-exempt interest. Taxpayer A will pay a federal income tax, disregarding the 10% surcharge, of $10,475, in contrast to Taxpayer B, who will pay a tax of $5,596, as follows:

	Taxpayer A		*Taxpayer B*	
Adjusted Gross Income ...		$50,000		$50,000
Tax-exempt municipal bond interest		50,000		none
Allocable Expenses	$25,000		$25,000	
Less:				
Amount Disallowed by ADR	12,500	$12,500	none	$25,000
Taxable Income		$37,500		$25,000
Tax		$10,475		$ 5,596

When prospective purchasers of tax-exempt securities realize that their right to deductions will be substantially eroded if either the House Bill or the Treasury proposal becomes law they may well curtail their purchases and even be forced to sell securities acquired since the cutoff date of July 11, 1969 in the House Bill. The incongruity of an individual who owns no tax-exempt securities paying less taxes than a taxpayer with the identical taxable income who accepts the lower interest rate borne by municipal bonds can have a serious impact upon the municipal bond market. The adverse effect of this potential interference with the borrowing power of states and municipalities stems primarily from the discriminatory disallowance of char-

itable contributions, state and local taxes, theft and casualty losses, and medical and dental expenses, none of which are even remotely connected with the receipt of tax-exempt interest.

In *National Life Insurance Company* v. *United States,* 277 U. S. 508, 522 (1928), the Supreme Court held that "Congress has no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others."

And yet this is precisely what happens under ADR as the foregoing example demonstrates. It is submitted that ADR plainly discriminates against those taxpayers (other than banks and other corporations) who receive state and municipal bond interest by compelling them to pay a higher tax than other taxpayers receiving the same amount of taxable income who do not own tax-exempt public securities.

C. *The Atlas Life Insurance Company case does not support ADR.*

United States v. *Atlas Life Insurance Company,* 381 U. S. 233 (1965), which considered the constitutionality of The Life Insurance Company Income Tax Act of 1959 does not support the ADR. That Act imposed a tax upon the taxable investment income of life insurance companies and upon one-half the amount by which total gain from operations exceeds taxable investment income. 73 Stat. 112, Code §§ 801-820. In arriving at taxable investment income, the Act recognized that life insurance companies are required by law to maintain policyholder reserves to meet future claims, that they normally add to these reserves a large portion of their investment income, and that these increments should not be subjected to tax. The Act defines life insurance reserves, provides a method for establishing the amount which for tax purposes is deemed to be added each year to those reserves, and prescribes a division of the investment income of an insurance company into two parts, the policyholder's share and the company's share.

Under section 804 the total amount to be added to the reserve is divided by the total investment yield and the resulting percentage is used to allocate each item of investment income, including tax-exempt interest, partly to policyholders and partly to the company. The effect of apportioning the annual addition to the reserve to non-taxable and taxable income *pro rata* is to limit the deductions allowed against taxable income to its proportionate part of the addition to the reserve. The remainder of each item is considered to be the company's share of investment income. In computing taxable investment income, the Act then allows a deduction of the company's share of tax-exempt interest from the total amount of investment income allocated to the Company.

Atlas claimed it was entitled to deduct from total investment income both the full amount of the annual additions to the reserves and the full amount of tax-exempt interest received. The company argued that by assigning part of the exempt income to the reserve account rather than assigning only taxable income, the Act places more taxable income on the company's share of investment return, with the result that it paid more tax because it had received tax-exempt interest.

The Supreme Court speaking unanimously stated that:

"... the policyholder's claim against investment income is sufficiently direct and immediate to justify the Congress in treating a major part of investment income not as income to the company but as income to the policyholders. 381 U. S. at 247-8

* * *

"Under the 1959 Act this portion is arrived at by subjecting each dollar of investment income, whatever its source, to a pro rata share of the obligation owed by the company to the policyholders, from whom the invested funds are chiefly obtained. In our view, there is nothing inherently arbitrary or irrational in such a formula for setting aside that share of investment income which must be committed to the reserves." 381 U. S. at 249

The Court pointed out that:

