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TAX REFORM ACT OF 1969

H.R. 13270

PART A.—TESTIMONY TO BE RECEIVED WEDNESDAY, SEPTEMBER 24, 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

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NACO

STATEMENTS ON BEHALF OF THE

NATIONAL ASSOCIATION OF COUNTIES

By

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Shelby County, Alabama

George Long
Virginia Association of Counties
and Chairman, National Conference of
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First Vice-president
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On

HR 13270

TAX REFORM ACT OF 1969

Before

COMMITTEE ON FINANCE

U.S. SENATE

September 24, 1969

SUMMARY OF MAJOR POINTS IN TESTIMONY OF

NATIONAL ASSOCIATION OF COUNTIES

1. Inclusion of municipal bond interest in the limit on tax preference proposal and the allocation of deductions rule is a severe threat to the basic intergovernmental relationships of our federal system. "New Federalism" is concerned with increasing decentralization of government authority, but these proposals would limit responsibility and authority of local and state governments.

2. Legislative proposals already have had an adverse impact on ability of local governments to borrow for needed projects. During the past four months, sixty percent of the increase in interest rates, accounting for $300 million in additional cost, has been attributed directly to these proposals.

3. During the past 11 months, 316 proposed issuances, worth $2 billion, have been denied by investors as unremunerative or have been placed in abeyance by the various potential issuing agencies. Also, during the first eight months of 1969, there was a sharp decrease of $2 1/2 billion of municipal bonds, representing a drop from $10 1/2 billion to slightly less than $8 billion.

4. If the proposed taxes had been applied to the $16 billion of municipal bonds issued in 1968, there would be additional interest costs of $4.5 billion over the lifetime of the bonds.

5. The constitutional uncertainty of some of the bill's aspects poses grave threats to the municipal bond market. A court challenge to the proposals included in HR 13270 can reasonably be expected. It would take several years to settle such litigation.

6. Alternative financing methods to assist local and state governments in meeting long-term capital needs should be considered separately and apart from the complex tax reform bill.

7. In the name of tax reform, the House-passed legislation will increase the property tax burden on every citizen of this country. The proposals before the Senate move the burden of capital finance to the shoulders of local property taxpayers, who cannot support it. This is not tax reform; it is tax paralysis.

I. General Aspects --- NACO's Position on HR 13270

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Mr. Chairman, Members of the Senate Finance Committee:

My name is Judge Conrad Fowler, and I am here today as President of the National Association of Counties. I come before you on behalf of the National Association of Counties to formally express its firm belief that the House-passed bill, HR 13270, which would tax the interest on municipal bonds, would be extremely harmful, and, in fact, has already posed a tragic blow to effective local government. A resolution recently passed by 3,000 members of the Association at our annual meeting in July opposes, in unequivocal terms, any direct or indirect taxation of the interest on municipal bonds. The Congress has heard our very strong arguments on this "intergovernmental" subject before, and through the years, has for very good reasons rejected the various attempts to remove the tax exemption from municipal bonds. We urge you now to reject this latest, ill-conceived, quickly-enacted House proposal, so we can continue to proceed with the multitude of desperately needed and essential local programs and projects which depend on financing through municipal bonds--schools, hospitals, public housing, etc.

The National Association of Counties, after lengthy discussion and review of the problems growing out of the proposed tax on bond interest, believes that inclusion of the proposed tax has, and would, precipitate irreparable damage to the present municipal bond market.

The nation's 3,049 county governments and their 70,000 elected officials join a host of other organizations--states, cities, towns, authorities, special districts--in expressing their concern over the proposed tax on municipal bond interest. At its national conference last summer, the Governors' Conference affirmed the basic principle that "neither the Federal or State governments without mutual agreement have the authority to tax the other"--a subject

which I will explore further. The Governors have already strongly opposed those aspects of the tentative House Ways and Means proposal which would impair the marketability of state and local securities and thus retard the provision of needed public services and facilities.

In our joint statement before the House Ways and Means Committee with the Mayors and Cities, Mayor Briley, our past president, referring to what is at stake for all of us at the local level, said, "The issues go to the heart of the ability of the three levels of government to co-exist and function effectively in our federal system."

The impact of these tax proposals is already significantly affecting efforts to borrow necessary monies for critical local projects across the nation. Interest rates on new bond issues are exorbitantly high on many issues, and bids from investors have just not been forthcoming. We feel strongly that new action which, directly or indirectly, taxes interest on local government bonds would precipitate fiscal disaster for county government. The size of the new issue market in local government financing is shrinking as officials postpone or cancel bond sales because of the progressive deterioration of the market. Senators, this is really a most serious situation for us.

As long as the tax bill remains a matter of debate in Congress, foreshadowing a possible tax on the bond interest, which if enacted would precipitate an extensive constitutional battle in the courts, the market for municipal securities remains uncertain. The problem is more costly for us than for you. One reliable bond counsel argues strongly that a rise of about $300 million in the borrowing costs to State and local governments over the past four months is traceable to a large extext, perhaps as much as

60%, to the adverse market implications due to the House of Representatives discussion and treatment of this issue.

In Alabama, and I know in many other states, local government construction of schools, hospitals, streets, bridges, airports, and other vitally needed public projects is already vastly more difficult. In some states, it is impossible. The information our Association is now receiving from its membership indicates that areas with local credit ratings, or with unrated credit, or with statutory or constitutional interest limits are not able to borrow at all. Local public financing is dead in those states. In the final analysis, then, it will be the local property taxpaying public which will have to bear a significantly increased burden for local projects with increased or new tax programs, or suffer without needed public facilities.

It is particularly crucial at this time to sustain at least a moderate level of public services and facilities. The inevitable result of taxing municipal bond interest will be a substantial curtailment in scheduled public construction of projects vitally needed on the State and local level. New and higher taxes will be required. Unfortunately, because of the relatively regressive nature of such taxes, particularly real property and sales taxes, they will fall most heavily on the average working man. Chances are most probable that many who are employed in construction industries--and related trades--will be without work if there is a cutback in scheduled public construction due to the higher interest rate which could result from passage of the pending tax legislation as well as the federal cut-back in construction.

Gentlemen, it seems clear to us that the House taxes on state and local bonds are wrong on many other counts as well. We feel that they are economically unsound, and they would obtain for the Federal government a comparatively

insignificant tax return--amounting at most to $80 million a year. In doing so, they further threaten the fiscal integrity of local government. We cannot over-emphasize this enough. The key issue largely remains the financial independence of local government.

As this Committee well knows, the President and this Administration are seeking to bolster, where possible, the responsiveness and responsibility of the states and local governments. If the states, counties, and cities are to have the real capacity to experiment and innovate, sufficient methods of financing, especially the effective use of tax exempt municipal bonds, must be kept available.

There is, then, a need to strengthen, not weaken, the fiscal process by which local governments respond to the needs of their citizens in finding a better, fuller way of life.

The demand for physical facilities at the state and local level is overwhelming and unprecedented. There is a backlog on the books over the nation of almost $8 billion in demand for water-sewer construction alone. The public housing programs and the Administration's plans for 500,000 units of low-cost housing are placing an additional burden on our tax-exempt market. Other federally stimulated programs include such other expensive areas as mass transit, airport development, pure waters, and health and mental health facilities construction. These, too, require a substantial outlay of local funds. This is in addition to the unprecedented need for more traditional local functions--city streets, schools, hospitals, correction facilities, etc.

I want, as others will do or have done, to comment in broad terms briefly on the constitutional aspects related to the proposal to tax interest on municipal securities. As one who has had a long interest in this issue, I believe that the proposed tax, as proposed by the House or the Treasury, is clearly unconstitutional. The body of our law supports this now, as does the thinking of many outstanding legal minds in our nation. Under the Constitution, the doctrine of reciprocal tax immunity is implicit, and is a bulwark of our federal system dating back to McCulloch v. Maryland. If the benefits of tax exemption are abrogated, and disaster follows, we might as well deliver to the Federal government full control over the determination of vital public projects in our home localities. This is totally against what we need to do in this country at this time in our history.

Let us also not forget that everyone purchasing an exempt security pays a tax to the issuing government, since he accepts a lower interest rate compared to other more lucrative securities available to the investor.

In conclusion, Gentlemen, I would like to reaffirm that the very heart of our democratic process lies in how well we--the local governments of this nation--function as responsive servants of our citizens. We have been criticized for years for not doing enough, and now with the concept of new federalism perhaps forthcoming, we find ourselves stymied. This is the prime issue, and its resolution will not be helped by these new tax proposals. The magnitude of our local financial requirements in the years ahead will be tremendous. Living as we do in a society which demands more and better local services, the financial crisis confronting local governmental units becomes enormous. It becomes discouraging to those elected local officials who carry the burden of providing the wherewithal for necessary local public programs.

Every year record levels of expenditure by local governments are reached, and the end is not in sight.

The proposals to tax the municipal bonds are major obstacles to our continuing effort to serve the local community, the State, and our Nation. In sum, the tax on municipal bond interest produces more problems than solutions for the Federal as well as the local governments.

II. Impact of LTP and ADR on County Government

Mr. Chairman, Members of the Senate Finance Committee:

I am William Conner, County Executive of New Castle County, Delaware. I appear today as a Vice President of the National Association of Counties, and on behalf of Delaware local government. I cannot over-emphasize the importance that county officials across the country attach to this issue or the concern that all local officials of my state feel with regard to these provisions of HR 13270 that would tax the interest on municipal bonds.

Clearly, taxation of this interest, while initially beguiling to would-be tax reformers, will inevitably expose our nation to a series of traumatic economic shocks during the years ahead. In brief, it is our considered opinion that taxing the interest on local bonds through limited tax preference and allocation of deductions strikes at the very keystone of financing state, county, and municipal government; it poses serious challenges to our federal system; it will adversely affect construction employment through the stoppage of essential public works; and most importantly, and unemphasized by many, if this same tax had been applied to the $16 billion of State and local bonds issued in 1968, those governments' local taxpayers would have a liability to pay over $12 Billion of additional interest costs during the life of 20 year BONDS! This is startling but conservative. It will raise local taxes and rents for millions of citizens throughout our land. We are estimating, and are reporting to you.

We hope you will consider the thinking of Mr. Justice Cardozo, who said in interpreting the landmark decision in the Federal-State tax field, the Pollock case of 1894, "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." Also see Hale v. Iowa State Board, 302 U.S. 95,107 (1937).

The National Association of Counties has consistently opposed taxation on local bond interest, for its members across this land know only to well that such a tax would do more than clog county finances; it might completely stop us from capital financing as has already occurred in some states.

Storm warnings are already up in the listening posts of the municipal bond market. Ever since the House began consideration of this package, the interest rate has moved steadily up at a frightful cost to county and other local governmental units throughout the 50 states, and is now almost one full percentage point over the level which would normally be expected at this time.

Counties are a key element in the over-all pattern of local government finance. They account for one-fifth of all government expenditures in the United States and participate importantly in the $16 billion issued annually in the municipal bond market. This market had been growing steadily; the 1968 issuances were 60% higher than 1963's (10% a year average). Counties have a current outstanding debt of $16 billion themselves, and the rate of increase even exceeds that of our Nation's cities.

Unfortunately for counties across the nation, since "tax reform" became a popular by-word in 1968, the municipal bond market has been under a cloud, the turbulence of which is gathering force as each day passes. The possibility of lost tax exemption has increased interest rates to the point where many local government bond issues have been rejected, postponed, or have not received bids on going to market. During the past eleven months, throughout the nation, some 316 bond issues bearing a valuation of nearly $2 billion have struck out with investors as unremunerative, or have been placed in abeyance by the various potential issuing agencies. That the tempo of such rejections is increasing can been seen from the January through August attrition in sales of local bonds. During the first two-thirds of 1969, there was a sharp fall-off of $2¼ billion, representing

a drop from $10½ billion to slightly less than $8 billion.

In Louisiana, bond sales this year are only 35% of those a year ago, recording a fall-off from $75 million to $26 million. Tennessee also has been having a difficult time with its bonds. So far during 1969, that state has marketed only one-sixth of the value of bonds it sold last year -- a reduction from $85 million to $14 million. Iowa has also felt the impact of rising interest and investor disenchantment, since its sales are off by one-third. With but few exceptions, the story is the same throughout the country. The national financial outlook at the state, county, and city level is bleak, indeed, with the various implications of HR 13270 largely responsible.

Counties, joined by the states and cities, are having great difficulty in funding rising capital costs. Interest rates are now in the neighborhood of 6½%, two full points higher than offered as recently as a year ago. Emergency legislation is being enacted in many of these states to keep borrowing capability abreast of the surging rates. Obviously, those states where the ceiling was as low as 5% have not floated an issue for some time, and even those with new 7% levels may have to resort to still another increase. In some states, it is impossible to finance new facilities until the state constitution is amended.

This bleak outlook for county government comes at a time when counties are faced with an expansion into functions and service areas once considered the exclusive province of municipalities--such fields as hospitals, health services, utility systems, airports, libraries, and outdoor recreation. Entirely new areas of county governmental responsibility, engendered by new federal and state statutory programs, present further fiscal difficulties. Such pressing problems as water and air pollution control, waste disposal, and

highway safety are very much county problems. Counties have been awakened to the urban challenge, only to find themselves being discouraged from acting to meet it by the same Congress which promised to help.

In my own County of New Castle, Delaware, bond financing for capital projects between 1968 and 1975 will exceed $56 million. With an expected increase in the interest rate, New Castle will pay an additional $7 million in interest over the life of just these $56 million of bonds. We need over $16 million for sewer construction during this seven-year period, and over $9 million to solve over-flooding problems by storm water drainage projects. Also included in the $56 million is $12 million for an addition to our water supply through the construction of a reservoir. So you can see, Gentlemen, the impact on even a smaller county can be and will be great.

A significantly increased tax burden is going to hit local taxpayers as a result of these proposed measures. In fact, by the fifth year after enactment of the application of the allocation of deductions rule, local taxpayers would be paying about ten times the sum garnered by the U. S. Treasury.

The widespread desire to see non-taxpayers in the highest brackets pay their fair share is understandable. However, the tax reformers are making a big mistake when they attempt to establish a direct relationship between the tax-exempt bonds issued by local governments, and a few rich men who pay little or no federal income tax. I cannot over-emphasize this. No one has told me, or you, how many of our bonds are held by the so-called millionaires.

Taxing interest of local bonds issued not only in the future, but in the past as well, is unwise and imprudent at any time, but I submit the fall of

1969 is an exceedingly untimely period to tamper with traditional federal-state tax relationships. High interest rates and inflation are twin problems of all our constituencies across the nation. Clearly, a so-called tax reform measure that exacerbates the average person's fight against the high cost of living is certain to be a most unpopular one, to say the least.

With regard to the proposed alternative to the current method of capital financing, our citizens will be greatly concerned over the increased power granted the Federal government under the proposed subsidy plan. It is wholly unrealistic to expect the federal government to make substantial subsidies available to local governments to finance, on a taxable basis, all kinds of local capital improvements, without exercising some control over which subjects warrant the subsidies. I cannot conceive that this Congress would approve a blanket authority to all local governments to authorize projects at their own discretion if it involves substantial sum of money.

It seems to me that in the name of tax reform and an attempt to close loopholes affecting a few hundred people, we are imposing increased financial burdens on millions of small taxpayers and seriously impairing the efforts that have been made in intergovernmental relationships to increase local responsibility and ability to finance local projects.

III. Alternative Financing Methods - The "Subsidy" Proposal in HR 13270

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My name is John Brewer and I am Chairman of the Board of Supervisors, Kent County, Michigan. I am speaking here today as Chairman of the Taxation and Finance Committee of the National Association of Counties and for the Michigan Association of Counties.

This is a critical hearing because, as my colleagues who preceeded me have demonstrated, unless the sections jeopardizing tax-exempt bonds are deleted from the proposed act, the financial capabilities of states, counties and municipalities throughout the country will be permanently damaged, essential projects necessary for the welfare of our citizens will be delayed or cancelled, and the already staggering tax burden placed on our citizens will be further increased.

The State of Michigan and its subordinate units of government: cities, counties and school districts, issued in 1968 $694 million in municipal bonds and in 1970, they expect to issue $839 million. The County of Kent and its subordinate units of government within the County has a state equalized valuation of one and a half billion dollars and a total bonded indebtedness of approximately $121,000,000.000.

The citizens of Kent County, Michigan have already been adversely affected by the bill before you. At this moment our county has some very real requirements for increased water lines, storm drains and expanded sewerage disposal systems. This is rather typical of the counties across the country. However, when Kent County, whose bonds have been rated double A and triple A, wished to sell bonds recently to finance these projects, we were turned down. There were no buyers, despite stated interest rates of 5½% to 6% --- the highest permitted by our Constitution. These projects are now being held in abeyance while we consider the next move. The citizens are waiting --- not happy.

For those who have no maximum ceiling on bond interest as we do in Michigan, the interest on tax-exempt bonds has already jumped to record levels merely since this legislation was proposed. Like Kent County, many states and local governments cannot even attract bids for their bond issues --- and their projects are at a standstill, unable to move ahead. Houston, Texas; Jefferson Parish, Louisianna; Hawaii; Jacksonville, Florida; New London, Connecticut, are only a few unable to sell their bonds.

We have heard here today numerous adverse impacts that the "limit on tax preference" and "allocation of deductions" proposals have had and will have on the citizens of state and local governments alike. I should like to talk briefly about alternative so-called "subsidy" approaches which have been proposed.

The House-passed bill provides alternative capital financing approaches which would provide a somewhat automatic, but variable, federal interest payment to those local governments which waive their tax exemption. State and local governments that voluntarily elect to issue taxable bonds could automatically become eligible for an interest payment, the amount of which would be governed by the difference between the yields on outstanding tax-exempt bonds and comparable taxable issues.

Several fatal problems exist with the legislation before you. The first of these problems revolves around who will determine the difference in taxable versus tax-exempt yields. The bill gives the authority directly to the Treasury Department and, in addition, allows it to vary the "subsidy" from 25% to 40%. Thus, in addition to having wide discretion with respect to setting regulations and conditions for the payments, the Treasury also has the authority to vary their amount.

In fact the "subsidy" plan gives state and local government no real options. The choice is to issue partially taxed bonds without a "subsidy" or fully taxable bonds with it, when the bonds are now fully exempt from tax.

Moreover, municipalities cannot exercise the "option" to issue taxable bonds since they have no power to trade away their immunity from taxation which inheres in the sovereignty of that parent state. Certainly Congress cannot grant them this power.

The crucial flow in the "subsidy" is, of course, its ephemerality. There is simply nothing to prevent Congress from curtailing, or indeed eliminating it at any time. The program would be a tool for further federal fiscal control over interest state and local affairs.

None of these "subsidy" proposals present any real alternative to the present tax-exempt system. Certainly, more of them can be postponed when offered in tandem with "limited tax preference" or "allocation of deductions" proposals, which, in effect, destroy any option to disregard them.

We should like to make this point very clear. If any form of a subsidy is ever to be acceptable to county government, it must be allowed to operate as an <u>optional</u> alternative and not under the pressures of present tax reform proposals upon our present market.

Once Congress acts to tax the interest on our bonds, either by an allocation of deductions rule or by the limit on tax preference formula, and with the resulting chaos expected from a constitutional test, there is a danger we might very well be forced economically into accepting a subsidy. Our bonds would be competing with high grade corporates and this very competition alone in a presently rising market would raise the yield that would have to be paid on taxable municipals to about 9 or 9½ percent. And the rising interest would, of course, increase the amount of federal subsidy required to attract municipalities, counties and states into the taxable bond field.

A word of caution would be appropriate at this point. If Congress did provide a permanent and unrestricted appropriation to subsidize through taxable bonds the projects of states and local governments throughout the nation,

the level of subsidy would be immense.

For example, if we assume that one-half of last year's $16 billion bond market were financed by taxable securities rather than the tax-exempt securities, and taking into account a conservative subsidy of say the difference between 6% tax-exempt and 9% taxable bonds, it has been estimated the Treasury would be paying out $250 million worth of interest subsidy cost every year. This could generate a possible revenue loss (not a tax gain) to the Federal government in the subsidy process, and if this were so, we fear that it would not be long before restrictions and further federal control would be imposed to somehow restrict the amount of projects qualifying for subsidy.

Obviously, there are serious disadvantages to the proposals on tax-exempt bonds as set forth in the bill. We are talking here about a $130 billion bond market growing, until last February, at a rate of more than 10% a year. Yet there has been very little substantive review of the potential impact the bill has on so sizable and important a market. The present lack of information as to the marketability of a taxable municipal and its effect on the tax-exempt and taxable markets requires that this matter be given far more study.

If any capital financing alternatives are to meet the test, they must be justified by their value to state and local governments, as well as their effect on federal programs. The climate created by tax reform is definitely no place to scrutinize the immense impact of any capital financing proposal on our markets, particularly the ill-considered House-passed subsidy. Capital financing alternatives should not be developed as an instrument of tax reform.

We therefore urge that the question of subsidy be removed from the emotional context of the tax reform, and be the subject of further hearings, including awaiting the results of the very significant study being conducted by the Advisory Commission on Intergovernmental Relations.

IV. Adverse Effects of HR 13270 on the Counties of Virginia

Mr. Chairman and Members of the Senate Finance Committee:

My name is George R. Long, and I am the Executive Director of the Virginia Association of Counties whose membership embraces 93 of the 96 counties of Virginia. I am also Chairman of the National Conference of Executives of State Associations of Counties whose members are the executives of associations of counties in 46 of the 50 states of the United States.

I appreciate the opportunity to appear before you and to present the critical position of Virginia and other county governments in the bond market as a result of the consideration by the Congress to tax interest accruing on local government bonds. Please note that the discussion pertains primarily to what has already occured and does not treat what is likely to occur if the proposal for such taxation is enacted into law. Virginia's position is described here because it is that state with which I am most familiar; however, the position of Virginia is parallel to the position of every other state.

To set the stage, Virginia's Public Finance Act of 1958, is typical of legislation of other states in providing that any county may issue bonds to obtain revenues for capital construction projects. The statute establishes a Commission on Local Debt to aid and assist local governments in the issuance and sale of bonds, and it sets certain standards and specifications with which the issuing jurisdiction must comply. One of the specifications is that the bonds shall not bear an interest rate of more than [illegible]% per annum. (Code

of Virginia (1950), Sec. 15.1-200.) Such ceilings on interest rates are set by state legislatures to protect the local taxpayers from the additional costs of higher interest rates. Until very recently such limitations have served Virginia and other states quite effectively in obtaining the most advantageous financing of state and local public construction.

In order to allow local governments to let contracts and commence construction on capital projects without delay, Virginia's Public Finance Act also provides for the negotiation of temporary loans in anticipation of revenues from bond issues. Three restrictions are placed on the county government in negotiating such loans: (1) the revenues obtained from the temporary loan must be used for the purpose for which the bonds were issued; (2) the amount of the loan may not exceed the maximum authorized amount of the bond issue; and (3) <u>such loans shall mature and be paid within two years from the date of issue of the original loan.</u>

Against this background of standards and arrangements, your attention is directed to the position of Virginia local governments in the bond market. When the Ways and Means Committee of the United States House of Representatives began seriously to consider the proposal to tax state and local government bond interest, interest rates in the bond market rose immediately. The competitive position of Virginia's local government in the bond market began to deteriorate and has continued to deteriorate to this date. When the interest rate on local government bonds soared above 6%, <u>even before the enactment of the proposal</u>, Virginia local governments were barred from the bond market.

Now, Virginia counties marketed $19,715,544.01 in bonds in the Fiscal Year 1964-65; they marketed $40,938,722.67 in FY 1965-66; they marketed $56,096,033.32 in FY 1966-67. The total outstanding bonded indebtedness of Virginia counties at the end FY 1966-67 was $444,131,000.00. Of this amount $285,396,000 was issued for public school construction and equipment. (Virginia, Reports of the Auditor of Public Accounts for FY 1964-65, FY 1965-66, and FY 1966-67.)

The Virginia Association of Counties canvassed all 96 Virginia counties to determine precisely what the impact of the increase of the interest rate on general obligation and revenue bonds had been on each county. Returns have been received from 80 counties of which 35 revealed plans for issuing bonds during a period beginning six months ago and extending into the future.

Attached as Table I herewith is a summary of the information received from the canvass of the Virginia counties. (Note that due to Virginia's city-county separation none of the data contained herein includes any statistics which relate to Virginia's 38 cities. This data pertains only to those parts of Virginia lying outside the boundaries of Virginia cities.)

The canvass shows that in the past six months Virginia counties have issued $25,200,000 in county bonds. Of this amount, $17,200,000 was issued by the rapidly growing, most populace Fairfax County just across the Potomac River. Not only has difficulty been encountered in marketing the $25,200,000 issued in the past six months, but a similar difficulty has been found in marketing some $19,280,000 issued in previous months.

REPORT ON BOND ISSUES IN VIRGINIA COUNTIES

	Bonds Issued in Past 6 Mos. $	Difficulty in Marketing - $	Temporary Loans in Anticipation of Bond Revenues $	Amount of Bond Issues Anticipated $
Accomack		300,000		300,000
Albemarle			700,000	5,000,000
Amherst				1,000,000
Augusta		3,500,000	3,000,000	
Buchanan				11,000,000
Campbell				525,000
Chesterfield	4,000,000			
Dinwiddie				1,300,000
Essex		1,000,000	250,000	1,000,000
Fairfax	17,200,000			13,000,000
Fauquier		3,000,000	3,000,000	3,000,000
Frederick		180,000		250,000
Gloucester		350,000	300,000	350,000
Hanover	1,000,000	1,600,000	300,000	1,000,000
Henrico				20,035,000
Isle of Wight				1,500,000
Loudoun		11,250,000	2,100,000	11,250,000
Louisa				2,000,000
Montgomery			75,000	2,500,000
Northumberland				500,000
Patrick	1,000,000			
Powhatan				2,250,000
Prince George		750,000		750,000
Prince William		13,000,000		21,000,000
Pulaski				6,000,000
Roanoke				15,800,000
Rockbridge			1,900,000	1,900,000
Scott				2,000,000
Spotsylvania			500,000	2,500,000
Stafford	2,000,000	2,000,000	1,000,000	5,000,000
Westmoreland				700,000
Wise				1,000,000
Wythe		950,000		950,000
York		6,500,000	400,000	3,750,000
Washington		100,000	475,000	200,000
	25,200,000	44,480,000	14,000,000	139,310,000

Further, there are outstanding temporary loans in anticipation of bond revenues of $14,000,000, some of which have matured, payment is due, and the county has defaulted on the loan. In recent weeks, only two counties have been able to negotiate temporary loans and these were negotiated with local banks with interest rates of 5.90% and 5.99%. One of these loans was spread among several banks in order to share the risk.

The canvass reveals that there were plans by Virginia counties to issue and market $139,310,000 in bonds in the immediate future. A majority of these bond revenues were to be used to construct and replace needed school buildings and facilities in Virginia counties. The second large portion of the bond funds was planned for construction of water and sewer facilities to stem the pollution of Virginia's streams and provide adequate, safe facilities for growth and development in the state.

In summary, the impact of the consideration of the proposal to tax the interest accruing from local and state government bonds along with the statutory interest rate has worked to remove local government bonds of Virginia, and nearly all states, from the bond market. The removal of such bonds from the market resulting in the reduction in volume offered is reflected in the slight decline in average interest rates in the past three weeks. The latest advice is that new issues are selling at the highest rate.

The counties across the country agree with the Virginia counties that it is not the intent of this Congress to stem progress in county government across the Nation. But, in effect, this is what has occurred! Nor do the counties believe that the Congress intends

to increase state and local taxes upon those taxpayers whom it is seeking to relieve. But that is what the enactment of the proposal to tax the interest of state and local bonds would do.

Thus, the counties urge that action be taken by the Committee to delete promptly the proposal to tax state and local government bond interest in House Bill 13270 known as the Tax Reform Bill, and return the bond market to a condition of stability. Let progress not be hindered further. Let us resume the task of solving the problems before us. Let us not compromise the obligation of local governments to pay their debts as they have contracted in good faith to do.

V. Expected Adverse Impacts of HR 13270 on the Counties of Georgia

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My name is Hill Healan and I am the Executive Secretary of the Association of County Commissioners of Georgia. I come before you today as representative of all the 159 counties in the State of Georgia whose membership within the Association is unanimously and unalterably opposed to the legislation now being considered by this Committee which adversely affects the principle of immunity of municipal bonds from federal taxation.

The counites of our state, like so many others throughout our land, have outstanding general obligation bonds. In addition, because the Constitution and statutes of Georgia are relatively liberal in the type of service and revenue which may form the basis of revenue certificates, many counties have revenue bonds for which certain revenues of the county are pledged.

It is a matter of common knowledge that many of the rural counties of Georgia are sadly lacking in public improvements such as streets, libraries, schools, water and sewer systems, and many other needed public improvements which can be obtained only through the issue and sale of bonds. Furthermore, the thickly populated areas, including the larger municipalities, have gigantic problems of sewage disposal, insufficient water supplies, and solid waste disposal which will require billions of dollars of financing if they are to be solved. For example, Fulton County, which includes the City of Atlanta, and has a population of over 550,000 people has a real and continuous need for sanitary sewerage and surface water drainage, requiring a minimum outlay of $150,000,000. The local government is perfectly willing to assume this

burden and solve its problem in its own way. But, it is literally beyond the power of local governments in our State to finance these much-needed projects involving enormous sums of money if the principal source of financing, namely, general obligation and revenue bonds, do not find a ready market at reasonable rates of interest.

Due to the limitations imposed by the Constitution of Georgia, most of the counties of Georgia have heretofore enjoyed excellent credit ratings, and as a result, have paid remarkably low interest rates on their borrowings. Many of the older outstanding bonds in our State bear very low interest rates. And why is this interest so low compared with comparable private credits? Not because of their high rating; not because of the assurance of prompt payment - but primarily because the interest coupons are exempt from income tax. The prime factor in the advantage over private bonds is always the exemption of interest on municipal bonds from Federal income tax.

As important as is the willingness of the individual taxpayer to buy and hold until redemption a tax-exempt municipal bond, it is equally important that these bonds be made attractive to the big investors, such as local trust banks and other institutions which, of necessity and partially as a gesture of civic pride, invest a substantial part of their assets in state and local securities. The tax exempt status of a bond is a controlling factor in its purchase by such institutions.

Normally, there has been a great deal of trading among financial institutions in municipal bonds, as they constantly seek to upgrade the income from their securities. This created a steady and active market until the present time.

Both attorneys and advisors who serve the counties of Georgia, and especially the smaller counties who do not have fiscal officers trained

and skilled in the management of securities, have advised me not only that the imposition of income tax upon the interest of municipal bonds will effectively impair their market; but they have also told me that the mere threat of future taxation possibly applied even to commercial banks has caused wide-spread alarm. Small individual investors, in many cases, are trying to unload their municipal holdings at this time for fear the Congress will persist in the House bill's plan to levy income taxes upon the outstanding issues. This "unloading" revenue is killing our market for new issues because what is done for individuals today, can be done tomorrow for banks and institutions which hold 2/3 of the municipal bonds.

The threat of this proposed legislation has already adversely affected the sale of millions of dollars of municipal bonds which would have financed desperately needed schools, hospitals, sewage plants, and dozens of other vital projects. These were not projects that were casually decided upon, for communities of people throughout the country do not saddle themselves and, in many cases, their children, with a financial burden to build marginal facilities. On the contrary, they were the subject of lengthy discussion, duly voted for and repayment provided for by a majority of the people. Local public improvements are needed everywhere, and unless the people are permitted to decide and provide for their needs on a local level, as they traditionally have, then only atrophy or stagnation will result, and initiative of local elected officials will be destroyed.

In Georgia, this year's sale of issues in the first quarter alone, are only half of the volume of last year, from $88 million to $45 million, and the number of issues has dropped from 21 to 11. The pace of these financing failures has

quickened in recent months as interest rates on local government bonds have risen to their highest levels in American financial history. As long as this "tax reform" bill remains a matter of Congressional debate, the market will naturally remain extremely worried and chaotic. This will naturally keep interest rates at abnormally high levels. For communities in desperate need of a new project, there is no alternative but to pay the added cost and wallow in what one bank referred to as the "disaster area in the financial world."

It is most unfortunate that obligations of such stable, high credit-rated governments as Fulton County and the City of Atlanta are being offered at substantial discount for early maturity because of the psychological effect of the pending tax measure.

Thus we are confronted not only with the real fact that a tax upon municipal bonds will weaken or destroy the market, but we are also faced with the fact that the threat of such taxation has had a bad psychological effect on the market even before a tax has actually been imposed.

One does not have to be a financial wizard to come to the conclusion that this measure does not provide "tax reform" as its title implies. Rather, the elimination of the Federal tax immunity, as it applies to municipal and state bond interest, would force the demand for higher interest rates on these bonds --- and higher interest rates mean higher local taxes, including property and sales taxes whose burden rests primarily on those with the least ability to pay. Congress would be merely shifting a considerable burden to local taxpayers, in the name of tax reform.

In conclusion, let me urge the Committee to continue to seek and to study alternatives to supply needed revenue, but to honor our plea to exclude the bonds of local government from any form of federal taxation,

whether by way of a "limit on tax preferences" or "allocation of deductions" or otherwise.

VI. Expected Adverse Impact of HR 13270 on the Counties of New Jersey

Mr. Chairman and gentlemen of the Committee, my name is Arthur R. Sypek, and I am appearing today as the First Vice President of the New Jersey Association of Chosen Freeholders. I am also the elected Director of the Mercer County Board of Chosen Freeholders, the governing body of the capitol county of New Jersey.

You have heard statements of the National Association of Counties' position against certain provisions contained in the proposed Tax Reform Act of 1969, and the decidedly adverse impact which these proposals could have on an already high interest rate bond market. I would like, however, to point out to the Committee the specific dollar impact of such changes on certain counties of New Jersey, as well as the deleterious effect on many essential capital improvement projects which could be placed in serious jeopardy if HR 13270 becomes law.

In my own county of Mercer, it is agreed among municipal financial experts that the elimination of tax-exempt status of municipal bonds will result in increasing the interest of municipal bonds by approximately 1.5-2% per year. Its effect, for example, on Mercer County's recent temporary financing of $9.6 million for Community College and general county improvements will be to cost the hard-pressed county taxpayers an additional 1.6-2.1 million dollars in interest costs over a twenty-year period. In addition, any future increase in interest rates of municipal bonds, as a result of eliminating their tax-exempt status, could well jeopardize the contemplated construction of $4 million areawide county vocational school system and the new Mercer County Administration Building.

One of Mercer County's newest and boldest innovations--the proposed regional solid waste disposal system, which would involve bond financing of incinerators and/or regional sanitary land-fill projects--could also be jeopardized by sharp increases in the interest rates, thus hampering the very kinds of regional development projects to which the Federal government itself has been committed for at least a decade.

In Essex County--the major urban county of northern New Jersey--capital projects requiring municipal bonds will exceed $5 million for 1969 and will be well over $7 million in 1970 and 1971. Included in the 1969 capital projects is over $860,000 for construction of the Essex County College Urban Campus. The same project will require over $3 1/2 million in 1970 and over $4 million in 1971. In Newark, we are erecting a new county building including a new jail adjacent to the Hall of Records, at an estimated cost of $2 million. From 1969 through 1973, approximately $1 1/2 million has been allocated for the construction or reconstruction of county highways.

Bergen County--one of the most populace counties in our state--needs about $4 million in capital projects in 1969 and for 1970 and 1971, over $3 million and $4 1/2 million, respectively. In Bergen County, they anticipate county needs of $20 million starting in 1974 for construction of a community college. An additional $20 million needed for that $40 million project would be financed by the State of New Jersey, presumably by municipal bonds. The county also needs between $1 and $2 million from 1969 through 1972 for roads and bridge construction.

I could go on all day, gentlemen. Where will we borrow this money in a terribly high interest market? The fact is, and I hope that I have made it clear to you, that New Jersey counties--the closest entity there is to regional government in our state--depend heavily on the effective use of municipal bonds. New Jersey counties require millions of dollars for a host of vitally needed projects, some of which I have just mentioned.

If the tax status of municipal bonds is changed, the county colleges, hospitals, bridges, highways, vocational schools, court houses, welfare institutions, jails, youth shelters and other projects and services could be seriously curtailed and additional new tax burdens would fall on already over-burdened New Jersey property taxpayers--the heaviest taxed of any group of home or property owners of any state in the country.

The counties of New Jersey, and the counties of all the states, ask you to maintain the status quo of municipal bonds. To alter the status quo--regardless of the sincere desire to improve the over-all tax structure--would severely hamper the ability of county government in New Jersey to respond to the growing needs of its citizens.

Thank you for hearing me.

VII. Summary of N.A.C.O.'s Position on HR 13270

Mr. Chairman, Members of the Senate Finance Committee:

I am Dale Anderson, County Executive of Baltimore County, Maryland, and a Director of the National Association of Counties. I appreciate this opportunity to summarize the drastic impact which the pending taxation of municipal bonds is having and will continue to have on county government finances.

As my fellow county officials have related, county governments all across the country have been stretched to the complete end of their fiscal capability and are reaching a point where revolt against ever-increasing rates of local taxation is not only possible but highly probable. County expenditures have increased almost 50% since 1962, rising from $8.9 billion in that year, to $12.9 billion in 1967. The financial plight of cities is well know, and amply demonstrated in the halls of Congress, but it is not generally known that county expenditures have outstripped even those of the beleaguered cities in the last five years. To finance these expenditures, we must depend on a tax which is one of the most regressive and one of the most inelastic in the entire lexicon of painful taxes. According to the Advisory Commission on Intergovernmental Relations, some 93% of total county expenditures is funded by the proceeds of property taxes. For every increased dollar of county expenditure, 93 cents has to come out of some local taxpayer's pocket in the form of property taxes.

In the 21 years from 1946 to 1967, state, county, and local property levies increased sharply from $8 billion to $47 billion. As an example of how these tax increases strike most cruelly at those with the least ability to pay, the Advisory Commission on Intergovernmental Relations has estimated that more than one-half of this tremendous increase is directly attributable to new and increased taxes, with less than half due to the response of old taxes to economic growth. I hope you will pardon us, therefore, if we become somewhat

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frenzied at the prospect of "reforming" the tax system by measures which will lead directly to further increases of property taxes. You must do more to help us. The nation's domestic priorities cannot afford the injury the House has proposed.

There is no question in our minds that this assault on the historic immunity of state and local government bonds from federal taxation represents a direct and frontal assault on the local homeowner. Just the discussion alone of the possibility of federal taxation has shaken the entire municipal bond market to its core. The amount of debt floated so far in 1969 is 40% lower than the equivalent amount in 1968, even though requirements for local capital improvements are continuing to increase tremendously. Right now, in September 1969, it has been estimated that a county government floating a bond issue will incur over 100 additional basis points in interest over the amount it would have incurred to market the issue prior to House hearings on this so-called tax reform legislation. It has been suggested that soaring municipal bond interest rates are due principally to the current climate of inflation and only secondarily to possible federal taxation of municipal bonds. I cannot accept that, since, if this were so, yields on similarly rated corporate and taxable bonds would have increased at the same rate, but they did nothing of the sort. In fact, the increase for similarly rated corporate bonds was only 10 basis points since July.

There is a limit to these rising municipal bond interest rates, but I am not sure it is a limit which people in my county can afford. The limit will be reached when local governments all over the country postpone or cancel many vital public improvement projects which have been anticipated and nurtured for years because they are unable or unwilling to accept impossibly high

interest rates. This is not an issue which is going to be centered in one section of the country rather than another. Rather, it has the capabilities of swelling into a public protest the likes of which, I predict, has seldom been seen in this nation's history. In the name of tax reform, you are considering legislation now which will be felt unfavorably by every person no matter how modest his means. If he owns a house, he will feel it in increased property taxes. If he rents his home, the owner's increased taxes will be reflected in the tenant's rent rise.

When one considers the relative pittance in increased federal revenues which will emerge from these tax proposals, it is almost impossible to understand how these plans were successfully passed by the House. For example, the Secretary of the Treasury estimates that the allocation of deduction provisions would result in an annual increment of $45 million to the U. S. Treasury. This number is miniscule in comparison to the additional interest costs which state and local governments will incur is the Federal Government is permitted to tax the interest on their obligations.

We have estimated that as a result of inclusion in the allocation of deduction rule alone, state and local taxpayers will have to pay amounts almost ten times more than the money returned to the Treasury in the fifth year of enactment. This provision seems even more questionable when you consider that all of the increased state and local taxes will be subject to deduction from federal income tax returns.

What is particularly objectionable to elected county officials like myself about this current legislation is the fact that it is included part and parcel in a package entitled: Tax Reform. This is a wonderful catch work to build wide-spread public support since it conveys the idea that somehow or other, the

end result of the legislation will be a lower tax bill for the average citizen of this country. But the provisions relating to municipal bonds cannot and will not work that way, and this is patently clear to every local government official. If our cost for selling bonds increases, our major source of funds is in regressive property taxes and sales taxes, the rates of which have to go up accordingly. Throughout the history of this country, we have preserved under the Constitution, the immunity of the sovereign states and their instrumentalities from federal taxation. It is particularly repugnant to those of us who are struggling with terrible financial burdens on the local level where the domestic ills of our nation are gathered to have our major revenue source jeopardized in the name of tax reform which promises to correct inequities. This is not tax reform; it is more like tax paralysis.

When we raise the property tax, it doesn't mean the homeowner is earning more income as it usually does when his income taxes go up. It doesn't mean either that he makes a conscious effort to purchase something and pays a sales tax. Nor even that he drives his automobile and pays a gasoline tax. All of these other taxes, of course, would have the threat of being increased. The property tax is as high as it can go. We must have some help.

I don't have to tell you that property taxes don't work with such a direct relationship between the payer and the beneficiary. I can cite case after case where a homeowner in Baltimore County has an income today about the same as he had five years ago, and his property taxes have gone up almost 40%. This increase in property taxes has absolutely no relationship to his ability to pay. If I can cite cases in Baltimore County, I'm sure every county official across the country can do likewise. So, when people who are for raising the interest on municipal bonds talk about inequities, I'd like

to know inequities to whom. In Baltimore County alone, I could probably match every millionaire who is said to be avoiding federal taxes because of his municipal bond holdings with thousands of hapless and irate homeowners who can't and shouldn't pay a dollar more in local property taxes.

Just last month, the Administration announced a sweeping package of welfare, revenue-sharing, mass transit, and housing proposals which promises for the first time to increase substantially federal assistance to the hard-pressed state and local governments. The potential of a hopeful "New Federalism" is particularly appealing to those of us whose citizens and resources have reached the end of the line. President Nixon said:

> "After a third of a century of power flowing from the people and the states to Washington, it is time for a new Federalism in which power, funds and responsibility will flow from Washington to the states and the people."

How this kind of philosophy can be advanced at the same time that the Federal government is threatening to destroy the municipal bond market is a puzzle for the future historians to decipher. The rhetoric of the Administration implies a commitment to decentralization of government, while at one and the same time, the Federal government is seriously jeopardizing the ability of state and local governments to meet their responsibilities.

Gentlemen, let me close for NACO by simply stating our overall position. There must be no inclusion of municipal bond interest in the limit on tax preference proposal or in the allocation of deductions rule in any manner whatsoever. The "tax-subsidy" proposals of Title VI are certainly not the answer.

SUMMARY OF REMARKS BY

LEWIS H. VADEN, TREASURER OF VIRGINIA

IN OPPOSITION TO
THAT PORTION OF HOUSE BILL NO. 13270
RELATING TO THE ELIMINATION OF THE
TAX-EXEMPT FEATURE OF
STATE AND LOCAL BONDS

I THE DAMAGE TO THE $130 BILLION MARKET

(a) Interest cost highest in history of municipal bond market

II STATE AND LOCAL BONDS ARE TAX-EXEMPT AS TO INCOME TAX ONLY

(a) The issuer, in effect, receives the benefit in the form equivalent to local taxation.

III PROPOSED FEDERAL SUBSIDY TO LOCAL GOVERNMENT FINANCING ON TAXABLE BONDS

(a) Would result in excessive cost to the Federal Government

IV GREATER CENTRALIZATION OF GOVERNMENT IN WASHINGTON

(a) Proposed bill requiring all State and local financing to be approved in Washington

THE DAMAGE TO THE $130 BILLION MARKET

The mere statement of Congressional purpose to infringe the historic tax immunity of the State and local government financing function has inflicted a drastic setback to the going values of State and local government bonds in the market; and, thereby, has brought about a rise of corresponding extent in local government borrowing costs. By one trade estimate, a rise of about $300 million in the borrowing costs to State and local governments over the past four months must be traceable to a large extent to the adverse market implications of the House of Representatives' treatment of the issue.

Since early July, when the Ways and Means Committee opened hearings on its final proposals, investment yields on new issues of local government AA-rated bonds have risen by about 75 basis points (from about 5.50 per cent to 6.25 per cent), while yields on similarly-rated corporate taxable bonds have risen by only about 10 basis points (from 7.95 per cent to 8.05 per cent). New York City had to pay from 7.43 to 7.48 per cent in late August to borrow on notes due next February and March. A long-term borrowing cost Baltimore, Maryland 6.35 per cent.

Moreover, the size of the new-issue market in local government financing is shrinking because of the decision of local officials to postpone or cancel bond sales on account of the progressive deterioration of the market.

Displacements of this kind, mostly from municipalities that cannot afford the costs of borrowing forced by the suggested removal of tax-exemption, have soared as high as one-third of a week's total volume - or as much as $127,687,000 in a single week - from a previous average of well below 21 per cent.

With this first adverse impact likely to be compounded by the prospect of prolonged litigation of the tax immunity issue in the courts, the Congressional move can be viewed as the start of a dismantling of market machinery that, since the end of World War II, has succeeded in broadening the outstanding float of local government bonds from $13.7 billion to $130 billion. An endorsement by the Senate of the Lower House's action would be a summary requisition on the bond market to find new buyers for from $10 billion to $20 billion of new local government bonds annually.

As things now stand, the uncertainties abounding in the stricken market are raising questions not so much of price as of what the nature of local government obligations may really be from now on. The investor just does not know what he is asked to buy: Is it something taxable instead of tax-exempt? Something tax-exempt now but taxable later? Something marketable at a price now, but perhaps unmarketable at any price later?

As a result of the above effect on the municipal market, all State

and local capital outlay financing has come to an abrupt halt in the Commonwealth of Virginia, as our present statutes do not permit the issuance of State or local bonds having a coupon in excess of 6 per cent. Therefore, with the current market for an A-grade 20 year maturity bond being 6.33% as of September 11, 1969, we are unable to market any of our local bonds.

STATE AND LOCAL BONDS ARE TAX-EXEMPT AS TO INCOME TAX ONLY

The purchasers or holders of municipal bonds at the time of purchase elect to receive a lesser yield than they would otherwise receive by procurring non-income tax-exempt securities. The smaller yield to the holder results in a lower debt service cost to the issuer. Therefore, in effect, the purchaser or holder of municipal bonds pays a local tax to the locality issuing income tax-exempt securities. This situation exists for the full life of the bond; that is, from the date of issue to the last date of maturity - so that during the full life of the bond the holder, in accepting a lesser yield, is in effect paying to the local government a local tax.

It is obvious from the above that in the most technical sense, there is no such thing as a completely tax-free municipal security. The present tax exemption applies only to State and Federal income tax and the holders are in effect taxed by accepting a smaller yield.

Buyers of such bonds will have to be found in great part away from the sources of demand supporting the existing market for tax-exempt securities. Commercial banks, a major buyer of local government tax-exempts, would be buyers of local government taxable bonds only in short-term maturities, that is obligations due within a year, or -- at the most -- two years. Individual investors, having been notified of the Congressional wish to do away with the tax-exempt market altogether, may be buyers of the new local government taxable bonds due in one year or less, but otherwise, their investment money will be attracted to equity securities or to whatever tax shelters may still be around in other fields, such as real estate or oil.

It must be kept in mind that the tax-exempt financing privilege enjoyed by municipal or county governments or their subdivisions cannot be renounced by such entities without the consent of the parent state, and that any unauthorized moves to do so will likely be contested in the courts. The same goes on the state administrative front. No governor or state legislature has the right to waive the right of the state community to borrow money on a tax-exempt basis; the authorization must come from a state constitutional convention. The legal complications attending any waiver of local government tax exemption, therefore, are bound to compound the uncertainties otherwise related to the founding

of a new public market capable to absorbing the $10 billion to $20 billion of new local government securities annually.

The long-term borrowing of State and local governments financed through the issuance of municipal bonds amounted to $16 billion during the calendar year 1968.

Under House of Representatives Bill No. 13270, it is proposed that the Federal Government would subsidize the State and localities in an amount equal to 30 to 40 per cent of the interest cost for the first five years and 25 to 40 per cent of the interest cost after five years. Assuming the interest cost required to be paid in accordance with the current municipal market - that is, 6.33 per cent for an A-grade 20 year maturity bond, the interest on $16 billion volume of sales for the calendar year 1968 would amount to $1,012,800,000.

Using the 40 per cent subsidy figure, this would require the Federal Government to pay, in subsidies, $405,120,000, which said figure would not include any administration cost nor the cost to the localities to journey to the Nation's Capitol to present their particular case, and I am to understand that the Secretary of the Treasury estimates that $45,000,000 would be derived from a tax on State and municipal bonds.

It is absurd to think, taking into account the cost of the subsidy program, that any increased amount of revenue could possible accrue to the Federal treasury.

GREATER CENTRALIZATION OF GOVERNMENT IN WASHINGTON

In recent months, there have been many encouraging reports to the effect that Congress is making an effort to decentralize government; however, the proposals in House of Representatives Bill No. 13270, wherein said bill proposes to eliminate income tax exemption on State and local bonds and to subsidize the states and localities as a result of tax exemption elimination would require every state, city, county, town and hamlet in the United States to come to Washington on bended knee for the approval by the Federal Government of its financing for any project such as a water system, sewerage, school house or any public improvement. Therefore, the Federal Government would be in the position to determine the feasibility of any capital improvement contemplated by the localities and would also determine the interest cost or debt service in the event the project was approved by some governmental agency.

I am of the opinion that this would create the greatest centralization of government in the Nation's Capitol than any proposal that has come up in recent times.

It is my firm belief and conviction that if debt is to be incurred in government, it should be kept as close to the people as is possible to do. The proposals as set forth concerning State and local financing in House Bill No. 13270 would take the matter about as far away from the people as one could imagine.

STATEMENT OF DAVID BUCKSON
ATTORNEY GENERAL OF THE STATE OF DELAWARE
ON BEHALF OF
NATIONAL ASSOCIATION OF ATTORNEYS GENERAL
BEFORE COMMITTEE ON FINANCE OF THE
UNITED STATES SENATE, ON H.R. 13270
SEPTEMBER 24, 1969

I am Attorney General of the State of Delaware, and former President of the National Association of Attorneys General which I represent here. Our Association consists of the chief law officers of each of the 50 States as well as of the Territories.

Our Association is proud that in 1938 it fathered what is now the Conference on Intergovernmental Fiscal Relations, which is the coalition of the national organizations of state and local governments and of the respective executive, fiscal and law officers of the States and local governments. They joined together at our invitation to preserve the exemption of state and local government institutions from federal taxation.

Each time in the past three decades when attempts were made to withdraw the tax exemption of state and local government bond interest, the Attorneys General of the States have appeared here by one of their number and protested. We are here to protest today the inclusion of state and municipal bond interest in the "limit on tax preferences" (LTP) of Sec. 301 of H.R. 13270 and in the "allocation of deductions rule" (ADR) of Sec. 302 of the bill as well as the ill-conceived rebate plan to Title VI and the "arbitrage bond" tax of Sec. 601(b).

We agree with the fiscal and economic objections of the Governors and other state and local government officers appearing at these sessions. But as the chief law officers of the States, our special competence is as to the legal aspects of proposals in this field.

In 1939 the State Attorneys General of that day submitted a brief to this Committee asserting the unconstitutionality of any federal tax on our bond interest without state consent. (Incidentally, former Chief Justice Warren was one of the signatories -- he was then Attorney General of California). We commend that brief to you and submit that nothing has happened in the intervening 30 years to change its conclusions.

The House Ways and Means Committee Report on this bill acknowledged that "there is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local obligations without the consent of the issuing governments." But it then said "this position has been disputed, and many authorities have indicated that the Federal Government does have a constitutional right to tax the interest on State and local securities." (House Report No. 91-413 (Part 1), p. 172).

You will note that those who deem the tax unconstitutional, including 50 State Attorneys General, and, we are told, the United States Attorney General are, to the Ways and Means Committee majority, merely a "body of opinion," while those who would sanction the tax are called "authorities." The identity and qualifications of these "authorities" are not given, but the report does thus reflect a bias in favoring a legal opinion which, at best, is sharply contested and, at worst, is contradicted by every Supreme Court decision on the subject.

Today's hearing might be a replay of the legal debate before this honorable body thirty years ago but for one enormous difference. Then the contestants on one side were the United States Department of Justice and the Treasury Department in their full official capacity and on the other side the State Attorneys General and the Municipal Law Officers. And the United States Senate of that time accepted the State and municipal view. Today the cast is the same on our side, but no present federal law officer denies us; indeed the Treasury acknowledges

at least grave constitutional doubts and, when pressed, a negative judgment on the constitutionality of taxing our bond interest, even under an LTP plan.

It is hard to see why the Ways and Means Committee, almost cavalierly and with no analysis in its report whatsoever, was willing to plunge this great and unique federal system of ours into the maelstrom of constitutional conflict, pitting the federal government against the states and generating a confrontation which is the opposite of the constructive federalism of which we hear so much.

Make no mistake about it. If sections 301, 302 and Title VI are enacted in their present form, we, the State Attorneys General, will challenge them and resist their enforcement. And we would expect to prevail in the Supreme Court.

Unfortunately, such an ultimate vindication of our opinion will not undo the damage accruing during the years of the judicial contest. The financial status quo cannot be preserved during our legal exercises. New schools will still have to be built and bonds will have to be issued as we seek our final judgment. Investors will have to protect themselves by assuming the worst and our interest rates will stay at taxable levels until the day of victory. But the states and municipalities who couldn't wait for that day will be paying the higher taxable rates on the bonds issued during the years of litigation for 15-20 years after the Supreme Court finally held this legislation unconstitutional.

I am amazed at the "authorities" who dogmatically assert the constitutionality of taxing state and municipal bonds without state consent. They acknowledge, as they must, that the United States Supreme Court flatly and unanimously held such a tax would be unconstitutional in Pollock v. Farmers Loan and Trust Co., 157 U.S. 429, 158 U.S. 601. You have already heard Assistant Secretary Cohen explain that the Court split 5-4 on other issues in that case, but was unanimous on this point.

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These alleged "authorities" also acknowledge, as they must, that the Supreme Court has never, to this day, challenged that opinion or suggested it was ready for reversal. Even the Court of the late 1930's, the high watermark of critical reexamination of the reciprocal constitutional tax immunity, always carefully preserved in the Pollock case and its doctrine as specifically different from such taxes as it sanctioned on salaries (Helvering v. Gerhardt, 304 U.S. 405) or a contractor's profits (James v. Dravo Contracting Co., 302 U.S. 134).

In the salary case, for example, Justice Stone said that immunity was sustained against a statutory effort "to tax income received from state bonds, and thus threaten impairment of the borrowing power of the state (Pollock v. Farmers Loan and Trust Co.)."

In the contractor case, the opinion was by Justices Black, Brandeis, Cardozo, Hughes and Stone, and they too referred to the Pollock case. They reaffirmed its validity in words prophetic of the market uproar produced by the House bill. "That doctrine," they said, "recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (Pollock v. Farmers Loan and Trust Co., supra), and which would directly affect the [state] government's obligation as a continuing security."

These judges even went on to say what all the state and local government witnesses are here pleading with you to recognize. "Vital considerations," the court said, "are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit."

Justice Cardozo, with his flair for the coinage of expressions, referred to Pollock in Hale v. Iowa State Board, 302 U.S. 95, and said, "By the teaching of the same 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."

McCulloch v. Maryland, 4 Wheat. 316, thus cited, has renewed significance in view of the readoption of its philosophy by the majority of the Supreme Court only last year in First Agricultural National Bank v. State Tax Commission, 392 U.S. 339. McCulloch is remembered as the constitutional landmark which first asserted the doctrine of constitutional governmental tax immunity to avoid destruction of our federal system. Its philosophy was expressed in the aphorism, "the power to tax involves the power to destroy."

The significance of last year's First Agricultural case is that the majority and minority locked horns, in final analysis, on the continuing validity, after 150 years, of John Marshall's conviction that "the power to tax involves the power to destroy." The case wasn't even an income tax case; it overturned a state sales tax on a privately-owned national bank. It wasn't technically, even a case of constitutional interpretation, but rather of a statute passed in the light of constitutional doctrine. But the majority opinion cannot be read without dispelling doubts that today's Court still sees intergovernmental taxation as destructive and therefore repugnant to the federal system and the respective federal and state partners in that system.

This should come as no surprise to those who have studied the only case of constitutional significance to this subject which came between the cases of the late '30s and today. This was the case of New York v. United States, 326 U.S. 572, where the Court split three ways in 1946. The tax involved was a federal excise tax on the sale of bottled mineral waters and it happened that the State of New York was engaged in selling, in the everyday market, bottled Saratoga Springs waters. The Court sustained the tax with Justices Black and Douglas dissenting, and I note that they are the only members of that bench still sitting.

Justices Frankfurter and Rutledge, while voting for the tax, were in another minority, quite obviously willing to scrap the immunity doctrine. The four other

judges supported the tax on the conventional ground that a government can lose its immunity when it descends into the market place. That reasoning has no significance to our present inquiry. What is significant is the reasoning of Justices Black and Douglas in arguing the tax was unconstitutional.

In pleading for a reversal of the "market place" exception, these two surviving Justices, after mentioning state issuance of securities, condemned all federal taxes against the states because "A tax is a powerful regulatory instrument."

To Justices Black and Douglas, according to that opinion in 1946, a federal system requires co-existence of the federal and state partners and the kind of co-existence contemplated by the Constitution does not allow for the use by either against the other of such a "powerful regulatory instrument" as a tax. To these Justices, a federal system is the opposite of centralization of power in the federal government and so they went further in their opinion and said of federal taxation of the states, "And no more powerful regulatory instrument for centralization of government could be devised."

You will recognize that this was really only an updated restatement of the century-old pronouncement that "the power to tax involves the power to destroy." Whereas Justices Black and Douglas expressed their judgment alone in New York v. United States, they formed part of the majority of the 1968 court in First Agricultural.

If we repeat the cases which others have cited to you, it is because all "authorities" share the same limited repertory. What I fail to see, however, is where, in this history of the constitutional rule, there is the slightest basis whatever for the constitutional view espoused by the Ways and Means Committee majority report when it recommended taxes, however limited, on state and municipal bond interest.

Certainly the Sixteenth Amendment, which first sanctioned an unapportioned income tax on all income, cannot be the answer. All the cases after Pollock that I have cited are also after the Sixteenth Amendment. The history of that Amendment and its judicial interpretation both reject the view that it undid, in any way, the constitutional prohibition against taxing state and municipal bonds.

When in 1910, while the Amendment was awaiting state ratification, the New York Governor suggested that possibility, and recommended against ratification on that sole ground, his suggestion was specifically contradicted by the Senators who were the champions of the Amendment and who had led the successful fight for its adoption by Congress. The states ratified the Amendment only after they had been assured in the most solemn way on the floor of the Senate that it did not contain authority to tax their bond interest. (45 Cong. Rec. 1968, 2245-7, 2539).

It is not too much to say that the good faith and credibility of the Senate would be sacrificed if it were ever maintained that the Sixteenth Amendment sanctioned the disputed provisions of H.R. 13270.