"The formula does pre-empt a share of tax-exempt interest for policyholders and the company will pay more than it would if it had full benefit of the inclusion for reserve additions *and at the same time could reduce taxable income by the full amount of exempt interest.* But this result necessarily follows from the application of the principle of charging exempt income with a fair share of the burdens *properly allocable* to it." 321 U. S. at 251 (italics supplied)

This treatment of tax-exempt income prevents, as it was intended to do, a double deduction. If life insurance companies could not only deduct *in full* the annual additions to reserves which were assigned to the policyholders but also *exclude* from their income the tax-exempt interest assigned to the policyholders, they would be in effect deducting tax-exempt interest which had already been excluded from their taxable income. Thus, life insurance companies would have an exemption and also a deduction for the same amount of tax-exempt interest.

The Court declined to consider any comparison of two life insurance companies which received the same amount of taxable income but one of which companies received tax-exempt municipal interest, pointing out that life insurance companies do not have a choice of investing or not investing but must invest either in one kind of security or another to accumulate funds for their policyholders and that the items of income and expense which entered into any computation of taxable income of a life insurance company were so interrelated that it was unrealistic to compare life insurance companies with different earning capacities in determining whether expenses were properly allocable to tax-exempt income. 381 U. S. at 250-1.

In so doing the Court accepted the distinction between an individual taxpayer and a life insurance company which had been urged upon it by the Department of Justice in its brief in the case. In the brief the Department had emphasized this distinction as follows:

"If we were dealing with a simple tax upon gross income received by a taxpayer *exclusively for his own benefit* without deductible costs, then it might be

true to say that a tax liability which is increased because of the additions of an increment of State bond interest is, to some extent, a tax on the income from the bonds. But that is not this case; here we deal with the net income after sundry subtractions from the received income coming into the company's possession.

"... but the arithmetic is meaningless unless we also consider *whether the State-bond interest has such a relation to other items entering into the determination of taxable net income that the receipt or non-receipt of the State bond justifies a change in the corresponding elements of the arithmetical computation.*" Pet. Br., pp. 22-3 (italics supplied)

It is this very distinction which is so blurred by the self-contradictory language in the Report of the Ways and Means Committee that the draftsmen of the House Bill could not find words to insert in the bill which would limit the ADR to an allocation of deductions involving expenses reasonably attributable to the production and collection of the interest received by an individual (or an estate or trust) from state and municipal securities.

The Supreme Court in the *Atlas* case was not "dealing with a simple tax upon gross income received by a taxpayer exclusively for his own benefit," as the Government's brief in *Atlas* stressed. In *Atlas* the income was partly for the benefit of the taxpayer (i.e., the Company) and partly for the benefit of the policyholders. Hence, the allocation sanctioned by the Court in *Atlas* is a far cry from the sweeping disallowance of deductions not germane to tax-exempt income received by a taxpayer exclusively for his own benefit. To do what the House Bill would purport to do makes ADR an arbitrary and discriminatory rule.

III

Sections 601 and 602 of the Bill provide for unnecessary and undesirable Federal control of State and Local financing; the Subsidy Program provided for therein is unworkable.

Section 601 of the House Bill contains provisions which purport to authorize an issuer of obligations which are presently exempt under section 103(a)(1) of the Code to issue obligations which would not be subject to such exemption. The election shall be made with respect to each issue of obligations to which it is to apply and the election with respect to any issue once made shall be irrevocable. Section 602(b) of the bill provides that the Secretary of the Treasury or his delegate shall pay a fixed percentage of the interest yield on each issue of obligations to which the foregoing election applies before the first day of each calendar quarter. The Secretary or his delegate shall determine the fixed percentage of interest yield which he determines is necessary for the government to pay "in order to encourage the States and political subdivisions thereof to make elections under section 103(b)". During the calendar quarters beginning prior to January 1, 1975, the fixed percentage shall be not less than 30 percent and not more than 40 percent; for calendar quarters beginning after December 31, 1974, the percentage shall be not less than 25 percent and not more

than 40 percent. Payment of any interest required shall be made by the Secretary of the Treasury or his delegate not later than the time at which the interest payment on the obligation is required to be made by the issuer.