While more is not needed, the Supreme Court has held over and over that the Amendment granted no such new power, but merely removed a need for apportionment for income taxes on income from property. Brushaber v. Union P.R.R. Co., 240 U.S. 1; Stanton v. Baltic Mining Co., 240 U.S. 103; Peck & Co. v. Lowe, 247 U.S. 165; and Eisner v. Macomber, 252 U.S. 189. Among the justices in these cases was a former Senator who had been a member while the matter was debated. All the justices were contemporary and fully understood the intent of the Congress and the re-assurances to the States which procured ratification.

This chronicle, I submit, leaves no question but that the LTP plan cannot constitutionally include state and municipal bond interest. And it persuades me also that the ADR cannot constitutionally include such interest. The

burdensome effect of ADR is at least as direct and serious as in the case of LTP. In fact our finance officers advise that ADR is the more burdensome of the two because it would affect more people, not being limited, as is LTP, to individuals having more "tax preference" income than adjusted gross income. And the Treasury has testified that ADR would produce more revenue than LTP, which tends to confirm that it is more burdensome.

I cannot accept Assistant Secretary Cohen's unqualified statement that all constitutional obstacles to ADR were removed by U. S. v. Atlas Life Ins. Co., 381 U.S. 233. The case deals with a unique kind of taxpayer, a life insurance company. The word "unique" is not just mine. The Treasury brief in that case used the same word, "unique," to characterize a life insurance company's peculiar financial structure. It is almost impossible to construct parallels to the ordinary individual who alone is the taxpayer under LTP and ADR in the House bill.

Life insurance companies have never been taxed under the ordinary parts of the Revenue Acts or Codes. They always required a special statute to meet their unique situation.

The fact is that life insurance companies are required by both actuarial necessity and by law to treat by far the larger part of their receipts as "reserves" accrued for the benefit of their policyholders, for ultimate certain distribution on death. Thus, for all practical purposes, what the company receives cannot fairly be taxed to it because so much of it (typically 80%) really belongs to the policyholders from the moment of its receipt.

What Congress did in the 1958 Act was merely to give tax reality to this practical reality. Every item of income was apportioned to a "company's share" on which the company paid taxes and a "policyholder's share" on which it did not. As the Supreme Court saw it, Congress simply forebade the company to assign all its tax exempt income to its own share so as to artificially minimize or extinguish

its own tax liability. Rather, it required that the tax exempt income, like all other income, be allocated proportionately to the two respective ownership interests, much as a trustee must do, the Treasury argued, as between trusts he is administering.

Now, when you seek to apply this concept to ADR with regard to individuals, it is obvious that essential elements are missing for any analogy. A life insurance company, for all practical purposes, can be deemed both an owner of its own "company's share" and a quasi-fiduciary for policyholders. But where is the second personality in the case of an ordinary individual? He seems to us one and inseparable. He certainly has no Atlas-type community of interests with the people to whom he makes the payments which produce his itemized deductions: his mortgagee with regard to interest deductions, or his school district with regard to school taxes, or the auto mechanic who repairs his wrecked car, or his church to which he contributes.

The relationship between the company and its allocated income in Atlas just doesn't exist between an individual and the allocated expenses under ADR.

All these unique characteristics of life insurance companies were stressed by the Atlas court, all of which would have been unnecessary if the court were ready to accept a stark plan like the present ADR under which the exemption of an individual's exemption is devalued by disallowing otherwise allowable and unrelated expense deductions.

Section 601(b) of the House bill seeks to tax certain state and municipal bonds which it calls "arbitrage bonds" without bothering to define the term. If the aim is to tax bonds issued for the purpose of raising money to invest in higher yielding bonds, then the provision is absolutely unnecessary. I don't know of a single state in which bonds could be lawfully issued for that purpose. If the aim is something else, the tax would unconstitutionally violate the basic immunity rule. In any event, the provision of the House bill is clearly an unconstitutional delegation of power to the Secretary of the Treasury to legislate.

As to Title VI of H.R. 13270, I hear its plan described as a "tax-subsidy" plan. I submit this is a most inaccurate label. A subsidy is a gratuity -- something paid without exacting repayment. What Title VI seeks is to exact a very substantial repayment from the states in the form of the waiver of their valuable constitutional immunity and to pay the states against their loss and presumably out of the very moneys they would have lost by their waiver.

Whatever else this is, it is not a federal subsidy of the states, although it may be vice versa. I shall call it a rebate plan.

When Attorney General Burch of Maryland testified on this subject before the Ways and Means Committee, no bill had yet been drawn. He said, "if a State consents, Congress may lawfully tax its bonds and those of its municipalities. If, then, the proposals on the Committee's agenda under this subject are unequivocally kept optional for each state, it will avoid the stated constitutional obstacle."

Unfortunately, the bill as passed by the House has not kept its tax proposals unequivocally optional. What we have is a package plan with mandatory LTP and ADR eliminating historic tax exemption and the rebate plan coercively driving the states to take what they can to escape the unacceptable issuance under LTP and ADR. The package is therefore unconstitutional in all its parts.

When Governor Tiemann first opened the possibility of a consensual double-coupon plan before the Ways and Means Committee, he opened a possibility for the practice of true cooperative federalism. The door was opened for negotiations between the state and federal governments, as to ways in which a truly optional plan might be made workable. As Chairman Mills said at that hearing, if the Governors urged and the States really supported a plan, even a constitutional amendment, if needed, could be readily ratified.

But instead of cooperative federalism, the Ways and Means Committee closed itself off from formal communication with the Governors or Attorneys General, retreated to its executive session and concocted this parody of Governor Tiemann's

idea, with an inadequate rate of repayment to the States and with the Secretary of the Treasury, of all people, fixing the rate of repayment; with a disqualification of selected bonds, thus boldly asserting the federal power to regulate by this mechanism; with no requirement of state consent for municipal waiver of what is a state immunity; and with no protection against federal pull back or cut down on the provisions for repaying the states. Title VI is not only unconstitutional but thoroughly wrong.

SUMMARY OF
JOINT STATEMENT
FOR
NATIONAL ASSOCIATION OF STATE AUDITORS,
COMPTROLLERS AND TREASURERS
BY LOUIS GOLDSTEIN, STATE COMPTROLLER OF MARYLAND
AND JOHN D. HERBERT, STATE TREASURER OF OHIO
MUNICIPAL FINANCE OFFICERS ASSOCIATION
BY DANIEL B. GOLDBERG, COUNSEL
BEFORE
UNITED STATES SENATE COMMITTEE ON FINANCE
ON
H.R. 13270
SEPTEMBER 24, 1969

I. The National Association of State Auditors, Comptrollers and Treasurers includes all state finance officers; and the Municipal Finance Officers Association includes the principal municipal finance officers, with ultimate responsibility for issuing the public bonds taxed by H.R. 13270.

II. Our ultimate conclusion is that inclusion of state and municipal bond interest in the bill's tax plans produces in final effect, not reform, but its opposite. This is because the provisions drastically increase state and municipal interest rates and force these governments into curtailing services needed by the average citizen and/or increasing local taxes, principally property and sales taxes, which fall with especial harshness on the persons with the least ability to pay.

III. Charts of recent market movements prove that the House program has caused state and municipal interest rates to skyrocket. The traditional gap between tax exempts and comparable taxable bonds has narrowed - what used to be 65% to 70% ratio (state and municipal savings of 30% to 35% of taxable rates) has jumped this year to 83% for a state and municipal savings of only 17%.

IV. The current market action proves that the enactment of the House Bill would cost fully one per cent additional interest rate.

V. On anticipated 1970 new issuance volume of $15 billion to $20 billion, the added dollar cost to state and local governments for the first year's payments on only the first year's issues would be $150 million to $200 million. The full life cost of only the first year's issuance would be at least $2 billion to $2½ billion. The second year's new issuance at the same volume level would double these figures. By the time new issuances had produced a level of post-1969 bonds outstanding equal to the present $130 billion, the annual state and municipal cost of the Bill, if enacted, would be $1.3 billion, and if that level were only maintained and not increased, the added cost over the life of those bonds would be some $17 billion.

VI. These enormous extra burdens on state and local governments and their taxpayers would offset many times over the mere $80 million a year which the Treasury concedes is all that would be realized from applying both LTP and the allocation plan to all state and municipal bonds, even those now outstanding.

VII. The enormous discrepancy between federal gain and state and local loss itself makes the bill ludicrous and the opposite of reform.

VIII. The violence of the market reaction contradicts the Treasury assertion that it results only from inclusion in LTP of state and municipal interest, which the Treasury opposes, and not from their inclusion in the allocation plan which Treasury favors: An LTP plan yielding $35 million a year cannot possibly explain a billion dollar a year interest reaction; even an $80 million revenue a year combined LTP - allocation plan cannot account for the loss.

IX. This enormous discrepancy results from the complete and reasonable loss of investor confidence in continued exemption, even such as survives in this bill,

once Congress, for the first time, brings itself to repudiate the basic concept of intact exemption by "gimmick" plans to reduce the value of exemption.

X. Investors regard this bill, if enacted, as introducing a cancer into an otherwise healthy body. They are not persuaded that there can be a small and safe cancer. Investor confidence can be restored only by scrapping all the bill's plans to curtail tax exemption of state and municipal bonds.

XI. There is no evidence of abuse of the exemption. The facts on the famous 154, non-taxpaying millionaires shows no holding of state or municipal bonds by the group.

XII. In the highest bracket, adjusted gross income of $315,000 and over, 38% of the individuals had no municipals at all, only 18% of them derived as much as 10% of their income from this source and only 6% derived as much as 25% from this source.

XIII. Gains from tax exemption in recent years have been more than offset by capital shrinkage of the market price of the bonds as interest rates have risen.

XIV. Municipals are not concentrated in the hands of millionaires. Only 31.8% of all such bonds are held by individuals of all income levels. All levels of income above $10,000 a year include some municipal holdings. Seven percent of those in the middle income bracket of $16,400 to $31,000 adjusted gross income, hold municipals. Such middle income persons can easily be caught by the House bill provisions.

XV. Enactment of the bill is bound to produce state retaliation in the form of LTP and allocation plans made applicable to the $300 billion of federal bonds hitherto exempt from state taxation. Even .015% (1½ basis points) resultant rise in federal interest rates would wipe out the entire revenue gain from applying the allocation plan to municipals. Only 3/100 of one per cent (3 basis points) of increase would more than

wipe out the $80 million which both the LTP and allocation plans would exact from state and municipal bondholders.

XVI. Municipal bondholders already pay 30% to 35% to the cost of government by accepting that much less interest than comparable taxable bonds would yield. Since 30% to 35% is the highest level of tax proposed on other "tax preference" income, there is no argument in equity for exacting it a second time from the holder of municipals.

XVII. State and municipal bond exemption is not a Congressionally created "tax preference" like the other classes of income so labeled. It derives from the constitutional form of our federal system which Congress is not free to change.

XVIII. The House proposals are unconstitutional. They collide with precedent and they fall afoul of the constitutionally interdicting rule that taxes may not be applied to state activities because taxation is, in the words of Justices Black and Douglas, such a powerful "regulatory instrument." An example of abusive regulation of state governmental activity by exercise of the power to tax bond interest already appears in the Revenue Code by last year's overkill mis-definition of industrial development bonds and by the 1968 Act's arbitrary selection for exemption of certain traditional governmental activities and the rejection of others. Correction of this error would be accomplished by Congressman Wilbur Mills' H. R. 12923 or Senator Baker's S. 2280.

XIX. The allocation of deductions plan is not constitutionally cleared by United States v. Atlas Life Ins. Co., as Treasury claims. That case dealt with the unique problems of taxing life insurance companies which, unlike individuals, have the dual characteristic of owner of part of their apparent income and custodian of much the

larger share for policyholders for ultimate payment to them as death benefits. Allocation can be reasonable between such dual interests without applying to an individual, who has no such duality.

XX. Inevitable constitutional litigation over the validity of the House Bill would produce market chaos for years, which would cost local taxpayers hundreds of millions of dollars whatever the outcome.

XXI. The provision taxing "arbitrage bond" interest is outrageous. It contains no definition of the term. If properly defined there are no such bonds which can be lawfully issued. The provision is probably aimed at the blameless practice of investing declining balances of municipal bond proceeds until they are applied to the capital improvement for which they were borrowed.

XXII. The "tax-recompense" plan of Title VI is a travesty of a truly optional plan combined with the inclusion of state and municipal bond interest in Sec. 301 (LTP), and 302 (allocation). It is outright coercion. The bill leaves no tax-exempt bonds to opt for. It is frightening to consider the Secretary of the Treasury as the arbiter of what the rate of recompense should be. A 25% floor under the recompense rate threatens a return to the issuers of less than tax exemption has saved them. The plan would leave the states and municipalities helpless if the recompense was withdrawn by a later Congress after the traditional tax-exempt market had withered away. And, finally the dangers of federal control in the plan are exposed by the fact that the bill starts off by making certain bonds ineligible.

JOINT STATEMENT
FOR
NATIONAL ASSOCIATION OF STATE AUDITORS,
COMPTROLLERS AND TREASURERS
BY LOUIS GOLDSTEIN, STATE COMPTROLLER OF MARYLAND
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H.R. 13270
SEPTEMBER 24, 1969

The National Association of State Auditors, Comptrollers and Treasurers and the Municipal Finance Officers Association, between them, include the finance officers of all the States and of the major political subdivisions of this country.*

It is our members who have the responsibility for issuing the state and local government bonds which finance our country's public capital improvements at the state, county and municipal levels.

REFORM IS THWARTED, NOT AIDED, BY HOUSE BILL

The inclusion of state and municipal bond interest in the base for the "limit on tax preference" provisions of section 301 of the House Bill and the "allocation of deductions" provisions of section 302 can lead to one result - to increase the share of the cost of government which is borne by persons of modest means, the average local taxpayers. This added burden will be compounded in many communities by reduced local services. This, we submit, is not reform, but its very opposite.

*Canadian members of Municipal Finance Officers are not here represented.

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Section 301 and 302 would impose taxes on the debt instruments by which our states, counties and cities raise the money to build our schools, our playgrounds, our highways, our parks, our sewers and the myriad of other state and local capital improvements which are closest to the average citizen. These proposed new taxes would produce their anti-reform effect by an obvious chain reaction: taxes on the bonds lead immediately to more interest costs to the state and municipal borrowers; more interest costs mean either higher state and local taxes or reduced services or both.

REGRESSIVE RESULTS

Every local citizen is hit in this way, no matter how modest his means.

Our cities have been consigned mostly to the regressive taxes which bear most heavily on those with the least ability to pay. Property taxes are still the mainstay of municipalities - fully 80% of local government revenues come from this one over-worked source. Sales taxes, which are growing in use, are also regressive, bearing especially heavily on the poor. Even our state tax structures can not approach the progressive character of the federal income tax system.

When you force up our interest costs you probably force us to meet the increase principally with higher property taxes. This means that every citizen is penalized by a higher cost of owning or renting a home. If we resort to sales taxes, every citizen is penalized by higher costs of purchasing even the bare necessities of everyday life.

We submit that the House took a short sighted view

of the very meaning of "Reform." Tax reform should mean the more equitable distribution of the costs of all government, not just the improved symmetry of the federal income tax alone.

STATE AND MUNICIPAL LOSS FAR EXCEEDS FEDERAL GAIN

This would be reason enough for rejecting these taxes on state and municipal borrowing even if the federal government were to gain more than the state and local governments would lose. The federal government is the "rich" member of the federal system. In the overall scheme of tax distribution between levels of government, it is not "reform" to increase federal revenues at the direct expense of state and local government even if the federal increase happened to exceed the state and local loss.

But here the error is compounded. The federal gain would be far less than the state and municipal loss.

The Treasury testified here on September 4 that the inclusion of municipal bond interest in the allocation of deductions plan would yield only $45 million a year even if it were applied to the entire outstanding $130 billion of state and municipal debt. If the plan is cut back to future issues only then it's hard to see how the first year's new issuance of an estimated $15 billion to $20 billion could produce much more than $5 million to $7 million in federal revenues.

The Treasury also testified that including municipal bonds in the LTP plan, which it opposes, would produce only another $35 million a year, again if applied to all outstanding bonds. If not so applied, the first year's production works out to a paltry $4 million to $5 million.

As against these insignificant federal gains, what would the state and local government losses be?

HOUSE BILL FORCED UP STATE AND MUNICIPAL INTEREST RATES

The violent market reaction to the House proposals gives some measure of the added interest costs involved.

We have charted the movement of interest rates over the past two years for standard indices of seasoned long term municipal bonds of average grade as compared with comparable taxable corporate bonds and federal government bonds. You will notice on the accompanying chart that the state and municipal bonds represented have consistently sold at lower yields than the taxable federal government or corporate bonds. The difference between the municipal and corporate bond indices is a rough measure of the average savings which tax exemption has meant to the average state or municipal issuer. Such a comparison isolates the changing value of tax exemption from other market factors.

The important thing to note is that while all interest rates have been increasing, the gap between tax exempt municipals and taxable federal and private bonds has been closing since the so-called "reform" program gathered momentum early this year.

We have illustrated this closing of the gap by a separate chart which plots the change in the ratio of tax exempt municipal yields to the taxable corporate yields. Two years ago, municipal yields on the standard "Bond Buyers 20" index were just about 70% of the yields of Industrial bonds on the Moody's average. That is to say that states and municipalities were saving some 30%, on the average, of what they would have paid at the time on fully taxable bonds. It is probable that the saving would be

more on new issues as compared with the seasoned issues in the index.

At any rate this ratio fluctuated, until this year, between 64% and 72%. We think it is fair to say that the traditional ratio has been roughly 65% to 70%, meaning that the state and municipal saving has therefore averaged 30% to 35%. This state and municipal saving is, of course, also the exact measure of the cost which the lending bondholder has paid for his expected tax exemption. We will discuss later the "equity" of making the bondholder pay a second 30% to 35% "minimum tax" to the federal government after thus contributing 30% to 35% of his interest potential to state and local government. But here let us trace the impact on state and local government only.

As the so-called "reform" movement gathered momentum early this year, the ratio of municipal to industrial yields leaped from its traditional levels, piercing the 80% mark this July. By mid-September it stood at 84%. The greatest jump occurred in May as the market came to digest the true import of the House Ways and Means Committee announcements. And the market ratio has continued in the same adverse direction to date.

This means that only the threat of the House plan, which is far from enactment, has produced a disastrous increase in the cost of state and municipal borrowing and has stopped many needed projects.

THE MEASURE OF THE INTEREST INCREASE

Between the end of 1968 and mid-September 1969 the ratio of municipal to corporate yields jumped from 71% to 84%, a loss to the states and municipalities of 13% of the taxable interest

rates. **13% of the typical taxable interest of over 8% today produces a loss to the municipal issuer of fully 1%. While this** loss may be attributed in part to other causes, let us remember that not everyone is convinced the House Bill will be enacted in its present form. Actual enactment, dispelling the last hope of retaining the exemption, would produce much sharper municipal interest losses.

All in all, we judge that one full per cent more interest is a quite conservative estimate of the increase which enactment of the House Bill would compel in the present market. Of course, the lesser known credits would suffer much more, particularly the small school districts and villages and counties whose sole attraction in the distant bond market has been their traditional exemption.

THE DOLLAR COST OF TAXING MUNICIPALS

If we apply this increase of **1%** to next year's anticipated **new issue volume of $15 billion to $20 billion, we find the House Bill** penalizing state and local government taxpayers by $150 million to $200 million in the first year of operation under the "reform" plan. But this is only the first year's cost on the first year's issuance.

What would be the cost of this first year's issuance over the life of the bonds thus issued in 1970? If we assume a 20 year term with equal annual debt service payments of principal and interest, we get an average life per issue of 13 years. And so our 1970 issues alone would involve some $2 billion to $2-1/2 billion in added interest costs.

We have prepared a chart distributing this added cost on just 1970 issues between the states, assuming an aggregate

new issuance of $19.5 billion and that each state's share will be the same as in 1968 when the aggregate was $16.1 billion. (1969 issuances have been so curtailed by adverse conditions that it is reasonable to assume that 1970 will "make-up" part of the 1969 drop from 1968, to average out 1969 and 1970 to the 1968 rate).

And all this is just from the first year's new issuance! If 1971 sees a further volume of new issues between $15 billion and $20 billion, the cost of the House plan to states and municipalities and their taxpayers would be $300 million to $400 million in 1971, and the issuances of 1970 and 1971 would involve, over their life, aggregate increased interest payments of some $4 billion to $5 billion.

And still we have priced out the effect on only two years of issuance, and not those to be issued after 1971.

A BILLION DOLLAR ANNUAL STATE AND MUNICIPAL LOSS VS. $80 MILLION FEDERAL GAIN

By the time new issues had aggregated only the present volume of $130 billion, the annual aggregate cost to local government taxpayers at the 1% increment, would be $1.3 billion dollars (and the amount of future payments contracted for would have increased by some $17 billion dollars, on the assumption of an average 13 years remaining bond life) - to be met for the most part from regressive local taxes.

Now it's time to compare the federal revenue expectation with the resultant local government cost. On the federal side the Treasury estimates $80 million a year, $45 million from allocation of deductions and $35 million from the limit on tax preferences.

In 1970 alone, as we have seen, the Treasury's estimated $80 million in revenue would be accompanied by $150 million to

$200 million in costs to the local taxpayers. In 1971 the $80 million federal revenue would involve $300 million to $400 million in added local costs, and with each additional year the gap would increase until the $80 million federal gain would involve $1.3 billion in state and municipal loss in the year when the newly issued municipal debt outstanding was as much as the present volume of $130 billion.

Furthermore, if this $1.3 billion is translated, as it must be, into state and local taxes, these taxes are, in turn, deductible items on federal income tax returns. If we assume an average deduction in only the 14% bracket, the federal government stands to lose $182 million dollars in this way. Even half this loss would more than wipe out the estimated $80 million revenue gain.

THE DESTRUCTION OF INVESTOR CONFIDENCE -
THE CANCER EFFECT

From these figures it must be obvious that far more is involved than the relatively limited application of an LTP plan which would yield the federal government only $35 million a year or an allocation of deductions plan which would bring in only $45 million dollars a year even if applied to presently outstanding bonds. How can such a small federal revenue gain produce such enormous market repercussions as to cost state and local government taxpayers over fifteen times as much as would be paid by the federal taxpayers. Who are the targets of the LTP and allocation plans?

The answer is plain to any student of the municipal market. Investors are not just mathematically pricing out the immediate dollar tax loss to them of these specific new plans. They are far more realistic. They are appraising the consequences of a basic Congression repudiation of the concept of tax

exemption of state and local government bonds. They are evaluating the consequences of a break in the hitherto impregnable dike which has, till this day protected the states and municipalities and their bondholders. When they are told that these plans are small and painless, they react as if told that only a small cancer has developed in an otherwise healthy body.

We must remember that a bond buyer has only one moment in time to decide how much interest he is willing to surrender in exchange for tax exemption on a bond with a 20 to 30 year life. That is the moment he pays for his bond knowing he will receive only the stated coupon rate no matter what Congress will do during those 20 to 30 years.

Until this year that bondholder had sublime faith that Congress would consider it unthinkable to tax these bonds. He assumed that Congress would consider it immoral to change the rules in the middle of the game and take away all or part of the tax exemption for which he had paid to the state or local government issuer by accepting 30% to 35% less interest than he could have received on a comparable taxable bond. And he considered it implausible that Congress would not heed the plea of state and local government officers not to burden them further when they were beset by the "crisis of the cities" and by the enormous burdens of record high interest costs and almost runaway inflation in the prices of needed capital improvements.

Right now that faith is badly shaken. The Treasury has recommended to both the House and this Committee that the allocation of deductions plan be applied and that it be applied even to

outstanding state and municipal bonds. The House has passed a bill applying both the LTP and the allocation plans to municipal bonds and applying the LTP plan even to oustanding bonds. The House Ways and Means Committee had tentatively voted to apply a minimum tax plan to corporate holders of outstanding state and municipal bonds and an allocation of deductions plan to banks who, in recent years, have bought for investment fully 80% on the average of all new state and municipal issues.

INVESTORS MUST ANTICIPATE FURTHER INROADS ON EXEMPTION

Against this background an investor would be foolhardy to assume that if Congress began by enacting the House Bill, or even only the Treasury-recommended allocation of deductions plan against individuals, the matter would stop there during the 20 to 30 year life of his bond. Being unable to protect himself later, he must protect himself now, when he parts with his money. He has to treat these plans as first steps, cancers, if you will, that are bound to spread. If LTP and allocation can apply to individuals, he asks himself, why will the next Congress not feel it "only fair" to extend them to corporations? If he is an individual he would suffer because the extension to corporations would hurt the market in which he might have to resell. If the bond buyer is a bank, it is too sophisticated to assume that the "reform zeal", once sanctioned by Congress, would not spread to financial institutions and other corporations. And if LTP can be applied so as to tax "disallowed tax preferences" at one-half their total this year, then why not at three-quarters next year? And if Congress sets a $10,000 leeway figure in both plans this year, then why not

$5000 next year, and no leeway at all the year after?

Obviously this necessary market psychology explains why Congress cannot drop even pebbles into the hitherto calm waters of unimpaired state and municipal bond tax exemption without causing tidal wave repercussions on state and local governments and their taxpayers, trapped as they are in their largely regressive tax systems.

THE MARKET RESPONSE WAS NOT LIMITED TO LTP PLAN

This market reaction also contradicts one of the tenets of the Secretary of the Treasury in his testimony here on September 4. The Secretary would have you believe that the acknowledged violent market reaction of recent months is attributable solely to the LTP plan which he opposes and not at all to the allocation of deduction plan which he supports. Perhaps the Treasury feels a need to explain away its failure to heed the warnings of the state and local government officers who predicted to the Ways and Means Committee exactly what has happened.

It would be better if the Treasury faced up to the fact that the market's confidence can be restored in only one way - complete elimination from the bill of all plans to curtail the value of exemption. Only then can investors feel secure that the disease has not been implanted and will not spread.

The Secretary argues that the market did not react when he first proposed the allocation plan to the House Ways and Means Committee, and therefore his plan cannot be the culprit. But he overlooks two things. The most important is that even those who understood the plan last March were just not ready to believe that Congress would take it seriously; the Treasury has been recommending the curtailment of exemption without success for over 30 years.

Secondly, the seriousness of the plan was not fully appreciated when it was first advanced.

RECOVERY OF MARKET REQUIRES ELIMINATION OF ALL DILUTIONS OF EXEMPTION

The fact is that the market reaction is so violent that it cannot be explained in terms of reaction to an LTP plan yielding only $35 million a year any more than it can be explained in terms of a combined LTP-allocation plan yielding only $80 million a year. Excising the LTP plan will help very little in restoring market confidence. Excising the whole "cancer" is what is needed.

REDUCED SERVICES THREATENED

Increased local costs are not the whole story. The "taxpayers' revolt" is not limited to federal income taxes. It has led to the defeat of many, many local bond issues where popular referenda are required. If the local taxpayers reject school bond issues at 6% interest rates because they mean higher property taxes, must we not expect even more violent reaction to 7% interest rates compelled by a so-called "Tax Reform Act"?

When a community is at the breaking point, what will happen is more schools unbuilt, more hospitals deferred, more water purification plants put off -- in short less public service for the average citizen in whose name this "reform" is invoked.

When traced down to their final regressive effects on the average local citizen, we submit that this "reform" to tax state and municipal bonds backfires badly - it is no reform at all. It is a perfect case of **throwing out the baby with the bath water.**

NO EVIDENCE OF ABUSE OF EXEMPTION HAS BEEN SUBMITTED

The case for this boomerang reform becomes even worse because the damage to be done to state and local government is without any evidence of excessive concentration of municipals in the hands of the wealthy. By now we all know how the previous Secretary of the Treasury overstated the story of the 154 millionaires who paid no tax. This magnificent example of misleading propaganda is credited by many as having fueled the "taxpayers' revolt" which led to this bill. And yet Assistant Secretary Cohen had to admit here on September 4 that "I think there was undue enthusiasm over the category of the 154."

What became evident in the September 4 testimony was that state and municipal bond interest had absolutely nothing to do with these 154 persons not paying taxes. There is absolutely no record knowledge that any of them held tax-exempt bonds. Their non-payment of taxes was attributed completely to other circumstances.

The only testimony before the House Ways and Means Committee on the extent of millionaire holdings of municipal bonds showed only a very small percentage of millionaire income derived from municipal bond interest. The Investment Bankers Association submitted a study showing that in the highest adjusted gross income bracket of $315,000 and over, 35% of the taxpayers did not own any municipals at all; only 18% of them derived as much as 10 per cent of their income from this source and only 6% derived as much as 25% from this source.

CAPITAL SHRINKAGES OFFSET EXEMPTION BENEFITS

There is one documented case of a millionaire old lady in her 90's who has all her wealth in municipals and pays no taxes.

Actually she is more to be pitied than envied. Since she bought her municipal bonds more than three years ago she has seen her capital shrink by fully thirty per cent as municipal bond prices plummeted to offset the skyrocketing interest costs which have plagued the economy. She has therefore lost more in capital than she received in total interest let alone the lesser amount she has "saved" by tax exemption.

This phenomenon of capital shrinkage is, unfortunately a general condition, affecting all bondholders. But the more typical investors are exemplified by the 82% of the total highest income class who received less than 10% of their income from municipal bond interest. These individuals had an opportunity to participate in rising stock market prices and increasing prices for real property and other forms of equity investment, while the 90 year old lady has had only losses.

MIDDLE INCOME PERSONS AFFECTED BY LTP AND ALLOCATION PLANS

Millionaires are not the only individuals holding state and municipal bonds. Individuals in all brackets hold only about 31.8% of the outstanding volume, and this percentage has been steadily declining. The Investment Bankers Association testimony before the Ways and Means Committee shows that 7% of the individuals in the middle income class ($16,400 to $31,000 adjusted gross income) hold municipals, and this percentage represented 88.6 thousand individuals.

Nor is it true that only millionaires would be hit by the House bill.

A middle income taxpayer can easily exceed his "limit on tax preferences" under the House Bill by capital gains. If he sells

a home he has held for 20 years and has a modest success in the stock market, he will be paying taxes on any municipal bond interest he receives, without having achieved the exalted status of millionaire.