Section 602(c) of the bill provides that, at the request of the issuer, the liability of the United States under section 602 to pay interest to the holders of an issue of obligations for which an election has been made shall be made through assumption by the United States of the obligation to pay a separate set of interest coupons issued with the obligations.

Section 601(b) of the bill provides that, under regulations prescribed by the Secretary or his delegate, any arbitrage obligation shall not be included within those obligations exempt from taxation under section 103.

The amendments relating to the subsidy program shall apply to obligations issued in calendar quarters beginning after the date of the enactment of those provisions. The amendment in respect of arbitrage obligations shall apply to obligations issued after July 11, 1969.

A. *Sections 601 and 602 of the bill provide a vehicle for continuing federal control of the purposes for which state and local obligations may be issued.*

In order to overcome the objections to a subsidy plan which are necessary to complement a program of taxable debt instruments to finance state and local government capital outlays, the provisions of sections 601 and 602 of the House Bill, according to the Report of the House Committee on Ways and Means, are "entirely elective" and the Report further states that there "is no review of the advisability of the local project or of the issuer's ability to repay". However, such a review will be required for the subsidy provisions of the bill apply only to obligations which, but for an election under proposed section 103(b), would be obligations to which section 103(a)(1) applies. Thus, neither industrial development bonds as defined in section 107 of the Revenue and Expenditure Control Act of 1968 nor arbitrage obligations would be eligible for the subsidy program. If Congress is concerned with tax reform it is incumbent upon it truly to reform the situation created by the unfortunate definition of industrial development bonds contained in section 107 of the Revenue and Expenditure Control Act of 1968 and to prevent the taxation of "arbitrage" obligations. As Senator Baker stated on May 27, 1969 in the Senate upon the introduction of S. 2280 in respect of section 107 of the Revenue and Expenditure Control Act of 1968:

> "... This measure originated by way of amendment on the Senate floor without the benefit of hearings in either House and was adopted after brief debate. Subsequent to adoption by the Senate of the Ribicoff amendment, a provision imposing the 10-percent surtax was also added to the same bill, and the attention of the Senate-House conferees, the other Members of Congress, and the country at large was naturally and appropriately focused on the all-important issues of the surtax and expenditure cut and not on the scope of the definition relating to industrial development bonds.

Many Members of Congress who supported the taxation of industrial development bonds later came to realize that, as a result of the cursory treatment given this subject, Congress had by means of the definition employed in the act gone much further than was ever intended. It became generally acknowledged that Congress had not only provided for the taxation of industrial development bonds but had also made a wholesale attack on numerous State and local obligations completely unrelated to industrial development. Chairman Wilbur Mills of the House Ways and Means Committee, stated this fact on the floor at the time of passage of the conference report and invited the National Governors Conference and others to provide corrective legislation.

* * *

The bill which I introduce today is essentially a revised version of the measure that I introduced late in the last session. Its purpose is to correct what most believe is clearly a distorted definition of the term "industrial development bond" as presently set forth in the statute."

Senator Baker has stated, and we fully concur, that section 107 of the Revenue and Expenditure Control Act of 1968 has the effect of including within the definition "industrial development bond" many bonds which would be issued to finance facilities for many "acknowledged and traditional State and local functions". He further stated at the time of the introduction of S. 2280:

"...What the act [Revenue and Expenditure Control Act of 1968] does is set up a list of approved purposes labeled "exemptions." Bonds for these purposes remain exempt and those for all other State and local governmental purposes are, as I have said, taxable when private occupants pay to use the financed facilities.

By establishing this honor roll rating, the Congress purported to classify as "good" or "bad" many legitimate functions of State and local governments, rewarding "good" purposes with exemption and penalizing "bad" purposes with taxation. Among the "bad" purposes are such fundamental governmental functions as education and health care, which obviously are totally unrelated to the development of new industrial plants, but the interest on the facilities of which is taxable if they are maintained by private occupants.

* * *

In my judgment, this type of continuing Federal regulation by the honor roll regulation of State and local governmental functions has no proper place in our federal system and accordingly should be abandoned."