PROSPECT OF STATE RETALIATION

We have seen no Treasury figures as to how much it would cost the Treasury if the States adopted similar "reforms" in their income tax structures.

We find it inconceivable, if these "reforms" are enacted by Congress, that States will refrain from imposing "limits on tax preferences" and "allocation of deduction" penalties on interest which their citizens receive on federal bonds. We would expect federal interest rates to jump up in response to such moves just as state and municipal rates have. On a $300 billion federal debt, interest rates would have to increase only a miniscule 1-1/2 basis points (.015%) to ultimately wipe out the estimated $45 million of gain from the Treasury's plan to apply allocation of deduction to state and municipal bond interest. 3 basis points (.03%) on federal debt would more than wipe out the $80 million which both LTP and allocation would produce from this source.

The probability is that retaliation alone would cost the Treasury far more than it would hope to realize.

THE MUNICIPAL BONDHOLDER ALREADY PAYS THE EQUIVALENT OF TOP LTP TAX

Even as to the top bracket municipal bondholder the "tax equity" argument for the House bill does not hold good. In the case of maximum application the LTP plan exacts tax at top bracket rates on only half of the excess of "tax preference" income over adjusted gross income. If an individual who has no municipal

bonds is in the 60% to 70% brackets, the topmost brackets, then the most he is asked to pay on his "disallowed tax preferences" is one half these rates, or 30% to 35%.

But, it will be remembered, this 30% to 35% is what every state or municipal bondholder in recent normal markets has already contributed to the cost of government by accepting that much less interest than he could have received from comparable taxable private bonds. Since the state or municipal bondholder, no matter what bracket he is in, is already contributing to the cost of government at the highest rates to be applied to the recipients of other "tax preference" income, where is the argument in "tax equity" for taxing the municipal bondholder again? Why should he, of all the recipients of so-called "tax preference" income be thus subjected to a double exaction for the support of government as the price for his so-called "tax-preference?"

We submit that even if you look at the matter from the viewpoint of the municipal bondholder alone and ignore the regressive repercussions on local taxpayers, the House Bill "reform" in his case does "inequity" rather than "equity."

STATE AND MUNICIPAL BOND EXEMPTION IS NOT A CONGRESSIONALLY-CREATED "TAX PREFERENCE"

Frankly, we are disturbed by lumping municipal bond interest with other situations as if they are alike. Each other item labelled a "tax preference" in the House Bill is the creation of the Congress to foster a policy which it was completely free to embrace or reject and which it may, therefore, limit.

But this is not the case with the exemption of municipal bond interest. The policy protected here goes far deeper than Congressional grace. It derives from the unique nature of our federal system which includes sovereign states, constitutionally immune from federal taxation just as the federal government is constitutionally immune from taxation by the states and local governments.

When Cordell Hull as the Ways and Means Committee spokesman for the first income tax act in 1913 explained the exemption of municipal bond interest, which appeared intact in that and every successive Revenue Act ever enacted, he stated that it embodied the constitutional doctrine.

Even were that not so, the policy preserved by this exemption goes to the very structure of our government and its ability to survive in its federal form, not wholly centralized and not wholly decentralized. This is not a matter of Congressional preferences, like the treatment of "hobby farm losses" or "accelerated depreciation" or "charitable contribution of appreciated property." It is far more fundamental, bottomed on the constitutional concept of a federal system which Congress is not free to change.

UNCONSTITUTIONALITY OF HOUSE PROVISIONS

From this circumstance flows our judgment that the House Bill provisions to tax municipal bond interest are unconstitutional. The application of the LTP provisions to such interest is admitted by the Treasury to be subject to grave constitutional doubts. We have more than doubts - we are convinced that such application is unconstitutional. The unconstitutionality of taxing municipal bond interest in full was unanimously decided in the only case in which the question could have been raised, Pollock v. Farmers Loan and

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Trust Co., 157 U.S. 429, 158 U.S. 601 (1895). Since Congress embodied this constitutional rule in every revenue act, there has of course been no departure from its holding. When the Treasury tried in the 1940's to break through, the courts turned them back in Commissioner v. Shamberg, 144 F. 2d 998 (1944), cert. den. 323 U.S. 792 (1945).

It used to be fashionable in the Treasury thirty years ago to argue that the Pollock case was out of style because the Supreme Court had come to sanction taxation of municipal salaries. But the salary case and all the other cases cited as weakening the Pollock case themselves distinguished Pollock.

THE UNCONSTITUTIONAL REGULATORY EFFECT OF TAXING MUNICIPALS

The distinction is clear. The burden of taxing municipal bonds is direct and immediate upon the states and their local subdivisions. Moreover, the potontial for regulation by taxing bonds is enormous and does not exist in the taxation of salaries.

For example, Congress last year added, on a floor amendment rider to the Revenue and Expenditure Control Act of 1968, a provision to tax municipal bonds encompassed by its definition of "industrial development bonds." Many bonds properly so labelled are not true exercises of the municipal borrowing power but pure conduits for private borrowing by industrial tenants of nominal public property. Such bonds were proper objects for federal taxation.

But -- and here's the rub -- the definition enacted does not limit the tax to these conduit bonds. By a definition which far overshot the normal meaning of the term defined, the act taxes as "industrial development bonds" almost any bonds to finance a governmental facility which would have private occupants. (Some classes of such facilities, like public housing, public markets and public transportation terminals must have private occupants to serve their public purpose.)

But then the 1968 Act set up a category of "certain exempt activities." If the purposes for which the bonds were issued made this "honor roll" of activities preferred by Congress the bonds were made exempt. But if the state or local government purpose failed to make the "honor roll," they were "black-listed" and the bonds were made taxable. What makes the whole exercise so alarming is the utter irrationality of the statutory classification as between different acknowledged governmental functions.

Thus the bonds are exempt if they are issued to finance a stadium for lease to a professional baseball team but taxable if the facility to be financed and leased is for cultural recreation such as concerts, opera, lectures and Shakespearean drama. The bonds are exempt if the purpose of issuance is to construct public housing for lease but not if the facility financed is a hospital or clinic for lease to doctors practicing their profession for profit. The bonds are exempt if the facility financed is a transportation terminal for aircraft or ships but not if it is a terminal for railroads or buses; and even here there is an exception for rail and bus terminals <u>wholly</u> devoted to commuter traffic but no exception for the normal terminal which accommodates both commuter and long haul traffic. Power and water systems can be financed tax exempt under this act if they are for local distribution but not if for regional distribution.

Obviously this was an outright exercise of Federal control of state and local government by the taxing power. If it is not amended as proposed in Congressman Wilbur Mills' pending H.R.12923 or Senator Baker's pending S.2280 - and that would be a <u>real</u> reform - it will undoubtedly be challenged as unconstitutional.

THE VIEWS OF JUSTICES BLACK AND DOUGLAS

But here its importance is to give point to the 1946 opinion of Justices Douglas and Black in New York v. United States, 326 U.S.572. They said "A tax is a powerful regulatory instrument.*** And no more powerful instrument for centralization of government could be devised." There was a reference in this context to the fact that "Tomorrow it (a state) may issue securities," with the obvious meaning that in such issuance a state must be free from taxation in order to escape the unconstitutional application of this "powerful regulatory instrument" and "this powerful instrument for centralization of government."

While this was in a dissent, the majority did not contradict the statement and, what's more, the Justices who wrote those words are the only members of the 1946 court still sitting. Justice Black had voted to tax municipal salaries eight years before and he obviously saw no inconsistency in thus distinguishing a tax on the issuance of securities.

APPLICATION OF LTP TO MUNICIPALS IS UNCONSTITUTIONAL

Is there any distinction in that LTP may tax half and not all of the municipal bond interest? The question practically answers itself. If more is needed we invoke the classic language of United States v. Railroad Co., 84 U.S. 322, 327, where the Court said:

> "If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted."

THE VITALITY OF THE CONSTITUTIONAL IMMUNITY

McCulloch v. Maryland - 4 Wheat, 316 (1819) is the historic case which first announced that ringing truth "the power to tax involves the power to destroy." While it used to be deemed quite smart to mew at this doctrine, it is hard to deny current standing to its force in the light of last year's majority opinion, by Justice Black, in First Agricultural National Bank v. State Tax Commission, 88 Sup. Ct. 2173.

The case involved the right of a state to impose sales tax on purchases by a privately owned national bank. The statute involved, like the statute exempting municipal bond interest, was shown by its Congressional debate to be based on constitutional principles of governmental immunity. Justice Black quotes the sponsors when they invoked Chief Justice Marshall's statement that "the power to tax involves the power to destroy." The dissenters quoted the minimizers of this doctrine, but they did not prevail.

The 1968 Supreme Court majority does, therefore, stand for this original principle which underlies reciprocal tax immunity.

THE UNCONSTITUTIONALITY OF APPLYING THE ALLOCATION PLAN TO MUNICIPALS

We submit that there is grave doubt, therefore, that an allocation of deductions plan which so dramatically raises the cost of state and municipal borrowing would survive constitutional attack. The Treasury testimony was, we believe, far too cavalier in saying that its plan has been unequivocally cleared by United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965).

That case involved what the Treasury brief itself described as the "unique" situation of life insurance companies. Determining the income of these companies has been a constant problem for Congress, resulting in a series of special statutory provisions applicable to them alone. The problem is that so much of the nominal income of a life insurance company is committed in advance to building up the reserves from which policyholders' death benefits are paid.

Congress, in the 1958 Life Insurance Company Tax Act recognized this peculiar situation by requiring the insurance company to allocate each item of income partly to "policyholders' share" and partly to a "company's share", with no tax being charged on the "policy holders' share."

This recognized the practical realities that the company is almost a trustee for policy holders of the major share of "its" income (85% in Atlas' case), and that Congress could therefore prevent it from assigning all its tax exempt income to the company's share.

The difficulty in applying this complex concept to the ordinary individual is that the individual simply doesn't have this dual status of the life insurance company as both owner of its own income and custodian of policyholders' income. He is the absolute and sole owner of all his income in every sense of the word.

In Atlas the Court approved allocating income, taxable and tax exempt, to different people who had ownership rights to it. What the Treasury proposes is to allocate expenses to different kinds of income of the same person where the income and the expenses are utterly unrelated.

CONSTITUTIONAL LITIGATION WOULD PRODUCE MARKET CHAOS

Obviously it would take prolonged litigation to settle this point. Such litigation, whether limited to the allocation plan or covering also the LTP plan, would undoubtedly cause chaos in the municipal market for many years, costing states and local governments millions in additional interest whatever the outcome and postponing thousands of sorely needed public improvements.

ARBITRAGE

One little noticed provision in the House Bill is Section 601(b) removing the exemption of "arbitrage bonds" without a word of definition to inform what such bonds might be.

Nor is there a word in the Ways and Means Committee hearings to give any basis as to why a "reform" is necessary in this area. The Treasury, on September 4th, did not repudiate this section but did admit that a statutory definition was needed, without offering such a definition.

The only legitimate definition of an arbitrage bond is that it is one issued for the primary purpose of investing the proceeds in other securities at a higher return. Since we know of no state in which such bonds are authorized, we have reason to fear that something far more sinister is intended.

States and municipalities often borrow at one time the total cost of a capital improvement which will take a few years to complete. After all, a bridge, for example, is worthless with the middle hundred feet uncompleted and so both the issuer and bondholders feel more secure knowing that they

do not have to depend on a problematic market to sell a second or third issue for completion.

The prudent state or municipal treasurer, of course, invests there bond proceeds pending application to land costs and contractors' bills. If the market is favorable he will try to invest in the highest yielding secure bonds whose maturities match his schedule of money disbursements.

We suspect that the authors of this sleeper tax provision on "arbitrage bonds" are aiming at this blameless practice.

Whatever they meant, we have here another example of how the federal government can, by taxing municipal bonds, embark on the dangerous waters of using the tax as that "powerful regulatory instrument" which Justices Black and Douglas decried.

The effort should be repudiated by the Senate and Section 601(b) should be stricken.

THE "TAX-RECOMPENSE" PLAN

Perhaps a truly optional "tax-recompense" plan would be constitutional whatever other merits or demerits it might have. If Congress truly gave each state an absolutely unfettered option to issue its bonds on either the traditional tax-exempt basis or subject to federal taxes, with agreed upon recompense, we would find no constitutional blemish.

But Title VI of the House Bill is a travesty of such an idea. It must be read with Sections 301 (LTP) and 302 (Allocation) which would destroy traditional exemption. The

option offered is to issue taxable bonds under Sections 301 and 302 without federal recompense or taxable bonds under Title VI with some federal recompense. The option to issue tax-exempt bonds is not to be found in the bill.

This LTP-allocation-"subsidy" package is simply not an optional plan. It is transparently an exercise in coercion to compel the states to take whatever they can get. It is therefore utterly unconstitutional and unworthy of Congressional consideration.

Furthermore, the House Bill seeks to give municipal issuers the option to issue taxable bonds. We note that municipalities do not have the constitutional power to trade away an immunity which inheres on the sovereignty of its state and the Congress can not grant that power by itself. It can do so if and only if the State legislature consents in accordance with the State constitution.

The House"tax-recompense" plan leaves it to the Secretary of the Treasury to decide the rate of recompense to issuers opting for taxable bonds. With all due respect to the present Secretary and Assistant Secretary, too many of their predecessors have shown such overt hostility to state and local government in general and to tax exemption in particular as to make the holders of their offices unacceptable as arbiters in this field. By merely proposing such "reforms" as the present, the Treasury can close the market gap between taxable and "tax-exempt" bonds and then invoke the lessened gap to justify cutting the percentage of recompense. We would thus be squeezed between a tax plan that pushes municipal interest rates up and a resultant basis for driving down the percentage of recompense.

Furthermore, the House Bill places a 25% floor under the recompense rate after five years. Under the bill's directions

to the Secretary, we must always expect that only the floor percentage would be proclaimed. Why 25%, we ask, when the market percentage has for years run 30% to 35%? Why not 50% when private companies can in effect compel such a Treasury contribution by deducting the bond interest from taxable income at corporate rates? And why less than the 42% which last year's Secretary reported to Congress he could derive by taxing state and local government bond interest?

What defense could the states and cities have, after the tax-exempt market evaporated with universal opting for taxation, if a later Congress had a change of heart and withdrew the offer of recompense?

Then finally, there is the sinister danger of federal controls over matters of local concern. Let no one tell us that this is far from the intent of the proponents. They are contradicted by their very House Bill.

The Bill makes certain bonds ineligible for "tax-recompense" treatment. "Arbitrage bonds", undefined, are one excluded class. And the spuriously defined "industrial development bonds" are another.

As we have shown, this means a baseball stadium bond, for example, can be eligible and a cultural center bond ineligible. When the bill starts its "tax-recompense" plan with such an arbitrary exercise in federal controls of and classification between legitimate governmental functions, states and municipalities are understandably unwilling to see the plan enacted.

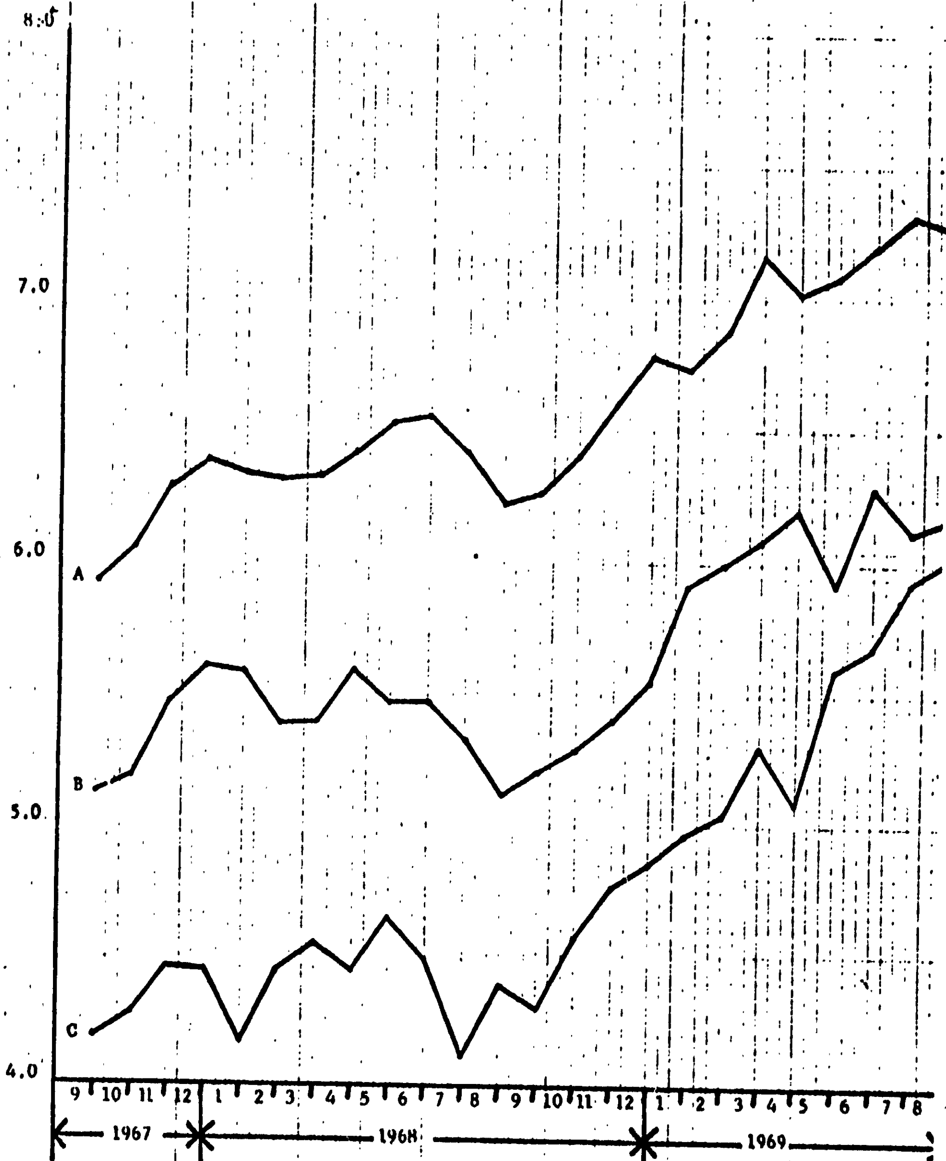
CONCLUSION

We strongly urge that the Senate delete from H.R. 13270 all provisions for the impairment of the exemption of state and municipal bond interest. This includes:

(1) Amendment of Section 301 (a) (1) by deleting from the new Code Section 84 to be added thereby, subsection (c) (1) (C) and subsection (c) (5);

(2) Amendment of Section 302 by deleting from the new Code Section 277 to be added thereby, subsection (c) (2) (B) and by deleting related technical amendments to Code Sections 265 and 643 (a) (6) (A);

(3) Deletion of Title VI in toto, including both the "arbitrage" and the "tax-recompense" provisions.


YIELD %
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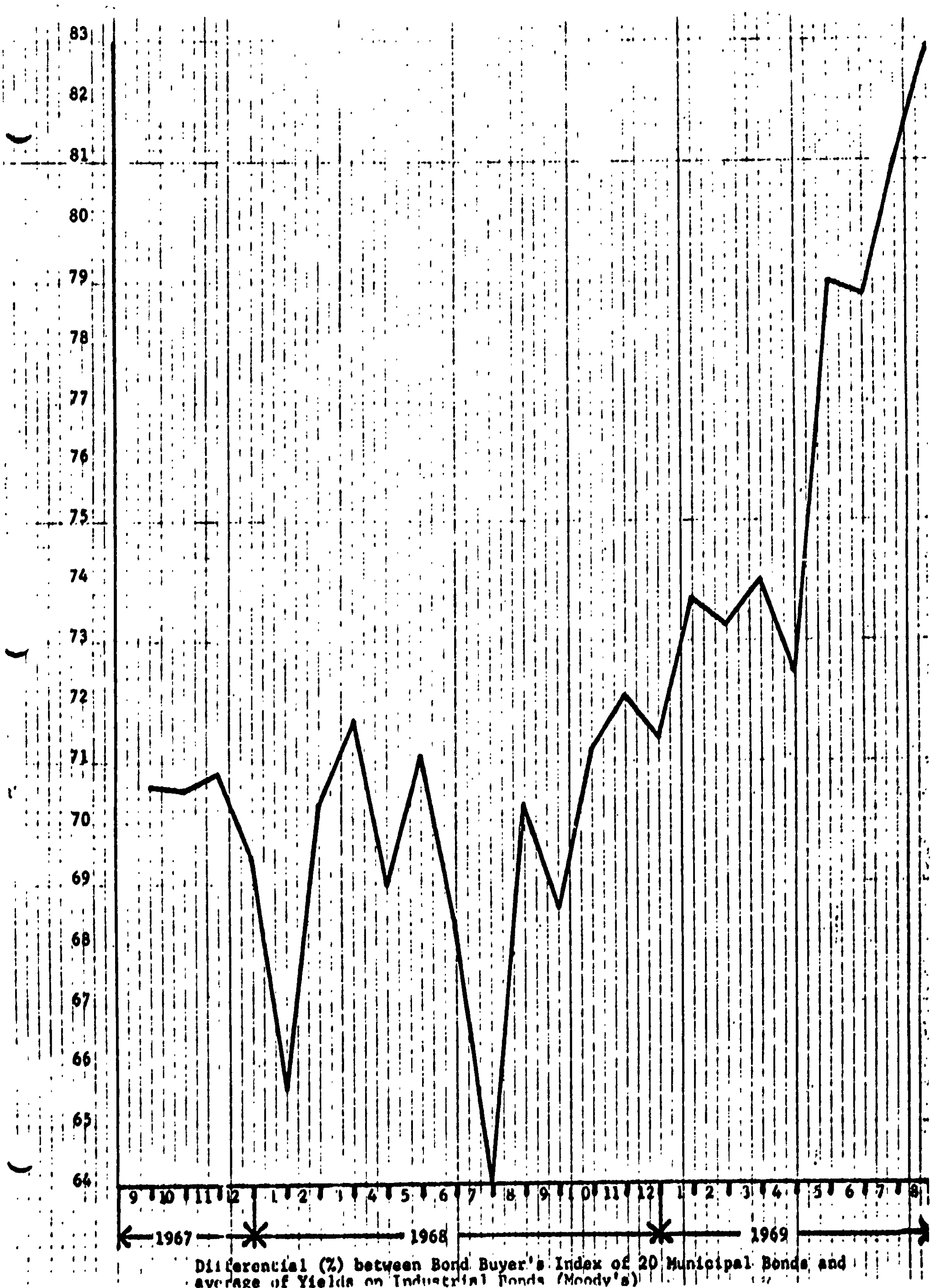
1967
1968
1969
A- Average of Yield's on Industrial Bonds (Moody's)
B- Yields of U.S. Government 20 year Bonds
C- Bond Buyer's Index of 20 Municipal Bonds



Differential (%) between Bond Buyer's Index of 20 Municipal Bonds and average of Yields on Industrial Bonds (Moody's)

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT ON 1970 ISSUES
DUE TO H. R. 13270
(MILLIONS)

State	(1) Issuances 1968 (Actual)	(2) Issuances 1970 (Projected)[1]	(3) Additional Interest Cost Due To Tax at 1% increment: First Year	(4) Additional Interest Cost Due To Tax at 1% increment: Life of Bond
Alabama	$ 299.0	$ 363.0	$ 3.6	$ 46.8
Alaska	69.0	86.0	.8	10.4
Arizona	90.0	109.0	1.1	14.3
Arkansas	36.0	44.0	.4	5.2
California	1,976.0	2,391.0	23.9	310.7
Colorado	72.0	87.0	.9	11.7
Connecticut	266.0	322.0	3.2	41.6
Delaware	61.0	74.0	.7	9.1
Florida	585.0	708.0	7.1	92.3
Georgia	221.0	267.0	2.7	35.1
Hawaii	90.0	109.0	1.1	14.3
Idaho	15.0	19.0	.2	2.6
Illinois	553.0	669.0	6.7	87.1
Indiana	216.0	262.0	2.6	33.8
Iowa	165.0	200.0	2.0	26.0
Kansas	108.0	131.0	1.3	16.9
Kentucky	367.0	444.0	4.4	57.2
Louisiana	531.0	642.0	6.4	83.2
Maine	64.0	77.0	.8	10.4
Maryland	512.0	619.0	6.2	80.6
Massachusetts	369.0	447.0	4.5	58.5
Michigan	694.0	839.0	8.4	109.2
Minnesota	299.0	362.0	3.6	46.8
Mississippi	141.0	171.0	1.7	22.1
Missouri	452.0	547.0	5.5	71.5
Montana	12.0	14.0	.1	1.3
Nebraska	372.0	450.0	4.5	58.5
Nevada	22.0	26.0	.3	3.9
New Hampshire	34.0	41.0	.4	5.2
New Jersey	472.0	571.0	5.7	74.1
New Mexico	50.0	61.0	.6	7.8
New York	2,197.0	2,659.0	26.6	345.8
North Carolina	223.0	270.0	2.7	35.1
North Dakota	9.0	11.0	.1	1.3
Ohio	700.0	847.0	8.5	110.5
Oklahoma	212.0	256.0	2.6	33.8
Oregon	219.0	265.0	2.6	33.8
Pennsylvania	1,187.0	1,437.0	14.4	187.2
Rhode Island	95.0	116.0	1.2	15.6
South Carolina	146.0	177.0	1.8	23.4
South Dakota	13.0	15.0	.1	1.3
Tennessee	212.0	256.0	2.6	33.8
Texas	775.0	938.0	9.4	122.2
Utah	22.0	26.0	.3	3.9
Vermont	54.0	65.0	.6	7.8
Virginia	202.0	244.0	2.4	31.2
Washington	320.0	387.0	3.9	50.7
West Virginia	52.0	63.0	.6	7.8
Wisconsin	237.0	287.0	2.9	37.7
Wyoming	37.0	45.0	.4	5.2
TOTALS	$16,125.0	$19,514.0	$ 195.1	$2,536.3

1. Assume 10% cumulative annual growth
2. Assume 13 year average life applicable to twenty year term with equal debt service

STATEMENT

of

William Summers Johnson
Director of Finance
City and County of Honolulu, Hawaii

to the

Committee on Finance
United States Senate

on the

Provisions of the Tax Reform Bill (H. R. 13270)
Affecting State and Local Government Bonds

Washington, D. C.
September 24, 1969

Mr. Chairman: My name is William Summers Johnson. I am Director of Finance of the City and County of Honolulu.

I appreciate the opportunity to testify on those features of the Tax Reform Bill which would affect the financing problems of the state and local governments. My statement is concerned with the problems of these governments generally, rather than the particular problems of Honolulu. Like other cities, Honolulu sells its bonds by competitive bidding in New York, and its interest costs are determined by the general level of interest rates on municipal bonds and the credit rating which the rating services assign to the city's bonds.

Much has been said about the growing financial problems of state and local governments, problems which are sometimes called a financial crisis. The demands upon these governments for public capital improvements have grown enormously over the post World War II years. In the 20 years prior to 1966, these governments had spent some $220 billion for capital outlays, about half of which had been financed by borrowing.1/ Between the end of 1950 and the end of last year, the net debts of the state and local governments increased more than five-fold, growing from about $22 billion to about $130 billion in 18 years.2/ In contrast, the net debt of the Federal Government has increased by only slightly more than one-third over this period.

Further, while the Federal budget has achieved a moderate surplus in the fiscal year just ended, the prospects are that the debt burden of state and local governments will grow at even larger increments in the years ahead. Enormous amounts of capital will be required to replace old and obsolete facilities and to expand facilities to provide for a growing population. And to meet these requirements, the public agencies will have to compete for funds against the rising demands for housing and other private needs.

Accordingly, it it hoped that the tax reform legislation as finally passed will not increase the borrowing costs of the state and local governments, or even leave the matter in doubt, but will help to reduce these borrowing costs.

It seems to me the House bill does leave this question in doubt. Thus, at a later point, I would like to suggest some modification of the bill which I believe will serve the three-fold purpose of (1) reducing borrowing costs of the state and local governments, (2) achieving the purpose of the legislation which is to make the tax system more equitable, and (3) avoiding some of the philosophical objections to the bill as it is now written.

1/ Joint Economic Committee, State and Local Public Facility Needs, Vol. 2, December 1966, p. 5.

2/ Appendix A.

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Role of Tax-Exempt Bonds

The fact that interest income from state and local government debt obligations is not subject to the Federal income taxation is of substantial benefit to these governments. It has meant that such obligations -- or what are called "municipals" -- could be issued at a lower interest cost than taxable bonds of the same maturity and credit rating -- a relationship which carries through to bonds resold in secondary markets.

For example, last December, before market rates were disturbed by this legislation, market yields on triple-A rated municipals were quoted at 4.50%. In contrast, corporate bonds of the same rating and U.S. Government bonds -- both taxable -- were quoted at yields of 6.45% and 5.65%, respectively.

The differential between interest rates on taxable bonds and non-taxable bonds of like maturity and credit rating at any particular time is a measure of the benefit of the tax exemption to the state and local governments. The greater the differential, the greater the benefit.

It is not, however, the supply of tax-exempt bonds that determines the level of interest rates on these bonds. On the contrary, between 80 and 90 per cent of all new credit instruments being issued are taxable, hence the taxable issues play the dominant role in determining bond rates. Rates on municipal bonds merely adjust to these rates, depending upon the marginal income tax rate of the bond investors.

To illustrate, an investor in the 50% tax bracket finds it advantageous to invest in tax-exempt bonds, rather than in taxable bonds, where the yield on tax-exempts exceeds 50 per cent of the yield on taxable bonds. Similarly, an investor in the 25 per cent tax bracket finds non-taxable bonds more advantageous than taxable bonds only when the yield on the municipals exceeds 75 per cent of the yield on taxable bonds -- a point at which the benefit to the state and local governments has greatly diminished and a bonanza has been created for investors in the higher tax brackets.

Changes in the ratio of the yields on the two types of bonds are influenced by several factors, including the supply of tax-exempt bonds outstanding relative to the supply of funds available in the hands of individuals, commercial banks and other institutions that invest in this type of bond.

Changes in effective tax rates are also quite influential in changing the benefits of the tax exemption, both to the investor and to the state and local governments. In the 1900's, there was little if any difference between the yields on taxable and non-taxable bonds because income tax rates were then so low that there was little advantage in investors' seeking tax-exempt income.

In contrast, passage of the surtax last year served to widen the spread between yields on non-taxable and taxable bonds. On the other hand, consideration of this legislation has had a dramatic opposite effect.

Taking a longer look at the trends over the post World War II years, however, it is evident that the benefit of the tax exemption to the state and local governments has substantially declined. A study prepared for the Joint Economic Committee in 1966 observed that "between 1946 and 1954 the municipal-corporate yield ratio jumped from 40 per cent to 80 per cent and then receded to around 75 per cent, where it has remained since." 3/

The question whether there has been a general tendency for the ratio to decline since 1965 is debatable. There is no precise statistical measure of this subject and the generalized measures have been clouded by several changes in effective tax rates and by two severe cycles in monetary policy which varied the investment capacity of the commercial banks. 4/

Growing Shortage of Funds for Municipal Financing

There have been some dramatic shifts in the flows of institutional funds over the post World War II years which have doubtless influenced the earlier decline in the benefits of the tax exemptions and seem to portend further difficulties for the state and local governments in the future.

While state and local government borrowing has rapidly increased, the great growth of investment funds has taken place in institutions which, because of their special tax status or the nature of their business, find it impractical to invest in tax-exempt bonds. These include the government pension funds -- state and local as well as Federal -- the private pension funds, the life insurance companies, savings and loan associations, mutual funds and the non-financial corporations.

As of the end of last year, only one of these groups had as much as three per cent of its total financial assets in municipal bonds. These were the state and local governments, presumably those who invested their employees' retirement funds in their own bonds only because they were unable to market the bonds elsewhere. 5/

Among institutional investors, only the commercial banks and the non-life insurance companies are significant investors in tax-exempt securities. The total financial assets of these two groups combined increased by slightly more than 200 per cent between 1947 and 1967, and amounted to $439 billion at the end of the latter year. 6/

More than this, individual investors have added little to their holdings of municipal bonds in recent years. Indeed, this market would

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3/ Op. Cit., State and Local Public Facility Needs and Financing, p. 12.

4/ Appendix C.

5/ Appendix B.

6/ Appendix D.

appear to have become pretty much saturated. Individual investors held some $40.6 billion of municipals at the end of 1966, increased their holdings by only $0.2 billion during 1967, and, according to preliminary data, actually reduced their holdings by $0.7 billion last year. 7/

Commercial banks, on the other hand, have become the predominant investors in municipal bonds. Last year they increased their holdings in these instruments by $8.1 billion and at the end of the year, held nearly half of all such bonds outstanding. According to preliminary data, state and local government debt obligations outstanding at the end of last year were held as follows:

	($ Billions)
	124.9
Commercial Banks	58.1
Individuals	40.1
Non-Life Insurance Companies	16.4
All Others	10.3

No doubt many commercial banks have invested in municipal bonds when it was not particularly profitable for them to do so -- in order to advance construction projects in their local communities. However, such heavy reliance on commercial banks as a market for municipal bonds poses some dangers, not the least of which is that this market may become saturated too. Commercial banks are subject to a variety of laws and regulations which limit their investments in particular types of securities, and their investment funds have not been growing as fast as those of other financial institutions.

Provisions of the Tax Reform Bill Affecting Municipal Finance

Against this background of the problems of the state and local governments, the provisions of the House bill affecting municipal finances will, I think, be better appraised.

In an effort to make the tax system more equitable, the drafters of the House bill have included several provisions which would make investment in state and local government bonds less attractive, particularly to high income individuals. The effect would be to raise interest costs on future issues of these bonds, relative to the cost of issuing fully taxable bonds.

As an offset, however, the bill provides for a new type of state and local government debt instrument which seems intended to assure that the borrowing costs of these governments will not be higher, relative to other borrowing costs, than in past years.

7/ Appendix E.

Coming first to those provisions of the bill which would tend to raise municipal borrowing costs, these are in the main four.

1. Limitations on Deductions of Interest (Sec. 221)

This limits the amount of the deduction which an individual may take for interest paid on funds borrowed to invest in or carry investment assets. An individual would be allowed to deduct such interest payments, on a current basis, only to the extent that the deduction does not exceed his investment income and long-term capital gains by $25,000 ($12,500 in the case of a married individual filing a separate return).

This will limit the advantages that high-income individuals can now enjoy by borrowing funds at a low interest rate, net of the tax deduction, and investing the funds in municipal bonds to receive a tax-free income.

2. Increase in Standard Deduction (Sec. 801) and Maximum Tax On Earned Income (Sec. 802)

The effect of these two sections is to reduce the tax rate on top income individuals and to reduce effective tax rates on individuals in all income groups.

Other things being equal, the effect will also be to raise municipal borrowing costs relative to other borrowing costs. As effective tax rates are reduced, taxpayers find investment in bonds yielding a tax-free income less advantageous.

3. Limit on Tax Preferences (Sec. 301)

This section defines tax preference income as tax-free interest from state and local government bonds, plus several other types of income now taxed at preferential rates or against which preferential deductions may be taken.

Under the bill, an individual will be allowed to claim the exclusions and deductions comprising tax preference income only to the extent that the aggregate of such income does not exceed 50 per cent of his total income (adjusted gross income plus tax preference items).

The excess over 50 per cent will be taxable at the individual's normal tax rate.

However, if the individual's aggregate tax preference income does not exceed $10,000, the rule does not apply. Further, the bill provides a formula for bringing interest income from municipal bonds under the formula only gradually. In the first year, one-tenth of such income is to come under the limit; in the second year, two-tenths; and so on until all such income comes under the limit ten years later.

4. Capital Gains and Losses on Bonds Held by Financial Institutions (Sec. 443)

Under present law, commercial banks and certain other types of financial institutions are taxed on their capital gains on bond transactions, like other taxpayers, at the capital gains rate. But unlike other taxpayers, however, these institutions are permitted to treat the excess of their capital losses over their capital gains on such transactions as ordinary losses, deductible from ordinary income.

Under the bill, the excess of gains over losses would be treated as ordinary income, taxable at ordinary income tax rates, and the excess of losses over gains would be deductible from ordinary income.

The principal investors in municipal bonds, the commercial banks, will find these bonds less attractive under the bill. In the past, it has been a general practice of commercial banks to increase their holdings of municipal bonds -- and other securities -- in periods of easy money, then sell these securities in periods of credit stringency, frequently at a capital loss, in order to raise funds to meet their loan demands.

However, this provision of the bill will not place municipal bonds at a disadvantage to other securities. All debt instruments are treated alike.

Furthermore, the commercial banks should find that the tax-exempt interest income available from these bonds will continue to make them quite attractive investments. Commercial banks on a whole have recently been in the 48% marginal tax bracket, and are now thought to be in an even higher bracket. To a firm in the 48 per cent tax bracket, an interest yield of 6.5% on a municipal bond is equivalent to a yield of nearly 12.4% on a taxable security.

The Cost-Sharing Municipal Bond (Sections 601 and 602)

The provisions of the House bill just discussed would, taken alone, have a substantial effect on the borrowing costs of the state and local governments. The effect would be to raise these costs, relative to other borrowing costs.

As an offset, however, the House bill authorizes a new type of debt instrument which the state and local governments may issue at their option. The interest income from this bond would be fully taxable, and would thus require higher interest rates, but the Federal Treasury would directly share the interest costs.

The proposed new bond thus takes advantage of the fact that the tax exempt feature of state and local government bonds is an inefficient means of aiding these governments. That is to say, the tax exemption involves a revenue loss to the Treasury, as compared to taxable bonds, which is much greater than the benefits derived by the state and local governments.

In its general form, the proposed new bonds contains some very attractive features. First, its use is optional on the part of the state or local government, and the governmental unit that issues it does so without giving up its right to issue also the traditional municipal bond.

Second, since the bond is taxable, it will sell at interest yields comparable to other bonds and will thus give the state and local governments access to the investment funds held by institutions that do not now invest in municipal bonds.

Finally, this bond would be marked in the usual way, utilizing the already-existing machinery of private financial services.

However, the formula for the Treasury's sharing in the state and local governments' interest cost is deficient -- and needlessly so.

The report of the Ways and Means Committee accompanying its bill states that --

> Historically, the ratio of yields on tax-exempt issues and taxable issues has been as low as 60 per cent, but in recent years has been close to 75 per cent. 8/

Then, for reasons that are not clear, the bill provides a range of direct payments to the issuer, the range being 30% to 40% of the interest cost of bonds issued within the first five years, and from 25% to 40% thereafter. Furthermore, the bill gives the Secretary of the Treasury discretion to set the exact percentage within these ranges at the beginning of each quarter of the year.

Add up the uncertainties which the bill poses for municipal finance, and it is easy to see why there has been a certain lack of enthusiasm for these features of the bill.

Giving the Secretary of the Treasury discretion to set the sharing formula within a range is puzzling and suggests

1. That the Secretary is expected to try to equate cost to the issuers of the new taxable municipals with those of ordinary municipals, or

2. That the Secretary is expected to shift the cost advantage one way or the other for the convenience of the Treasury, or

3. That the Secretary might use his flexibility for general economic regulation, reducing the subsidy at times when the Administration wishes to dampen demands on credit markets and the construction industry and increasing the subsidy at other times.

None of these purposes seems desirable. Certainly the purpose should not be to maintain any particular relationship between the supply of the new

8/ House Report No. 91-413 (Part I) p. 72.

taxable municipals and the ordinary municipals; the purpose should be to increase the supply of the new taxable bonds and thus diminish the tax revenue losses flowing from the ordinary municipals. Nor is it comforting to think that the financing ability of the state and local governments may be modified either for the convenience of the Treasury or for general economic regulations.

Costs and Benefits of Tax Exemption

A study made for the Brookings Institution in 1963 developed some advanced techniques for estimating the benefit of the tax exemption to the state and local governments and the revenue loss to the Treasury.

This study concluded that the benefit to the state and local governments amounted to an interest rate savings of between 133 and 186 basis points below the contemporary rate on comparable corporate bonds. A group of experts who reviewed the study reached a conclusion that the more exact differential is 150 basis points. 9/

Further, in 1966, the Treasury updated this study on the basis of the 1965 experience, with these calculations:

1. At the minimum differential of 133 basis points, the benefit of the tax exemption to the state and local governments would amount to $1.9 in savings in interest costs over the life of the bonds, and the Treasury's revenue loss would amount to $2.9 billion.

2. At the maximum differential of 186 basis points, the benefit to the state and local governments would amount to $2.6 billion, and the Treasury's revenue loss would amount to $3.2 billion.10/

In other words, if the municipal bonds issued in 1965 had not been tax-exempt, each dollar of increased cost to the state and local governments would have resulted in increased revenues to the Treasury of between $1.23 and $1.52. At the concensus differential -- 150 basis points -- each $1 of benefit to the state and local governments costs the Treasury $1.42 in lost revenues.

This suggests that the state and local governments could be given the option of issuing fully taxable bonds on which the Treasury would pay 42 per cent of the interest cost, with no net cost to the Treasury omitting any additional administrative costs.

9/ Op. Cit., State and Local Public Facility Needs, Note 7.

10/ Ibid, p. 332.

Taxing Municipal Bonds Unnecessarily

This leads me to suggest the interest-cost sharing formula be modified in two respects. First, that it be made definite and that it provide for gradually increasing cost sharing.

Thus, it would seem appropriate to set the first year rate at 30%, and provide for an increase of one percentage point each year, until the 40% level is reached 10 years hence.

This would accomplish the equity purposes of the limited tax preference provision (LTP), not by taxing the tax-exempt bonds, but by causing them to largely disappear. And at the same time, this formula would be of more certain benefit to the state and local governments.

Additionally, it would bring about an orderly shift from non-taxable to taxable municipals outstanding without serious capital losses. In view of the certain rise in the Treasury payments, an investor would tend to shift out of the old municipals and their yields would tend to rise relative to taxable bonds. Accordingly, the state and local government would find it advantageous to refund by the new taxable bond, thus reducing the supply of the non-taxables as these become less desirable to investors.

Finally, this method of accomplishing the purposes would avoid the objections, hotly held, to the indirect tax on state and local government bonds or set out in the LTP provisions.

Mr. Chairman, as one of many municipal finance officers who are being sorely pressed by the recent rise in interest rates on state and local government bonds, may I say that it is most important that the issues involved in the municipal finance features of this legislation be resolved -- one way or another -- as soon as possible.

Thank you.

APPENDIX A

NET PUBLIC AND PRIVATE DEBT IN THE U. S.

END OF YEAR	FEDERAL GOVERNMENT AND AGENCY	STATE AND LOCAL GOVERNMENTS	PRIVATE	TOTAL
		(Billions of Dollars)		
1950	217.4	21.7	246.3	485.4
1955	229.6	40.2	391.6	661.4
1960	239.8	63.0	565.7	868.5
1965	266.4	99.9	868.6	1234.9
1968*	292.5	129.5	1103.8	1525.8
		PERCENTAGE OF 1950		
1950	100.0	100.0	100.0	100.0
1955	105.6	185.3	159.0	136.2
1960	110.3	290.3	229.7	178.9
1965	122.5	460.4	352.7	254.4
1968*	134.5	596.8	448.2	314.3

*Preliminary

Source: Economic Report of the President, January 1969, p. 296.

APPENDIX B

HIGH GRADE MUNICIPAL AND CORPORATE

BOND YIELDS

SELECTED DATES

YEARLY AVERAGE	STATE AND LOCAL GOVERNMENTS (Aaa)	CORPORATES (Aaa)	
1945	1.07	2.62	40.8
1955	2.18	3.06	71.2
1963	3.06	4.26	71.8
1964	3.09	4.40	70.2
1965	3.16	4.49	70.3
1966	3.67	5.13	71.5
1967	3.74	5.51	67.9
1968	4.20	6.18	68.0
MONTHLY AVERAGE 1969			
Jan.	4.58	6.59	69.5
April	5.00	6.89	72.6
July	5.60	7.08	79.1

SOURCE: Moody's, as reported in Federal Reserve Bulletins to July, 1969.

APPENDIX C

ALL FINANCIAL ASSETS AND
STATE AND LOCAL GOVERNMENT OBLIGATIONS
HELD BY INSTITUTIONAL INVESTORS
December 31, 1968
($ Billions)

	(1) All Financial Assets	(2) State and Local Government Obligations	Column 2 as % of Column 1
Buyers of Tax Exempts - Total	486.9	74.5	15.3
Commercial Banks	438.8	58.1	13.2
Non-Life Insurance Companies	48.1	16.4	34.1
Non-Financial Corporations	352.3	2.9	0.8
Non-Buyers of Tax Exempts - Total	1388.1	6.9	0.5
U.S. Government	189.6	----	----
State and Local Governments	113.9	3.6	3.2
Life Insurance Companies	182.4	3.0	1.6
Savings and Loan Associations	152.8	----	----
Private Pension Funds	94.7	----	----
Mutual Savings Banks	71.2	.2	0.3
Finance Companies	50.7	----	----
Investment Companies	47.3	----	----
Credit Unions	12.3	----	----
Rest of World*	120.9	.1	0.1
Memorandum			
Households	1713.5	40.1	2.3

* Foreign persons, international agencies, agencies of foreign banks and U.S. Banks in possessions.

SOURCE: Federal Reserve Board, Federal Reserve Bulletin, May 1968, p. A-67.10 et seq. and May 1969, p. A-68, et seq.

APPENDIX D

FINANCIAL ASSETS HELD BY INSTITUTIONS

1947, 1957, and 1967

($ Billions)

	1947	1957	1967	1967 as % of 1947
Buyers of Tax-Exempts - Total	145.6	219.1	438.9	301.4
Commercial Banks	136.8	197.0	393.9	287.9
Non-Life Insurance Companies	8.8	22.1	45.0	511.4
Non-Buyers of Tax-Exempts - Total	303.6	608.0	1,277.4	420.8
Non-Financial Corporations	83.5	169.3	322.7	386.5
/1 U.S. Government	80.9	110.3	171.3	211.7
State and Local Governments	17.6	40.1	100.7	572.2
Life Insurance Companies	50.9	98.3	173.0	339.9
Savings and Loan Associations	11.7	48.1	143.8	1,229.1
Mutual Savings Banks	19.7	35.2	66.4	337.1
Credit Unions	.5	3.4	11.2	2,240.0
Private Pension Plans	3.1	22.4	86.9	2,803.2
Finance Companies	5.1	19.6	46.6	913.7
/2 Mutual Funds	1.4	8.7	44.7	3,192.9
/3 Other	27.4	52.6	110.1	401.8

/1 Includes "monetary authorities"

/2 Open-end investment companies only

/3 Includes foreign and international agency holders of obligations of U.S. persons and governments, plus brokers and dealers in securities and agencies of foreign banks

SOURCE: Federal Reserve System, Flow of Funds Accounts 1945-1967, February, 1968.

APPENDIX E

HOLDINGS OF STATE AND LOCAL GOVERNMENT OBLIGATIONS

BY INDIVIDUALS AND INSTITUTIONS

END OF SELECTED YEARS - 19[illegible]-68

($ Billions)

	1945	1950	1955	1960	1965	1966	1967	1968
TOTAL	15.5	24.7	44.8	68.7	100.0	105.9	117.5	124.9
Individuals	7.2	9.6	18.6	28.7	37.2	40.6	40.8	40.1
Commercial Banks	4.1	8.1	12.7	17.6	38.5	40.2	50.0	58.1
Non-Life Insurance Companies	0.2	1.1	4.2	8.1	11.4	12.1	13.7	16.4
Non-Financial Corporations	0.3	0.5	1.2	2.4	3.6	4.4	5.1	2.9
State and Local Governments	2.6	3.6	5.1	7.2	5.0	4.6	4.1	3.6
Life Insurance Companies	0.7	1.2	2.0	3.6	3.5	3.1	3.0	3.0
Mutual Savings Banks	0.1	0.1	0.6	0.7	0.3	0.3	0.2	0.2
Finance N.E.C.	0.3	0.4	0.3	0.4	0.5	0.6	0.6	0.6

SOURCE: Federal Reserve System, Flow of Funds Accounts 1945-67, and Bulletin, May 1969.

THE COUNCIL OF STATE GOVERNMENTS
WASHINGTON OFFICE
1735 DeSales Street, N. W., Washington, D. C. 20036 • (202) 737-9717

Statement of

Senator Elmer O. Friday

State of Florida

on

H. R. 13270

The Tax Reform Act of 1969

Before The

Committee on Finance
United States Senate

September 24, 1969

HEADQUARTERS: IRON WORKS PIKE, LEXINGTON, KENTUCKY 40505

Mr. Chairman, Members of the Senate Finance Committee: I am Elmer O. Friday, State Senator from Florida.

I welcome the opportunity to come before you this morning to speak, as Vice-Chairman of the Council of State Governments, on recommendations and criticism as they relate to the state and municipal bond section of the "Tax Reform Act of 1969", (H. R. 13270). The Council is a joint agency of the fifty states established for the improvement of inter-state relations, federal-state relations and the state executive, legislative and judicial functions.

The Council is opposed to the provisions of the bill which drastically alter the tax treatment of municipal bonds. This alteration is wrong in concept and goes far beyond any stated need to attain tax equality. The structure of the bond market has already been disrupted by economic factors and your contemplated action, and it may be many years before it again settles down regardless of the acts taken by this committee and the United States Senate as a whole.

On July 30th of this year the Wall Street Journal commented that this was the worst single day in the market's history as far as tax exempt bonds were concerned.

The communities of Florida, and the other 49 states, are in a time of real financial crisis, and increasing bond interest rates poses a serious threat to the fiscal ability to fulfill the needs of the people by our state and local governments. The course of municipal bond interest rates this year supports this opinion.

This congress and the agencies of this body have, over the past years, come to a growing awareness of the condition of the health and economy of this nation by pollution of its air and water. You, and the people of this nation, are determined to wage war on this implacable foe of society, which

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spawns it. In Florida, as in the other states, the bulk of this danger springs from the dumping of raw sewage into our waters by our cities and towns!! You, at the federal level, and we at the state level, have pointed to these matters and said "Clean it up!" Now you would take away the only financing available to them. Gentlemen, our citizens should, and would, rise up in anger and despair. It is reliably estimated that 60% or more of the pollution in Florida's waters is done by the cities and communities of that state, and I am advised through my associates in the Council of State Governments and the National Legislative Conference that this same condition prevails in most other states of the nation. You have done much. But you have also, and rightly so, pointed to the responsibility of the state and local governments in this field.

I would now like to address my remarks to you regarding the effects a bill such as H. R. 13270 would have on the state of Florida. Let me hasten to add, however, that its adverse repercussions would be similar for all state and local governments, and only the dollar figures for the affected governmental services would vary. If any new means of taxation affecting these securities is enacted, municipal bond interest rates will rise very significantly. This will impair the ability of states to borrow money. It will add to the now overburdened tax-payers responsibility. You and I know full well that it takes one and one-half to two dollars sent to Washington to get one dollar back. I believe the states would have to do one of three things to accommodate: 1. Reduce the financing by bonds, but increase taxes to furnish current financing and service; 2. Pay the increased interest costs, thus greatly increasing the state debt and cost to tax-payers; or 3. Reduce needed and necessary services to the people.

Florida would have been deprived of such projects as the 9 million dollars of bonding for the medical school at the University of South Florida... under

the present system the bonding of this project barely squeaked through. It would not have been possible to attain the Fort Pierce 5 million dollar water and sewer project, the 13 million dollar Dade County school bond issue and the 19 million dollar Hillsborough County bond issue. It would have placed in serious jeopardy the St. Lucie County Beach Erosion Project and it would place the 90 million dollar City of Jacksonville sewer project in a nearly impossible category.

The interest subsidy will be expensive to administer and could be used to coerce local governmental units to turn even more to Washington. If the rate of subsidy is high, local governments will be forced to abandon the present system entirely. Bonds, Mr. Chairman, are one of our most effective capital outlay sources and we should not damage them. During this past year we have seen federal cut-off of programmed funds to the states -- federal highway systems, and the present cut-back by this administration. Who is to say that this new subsidy would not be wiped out by Executive Order?

Let me illustrate the effects of taxation on Florida. In 1968 we issued 585 million dollars worth of bonds with an average interest rate of 4 1/2 percent and an annual debt service of 4.5 million dollars, with an average maturity period of twenty years. Had there been a tax on municipal bond interest, the rates might have been as high as 6 1/2 percent. This means we would have had to reduce our issuance by approximately 15 percent ... or to put it another way, about 78 million dollars worth of projects would not have been built. To retire the 1968 debt of 585 million dollars will require 900 million dollars in principal and interest payments ... the same debt at 6 1/2 percent interest, principal and interest payments would be 1.06 billion dollars over the life of the bonds, costing the taxpayers an additional 106 million dollars. The other alternative would be to cut back on much needed projects and services or to raise taxes. I am opposed to any further tax burden being placed on the people.

An analysis requested by your committee's staff and prepared by the staff of the House-Senate Committee on Internal Revenue Taxation points that this section of the bill "opens the way to complete repeal of the state and local tax exemption."

After House passage of this measure the municipal bond buyer's index soared to a historical high of 6.02 percent, rising 11 points over the previous week. It has now climbed to 6.20 percent.

Reflecting the apathy and uncertainty of the market, the placement ratio dropped to 60.9 percent.

Since early July when the House opened hearings in the Ways and Means Committee, new issues of local government "AA" rated bonds have risen by about 70 points, while yields on similar corporate taxable bonds have risen only 5 points.

I think, Members of this committee, it is quite clear that none of these proposals are acceptable to the states. We cannot pay the higher taxes if interest is taxed. It is difficult to finance needed projects from current taxes. Most assuredly, we cannot cut back on necessary services to the people. These services must be provided and they must be financed by bonds at reasonable rates if the states are to be full partners in our federal system.

In an effort to get at a handful of taxpayers who invest heavily in tax-exempt bonds and thus pay little or no tax, you would have damaged the ability of local governments to finance their growing needs without seeking help from Washington.

Mr. Chairman, Members of the committee, I greatly appreciate your affording me the opportunity to be heard.

NATIONAL INSTITUTE OF MUNICIPAL LAW OFFICERS
839 - 17th Street, N.W.
Washington, D.C. 20006

Statement of Thomas M. O'Connor in Opposition to H.R. 13270, Before the Senate Finance Committee, September 24, 1969

SUMMARY

My name is Thomas M. O'Connor, City Attorney of San Francisco and President of the National Institute of Municipal Law Officers (NIMLO).

I have filed a statement on behalf of our association with the Committee and I ask that it be made a part of the record. Within the time alloted to me, I will summarize the points made in that statement.

The National Institute of Municipal Law Officers composed of 1340 cities acting through their chief legal officer hereby reaffirm their 1965 Resolution petitioning the Congress of the United States to "reject all measures allowing direct or indirect taxation of municipal bonds."

We submit that H.R. 13270 must be rejected for the following reasons

(1) The Bill is unconstitutional because it violates the constitutional doctrine of intergovernmental immunity enunciated in McCulloch v. Maryland. A specific application of this doctrine resulted in a recognition in Pollock v. Farmers' Loan & Trust Co. of the immunity of the interest of state and municipal bonds from federal income taxation.

(a) The Pollock decision rests on the constitutional repugnance to any attempt by one level of government to interfere with another level of government's exercise

of its sovereign power.

(b) The power to borrow is an essential power of government and any attempt to impose a clog on this power is unconstitutional.

(2) The Supreme Court has never retreated from the Pollock decision.

(a) Hale v. Iowa State Board (1937), by Cardozo, J.

"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."

(b) Helvering v. Gerhardt (1938), by Stone, J.

In Helvering v. Gerhardt, 304 U.S. 405, 417 (1938), the Court said that State immunity has been sustained 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 & T. Co. ***)."

(c) James v. Dravo Contracting Co. (1937), by Hughes, J.

"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 obligation as a continuing security. Vital considerations are there involved, respecting the permanent relations of the government to investors in its securites and its ability to maintain its credit ***."

(d) First Agr. Nat. Bank v. State Tax Commission (1938), by Black, J.

reapplied the principle of McCulloch underlying Pollock.

(3) Adoption of the Sixteenth Amendment did not have any impact on the Pollock decision holding municipal bonds tax exempt.

(a) The legislative history of the Amendment discloses that Congress had no intention to change the Pollock rule on municipal bond exemption.

(b) The Supreme Court's interpretations of the Sixteenth Amendment demonstrate that it did not grant the federal government the power to tax municipal bonds.

(1) <u>Brushaber</u> v. <u>Union Pacific Pacific Railroad Company</u>

(2) <u>Stanton</u> v. <u>Baltic Mining Co.</u>

(3) <u>Peck and Company</u> v. <u>Lowe</u>

(4) <u>Eisner</u> v. <u>Macomber</u>

(4) <u>United States</u> v. <u>Atlas Life Insurance Co.</u>, contrary to statement made to this Committee by the Treasury, does not support the constitutionality of the allocation of personal deductions provision of H.R. 13270.

(1) <u>Atlas</u> involved only the taxation of insurance companies which are recognized to be unique; it did not involve individuals.

(2) <u>Atlas</u> involved an allocation of income; it did not involve an allocation of deductions by individuals.

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Statement of Thomas M. O'Connor in Opposition to H.R. 13270, Before the Senate Finance Committee, September 24, 1969

My name is Thomas M. O'Connor. I am the City Attorney of the City of San Francisco, California, and President of the National Institute of Municipal Law Officers.

I appear here today to oppose the unconstitutional proposal to impose a federal tax on the income derived from state and municipal bonds.

The National Institute of Municipal Law Officers is an association of 1,340 of the largest cities located in all the states, acting through the heads of their legal departments, the city attorney. These city attorneys and their more than 5,000 assistants participate actively in our organization's work. In Washington, D.C. we maintain a national headquarters, which we utilize as a clearing house for municipal legal information and from which we send out publications on current developments in the field of municipal law. We also carry out extensive research in this field. Our primary reason for existence is to keep attorneys for cities informed of what other cities have done, are doing, and plan to do, in the legal field, so as to increase the information resources of our member municipalities manyfold. All of our services are supported entirely by appropriations from the tax funds of cities.

In 1965, the National Institute of Municipal Law Officers resolved as follows:

URGING RECIPROCITY OF TAX IMMUNITY BETWEEN FEDERAL AND MUNICIPAL BONDS AND SECURITIES
(Adopted at Annual Conference October 14, 1965)

WHEREAS, the exemption of municipal bond interest from federal income taxation is critically important in enabling the cities to discharge their mounting burden of responsibility at the lowest cost, and

WHEREAS, suggestion has been made that indirect federal taxation of municipal bond interest be sanctioned by disallowance of a prorated portion of otherwise allowable expense deductions of investors who receive part of their income from municipal bond interest, and

WHEREAS, by Revised Statutes (Section 3701) Congress has expressly prohibited such indirect taxation of federal bond interest by the states and cities, and

WHEREAS, the exemption of public securities - federal obligations from state and local taxes and state and local obligations from federal taxes - has traditionally been and of right ought to be reciprocal,

NOW, THEREFORE BE IT RESOLVED by the National Institute of Municipal Law Officers that the Congress of the United States is urgently petitioned to reject all measures allowing direct or indirect taxation of municipal bonds.

We submit that both the minimum tax and allocation of deduction proposals impose an unconstitutional tax upon political subdivisions of the states. No matter how explained and no matter how clothed in bureaucratic double talk, the legal effect of these proposals is crystal clear. Both proposals clearly violate the Constitution of the United States by violating the constitutional doctrine of intergovernmental immunity.