Just as we support meaningful redefinition of the term "industrial development bond" we object to any congressional determination of "good" or "bad" purposes. The goodness or badness of purposes for which state or local obligations may be issued can best be determined by states and local government in accordance with state established concepts of public purpose and not by Congress.

The statutory authorization to exclude arbitrage obligations from the subsidy program and to include income derived from arbitrage obligations in the gross income of the recipients thereof is another ill-conceived congressional attempt involving federal review of the purposes for which state or local obligations may be issued. The Report of the House Committee on Ways and Means states that "[s]ome State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions for which the funds from tax exempt issues are employed to purchase higher yielding federal obligations whose interest is not taxed in their hands." No examples of such arbitrage transactions are given. We know of no situation in which bonds have been issued in an arbitrage transaction as we believe that term to be used by the House and thus we have grave doubts as to the need for a legislative remedy for a supposed evil which does not exist. However, we are quite concerned that the term may be so defined to attack necessary and proper state and local financing methods. For example, it is quite common for state and local governments to invest in higher yielding taxable obligations pending the use of the proceeds of the bond issue. Such proceeds may be used for the construction of needed capital facilities or may be used to refund outstanding obligations. In either case it may be prudent, and indeed required, that the state or political subdivision invest those funds in the highest yielding and safest investments available to them including United States government securities, until such time as they can be used for the purpose for which they are intended.

The Report states that "it is contemplated that the regulations to be issued by the Secretary of the Treasury concerning this section of the bill will provide rules for the temporary investment of the proceeds of a state or local government obligation pending their expenditure for the governmental purposes which gave rise to their issue." However, neither the bill nor the Report provide the Secretary with any discernible standard as to what type of arbitrage obligations will be included in the definition promulgated by the Secretary of the Treasury.

We assume, but are uncertain, that the term as used in the House Bill has the ambivalent meaning given to it in the Treasury Department announcement contained in Technical Information Release No. 840, dated August 11, 1966. That Release stated that a study would be conducted to determine whether certain obligations should be considered as obligations of states, territories, possessions and their political subdivisions or the District of Columbia. The obligations which were to be the subject of the study were "obligations issued by these govermental units where a principal purpose is to invest the proceeds of the tax exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield."

Pending such study, the Treasury Department announced in the Release that it would decline to issue rulings that interest on obligations falling within two categories would be exempt from federal income taxation under section 103 of the Code.

The obligations were those

"1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested

in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.

2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded."

The Treasury Department then gave three examples of transactions where no rulings would be issued. The examples were

"First, a State may issue obligations and invest the entire proceeds in United States bonds with similar maturities bearing a higher interest yield. The United States bonds are then placed in escrow to secure payments of interest and principal on the States obligations. The profit on the interest spread accrues to the State over the period of time that these obligations are outstanding.

Second, a municipality may immediately realize the present value of the arbitrage profits to be derived over the future by casting the transaction in the following form: It may issue obligations in the amount of $100 million, use $20 million to build schools or for some other governmental purpose, and invest the balance, $80 million, in United States bonds which bear a higher interest yield. The United States bonds are escrowed to secure payment of interest and principal on the municipal obligations. The interest differential is sufficiently large so that the interest and principal received from the United States bonds are sufficient to pay the interest on the municipal obligations as well as to retire them at maturity.

Third, a municipality may issue obligations for the stated purpose of refunding outstanding obligations first callable more than five years in the future. During the interim before the outstanding obligations are redeemed the proceeds of the advance refunding issue are invested in United States bonds bearing a higher interest yield, and such bonds are escrowed as security for the payment of either of the issues of municipal obligations. During that interim period, arbitrage profits based on the interest spread inure to the municipality."