Furthermore, I submit that no time could be more untimely for the Federal government to attempt to impose such a new and devastating financial burden upon city taxpayers. As it is city tax rates are enormously high. This Bill would cause them to skyrocket. Every Senator who votes for this Bill will be voting to

increase city tax rates in nearly every city of his state. The economic experts have estimated that a rise of $300,000,000 in the borrowing costs to state and local governments over the past four months is traceable to the mere threat that the Senate would enact the proposals taxing municipal bond interest which were passed by the House. However, I will not dwell upon the crippling economic impact which H.R. 13270 would have on local governments since it is my understanding that evidence showing the direct economic burden of the proposals will be presented to this Committee by other witnesses. My remarks will be limited to a demonstration that the proposals violate the basic constitutional principles underlying our dual sovereignty form of government.

In considering any legal or constitutional issue it is essential that it be studied in historical perspective. I therefore start with the founding of our Nation and the principles agreed upon and written into our great constitutional charter as they are so clearly stated by Chief Justice Marshall in the famous case of McCulloch v. Maryland, 4 Wheat. 316 (1819). There, during the very infancy of our Country, the basis for the doctrine of reciprocal sovereign immunity was enunciated in clear and unmistakable language as the keystone for our federal system of government. This doctrine has stood as a rock of Gibraltar against the interference, through taxation, by one level of government with the exercise of essential sovereign powers by another level of government. Indeed, just last year the Supreme Court reapplied the doctrine of the McCulloch decision when it struck down an attempt by the state of Massachusetts to impose a sales and use tax on a national bank in First Nat. Agr. Bank v. State Tax Commission, 88 Sup. Ct. 2173 (1968).

With this reference to the McCulloch case, we come now to the famous Pollock case, 158 U.S. 601 (1895). In Pollock, a specific application of the constitutional doctrine of intergovernmental immunity resulted in a recognition of the immunity of the interest on local government bonds from Federal income taxation. The Supreme Court has never retreated from this position.

The Pollock case involved three issues: -- (a) the power of the Federal Government to levy an income tax without apportionment on income from the source of professions or businesses, (b) the power of the Federal Government to levy an income tax without apportionment on income from the source of real or personal property, and (c) the power of the Federal Government to levy an income tax on the interest on state and local obligations. The first two questions involved interpretation of Article 1, section 2, clause 3 of the Constitution, which provides that direct taxes shall be apportioned among the several States according to population. It was finally decided that apportionment was necessary for a tax on income derived from the source of real and personal property, but not on income from the source of businesses and professions. This part of the decision led to the adoption of the Sixteenth Amendment permitting a non-apportioned income tax.

The third question, involving the Federal power to tax State and municipal obligations, however, did not concern the manner of levying the tax; it involved no determination as to whether the tax was direct or indirect, from what source it was derived, and whether apportionment was necessary. In the case of a tax on State and municipal obligations, the question was one of power or absence of power to levy the tax at all, whether with or without

apportionment. On this third point, the Chief Justice said:

> "We have unanimously held in this case that so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the states, and on their instrumentalities to borrow money and consequently repugnant to the Constitution."

The Supreme Court has often been confronted with proposed extensions of the basic doctrine of reciprocal immunity of State and Federal Governments from taxation, each by the other. Some of these extensions it has sanctioned. Some it has rejected. But the Court has never once wavered from the simple proposition that the Federal Government lacks the power to impose a tax upon State and municipal obligations.

The reasoning of all the Justices on this point in the Pollock case was well expressed by Mr. Justice Cardozo for the Court 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."

Similarly, Mr. Justice Stone, in Helvering v. Gerhardt, 304 U.S. 405, 417 (1938), said that State immunity has been sustained 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 & T. Co. ***)."

It will be seen, therefore, that the decision in the Pollock case on this point rested upon the conclusion of the Court that a tax on State and municipal bond interest threatens a destructive burden on the exercise of the borrowing power of the States and their agencies. This was a conclusion of fact. The Court took judicial notice of what appeared to it an undeniable fact.

Throughout the three-quarters of a century during which the Pollock doctrine has remained in force and been relied upon by State and local governments and investors in their securities, this factual basis of the Court's opinion was never questioned -- it was considered unquestionable.

In James v. Dravo Contracting Co., 302 U.S. 134, 153, the Court reasserted the Pollock rule in the following words:

> "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 obligation 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 ***."

Adoption of the Sixteenth Amendment had no impact on the portion of the Pollock decision which held that the interest on State and municipal bonds was immune from federal taxation. This conclusion is supported by both the legislative history of the Amendment and the case law interpreting it.

To allay the fears of those who believed that adoption of the Sixteenth Amendment would permit the federal government to impose a tax on the interest of State and local government bonds, Senator Borah of Idaho made the following statement on the floor of the United States Senate on February 10, 1910:

> "The amendment did not deal, does not purport to deal and was not intended to deal with the question of power . . . to construe the proposed amendment so as to enable us to tax the instrumentalities of the state would do violence to the rules laid down by the Supreme Court for a hundred years, wrench the whole Constitution from its harmonious proportions and destroy the object and purpose for which the whole instrument was framed." 45 Cong. Rec. 1698.

On February 23, 1910, Senator Brown, the sponsor of the Senate Joint Resolution which eventually became the Sixteenth Amendment, stated:

> ". . . the proposed amendment will not authorize any additional burden on the several states in the exercise of their sovereign rights guaranteed by the Constitution as it exists today."

And to evidence his desire to overcome only the part of the Pollock decision which dealt with apportionment, he repeated:

> "The proposed amendment has a single purpose and that is to confer on Congress the undoubted power to tax incomes directly without regard to apportionment."

Later, even more pointedly, he said:

> "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. Nor can the State lay its taxing finger on Federal bonds or Federal agencies. Each is beyond the reach of the other as far as taxation is concerned. The proposed amendment in no sense seeks nor can it reasonably be argued to suggest any change in the independent or sovereign rights of either sovereignty as enjoyed and defined by the courts ever since the Government was organized." 45 Cong. Rec. 2245-2247.

Shortly afterwards Senator Elihu Root of New York stated that:

> "The objection made to the amendment is that this will confer upon the National Government the power to tax incomes derived from bonds issued by the states or under the authority of the States and will place the borrowing capacity of the State and its governmental agencies at the mercy of the Federal taxing power. I do not find in the amendment any such meaning or effect." 45 Cong. Rec. 2539.

What clearer expositions of the true sense of the Sixteenth Amendment could be desired? Particularly significant, moreover, is the fact that in the entire Congressional consideration and debates there is not the slightest suggestion of a contrary opinion. The judgment of the contemporaries of that day could not

have been more overwhelmingly convincing as to the application of the Sixteenth Amendment.

Good faith with the states clearly dictates that since the states ratified the Amendment to aid the Federal government in financing itself on such a clearly expressed understanding, the Federal government should not now attempt to violate the understanding. The nearly sixty years which have elapsed have not eradicated the record of the understanding. It is recorded in such unmistakable language that none can misunderstand.

Assuming that the advocates of the proposals now before this Committee are unwilling to accept the legislative background set forth above as conclusive -- although we believe it is -- I now examine several of the decisions of the Supreme Court of the United States since the adoption of the Sixteenth Amendment in 1913. Those cases firmly establish that the Sixteenth Amendment did not confer upon the Federal government the power to tax city and state bonds which it concededly did not have before this Amendment went into effect.

The first case coming before the Supreme Court following the adoption of the Sixteenth Amendment involving its interpretation and construction was Brushaber v. Union Pacific Railroad Company, 240 U.S. 1 (1916). In this case the Court held that the amendment did not extend the Federal taxing power to new subjects, but merely eliminated the necessity for apportioning direct taxes upon income derived from property.

Following the Brushaber case were other decisions which pointed out with equal clarity the fact that the "provisions of the Sixteenth Amendment conferred no new power of taxation" but merely removed all occasion for an apportionment among the states of taxes

laid upon income. Stanton v. Baltic Mining Company, 240 U.S. 103 (1916), Peck and Company v. Lowe, 247 U.S. 165 (1918), and Eisner v. Macomber, 252 U.S. 189 (1920), all repeat the view that the Amendment did not go any further than the decision expressed in the Brushaber case.

In view of the foregoing it is readily understandable why the Administration, in its testimony before the Senate Finance Committee, readily admitted that the inclusion of municipal bond interest, in a minimum tax calculation posed a grave constitutional question. In fact, when pressed, Secretary Kennedy stated flatly that such a tax would be unconstitutional.

However, with regard to the allocation of personal deductions, the Treasury representatives attempted to convince the Senate Finance Committee that this proposal raised no constitutional question. As support for their conclusion, they cited the Committee to the case of United States v. Atlas Life Insurance Company, 381 U.S. 233 (1965). This reliance on the Atlas case, however, is clearly misplaced. Atlas did not involve individuals, it involved insurance companies and Atlas did not involve the allocation of deductions, it involved the allocation of income.

The problems involved in the taxation of an insurance company are so different from those involved in the taxation of individuals that a case involving one is of little or no precedential value in a case involving the other. The equitable taxation of an insurance company has always been a troublesome problem for Congress and has resulted in Congress adopting a whole series of special statutory provisions applicable to only insurance companies. Part of the difficulty is caused by the fact that an insurance company is required by law to set aside a very

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high percentage of its income. This reserve or policyholders' share is allowed as a deduction for purposes of company income taxes. The federal government itself, in its brief to the Supreme Court in the Atlas case recognized the sui generis nature of the taxation of insurance companies. Thus on page 30 of its brief the government stated that "the policyholders' reserve of a life insurance company is unique."

The Insurance Tax Act which was in question in the Atlas case required insurance companies to divide each type of income which it received into a policyholder's share (reserve) and a company share (company's income) according to the percentage of total income which was allocated to each.

It was the allocation of income contained in the Insurance Act and that allocation alone which the Supreme Court held not to impose a constitutionally impermissible tax on municipal bond interest income. The Court's decision was based on its belief that to allow insurance companies an arbitrary assignment of tax exempt income to the company share of income would bestow a benefit on insurance companies which is not required by the doctrine of intergovernmental immunity.

CONCLUSION

For reasons of both constitutional law and sound public policy we urge this Committee to reject those provisions of H.R. 13270 which would unconstitutionally impose a clog on the borrowing power of the states and their Political subdivisions.

SUMMARY OF THE PRINCIPAL POINTS OF THE TESTIMONY OF WILLIAM E. SIMON ON BEHALF OF THE INVESTMENT BANKERS ASSOCIATION BEFORE THE SENATE FINANCE COMMITTEE ON H.R. 13270

September 24, 1969

1. Impairment of the income tax exemption of state and municipal bonds will drastically increase the cost of future local government financing.

2. A Federal tax aimed at investors in municipal bonds will be passed along to the average taxpayer and especially homeowners in the form of higher local taxes.

3. The market for municipal bonds has become almost completely demoralized and many local governments have been unable to issue their bonds at rates within the maximum limits fixed by law, as a result of investor reaction to House passage of H.R. 13270, and specifically to Section 301 (the limit on tax preferences) and Section 302 (allocation of deductions).

4. The mere threat of the proposed change of status has already raised municipal bond interest rates by at least ½ of 1% to a full 1%.

5. The allocation of deductions would affect many more taxpayers than would the limit on tax preferences. Under either of these proposals, the states and their municipalities will pay far more in interest costs than the Treasury will ever gain in revenue.

6. The proposed breaching of the tax exemption on outstanding state and local bonds is in effect a capital levy in that it causes a major reduction in the market value of outstanding bonds. More serious from the viewpoint of the state and local governments, this breach of what was believed to be a constitutional exemption will permanently deter many investors from buying municipal bonds.

7. The House plan for a Federal subsidy to state and local governments issuing taxable bonds would put state and local borrowing into direct competition with bonds of the Federal Government and its agencies, with private industry borrowing, and with mortgages. This, in turn, would likely bring about an across-the-board rise of 3/4 of 1% in the level of interest rates on taxable securities, both those of the Federal Government and those of private industry. This escalation of interest rates would hit first and hardest at the already depressed home mortgage market.

8. Results of a comprehensive survey of institutional investors conducted by Dr. Sally S. Ronk, noted authority on the flow of funds in the financial markets, show that the Treasury would lose $121 million on each year's municipal financing if tax exempt issues were replaced by taxable issues. As previously indicated, the shifting of municipal bond financing to the taxable market would cause long-term interest rates to rise at least 3/4 of 1% above what they would otherwise be.

Statement by the Investment Bankers Association
Before the
Senate Finance Committee
on the Subject of Tax Treatment of State and Local Bond Interest
September 24, 1969

My name is William E. Simon, and I am chairman of the Municipal Securities Committee of the Investment Bankers Association of America.

Our complete statement has been sent to your Committee staff, and we request that it be made a part of the record. With your permission, I shall now summarize that statement.

I am authorized to represent the 600 investment firms and banks, members of our Association, who underwrite and make secondary markets for bonds of the fifty states and their counties, municipalities and special districts. We are deeply concerned about the implications of the current proposals for indirect taxation of the interest paid on bonds of state and local governments.

We expect to continue to serve as bankers for these states and municipalities, whether their bonds are wholly exempt from income taxation, wholly taxable or partially taxable. Accordingly, we can be objective in appraising the effects of the dispute about tax exemption and tax equity.

Nevertheless, we feel a heavy responsibility to offer you our opinion as to the market effect of the proposed infringement of the existing tax exemption. This market effect is vitally important to the states, because they must have the continued confidence and support of investors in order to obtain the huge sums of capital needed for public projects.

To the degree that investment interest is alienated, state and local governments will pay more than necessary for their future borrowing. That added cost can be met only by raising the rates of income and sales and local property taxes. Thus the Federal tax aimed at investors in municipal bonds will be passed along to the average taxpayer and especially to homeowners.

In our testimony before the House Ways and Means Committee on March 11th, we warned that any impairment of the income tax exemption of state and municipal bonds would drastically increase the cost of future local government financing.

This prediction has been fully realized in the cumulative reaction of investors to H.R.13270, and specifically to Section 301 (the limit on tax preferences) and Section 302 (allocation of deductions). By late August, the market for municipal bonds had become almost completely demoralized. Many local governments were unable to issue their bonds at rates within the maximum limits fixed by their controlling state finance laws. It was difficult to get realistic bids for municipal bonds which investors wanted to sell.

During the twenty-five years 1944-1968 state and local governments had been able to borrow capital funds at tax exempt rates averaging about two-thirds of the interest cost of long term taxable bonds issued by private corporations of comparable security quality. This interest cost relationship held at about 70% despite the rapid increase of total state and local borrowing from $11 billion in 1966 to more than $16 billion in 1968.

In the first eight months of 1969, the amount of new municipal bond issues was 25% less than in the same months of 1968; this meant that the underwriting and distribution load was $2.5 billion lighter. Yet, the interest rate spread between "tax exempt" and taxable bond issues has narrowed significantly. Instead of the long-prevailing 65-70% of taxable rates, bond issues offered in late August by state and local governments bore interest rates approximating 80-85% of those on comparable quality new issues of private corporations. Some part of this rise in the exempt/taxable ratio has been caused by the progressive increase in the intensity of credit restraint affecting especially the commercial banks' ability to buy municipals. But very similar monetary conditions governed banking

in the Summer and Fall of 1966; in fact, at that time, commercial banks sold municipal bonds out of their portfolios in greater volume than in 1969. New issue volume was comparable. Yet the ratio of tax exempt to taxable borrowing costs, using the same indices for comparison, in 1966 did not rise above 75%, and was 75% only for a single month. In comparison with 1969's higher ratio, the remaining 7 or more percentage points easily represent a minimum of a half of 1% per annum of added local government borrowing cost attributable to the threat that municipal bond interest will be partially taxed.

And this higher cost relationship is obviously only anticipatory. The actual enactment of legislation assessing Federal income tax in relation to ownership of state and municipal bonds, in our opinion would further increase the interest penalty on local government.

We believe that if the treatment of municipal bond interest proposed in H.R.13270 is enacted into law, investors will want "tax exempt" rates closer to taxable rates than anything we have seen to date. From the minimum of 1/2 of 1% already indicated, we fear that the resulting penalty on municipal bond costs could easily rise to a full 1% or more, at current levels of long-term interest rates.

Even if the threat is limited to allocation of deductions, investors must conclude that the wall of reciprocal sovereignty has been breached, and their psychological reaction would surely exceed the actual reduction in the income value of tax exemption. If the rules of the game can be changed in relation to outstanding bonds, investors will demand a margin of protection against further deterioration.

The allocation of deductions would affect many more taxpayers than would the limit on tax preferences, and the definition recommended by the Treasury is much harsher than that in H.R.13270, in that the full amount of interest on municipal bonds, both outstanding and future issues, would immediately be a factor in the allocation of deductions.

Furthermore, commercial banks and other institutional investors would have to infer that the allocation formula with some modification could easily be extended to them; and that prospect would be absolutely catastrophic to the market for municipal bond issues, because of its prime dependence on bank support. Hundreds of small commercial banks, heavily invested in municipal bonds, should not be subjected to the possibly serious capital consequences of tax-imposed further depreciation of their portfolios.

In testifying before this Committee on September 4th, the Treasury disclosed the estimate that the inclusion of municipal bond interest in the base for allocation of deductions, according to its proposed formula, would yield revenue of only $45 million a year.

We submit that this estimate proves our contention that if this indirect tax is imposed, the states and their municipalities will pay far more in interest costs than the Treasury will ever gain in revenue. On the basis of a presently indicated bond rate increase of 1/2 of 1% per annum, impairment of the tax immunity of municipal bond interest would impose an added cost of $75,000,000 a year extra on the $15 billion of state and local borrowing which is the minimum annual amount necessary to maintain the present rate of construction of public projects. Whereas the tax yield to the Treasury would grow very slowly at the rate of a few million dollars a year, the cost to the states and their agencies would mount rapidly. Within five years, their cost would be in excess of $300 million a year, or about five times the Treasury's annual revenue estimated by projecting the $45 million figure.

The initial reaction of investors to the tax proposals affecting state and municipal debt was one of incredulity that Congress would or could legislate such a drastic change in the mutually sovereign relations of the state governments and the Federal Government, established by the Constitution as hitherto interpreted by the Supreme Court of the United States. Particularly incredible was the proposal that the interest on outstanding bonds be included in the computation

of tax liability; because investors had believed that the interest rate advantage obtained by offering tax exemption was in effect a contract consideration assuring them of exemption throughout the terms of their loans. Putting it another way, the investor who accepted an interest rate which was 70% of a comparable taxable rate, in effect is paying a 30% tax on the higher gross income which he might have had.

The sudden breaching of this long standing exemption, even though it may be indirect through the related penalty of reducing allowed deductions, is in effect a capital levy in that it causes a major reduction in the market value of outstanding bonds. For example, on a 3 1/4% bond such as could have been issued four years ago with an original maturity of thirty years, the inflation which has affected all fixed income securities would already have lopped off in market value at least one-third of the face value of the bond; and now the threat to tax the interest has reduced the market value by another 8 or 10 points to a net of about $56 per $100 of original loan value.

More serious from the viewpoint of the state and local governments, this breach of what was believed to be a Constitutional exemption will permanently deter many investors from buying municipal bonds. The acceptance of state and local government bonds is based on belief in the good faith of government at all levels.

The Treasury understandably opposes the House plan for a Federal subsidy to compensate the states for their added cost if they will voluntarily convert their financing to fully taxable form. Such a conversion, if comprehensive, would put state and local borrowing into direct competition with bonds of the Federal Government and its agencies, with private industry borrowing, and with mortgages. In sum, the effect of the carrot and stick campaign to drive local government out of the tax exempt form of financing would be a broad rise in the level of interest rates on taxable securities, both those of the Federal Government and those of private industry.

A comprehensive study of institutional investors conducted by Dr. Sally S. Ronk, well known as an authority on the flows of funds in the capital markets, shows that the participants in the study expect an across-the-board increase of 3/4 of 1% on all long-term fixed income investments, and it could well be more. The resulting annual cost to the Treasury is estimated at $121 million.

The mortgage market especially would be further diminished, as state and local pension funds diverted their buying power from mortgages to the bonds of their own municipalities. In our opinion, total demand for long-term fixed income securities would be lessened, because only tax exempt bonds can compete with equities for investment favor.

The shift of municipal borrowing to taxable form would involve a tremendous reshuffling of the market in regard to underwriting and sales procedures, and investor groups. Nor should it be assumed that the states and their subdivisions could compete on equal rate terms with high quality private corporation securities. Private corporations can offer an equity interest in addition to higher interest rates, while municipalities have nothing but interest rate to overcome investor reluctance - no equity, no convertibility, no warrants.

To us it is inconceivable that at a moment of unprecedented restraint on money supply, when the bond markets are already close to disorder, an attempt is made to revolutionize the status of municipal bonds for the sake of getting at a handful of presumed tax avoiders, who if they ever did invest in municipal bonds must wish most heartily that they had not.

<u>Conclusion</u>

We respectfully urge upon this Committee that interest paid on state and municipal bonds should be exempted from both the limit on tax preferences and the allocation of deductions. In our opinion, the indirect taxation proposed in H.R.13270 would cost the states much more than it would yield in revenue to the Treasury. This would mean a heavier tax burden falling mainly on the middle-income homeowner. The efficiency of the municipal bond market must be preserved if we are to supply the capital requirements of the states and their political subdivisions. That market cannot function efficiently if it is to be harassed by complex applications of indirect taxation of municipal bond interest.

Statement by the Investment Bankers Association
Before the
Senate Finance Committee
on the Subject of Tax Treatment of State and Local Bond Interest
September 24, 1969

My name is William E. Simon, and I am Chairman of the Municipal Securities Committee of the Investment Bankers Association of America. In order to answer any questions you may have, I am accompanied by several associates experienced in this area.

I am authorized to represent the more than 600 investment firms and banks, members of our Association, who underwrite and make secondary markets for bonds of the fifty states and their counties, municipalities and special districts.

Many of our member firms have participated in this financing for fifty years. In light of that experience, we are deeply concerned about the wider implications of the current proposals for indirect taxation of the interest paid on bonds of state and local governments.

We expect to continue to serve as bankers for these states and municipalities, whether the interest on their bonds is wholly exempt from income taxation, wholly taxable or partially taxable. Accordingly, we can be reasonably objective in appraising the capital market and economic effects of the tax reform proposals embodied in H. R. 13270 insofar as they relate to state and municipal bonds. These comprise (1) the limited tax preferences proposal, (2) the allocation of deductions proposal, and (3) a Federal subsidy in aid of municipal borrowing in taxable form.

This proposed alternative financing method, which provides for the issuance of taxable state and municipal bonds with a Federal subsidy to the issuer of between 25% and 40% of the interest, represents an attempt to induce state and local governments to convert their financing to taxable form, voluntarily surrendering tax exemption.

We shall deal in detail with the wider economic and market implications of all three of these proposals today.

THE CONSTITUTIONAL QUESTION

Differing opinions are expressed as to whether tax exemption is implied by the Constitution as a part of reciprocal immunity in the Federal-state relationship. There is no doubt, however, that the origin of tax exemption is Constitutional, and that it was placed in the first Revenue Act following the adoption of the 16th Amendment because the Congress then believed that the Constitution required this provision.

Because of this history and background it is improper to bracket consideration of tax-exempt bond interest with those other exclusions and deductions which Congress has adopted from time to time in order to stimulate certain types of economic or social activity, or with those provisions of the Code which have inadvertently created "loopholes." Nevertheless, much of this year's discussion has linked municipal bond financing in the public's mind with these other devices, and we believe quite unfairly.

RECENT MARKET DEVELOPMENTS: THE IMPACT OF TAX REFORM

The year 1969 has been a difficult one for the municipal market. Measured by Moody's Aa municipals, the average yield has risen from 4.60% in January to 5.93% at the end of August.

During the twenty-five years 1944-1968, state and local governments had been able to borrow capital funds at tax exempt rates averaging about two-thirds of the interest cost of long term taxable bonds issued by private corporations of comparable security quality. This interest cost relationship held at about 70% despite the rapid increase of total state and local borrowing from $11 billion in 1966 to more than $16 billion in 1968.

In the first eight months of 1969, the amount of new municipal bond issues was 25% less than in the same months of 1968; this meant that the underwriting and distribution load was $2.5 billion lighter. Yet, the interest rate spread between "tax exempt" and taxable bond issues has narrowed significantly. Instead of the long-prevailing 65-70% of taxable rates, bond issues offered in late August by state and local governments bore interest rates approximating 80-85% of those on comparable quality new issues of private corporations. Some part of this rise in the exempt/taxable ratio has been caused by the progressive increase in the intensity of credit restraint affecting especially the commercial banks' ability to buy municipals. But let us look at very similar monetary conditions governing banking in the Summer and Fall of 1966. At that time, commercial banks sold municipal bonds out of their portfolios in greater volume than in 1969. New issue volume was comparable. Yet the ratio of tax exempt to taxable borrowing costs, using the same indices for comparison, in 1966 did not rise above 75%, and then only for a single month. In 1969's higher ratio, by 7 or more percentage points, easily represents, at today's level of interest rates, a half of 1 per cent per annum of added local government borrowing cost attributable to the threat that municipal bond interest will be partially taxed.

As a result of the disclosure in late July by the House Ways and Means Committee of its intention to apply both the limit on tax preferences and the allocation formula to tax exempt bonds, it was necessary to restructure and reword notices of sale, underwriting agreements, and legal opinions in order to put prospective investors on notice that tax exemption is threatened. Both individual and institutional investors have shown sharply diminished confidence in the municipal market because of these changes and the uncertainty thus created.

Some dealers and at least one bank announced their intention to withdraw from bidding on new municipal issues until their tax status was clarified. The new issue budding on Tuesday, July 29th revealed unmistakably that the municipal market was on the brink of chaos. The $65.0 million "Aaa" rated State of Ohio issue was sold to the winning bidders at 5.94% net interest cost, an increase of nearly ½ of 1% over that which would have prevailed only two weeks earlier. The second bid represented nearly ½ of 1% higher net interest cost over the first bid, an unthinkable bidding spread in any normal market. On that same day two cities, Chicago, Illinois, and Newark, New Jersey, were able to secure only one bid each. No bid at all was received for the $7.4 million Eastern Kentucky University issue. The municipal market, which has continued to function, although with understandably reduced efficiency under the tightest money conditions ever witnessed in modern times, was on the verge of collapse directly owing to the tax proposals under consideration by the House Ways and Means Committee.

We think it likely that these proposals, if enacted into law, could cost states and local governments a minimum of 1% per year additional interest on their "tax-exempt" financing. That means an increased financing cost of at least $150 million per year, all of which hard pressed states and municipalities will be forced to raise from taxpayers already groaning under the burden of state, local, and Federal taxation.

LIMITED TAX PREFERENCES (MINIMUM INDIVIDUAL INCOME TAX) PROPOSAL

As we stated before the House Ways and Means Committee on March 11th, the inclusion of the interest on state and local government obligations in gross income, for purposes of computing a limit on tax preferences or a minimum income tax, would do significant and lasting damage to existing and future state and local government bond markets, without achieving any appreciable increase in

tax equity. In view of the demonstrated gravity of the market consequences, we feel compelled to draw to the attention of your Committee the following considerations.

Our confidence in the capability of the tax-exempt market to provide for growing state and local capital needs is predicated on continuance of the present unqualified tax exemption provided in Section 103 of the Revenue Code, for obligations of the states and their political subdivisions. The proposal for a minimum income tax comes to you under the name of "equity" and "fairness" in the application of the individual income tax. Equity and fairness in taxation are standards which we all support. In looking at tax exemptions, weight must be given, however, to the policy and historical considerations upon which a particular exemption is based. Furthermore, the question of the presumed greater equity resulting from inclusion of interest on state and local bonds in the expanded base for this proposed alternative tax computation must be weighed against its adverse effect on the value of tax exemption to state and local governments in maintaining a preferred market for state and local borrowing.

Individuals, together with trust departments of banks, and investment counsel acting on their behalf, are important factors in the municipal market, although annual additions to their holdings vary widely in amount. (See Exhibit 2) The role of individual investors on the municipal market increases in relative importance when the buying by banks and casualty insurance companies is reduced. This phenomenon occurred in 1966 when individuals purchased 40% of net new issues. There is no doubt that inclusion of tax-exempt interest in the alternative minimum tax would significantly reduce municipal bond purchases on behalf of individuals. Those unaffected by the initial minimum tax would only wonder how soon the next step in this direction would affect them.

Undoubtedly there would be a legal test as to whether a law taxing interest on state and municipal bonds would be Constitutional. Because of diversity of legal opinion upon this point, no one could be certain of the outcome until a decision was reached by the U. S. Supreme Court. If the Atlas Life Insurance Company case is any precedent, at least three years could elapse before a decision by the U. S. Supreme Court. During that period, tax-exempt bonds through sheer uncertainty and apprehension would sell at only slightly lower yields than taxable securities of comparable quality, because the intermediate and long term market would in effect have become a game of chance in which the few remaining buyers were merely betting on the outcome of the litigation. Furthermore, some individuals would undoubtedly sell their holdings in fear of an unfavorable decision.

Banks and other institutional investors in tax exempts are fully aware that a minimum tax applying to them was weighed by the House Ways and Means Committee and eliminated at the last moment. Under these circumstances, they could only assume that the next change in the tax law would directly attack the value of tax exemption to them. Their natural reaction would be to reduce their purchases sharply, and, if they bought at all, to confine their buying to the shortest maturities. Any municipal financing that could be done would probably be at sharply higher interest rates, the cost of which would be borne by the general taxpayers in the borrowing states and municipalities.

Putting this matter in proper perspective, tax exemption is not simply a gift from the Federal Government to certain investors. It is a quid pro quo for the acceptance of lower rates of return than the investor could obtain on alternative investments. An investor in tax-exempt bonds has accepted close to one-third less income than he could receive from taxable obligations - this is what he has paid for the tax exemption. Thus in a very real sense, and certainly

in terms of equity, the investor in tax-exempt bonds has already paid the equivalent of a minimum income tax and has paid it in advance.

For this reason especially, the application of either the limit on tax preferences or the allocation of deductions to interest derived from outstanding municipal bonds, creates a real shock wave for investor confidence.