If the Treasury Department has completed its study it has not announced the results thereof* and therefore we express grave doubts of the need for a legislative remedy. We can understand the concern of the Treasury Department in respect of the problem presented by the first category or the first and second examples so long as their concern is expressed with respect to transactions where all or a substantial part (80%) of the proceeds of the issue are to be solely for the purpose of investment

* The tax reform studies and proposals of the Treasury Department submitted to the Committee on Ways and Means of the House of Representatives on January 17, 1969 make no reference to arbitrage obligations. See *Tax Reform Studies and Proposals, U. S. Treasury Department*, Joint Publication, Committee on Ways and Means, U. S. House of Representatives and Committee on Finance, U. S. Senate, Washington: Government Printing Office, 1969.

in taxable obligations and have no other purpose such as the refunding of outstanding obligations where such refunding is permitted by state or local law or the instruments pursuant to which such outstanding bonds being refunded were issued. We are of this view for it would be difficult to find a public purpose if the language means what it says. We assume that the first category does not apply to refunding bonds for it appears to have been the intent of the Treasury Department to deal with refunding in the second category. It would be impossible to justify an argument that the first category would include such refunding obligations where they are callable less than five years in the future. The second category and the third example set forth in the Release could prevent a financing which involves a justifiable public purpose under state law and the facts underlying the financing program. There is no valid reason for Congress to impose its will in respect of the desirability of particular financing programs of state and local governments by denying the tax exemption to income derived from bonds of such state and local governments for such otherwise justifiable purposes.

We further express our concern over the provision in the bill which states that the provisions in respect of arbitrage bonds shall apply to obligations issued after July 11, 1969. Since the statute provides no discernible standard as to what type of arbitrage obligations will be included in the definition promulgated by the Secretary of the Treasury and since the provisions of the bill relating to arbitrage obligations are retroactive to July 11, 1969, issuers of securities will be unable to determine whether their obligations will be deemed to be arbitrage obligations the income of which will be subject to federal income tax and which will not be obligations to which the subsidy program will apply.

B. *The subsidy plan is unworkable in several respects.*

The subsidy program is unworkable as applied to any political subdivisions of a state. Assuming that a state can exercise the election provided by section 601, it would appear that a political subdivision of the state would be unable to exercise such an election without a grant of authority to do so. We are not aware that any state presently has authorized its political subdivisions to exercise such an election.

A political subdivision is merely a creature of the state and derives all of its power from the state. It is a general and undisputed proposition of law that a municipal corporation possesses and can exercise only those powers expressly granted, those necessarily or fairly implied in or incident to the powers expressly granted and those essential to the accomplishment of the declared objects and purposes of the corporation. Any fair, reasonable, substantial doubt concerning the existence of power is resolved by the courts against the corporation and the asserted power is denied. Neither the corporation nor its officers can do any act, or make any contract or incur any liability not authorized by its charter or the statute creating it, or by some other legislative authorization. All acts beyond the scope of powers granted are void. The power of the legislatures of the states to control their respective political subdivisions

without hinderance, so far as the federal constitution or its laws are concerned, has been consistently recognized by the Supreme Court. The only restraint on this broad authority is that such exercise of power shall not contravene a federally protected right of one to whom that right is guaranteed. See *Hunter* v. *Pittsburgh*, 207 U. S. 162 (1907); *Gomillion* v. *Lightfoot*, 364 U. S. 339 (1960); *Baker* v. *Carr*, 369 U. S. 186 (1962). Thus where the City of Baltimore challenged, under the equal protection clause of the Fourteenth Amendment of the federal constitution, a state statute exempting a railroad from a City ad valorem tax, the Supreme Court rejected the City's contention of unconstitutionality with the assertion that a municipal corporation "has no privileges or immunities under the federal constitution which it may invoke in opposition to the will of its creator". *Williams* v. *Mayor and City Council of Baltimore*, 289 U. S. 36, 40 (1933).

Consistent with these well-defined concepts of state law, since there is no legislation of which we are aware in any state authorizing, implicitly or explicitly, the issuance of taxable bonds, it would appear that no political subdivision of any state has the power at present to issue taxable bonds notwithstanding the passage of the bill.

In order for a municipality to be empowered to elect to issue taxable bonds each state would have to pass enabling legislation and in some states the state constitution would need to be amended prior to the passage of such enabling legislation. Anything less than passage of state legislation would entangle a political subdivision desiring to make an election in protracted litigation testing the power of such political subdivision to exercise such election without enabling state legislation. Such litigation, of course, would have to be resolved prior to selling taxable obligations. As a practical matter no political subdivision would welcome delay in financing needed projects resulting from the time required to (1) enact necessary legislation or (2) to await the outcome of litigation, the success of which is conjectural.

The bill provides that the Secretary or his delegate "shall pay a fixed percentage of the interest yield on each issue of obligations" to which an election applies. The Committee report states that "[d]etermination of the interest yield on any issue of obligations is to be made immediately after they have been issued." It must be assumed that the term "interest yield" means return on investment to a bondholder based on the cost of the bond. The choice of the term "interest yield" is unfortunate for it relates to an amount to be received by the purchaser of the state or local obligations and not to the amount of interest payments required to be made by the state or local government, i.e. "interest rate". Since we are dealing with a subsidy plan to "encourage the States and political subdivisions thereof to make elections under section 103(b)" the amount of interest to be paid or interest rate would appear to be the proper criterion. However, since the percentage is to be based on "interest yield" the interest yield may be computed to maturity or to the earliest possible redemption date. If computed to the earliest date of redemption, no subsidy payments would be available on interest payment dates subsequent to the earliest redemption date if those obligations were not redeemed. No adjustments for redemption are

specifically provided for in the bill. However, it is reasonable to assume that adjustments will be required depending on the redemption date and the redemption price. However, even though there is no specific statutory basis for the view that an adjustment would be made the implication of such authority furthers the contention that there will be a substantial amount of federal control in respect of obligations to which the election applies, not only with respect to the purpose for which the obligations are issued but details of the financing transaction which are a necessary incident to such financings. This is further evidenced by the Committee Report's statement in respect of premium or discount applied in the issuance of obligations:

"...Where it is the most practicable method of effecting the intent of the bill, adjustment for any premium or any discount at which the obligations are issued may be made between the issuer and the United States at the time of issuance or such later time or times as may be appropriate."

Section 602(c) of the bill provides that at the request of the issuer, the liability of the United States under Section 602 to pay interest to the holders of an issue of taxable obligations shall be made through assumption by the United States of the obligation to pay a separate set of interest coupons issued with the obligations. This dual coupon concept has not to our knowledge been extensively explored by the legal community associated with the issuance and sale of state or local obligations. As a result substantial legal problems may exist. Thus while the Committee Report concedes that "the use of such dual coupon obligations might be necessary to avoid violation of the maximum interest rate limitations imposed on some States and localities by local law", a review of those limitations leads one ineluctably to the conclusion that the limitations would still apply.

While we have briefly discussed the provisions of the proposed subsidy plan and the ramifications resulting therefrom, we would like to call attention to the amount of federal control which appears from the various provisions. Reference has been heretofore made to some of the items of control. The federal government would be required to have personnel available to undertake the various responsibilities, including those mentioned below, which appear explicitly or implicitly in the language of the bill. First, the federal government would appear to be required to satisfy itself that the obligations to be issued were valid and legally binding obligations of the state or political subdivision. The extent of the government's involvement in this particular role would vary with each issue of obligations. Second, contemporaneously with such review the federal government would have to satisfy itself that the obligations to be issued would not be deemed to be industrial development bonds within the meaning of the Revenue and Expenditure Control Act of 1968 or arbitrage obligations. Third, determinations of interest yield would be required to be made by the federal government in respect of each issue of obligations. The exact amount of the interest yield would be of such importance to each issuer that an official of the federal government would have to be available upon the receipt of the bid for or upon the negotiation of the sale of an issue of obligations to confirm such amount. Fourth,

machinery would be required to be established to provide that the federal government's share of the interest payments would be made not later than the time at which the interest payments on the obligations are required to be made by the issuer. Finally, personnel would also be required to make adjustments in the subsidy payments in the event that taxable obligations were redeemed prior to maturity. No discussion of the necessity of administering the foregoing functions appears to have been heretofore considered by Congress. The Committee Report is silent as to the need for the creation of administrative machinery and no reference is made to the cost of such administrative machinery in that section of the Committee Report relating to "Revenue effect."

For the reasons set forth above, we recommend that sections 601 and 602 of the bill not be enacted.

Respectfully submitted,

HAWKINS, DELAFIELD & WOOD
67 Wall Street
New York, New York 10005

Dated: September 19, 1969