In our opinion, there is no such thing as a limited exposure of municipal bonds to Federal taxation. Either the interest is exempt or it is taxable to the same degree as private corporation securities. If the U. S. Supreme Court rules that Congress can impose a conditional tax based on the circumstances of the bondholders, then investors must assume that some future Congress may go all the way to direct taxation. See Appendix A for a detailed discussion of the effects of the limit on tax preferences (minimum income tax) treatment of tax exempt interest.

THE ALLOCATION OF DEDUCTIONS PROPOSAL

The proposal for allocation of deductions, in theory would increase the taxes collected from taxable income rather than collect a tax on tax-exempt bond interest. But as it would reduce the net income value of such interest, its effect actually would be that of an indirect tax on tax-exempt interest. The allocation of deductions would hit many more taxpayers than would the limit on tax preferences. Section 302 of H. R. 13270 provides that only tax-exempt interest income received from obligations issued after July 12, 1969, be included, and this inclusion is phased in over a ten-year period. In testimony before this Committee, the Treasury has advocated that allocation be applied retroactively to outstanding issues as well as future, and that the full amount of interest received on municipal bonds would immediately be a factor in the determination of tax liability.

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For either concept, the extent of the effect of allocation depends upon the relationship of certain defined preference income to total income, applied to the aggregate of allocable non-business deductions. The larger the relative amount of such deductions, the greater the impact. A study of the effect of allocation on typical investors (attached hereto as Appendix B) suggests that allocation would reduce the net yield of tax-exempt income by 1/4 to 3/4 of 1%, the average being about 1/2 of 1%. This would mean that a 5 1/2% tax-exempt yield would be worth only about 5% to the investor.

If tax-exempt income is made less attractive, more individual investors will be persuaded to follow the present trend toward heavier concentration in common stocks or other investments. With substantial losses already suffered in his bond portfolio, an individual investor is certainly in no mood to absorb this added blow. As a result individual investors would require substantial leeway in the form of greater yield on tax-exempts, as protection against changes in his individual exposure to allocation.

The application of allocation to individuals would raise serious questions for institutional investors, particularly commercial banks, who must fear that they might be next in line for an extension of this proposal. It is well known that H. R. 13270 at one point contained an extremely harsh provision applying this proposal to commercial banks; and that this provision was deleted only at the last moment. Given the banks' important position as buyers of tax-exempt bonds, their warranted fears can be absolutely catastrophic to the market.

The municipal market has already experienced the results of an allocation arrangement, contained in the Life Insurance Tax Act of 1959. The Atlas Life Insurance Company contested these provisions in litigation which lasted from

May 1962 until May 1965. There was one victory along the way in the Circuit Court of Appeals, but the Company finally lost in the U. S. Supreme Court.

The attached Exhibit 3 shows what actually happened to the life insurance companies' share of the tax-exempt market during this period as the result of the allocation of income formula. In 1961, state and local holdings of life insurance companies were $3.9 billion or 3.07% of total assets, and acquisitions were $506 million or 2.01% of total acquisitions. By 1968, municipal holdings were down to $3.2 billion or 1.69% of total assets, and acquisitions were down to $278 million or 0.58% of total acquisitions. The results speak for themselves. The life insurance companies' sector of the municipal market was severely constricted. Since 1962, life insurance companies have been net sellers of state and local bonds in every single year, as shown in Exhibit 2.

Furthermore, many life insurance company acquisitions of state and local securities are motivated by other than purely investment considerations such as yield and quality. For example, insurance companies derive important advantages from the purchase of municipal bonds of certain states in order to reduce the rates of taxation on their premium income from those states. Although other assets within the state may be similarly used, municipal bonds are satisfactory for this purpose in all of such states. Also, it should be noted that a considerable share of life insurance company municipal bond acquisitions are of discount bonds at low percentage of par value with coupons as low as 1/4, 1/10, and 1/20 of 1%. As far as these bonds are concerned, the tax-exempt interest feature is of minimal significance, and attention is focused on the capital gain aspects of the transaction.

As we look at this precedent and contemplate the possible application of allocation of deductions to individuals, we should note that individual investors are a factor in the tax-exempt market some ten times as large as were the life companies at their peak.

THE FINANCIAL EFFECTS OF THE LIMITED TAX PREFERENCES AND ALLOCATION OF DEDUCTIONS PROPOSAL

In testifying before this Committee on September 4th, the Treasury disclosed the estimate that the inclusion of municipal bond interest in the base for allocation of deductions, according to its proposed formula, would yield revenue of about $45 million a year.

We submit that this estimate proves our contention that if this indirect tax is imposed, the states and their municipalities will pay far more in interest costs than the Treasury will ever gain in revenue. On the basis of a presently indicated bond rate increase of at least 1/2 of 1% per annum, impairment of the tax immunity of municipal bond interest would impose an added cost of $75,000,000 a year on the $15 billion of state and local borrowing which is the minimum annual amount necessary to maintain the present rate of construction of public projects. Whereas the tax yield to the Treasury would grow very slowly at the rate of a few million dollars a year, the cost to the states and their agencies would mount rapidly. Within five years, their cost would be in excess of $300 million a year, or about five times the Treasury's annual revenue estimated by projecting the $45 million figure.

In our opinion, this estimate of added cost to state and local governments is conservative in that it measures only the already demonstrated harm to the municipal market. We believe that if the treatment of municipal bond interest proposed in H. R. 13270 is enacted into law, investors will want "tax exempt" rates closer to taxable rates than anything we have seen to date. From the 1/2 of 1% already indicated, we fear that the resulting penalty on municipal borrowing costs could easily rise to a full 1% or more, at current levels of long-term interest rates. This would double the estimate of annual cost increase, to $600 million, without yielding any significant addition of revenue to the Treasury.

On these comparisons, any fiscal purpose of the proposed tax law amendments appears to be self-defeating. There remains the question whether tax equity is improved. On this score we assume that the purpose is to discourage a very small number of individuals in high income brackets from minimizing their taxable income through ownership of municipal bonds.

There is reliable evidence that most wealthy persons do not invest heavily in tax exempts; (see page 12) and that an extremely low percentage of taxable estates was invested in state and municipal bonds. Finally, the Treasury has never demonstrated that the famous 154 individuals having incomes in excess of $200,000 on which they paid no Federal tax, ever relied to any significant degree on investment in tax exempt bonds.

PUTTING STATE AND LOCAL GOVERNMENT FINANCING IN PERSPECTIVE

In order to establish the basic facts related to the financing of state and local government, we offer brief discussions of the distribution of municipal bond ownership, the cost of tax exemption to the Federal Government, the recent growth and projected growth in state and municipal bond issues, and the size and composition of the new issues of long-term fixed-income obligations.

Outstanding State and Local Debt and its Ownership

Outstanding state and local debt, and the interest paid on it is as follows:

Table I

	1966	1967	1968
(Beginning)	104,700,000,000	111,600,000,000	122,000,000,000
(End)	111,600,000,000	122,000,000,000	132,300,000,000
	216,300,000,000	233,600,000,000	254,300,000,000
Average outstanding debt	108,150,000,000	116,800,000,000	127,150,000,000
Interest paid	3,451,000,000	3,813,000,000	4,437,000,000
Interest cost	3.19%	3.26%	3.49%

Exhibit 4 shows the total outstanding debt each year since 1946, who owned it, and in what proportions:

Looking at the principal classes of ownership, it is readily observable that the holdings of commercial banks increased from 25% of the total in 1945 to 44% in 1968, and that the holdings of fire and casualty insurance companies increased from 1.5% in 1945 to 11% in 1958 and have since stabilized at that level. The holdings of individuals declined from 46% in 1945 to 32% in 1968.

Since the current hearings have emphasized individual ownership, it is of especial interest to examine the relationship of municipal bond ownership to income brackets. Contrary to popular belief, a survey made by Professor Benjamin Okner, using results gathered by the Michigan Survey Research Center [1] from a sample of high income persons, concluded that most wealthy persons do not invest heavily in municipals. Based on 1964 data, he estimated that only 10 per cent of the persons with incomes of over $10,000 owned any municipals and that only 1 per cent of them derived as much as 25 per cent of their income from such securities. While 65 per cent of those persons in the highest category, those with incomes of $315,000 or more, held some municipals, only 18 per cent of them derived as much as 10 per cent of their income from this source, and only 6 per cent derived as much as 25 per cent from this source. (See Exhibit 5)

Affording corroboration of this survey, the estate returns filed in 1966 with the Internal Revenue Service (the most recent year for which a report is available) demonstrated that an extremely low percentage of taxable estates was

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[1] Income Distribution and the Federal Income Tax, Michigan Governmental Studies No. 47, Institute of Public Administration, University of Michigan, 1966, Appendix A.

invested in state and municipal bonds. Investments in corporate stock were 17 times as large as investments in municipal bonds.

Only 4 brackets of decedents' total estates held more than 5 per cent of their assets in municipal bonds. These were the $2 to $10 million estates in which almost 800 estates held an aggregate of $234.1 million of such bonds which constituted 7.3 per cent of the assets of such estates. The percentage of assets invested in municipal bonds reached no higher than 8.63 per cent, which was recorded for the $5 to $10 million estate bracket. Estates of the larger and smaller size brackets held a smaller part of their assets in municipal bonds. The average of the municipal bond holdings of all taxable estates reported on a total estate basis was 2.7 per cent of total assets. (See Exhibit 6)

Recent Growth in State and Municipal Financing Volume and Project Growth

As can be seen from Column 1 of the following table, municipal bond financing has been growing at a compounded growth rate of 8.7% in the period from 1960 through 1968, after deleting the industrial revenue financing which was an extraneous and foreign element in the market and which has been terminated for all practical purposes by the provisions of the Revenue Control and Expenditures Act of 1968.

TABLE I

	Growth @ 8.7% millions	Actual millions	J.E.C. Estimate[2] millions
1960	7,230	7,230	
1961	7,859	8,360	
1962	8,543	8,558	
1963	9,286	10,107	
1964	10,094	10,544	
1965	10,972	11,084	
1966	11,927	10,589*	14,200
1967	12,965	12,088**	14,900
1968	14,093	14,044***	15,700
1969	15,319		16,600
1970	16,652		17,600
1971	18,101		18,600
1972	19,676		19,500
1973	21,388		20,800
1974	23,249		21,800
1975	25,272		22,700

*Excludes $500 million industrial aid financing.
**Excludes $1,300 million industrial aid financing.
***Excludes $1,600 million industrial aid financing, and $730 million anticipatory financing to avoid provisions of Revenue Control and Expenditures Act of 1968, Watson Amendment in California and similar measure in Oregon.

[2] State and Local Public Facility Needs and Financing, a study prepared for the Joint Economic Committee of the Congress of the United States, December 1966. The National League of Cities, in conjunction with the Urban Institute, is currently engaged in updating data on anticipated capital outlays of states and municipalities through 1975. Data from this study are not yet available.

Furthermore, in its December 1966 study, the Joint Economic Committee indicated that capital outlays through 1975 could be handled by the present market mechanism. The Joint Economic Study estimates at present are well ahead of actual financing volume, considering that much of 1968 new issue municipal borrowing can be attributed to anticipatory borrowing (California, Oregon and Port of New York Authority) and industrial development financing. Other studies of the

fiscal outlook of state and local government financing through 1975[3] came to a similar conclusion.

Size and Composition of the Capital Market

Tables A and B show the gross acquisitions of long-term fixed-income obligations, averaged for the period 1965-1968 by categories of borrowers, also a percentage distribution of such acquisitions by investor groups. This study for the first time gives a comprehensive picture of the new-issue market. It was constructed by Dr. Sally S. Ronk, Vice President of Bankers Trust Company, New York. This demonstrates how state and municipal bonds fit into the total market of fixed income obligations.

Inflation and the Capital Markets

The major difficulty experienced by state and local governments in raising long-term money in the capital market today is part of a general problem faced by borrowers in all sectors of the market for fixed-income obligations in an inflationary environment.

The bear market trend in bonds since 1946 and the severe decline in bond prices over the past four years have left many investors disillusioned with fixed-income obligations. In many cases, declining bond prices and the erosion in the purchasing power of the dollar have resulted in a negative return on an investor's funds in recent years. In the face of this experience, the financing of many essential social programs at supportable interest rates depends critically on investors' expectations about the future course of inflation.

Appendix C depicts the comparative performance of investments in (a) municipal bonds of 20-years maturity, average quality, (b) high grade corporate bonds, and (c) common stocks represented by Standard & Poor's 500-stock average.

[3] Fiscal Outlook for State and Local Government to 1975, Tax Foundation, Inc. 1966
Fiscal Issues in the Future of Federalism, A CED Supplementary Paper, Committee for Economic Development 1968.

The appendix demonstrates that investment in municipal bonds has been anything but profitable over the past 10 years, despite the complete exemption of income from Federal taxation. In view of this record, it is easy to understand why investors prefer stocks. The comparatively poorer showing for taxable corporate bonds indicates why individual investors of upper income brackets would be unlikely to invest in taxable municipal bonds.

Inflationary expectations are already reflected in the portfolio decisions of institutional investors. This is shown by the preference for common stocks. Net purchases of common stocks by non-bank financial institutions gained momentum only gradually in the past 20 years, but have sharply accelerated during the last four. In the period from 1948 through the early 1960's, whenever non-bank financial institutions occasionally stepped up their purchases of stocks, they also increased their net investment in bonds. Since 1963, net acquisitions of mortgages and bonds have been on a plateau of around $27 billion annually, with the exception of the credit crunch year of 1966 when net new bond investments fell sharply. Thus, in contrast to earlier years, in which annual net new investments in both bonds and stocks increased irregularly, the annual commitment in bonds has been held in check lately while the acquisition of stocks has increased significantly. (See Exhibit 1)

If inflationary expectations are not retarded, this trend may well persist. Public retirement funds are continuing to liberalize their portfolio policies in favor of equities, although a large percentage of net new funds is still invested in bonds. Corporate pension funds are allocating an increasing proportion of new money to equities. Life insurance companies are stepping up their equity purchases.

During the next decade, much of the cost of new capital facilities will have to be financed by flotation of debt securities, which will be made much more difficult if inflation does not abate.

ECONOMIC COSTS OF ISSUANCE OF TAXABLE MUNICIPAL BONDS WITH A FEDERAL SUBSIDY

The proposal that the Federal Government subsidize state and local government borrowings by paying the differential between the tax-exempt and taxable interest rate is based partly on the assumption that the Federal government could recoup the subsidy through taxing all of the interest on municipal bonds. This would only be true, of course, if purchasers of taxable municipal bonds had an average effective tax rate equal to or higher than the percentage required for the subsidy.

The contention that the Federal government would end up without loss under this proposal appears to reflect the belief that the buyers of tax-exempt municipal bonds would be the same as the buyers of taxable municipal bonds. Since the marginal tax rate of the buyers of the average volume of new issues of municipal bonds, 1965-68, was 44.7 per cent, the subsidy could be quite high, if this were so. However, the assumption that taxable municipal bonds could continue to be sold to the previous buyers of tax-exempts is not valid.

In order to ascertain what the shifts in the flows of funds through the credit markets might be if only taxable municipal bonds were issued, the Investment Bankers Association sent out a questionnaire to 1,500 leading institutional investors and investment advisers. The results of 350 replies have been tabulated, and turned out to represent past experience for each investor group very satisfactorily.

New issues of tax-exempt bonds in 1965-68 averaged $13.3 billion annually. This was 13½ per cent of total new issues of long-term fixed-income obligations

including mortgages (Tables A and B). The average yield on high-grade municipal bonds over the same four years was 3.87 per cent, so the interest cost to state and local governments of this borrowing at that average yield would be $515 million each year. The average yield on high-grade corporate bonds was 5.68 per cent, so that state and local governments were able to save 181 basis points, or about 32 per cent of the corporate rate, because of tax exemption; this amounted to about $241 million a year.

The actual averages for 1965-68 of the flows of funds through the credit and equity markets, by major type of fund--long-term fixed income investments, short-term obligations and corporate stock--are shown in Table C. In Table D, the breakdown of long-term fixed-income obligations into mortgages, corporate bonds, etc. is given.

On the basis of the questionnaire results, we have taken what investors said they would do with their funds, if only taxable municipal bonds were issued, as the best method of showing how the flow of funds would be redirected. The results are shown in Tables E and F. Finally, we have translated the net flows of long-term fixed-income obligations shown in Table F to gross acquisitions (Table G). The changes from the actual 1965-68 averages are dramatic and would involve greatly increased upward pressures on long-term interest rates.

In the case of municipal bonds, not enough interest was expressed on the part of buyers to take up the same volume of taxable issues as was issued in tax-exempt form in 1965-68. The assumption was made, therefore, that $2½ billion of former bond financing by state and local governments would be shifted to the short-term market.

Since savings institutions, with fairly low tax rates, indicated that they would be somewhat more interested in taxable municipal bonds than they have been in tax exempts, and since commercial banks, fire and casualty insurance

companies and individuals indicated that they would be less interested, the average marginal tax rate on gross new issues of taxable municipal bonds would fall to 33 1/3 per cent, as shown in Table H.

However, shifts in the flows of funds among buyers in various tax brackets would also affect the average marginal tax rate on the gross volume of all new long-term taxable obligations. This rate averaged 23.2 per cent in each year 1965-68. The average marginal tax rate of buyers of tax-exempt bonds in 1965-68 was 44.7 per cent, so that if the same buyers should buy taxable municipal bonds, the average marginal rate on all new long-term issues of fixed-income obligations would rise to 26.1 per cent, an increase of 2.9 percentage points. Because of the interest of lower tax-bracket buyers in taxable municipal bonds, however, the marginal tax rate on the redirected gross flow of long-term fixed income obligations would rise only to 25.1 per cent, an increase of 1.9 percentage points. Thus, it is erroneous to compute a gain to the Treasury as arising from the excess of tax revenues on municipal bonds over subsidy costs which is based on current buyers of tax exempts.

When the redirected flows of funds and the minimum subsidy are accounted for, the Treasury would actually come out with a net loss rather than a net gain, as follows:

	(Millions of dollars)
New issues of taxable municipal bonds under assumed conditions (Table G)	10,700
Interest at average high-grade corporate rate, 1965-68, of 5.68%	608
Interest at average high-grade municipal rate, 1965-68, of 3.87%	414
Minimum subsidy required (1.81%, or 32% of corporate rate)	194
Taxes returned on interest of $608 million at marginal tax rate of 25.1%	41

Incidentally, this loss to the Treasury would be a minimum loss since the rate of subsidy might need to be substantially higher. Many municipal bond issues are relatively small and in order to be marketed would, in the judgment of many observers, need to carry higher rates than the generally larger corporate issues of comparable quality.

In addition to the above loss, the Treasury, as well as state and local governments and all borrowers, would lose as a result of the permanent rise in long-term interest rates above what they would otherwise be caused by the shifting of municipal bonds to the taxable market.

The Investment Bankers Association included a question in its questionnaire regarding the anticipated change in interest rates if only taxable municipal bonds were issued. The answers from 329 respondents in the financial community -- portfolio managers and investment advisers - indicated that the average rise expected was in the neighborhood of 75 basis points. (Table I)

Such a rise would mean an additional cost to the Federal government on its $7.1 billion of gross new long-term issues (Table G) of $53 million, making a total loss to the Treasury of $94 million a year.

In addition, the Treasury would have to pay more because its 32 per cent subsidy on taxable municipal bonds would have to rise; this would amount to $27 million. Thus, the total cost to the Treasury would be $121 million, while state and local governments would incur additional costs of $53 million (two-thirds of 75 basis points higher interest on $10.7 billion of new issues).

Not only would costs to all levels of government rise, but homeowners and business too would be required to bear higher interest costs on mortgages and corporate bonds. A 75 basis points rise in interest rates on gross new mortgages alone would be $434 million.

These more or less direct costs of shifting municipal bonds to the taxable market (including higher interest on corporate bonds of $129 million) total $737 million, a not inconsiderable figure.

Not all of the costs would be direct, however; there would be side effects because business would attempt to pass along its increased interest costs in higher prices. The inflationary effects would be enhanced if the rise in long-term interest rates were transmitted to the short-term credit markets, where we have already assumed increased pressure from larger state and local government borrowings.

Finally, the average marginal tax rate of borrowers in the credit markets is higher than that of lenders. Since borrowers may deduct their interest cost and this lowers their taxes, while lenders who receive this interest pay taxes at varying rates on it, this means that, when interest rates rise, the Treasury loses money. Business, with high marginal tax rates, accounts for a large proportion of total funds raised, while savings institutions, with relatively low marginal tax rates, loom fairly large in the total of funds supplied. The average marginal tax rate of borrowers, at 32 per cent (Table J), exceeds that of lenders, at 28.9 per cent, by 3.1 percentage points. Because short-term funds, included in these totals, may turn over several times a year, it is not possible to calculate accurately the loss to the Treasury on this score, but it could be significant.

Conclusion

Therefore, our studies indicate strongly that the issuance of taxable municipal bonds will involve an across-the-board interest rate increase of about 3/4 of one per cent. When all of the economic and capital market side effects are taken into account, the U.S. Treasury will be poorer by $121 million. At the same time, homeowners, states and municipalities and business will suffer increased

interest costs amounting to $737 million. These results do not bear out previous contentions that the issuance of taxable municipal bonds is cost free.

Furthermore, we respectfully urge upon this Committee that interest paid on state and municipal bonds should be exempted from both the limit on tax preferences and the allocation of deductions. In our opinion, the indirect taxation proposed in H.R.13270 would cost state and local governments much more than it would yield in revenue to the Treasury. This would mean a heavier tax burden falling mainly on the middle-income homeowner. The efficiency of the municipal bond market must be preserved if we are to supply the capital requirements of the states and their political subdivisions. That market cannot function efficiently if it is to be harassed by complex applications of indirect taxation of municipal bond interest.

NET NEW INVESTMENTS OF NON-BANK FINANCIAL INSTITUTIONS

IN BONDS AND STOCKS
(Billions $)

Years	Total	Bonds*	Stocks	Stocks as % of Total
1949	8.8	7.7	1.1	12.5
1950	9.6	8.4	1.2	12.5
1951	10.7	9.6	1.1	10.3
1952	13.8	12.1	1.7	12.3
1953	14.7	13.6	1.1	7.5
1954	18.2	14.5	3.7	20.3
1955	19.4	16.1	3.0	15.5
1956	17.2	15.0	2.2	12.8
1957	17.4	14.7	2.7	15.5
1958	20.2	17.2	3.0	14.9
1959	22.2	18.8	3.4	15.3
1960	21.8	18.1	3.7	17.0
1961	25.5	20.7	4.8	18.8
1962	27.9	23.6	4.3	15.4
1963	28.9	26.8	2.1	7.3
1964	28.9	27.0	1.9	6.6
1965	32.3	26.6	5.7	17.6
1966	27.2	20.7	6.5	23.9
1967	33.5	26.6	6.9	20.6
1968E	37.0	27.0	10.0	27.0
(Annual Averages)				
1949-53	11.5	10.3	1.2	10.4
1954-58	18.5	15.5	2.9	15.7
1959-63	25.3	21.6	3.7	14.6
1964-68	31.2	25.6	5.8	18.6

*Includes mortgages

EXHIBIT 1

33-758 O - 69 -- No. 10 -- 13

STATE AND LOCAL GOVERNMENT FINANCING*

(In billions of dollars)

	1961	1962	1963	1964	1965	1966	1967	1968 (est.)	1969 (proj.)
Construction put in place (Table 32)**	13.3	14.0	15.4	16.5	18.0	20.0	22.1	24.2	26.5
Increase in debt									
New long-term offerings	8.4	8.6	10.1	10.5	11.1	11.1	14.3	16.4	14.5
Less: Refundings***	.1	.3	.4	.3	.4	.2	.2	.2	.1
Retirements and other adjustment†	3.8	3.7	3.5	4.9	4.6	5.4	5.3	6.1	6.0
Increase in long-term debt	4.5	4.6	6.2	5.4	6.1	5.5	8.8	10.1	8.4
Increase in Federal Government loans (Table 29)	.3	.6	.3	.4	.4	.8	.3	.3	.4
Increase in short-term debt	.4	.4	.5	.5	1.3	.4	1.3	-.1	.7
Increase in gross debt (Table 2)	5.2	5.6	7.0	6.2	7.8	6.8	10.5	10.3	9.5
Increase in ownership									
Savings institutions:									
Life insurance companies (Table 15)	.3	.1	-.2	-.1	-.2	-.4	-.1	--	.1
State and local government retirement funds (Table 17)	-.1	-.6	-.4	-.4	-.3	-.1	--	-.2	-.2
Fire and casualty insurance companies (Table 18)	.9	.6	.7	.3	.2	.6	1.5	1.5	1.7
Contractual-type savings institutions	1.0	.1	.2	-.2	-.3	.1	1.3	1.3	1.6
Mutual savings banks (Table 20)	--	-.2	-.1	--	-.1	-.1	--	--	--
Total savings institutions	1.1	--	.1	-.2	-.4	.1	1.3	1.3	1.6
Commercial banks (Table 25)	2.8	4.4	5.2	3.6	5.1	2.4	9.0	8.3	5.0
Nonfinancial corporations (Table 27)	-.2	-.4	.9	.2	.7	.8	.7	.1	.8
Other investor groups:									
Federal agencies (Table 29)	.3	.6	.3	.4	.4	.8	.3	.3	.4
State and local governments (Table 29)	.1	-.3	-.3	-.1	-.1	-.1	--	-.2	--
Total other investor groups	.4	.3	--	.3	.3	.7	.3	.1	.4
Residual: Individuals and others†† (Table 31)	1.1	1.3	.8	2.3	2.1	2.8	-.8	.5	1.7
Total	5.2	5.6	7.0	6.2	7.8	6.8	10.5	10.3	9.5
Memorandum									
New industrial bond offerings†††	--	.1	.1	.2	.2	.5	1.3	1.6	.3

*1961-67, construction put in place from Construction Review, U.S. Department of Commerce (new series beginning in 1963); new long-term offerings from The Bond Buyer; data on changes in debt based on Flow of Funds Accounts, Federal Reserve; ownership data based on book values.
**Financed by Federal grants-in-aid as well as by state and local funds.
***1961-67, based on The Bond Buyer; excludes advance refundings.
†Residual. Includes adjustments for issues offered in the calendar year before issuance.
††Includes revaluation of book assets of some holders.
†††1961-67, Investment Bankers Association data.

Exhibit 2

U. S. Life Insurance Company Holdings & Acquisitions Of U. S. State & LocalBonds, 1959 - 1968
(000,000 omitted)

Year	State & Local Holdings	Total Assets	S & L Holding as % of Total Assets
1959	3,200	113,650	2.82%
1960	3,588	119,576	3.00
1961	3,888	126,816	3.07
1962	4,026	133,291	3.02
1963	3,852	141,121	2.73
1964	3,774	129,470	2.52
1965	3,530	158,884	2.22
1966	3,260	167,455	1.95
1967	3,145	177,832	1.77
1968	3,194	188,636	1.69

	S & L Acquisitions	Total Acquisitions	S & L Acquisitions as % of Total Acquisions
1959	670.	20,022	3.35%
1960	466	20,354	2.29
1961	506	25,150	2.01
1962	486	28,558	1.70
1963	371	32,167	1.15
1964	365	33,959	1.07
1965	296	39,451	0.75
1966	215	36,955	0.58
1967	212	43,447	0.49
1968	278	47,970	0.58

Source: Institute of Life Insurance

Exhibit 13

OWNERSHIP OF STATE AND LOCAL GOVERNMENT SECURITIES, END OF YEAR 1945-1952*

(In millions of dollars)

	1945	1946	1947	1948	1949	1950	1951	1952
Savings institutions								
Life insurance companies	722	614	609	872	1,052	1,152	1,170	1,153
Fire and casualty insurance companies	240	229	301	490	723	1,026	1,387	1,784
State and local government retirement funds	1,110	1,000	1,090	1,210	1,410	1,585	1,665	1,800
Mutual savings banks	84	58	57	73	93	96	140	335
Total savings institutions	2,156	1,901	2,057	2,645	3,278	3,859	4,362	5,072
Business								
Nonfinancial corporations	300	300	400	400	500	500	600	700
Commercial banks	4,000	4,400	5,300	5,700	6,500	8,100	9,200	10,200
Total business	4,300	4,700	5,700	6,100	7,000	8,600	9,800	10,900
Government								
Federal agencies	500	500	500	600	500	600	800	1,100
State and local governments	1,500	1,400	1,400	1,400	1,700	2,000	2,100	2,200
Total government	2,000	1,900	1,900	2,000	2,200	2,600	2,900	3,300
Residual: Individuals and others	7,544	7,599	7,843	8,855	9,722	10,241	10,938	11,728
Total debt outstanding	16,000	16,100	17,500	19,600	22,200	25,300	28,000	31,000

* Total from U.S. Department of Commerce, "Gross Public and Private Debt," *Survey of Current Business*, May 1969; ownership from various sources, as follows: life insurance companies - Institute of Life Insurance, "Life Insurance Fact Book"; fire and casualty insurance companies - Best & Company, "Aggregates and Averages"; state and local government retirement funds - Bureau of the Census, "Employee Retirement Systems of State and Local Governments" (based on data for fiscal years); mutual savings banks - National Association of Mutual Savings Banks, "National Fact Book"; commercial banks, nonfinancial corporations, and Federal agencies - Federal Reserve, "Flow of Funds accounts"; state and local governments - U.S. Department of Commerce total for state and local governments (or difference between gross and net debt in source cited above) less holdings of retirement funds.

Exhibit 4a

OWNERSHIP OF STATE AND LOCAL GOVERNMENT SECURITIES, END OF YEAR 1953-1960*

(In millions of dollars)

	1953	1954	1955	1956	1957	1958	1959	1960
Savings institutions								
Life insurance companies	1,298	1,846	2,038	2,273	2,376	2,681	3,200	3,588
Fire and casualty insurance companies	2,523	3,337	4,092	4,726	5,307	6,019	6,909	7,871
State and local government retirement funds	2,075	2,385	2,725	3,115	3,535	3,950	4,235	4,370
Mutual savings banks	428	608	646	676	685	729	721	672
Total savings institutions	6,324	8,176	9,501	10,790	11,903	13,379	15,066	16,501
Business								
Nonfinancial corporations	800	1,000	1,200	1,300	1,500	2,000	2,600	2,400
Commercial banks	10.800	12,600	12,700	12,900	13,900	16,500	17,000	17,600
Total business	11,600	13,600	13,900	14,200	15,400	18,500	19,600	20,000
Government								
Federal agencies	800	500	500	600	700	1,000	1,200	1,500
State and local governments	2,200	2,300	2,400	2,500	2,500	2,600	2,700	2,800
Total government	3,000	2,800	2,900	3,100	3,200	3,600	3,900	4,300
Residual: Individuals and others	14,076	15,624	18,999	21,910	24,097	24,321	26,334	29,399
Total debt outstanding	35,000	40,200	45,300	50,000	54,600	59,800	64,900	70,200

* Total from U.S. Department of Commerce, "Gross Public and Private Debt," Survey of Current Business, May 1969; ownership from various sources, as follows: life insurance companies - Institute of Life Insurance, "Life Insurance Fact Book"; fire and casualty insurance companies - Best & Company, "Aggregates and Averages"; state and local government retirement funds - Bureau of the Census, "Employee Retirement Systems of State and Local Governments" (based on data for fiscal years); mutual savings banks - National Association of Mutual Savings Banks, "National Fact Book"; commercial banks, nonfinancial corporations, and Federal agencies - Federal Reserve, "Flow of Funds accounts"; state and local governments - U.S. Department of Commerce total for state and local governments (or difference between gross and net debt in source cited above) less holdings of retirement funds.

Exhibit 4b

OWNERSHIP OF STATE AND LOCAL GOVERNMENT SECURITIES, END OF YEAR 1961-1968*

(In millions of dollars)

	1961	1962	1963	1964	1965	1966	1967	1968 Prel.
Savings institutions								
Life insurance companies	3,888	4,026	3,852	3,774	3,530	3,260	3,145	3,194
Fire and casualty insurance companies	8,723	9,333	10,073	10,378	10,612	11,261	12,735	14,200
State and local government retirement funds	4,225	3,775	3,315	2,915	2,640	2,490	2,450	2,200
Mutual savings banks	677	527	440	391	320	251	219	194
Total savings institutions	17,508	17,661	17,680	17,458	17,102	17,262	18,549	19,788
Business								
Nonfinancial corporations	2,200	1,800	2,700	2,900	3,600	4,400	5,100	5,200
Commercial banks	20,300	24,800	30,000	33,500	38,600	41,000	50,000	58,100
Total business	22,500	26,600	32,700	36,400	42,200	45,400	55,100	63,300
Government								
Federal agencies	1,800	2,400	2,700	3,100	3,500	4,400	4,600	4,900
State and local governments	3,100	3,000	2,700	2,400	2,200	2,000	1,700	1,500
Total government	4,900	5,400	5,400	5,500	5,700	6,400	6,300	6,400
Residual: Individuals and others	32,392	35,239	34,920	38,342	39,698	42,538	42,051	42,812
Total debt outstanding	77,300	84,900	90,700	97,700	104,700	111,600	122,000	132,300

* Total from U.S. Department of Commerce, "Gross Public and Private Debt," Survey of Current Business, May 1969; ownership from various sources, as follows: life insurance companies - Institute of Life Insurance, "Life Insurance Fact Book"; fire and casualty insurance companies - Best & Company, "Aggregates and Averages"; state and local government retirement funds - Bureau of the Census, "Employee Retirement Systems of State and Local Governments" (based on data for fiscal years); mutual savings banks - National Association of Mutual Savings Banks, "National Fact Book"; commercial banks, nonfinancial corporations, and Federal agencies - Federal Reserve, "Flow of Funds accounts"; state and local governments - U.S. Department of Commerce total for state and local governments (or difference between gross and net debt in source cited above) less holdings of retirement funds.

Exhibit 4c

WORK SHEET FOR THE DISTRIBUTION OF TAX-EXEMPT INTEREST
(By Adjusted Gross Income Class)

Item	Under $10,700	$10,700-16,400	$16,400-31,000	$31,000-73,000	$73,000-165,000	$165,000-315,000	$315,000 and over	Total
(1) Did not own municipals........	100.0%	97.1%	93.0%	77.4%	53.3%	51.7%	35.3%	89.8%
(2) Owned municipals, interest as per cent of income.......	. . .	2.9	7.0	22.6	46.7	48.3	64.7	10.2
(3) Under 10 per cent...........	. . .	2.7	6.1	15.9	22.6	37.6	47.0	7.7
(4) 10-24 per cent.............	. . .	.2	.4	5.0	7.8	7.2	11.8	1.4
(5) 25 per cent or more.........	. . .	. . .	.5	1.7	16.3	3.5	5.9	1.1
(6) Total..............	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
(7) Average interest as per cent of income, for those with...	. . .	2.6%	9.0%	7.5%	17.1%	6.7%	8.5%	8.4%
(8) Total number of returns (thousands).................	56,336	4,542	1,275	466	83	5	4	62,711
(9) Number of returns with interest (thousands)........	. . .	131.7	88.6	105.4	38.8	2.4	2.6	369.5
(10) Average amount interest, for those with, unadjusted..	. . .	$ 319	$1,818	$2,784	$13,235	$15,664	$46,264	$3,159
(11) Aggregate interest, unadjusted (millions).......	. . .	$42.0	$161.1	$293.3	$513.2	$37.8	$119.7	$1,167.1
(12) Percentage distribution of aggregate interest.......	. . .	3.6%	13.8%	25.1%	44.0%	3.2%	10.3%	100.0%
(13) Aggregate interest, adjusted (millions).........	. . .	$36.0	$138.0	$251.0	$440.0	$ 32.0	$ 103.0	$1,000.0
(14) Average amount interest, for those with, adjusted....	. . .	$ 273	$1,557	$2,382	$11,347	$13,256	$39,799	$2,706

Source: Okner, (See reference, p. 3)

Exhibit 5

Estate Tax Returns Filed during 1966 by Size of Estate and Composition of Assets (in millions of dollars)

Size of Total Estate	Number of Returns	Total Estate	Amount held in state and municipal bonds	Per cent held in state and mun. bonds	Per cent held in corporate stock	Per cent held in other assets
$ 0.06 under $ 0.08	8,770	631.2	.9	.14	23.74	76.12
0.08 " 0.10	8,707	778.1	1.7	.21	26.52	73.27
0.10 " 0.15	15,919	1980.5	5.4	.27	29.28	70.45
0.15 " 0.20	10,465	1808.5	7.0	.38	33.44	66.18
0.20 " 0.30	9,712	2354.7	16.8	.71	38.15	61.14
0.30 " 0.50	6,689	2543.4	33.5	1.31	44.63	54.06
0.50 " 1.00	4,133	2818.8	84.9	3.01	52.22	44.77
1.00 " 2.00	1,532	2079.2	97.5	4.68	56.49	38.83
2.00 " 3.00	400	964.7	60.8	6.30	55.72	37.98
3.00 " 5.00	236	898.1	62.5	6.95	61.07	31.98
5.00 " 10.00	130	890.8	76.9	8.63	57.42	33.95
10.00 " 20.00	33	449.8	33.9	7.53	65.40	27.07
20.00 or more	19	599.9	26.1	4.35	71.36	24.29
Totals	66,745	18797.7	507.9	2.70	45.43	51.87

Note: Data presented here relate only to taxable estates. Total estate differs from gross estate by the inclusion of life insurance at face value (before deduction of outstanding loans), and the exclusion of gifts made during the decedent's life.

Source: Statistics of Income, 1965, Estate Tax Returns filed during calendar year 1966: United States Treasury Department, Internal Revenue Service, Washington, D.C., November 2, 1967, pp. 71-72.

Exhibit 6

Table A

GROSS ACQUISITIONS OF NEW ISSUES OF LONG-TERM FIXED-INCOME OBLIGATIONS, AVERAGE 1965-68 BY INVESTOR GROUP*

(In billions of dollars)

	Mortgages	Corporate bonds	U.S. Gov't bonds and notes	Federal agency securities	Total taxable issues	Municipal bonds	Total
Savings institutions							
Life insurance companies	9.4	5.3	--	.1	14.8	.2	15.0
Private noninsured pension funds	.7	2.2	--	.1	3.0	--	3.0
State and local government retirement funds	1.3	3.3	--	.2	4.8	.2	5.0
Fire and casualty insurance companies	--	.7	.1	.1	.9	1.5	2.4
Savings and loan associations	20.8	--	.2	.1	21.1	--	21.1
Mutual savings banks	7.5	.9	.1	.4	8.9	--	8.9
Credit unions	.2	--	--	--	.2	--	.2
Investment companies	--	.4	--	--	.4	--	.4
Total savings institutions	39.9	12.8	.4	1.0	54.1	1.9	56.0
Business							
Business corporations	.3	--	.1	.2	.6	--	.6
Commercial banks	12.8	.1	1.6	1.0	15.5	7.9	23.4
Total business	13.1	.1	1.7	1.2	16.1	7.9	24.0
Government							
Federal agencies	3.9	--	--	--	3.9	--	3.9
State and local governments	.2	.9	.1	.2	1.4	.2	1.6
Total government	4.1	.9	.1	.2	5.3	.2	5.5
Foreign investors	--	.1	--	--	.1	--	.1
Residual: individuals and others	2.9	3.4	.9	1.6	8.8	3.3	12.1
Total	60.0	17.3	3.1	4.0	84.4	13.3	97.7

* For each instrument represents net change in holdings of each investor group plus estimated retirements and refundings; data for U.S. Gov't and agency securities are for issues offered during the period with maturities of two years or more; data for municipal bonds are for new issues of 1 year or more to maturity.

Table B

PERCENTAGE DISTRIBUTION OF GROSS ACQUISITIONS OF NEW ISSUES OF LONG-TERM FIXED-INCOME OBLIGATIONS, AVERAGE 1965-68*

(In per cent)

	Mortgages	Corporate bonds	U.S. Gov't bonds and notes	Federal agency securities	Total taxable issues	Municipal bonds	Total
Savings institutions							
Life insurance companies	62.7	35.3	--	.7	98.7	1.3	100.0
Private noninsured pension funds	23.3	73.3	--	3.3	100.0	--	100.0
State and local government retirement funds	26.0	66.0	--	4.0	96.0	4.0	100.0
Fire and casualty insurance companies	--	29.2	4.2	4.2	37.5	62.5	100.0
Savings and loan associations	98.6	--	.9	.5	100.0	--	100.0
Mutual savings banks	84.3	10.1	1.1	4.5	100.0	--	100.0
Credit unions	100.0	--	--	--	100.0	--	100.0
Investment companies	--	100.0	--	--	100.0	--	100.0
Total savings institutions	71.2	22.9	.7	1.8	96.6	3.4	100.0
Business							
Business corporations	50.0	--	16.7	33.3	100.0	--	100.0
Commercial banks	54.7	.4	6.8	4.3	66.2	33.8	100.0
Total business	54.6	.4	7.1	5.0	67.1	32.9	100.0
Government							
Federal agencies	100.0	--	--	--	100.0	--	100.0
State and local governments	12.5	56.2	6.2	12.5	87.5	12.5	100.0
Total government	74.5	16.4	1.8	3.6	96.4	3.6	100.0
Foreign investors	--	100.0	--	--	100.0	--	100.0
Residual: individuals and others	24.0	28.1	7.4	13.2	72.7	27.3	100.0
Total	61.4	17.7	3.2	4.1	86.4	13.6	100.0

* For each instrument represents net change in holdings of each investor group plus estimated retirements and refundings; data for U.S. Gov't and agency securities are for issues offered during the period with maturities of two years or more; data for municipal bonds are for new issues of 1 year or more to maturity.

Table C

NET FUNDS RAISED AND SUPPLIED
IN U.S. CREDIT AND EQUITY MARKETS, AVERAGE 1965-68*

(In billions of dollars)

Funds supplied by	Total funds raised	Long-term fixed-income obligations: Total	Long-term fixed-income obligations: Term loans and foreign securities	Long-term fixed-income obligations: Other**	Short-term fixed income obligations***	Corporate stock
Savings institutions						
Life insurance companies	8.3	6.8	.2	6.6	.6	.8
Private noninsured pensions funds	5.9	1.7	--	1.7	-.2	4.4
State and local government retirement funds	3.7	3.4	--	3.4	-.3	.5
Fire and casualty insurance companies	1.8	1.8	--	1.8	-.4	.5
Savings and loan associations	8.2	7.7	--	7.7	.5	--
Mutual savings banks	4.0	4.5	--	4.5	-.8	.2
Credit unions	1.1	.1	--	.1	1.0	--
Investment companies - open end	1.8	.4	--	.4	.2	1.2
Total savings institutions	34.7	26.4	.3	26.2	.6	7.6
Business						
Business corporations	10.6	.5	--	.5	10.0	--
Commercial banks	30.4	16.6	2.5	14.1	13.7	--
Brokers and dealers	1.2	--	--	--	1.2	--
Other consumer lenders	.8	--	--	--	.8	--
Total business	42.9	17.0	2.5	14.6	25.7	--
Government						
Federal agencies	2.9	2.9	--	2.9	--	--
State and local governments	3.0	1.1	--	1.1	2.0	--
Total government	5.9	4.0	--	4.0	2.0	--
Foreign investors	.3	-.2	--	-.2	-.1	.6
Residual: Individuals and others	2.1	8.1	.9	7.2	1.7	-7.5
Total funds supplied	86.1	55.4	3.6	51.8	30.0	.7

* Based on Bankers Trust Company, "Investment Outlook for 1969" except for U.S. Government bonds and notes and Federal agency securities which are based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership."

** Comprises mortgages, corporate bonds, U.S. Government bonds and notes and Federal agency securities offered during period with maturities of two years or more, and municipal bonds.

*** Comprises other U.S. Government and agency securities, short-term municipal securities, open market paper, other business credit (including bank short-term loans), security credit, consumer credit, other bank loans, and policy loans of life insurance companies.

Table D

NET FUNDS RAISED AND SUPPLIED THROUGH LONG-TERM FIXED-INCOME OBLIGATIONS IN THE U.S. CREDIT MARKETS, AVERAGE 1965-68*

(In billions of dollars)

Funds supplied by	Total funds raised	Taxable issues: Total	Mortgages	Corporate bonds	U.S. Gov't bonds and notes**	Federal agency securities**	Municipal bonds
Savings institutions							
Life insurance companies	6.6	6.8	3.7	3.0	--	.1	-.2
Private noninsured pension funds	1.7	1.7	.3	1.3	--	.1	--
State and local government retirement funds	3.4	3.6	.6	2.8	--	.2	-.2
Fire and casualty insurance companies	1.8	.8	--	.6	.1	.1	1.0
Savings and loan associations	7.7	7.7	7.4	--	.2	.1	--
Mutual savings banks	4.5	4.5	3.2	.8	.1	.4	--
Credit unions	.1	.1	.1	--	--	--	--
Investment companies - open end	.4	.4	--	.4	--	--	--
Total savings institutions	26.2	25.6	15.3	8.8	.4	1.0	.6
Business							
Business corporations	.5	.5	.2	--	.1	.2	--
Commercial banks	14.1	8.0	5.4	--	1.6	1.0	6.1
Total business	14.6	8.5	5.6	--	1.7	1.2	6.1
Government							
Federal agencies	2.9	2.5	2.5	--	--	--	.4
State and local governments	1.1	1.2	.2	.7	.1	.2	-.1
Total government	4.0	3.7	2.6	.7	.1	.2	.4
Foreign investors	-.2	-.2	--	-.2	--	--	--
Residual: Individuals and others	7.2	6.1	.6	3.0	.9	1.6	1.1
Total funds supplied	51.8	43.7	24.1	12.4	3.1	4.0	8.1

* Based on Bankers Trust Company, "Investment Outlook for 1969", except for U.S. Government bonds and notes and Federal agency securities; excludes term loans and foreign securities.

** Based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership"; comprises issues offered during the period with maturities of two years or more.

Table E

NET FUNDS RAISED AND SUPPLIED
IN U.S. CREDIT AND EQUITY MARKETS, AVERAGE 1965-68*

- Adjusted for Shifts Resulting from Issuance of only Taxable Municipals** -

(In billions of dollars)

Funds supplied by	Total funds raised	Long-term fixed-income obligations			Short-term fixed income obligations†	Corporate stock
		Total	Term loans and foreign securities	Other***		
Savings institutions						
Life insurance companies	8.3	6.7	.2	6.5	.6	.9
Private noninsured pensions funds	5.9	1.6	--	1.6	-.2	4.5
State and local government retirement funds	3.7	3.3	--	3.3	-.3	.6
Fire and casualty insurance companies	1.8	1.7	--	1.7	-.4	.6
Savings and loan associations	8.2	7.7	--	7.7	.5	--
Mutual savings banks	4.0	4.5	--	4.5	-.8	.2
Credit unions	1.1	.1	--	.1	1.0	--
Investment companies - open end	1.8	.4	--	.4	.2	1.2
Total savings institutions	34.7	26.0	.3	25.8	.6	8.0
Business						
Business corporations	10.6	.5	--	.5	10.0	--
Commercial banks	30.4	14.8	2.5	12.3	15.6	--
Brokers and dealers	1.2	--	--	--	1.2	--
Other consumer lenders	.3	--	--	--	.8	--
Total business	42.9	15.3	2.5	12.8	27.6	--
Government						
Federal agencies	2.9	2.9	--	2.9	--	--
State and local governments	3.0	1.1	--	1.1	2.0	--
Total government	5.9	4.0	--	4.0	2.0	--
Foreign investors	.3	-.2	--	-.2	-.1	.6
Residual: Individuals and others	2.1	7.5	.9	6.6	2.4	-7.9
Total funds supplied	86.1	52.8	3.6	49.2	32.7	.7

* Based on Bankers Trust Company, "Investment Outlook for 1969" except for U.S. Government bonds and notes and Federal agency securities which are based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership."

** Based on results of Investment Bankers Association questionnaire.

*** Comprises mortgages, corporate bonds, U.S. Government bonds and notes and Federal agency securities offered during period with maturities of two years or more, and municipal bonds.

† Comprises other U.S. Government and agency securities, short-term municipal securities, open market paper, other business credit (including bank short-term loans), security credit, consumer credit, other bank loans, and policy loans of life insurance companies.

Table F

NET FUNDS RAISED AND SUPPLIED THROUGH LONG-TERM FIXED-INCOME OBLIGATIONS IN THE U.S. CREDIT MARKETS, AVERAGE 1965-68*

- Adjusted for Shifts Resulting from Issuance of only Taxable Municipals** -

(In billions of dollars)

Funds supplied by	Total funds raised	Taxable issues: Total	Mort-gages	Corporate bonds	U.S. Gov't bonds and notes***	Federal agency securities**	Municipal bonds
Savings institutions							
Life insurance companies	6.5	6.2	3.5	2.7	--	--	.3
Private noninsured pension funds	1.6	1.3	--	1.0	.1	.2	.3
State and local government retirement funds	3.3	3.0	.7	2.1	--	.1	.4
Fire and casualty insurance companies	1.7	1.4	.4	.8	.1	.1	.3
Savings and loan associations	7.7	7.6	7.3	--	.2	.1	.1
Mutual savings banks	4.5	4.4	3.2	.8	.1	.3	.1
Credit unions	.1	.1	.1	--	--	--	--
Investment companies - open end	.4	.4	--	.4	--	--	--
Total savings institutions	25.8	24.4	15.2	7.8	.5	.8	1.5
Business							
Business corporations	.5	.5	.2	--	.1	.2	--
Commercial banks	12.3	9.4	4.7	.1	2.9	1.7	2.9
Total business	12.8	9.9	4.9	.1	3.0	1.9	2.9
Government							
Federal agencies	2.9	2.5	2.5	--	--	--	.4
State and local governments	1.1	1.2	.2	.7	.1	.2	-.1
Total government	4.0	3.7	2.6	.7	.1	.2	.4
Foreign investors	-.2	-.2	--	-.2	--	--	--
Residual: Individuals and others	6.6	5.9	1.4	3.9	-.5	1.1	.7
Total funds supplied	49.2	43.7	24.1	12.4	3.1	4.0	5.5

* Based on Bankers Trust Company, "Investment Outlook for 1969", except for U.S. Government bonds and notes and Federal agency securities; excludes term loans and foreign securities.

** Based on result of Investment Bankers Association questionnaire.

*** Based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership"; comprises issues offered during the period with maturities of two years or more.

Table G

GROSS ACQUISITIONS OF NEW ISSUES OF LONG-TERM FIXED-INCOME OBLIGATIONS, AVERAGE 1965-68
BY INVESTOR GROUP*

- Adjusted for Shifts Resulting from Issuance of only Taxable Municipals** -

(In billions of dollars)

	Mortgages	Corporate bonds	U.S. Gov't bonds and notes	Federal agency securities	Total taxable issues	Municipal bonds	Total
Savings institutions							
Life insurance companies	9.2	4.9	--	--	14.1	.8	14.9
Private noninsured pension funds	.3	1.9	.1	.2	2.5	.3	2.8
State and local government retirement funds	1.4	2.8	--	.1	4.3	1.1	5.4
Fire and casualty insurance companies	.4	.9	.1	.1	1.5	.8	2.3
Savings and loan associations	20.7	--	.2	.1	21.0	.1	21.1
Mutual savings banks	7.6	.9	.1	.3	8.9	.1	9.0
Credit unions	.2	--	--	--	.2	--	.2
Investment companies	--	.4	--	--	.4	--	.4
Total savings institutions	39.8	11.8	.5	.8	52.9	3.2	56.1
Business							
Business corporations	.3	--	.1	.2	.6	--	.6
Commercial banks	12.1	.1	2.9	1.7	16.8	4.7	21.5
Total business	12.4	.1	3.0	1.9	17.4	4.7	22.1
Government							
Federal agencies	3.9	--	--	--	3.9	--	3.9
State and local governments	.2	.9	.1	.2	1.4	.2	1.6
Total government	4.1	.9	.1	.2	5.3	.2	5.5
Foreign investors	--	.1	--	--	.1	--	.1
Residual: Individuals and others	1.6	4.3	-.5	1.1	6.5	2.6	9.1
Total	57.9	17.2	3.1	4.0	82.2	10.7	92.9

* For each instrument represents net change in holdings of each investor group plus estimated retirements and refundings; data for U.S. Government and agency securities are for issues offered during the period with maturities of two years or more, data for municipal bonds are for new issues of 1 year or more to maturity.

** Based on results of Investment Bankers Association questionnaire.

Table 8

MARGINAL TAX RATES PAID BY LONG-TERM LENDERS IN U.S. CREDIT MARKETS

- With and Without Municipal Bonds as Taxable -

(Amounts in billions of dollars)

Funds supplied by	Marginal tax rate	Gross taxable long-term funds supplied, average 1965-68	Gross tax-exempt municipal bonds supplied, average 1965-68	Gross taxable municipal bonds supplied (if only taxable municipal bonds are issued)	Gross taxable long-term funds supplied (if only taxable municipal bonds are issued)
Savings institutions					
Life insurance companies	20	14.8	.2	.8	14.9
Private noninsured pension funds	0	3.0	--	.3	2.8
State and local government retirement funds	0	4.8	.2	1.1	5.4
Fire and casualty insurance companies	48	.9	1.5	.8	2.3
Savings and loan associations	20	21.1	--	.1	21.1
Mutual savings banks	20	8.9	--	.1	9.0
Credit unions	0	.2	--	--	.2
Investment companies - open end	0	.4	--	--	.4
Total savings institutions		54.1	1.9	3.2	56.1
Business					
Business corporations	48	.6	--	--	.6
Commercial banks	48	15.5	7.9	4.7	21.5
Total business		16.1	7.9	4.7	22.1
Government					
Federal agencies	0	3.9	--	--	3.9
State and local governments	0	1.4	.2	.2	1.6
Total government		5.3	.2	.2	5.5
Foreign investors		.1	--	--	.1
Residual: Individuals and others					
Taxable debt securities and mortgages	28.5	8.8		2.6	9.1
Dividends	36.7				
Municipal bonds, tax-exempt	42.3		3.3		
Total funds supplied		84.4	13.3	10.7	92.9
Marginal tax rate on total long-term funds supplied		23.2	44.7	33.5	25.1

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Table I

ANTICIPATED EFFECT ON GENERAL LEVEL OF LONG-TERM INTEREST RATES IF ONLY TAXABLE MUNICIPAL BONDS ARE ISSUED HEREAFTER (IRRESPECTIVE OF ALL OTHER FACTORS)

- Investment Bankers Association Questionnaire, August 1969 -

		Number anticipating							
				Rise (basis points)					
	Total responses	Decline	Stay the same	Total	Less than 50	50-99	100-149	150 or more	Average change anticipated* (basis points)
Savings institutions									
Life insurance companies	59	3	15	41	17	21	3	--	29
Private noninsured pension funds	49	1	2	46	7	24	9	6	80
State and local government retirement funds	19	3	3	13	8	3	1	1	23
Fire and casualty insurance companies	45	2	5	38	7	16	11	4	76
Savings and loan associations	16	1	5	10	4	1	2	3	26
Mutual savings banks	31	1	3	27	14	8	5	0	39
Total	219	11	33	175	57	73	31	14	65
Commercial banks	56	--	--	56	5	24	11	16	92
All institutions	275	11	33	231	62	97	42	30	70
Investment advisers to individuals	54	1	3	50	6	25	13	6	83
Total	329	12	36	281	68	122	55	36	72
Persentage distribution	100.0	3.6	10.9	85.4	20.7	37.1	16.7	10.9	

* Median.

Table J

MARGINAL TAX RATE ON INTEREST PAID BY ISSUERS ON NET NEW ISSUES OF DEBT, 1965-68 AVERAGE

	Net new issues	Marginal tax rate
Investment funds		
Home mortgages	13.4	23.7
Multifamily and commercial	8.5	48.0
Farm mortgages	2.2	22.0
Total mortgages	24.1	
Corporate bonds	12.4	48.0
State and local government securities	8.8	--
Foreign securities	1.2	--
Term loans	2.4	48.0
Total investment funds	48.9	
Short-term funds		
Stock market credit, except bank loans:		
Brokers and dealers	.6	48.0
Customers	1.2	36.9
Consumer credit	8.2	23.7
Policy loans	1.0	23.7
Other short-term funds	19.8	48.0
Total short-term funds	30.8	
U.S. Government and agency securities		
U.S. Government securities, publicly-held	1.4	--
Federal agency net borrowing, publicly-held	4.2	--
U.S. Government and agency securities, publicly-held	5.6	--
Total funds	85.3	32.0

APPENDIX A
Additional Comment on Limited Tax Preference
(Minimum Individual Income Tax)
Treatment of Tax-Exempt Interest

In the arithmetic used in discussions of tax reform there is generally a failure to consider one major point. This point is that a substantial price has been paid by the investor for tax exemption in the form of acceptance of a lesser interest rate.

(1) One way to look at this is in terms of capitalizing it in price. The following table shows this by indicating the value of 25-year bonds with a coupon based on the level of the tax-exempt market at a yield based on the corporate market. The relation between yields in the two markets is computed at 70%, the approximate level which has held over a number of years. Given stability in this relationship it will be seen that the price paid by the investor for tax exemption goes up as yields rise. The outgoing Treasury minimum tax plan overlooks this

Tax Exempt Coupon		Corporate Bond Yields	Dollar Price at Corporate Yield	Price Paid for Tax Exemption*
5 ¼%	@	7 ½%	74.76	25.24
4.90's	@	7 %	75.37	24.63
4.20's	@	6 %	76.84	23.16
3 ½'s	@	5 %	78.72	21.28
3.15's	@	4 ½%	79.86	20.14

*It is assumed that the investor paid 100 for the tax-exempt bonds in each case.

factor. The inclusion of percentage depletion in oil and other minerals is "in excess of capital investment". Equal treatment for tax-exempt income would require consideration of the price paid for it as above.

(2) One of the questions Congressman Byrnes posed to witnesses during the House Ways and Means Committee hearings was "doesn't the individual taxpayer get much more out of the tax exemption than the borrowing municipality?" One of the answers given him at the time was that the investor has to estimate what his advantage will be because he cannot know his prospective tax bracket 10, 20, 30 years hence (and in the intervening years). Thus he needs a margin solely to assure that he will come out even.

Computations of relative advantage must make some assumption as to future tax rates and income brackets, and usually assume a continuance of the present situation. Those which follow make this assumption. Statements of the most extreme cases of tax sheltered income are based on instances where adjusted gross income is large, but no tax is paid. Tax-exempt interest on municipal bonds is not included in these instances, because it is not a part of adjusted gross income. Because the minimum tax is designed to reach such persons, and because some of them may also have tax-exempt interest income, we have prepared some examples to show (1) relative benefit to the taxpayer and to the borrowing municipality in such instances and (2) the impact of the proposed munimum tax. A later example shows this comparison for a taxpayer with at least $200,000 of taxable income.

Each example shows the alternative result if, instead of an investment in tax-exempt bonds, the individual had purchased taxable bonds and was paying annual income tax on the interest from them. The 70% ratio of tax-exempt income to taxable income is again used in these comparisons. The income tax rates used are those for joint husband and wife returns. The surtax is not included as it seems inappropriate to apply this temporary measure over the life of a long-term bond. In computing the impact of the minimum tax it is assumed that tax-exempt bond interest amounts to only about a quarter of total income. This is in line with investment proportions recommended by professional investment advisers, and very few investors have a much larger concentration in tax-exempt bonds.

In the first example (Exhibit 4) $50,000 tax-exempt interest income is received, and any other income is protected by various exclusions and deductions. If the investor had purchased taxable bonds instead, he would have received $71,400 in taxable income ($\frac{100}{70}$ X $50,000). The tax on $71,400 would be $28,490 (an average rate of 40%), and there would remain $42,910 after tax. By having tax-exempt income the taxpayer has benefited $7,090 ($50,000 - $42,910). The borrowing municipality - assuming for simplicity that only one is involved - has saved

$21,400 ($71,400 - $50,000) by being able to do its financing in the tax-exempt market instead of having to sell taxable bonds. If the minimum tax as proposed were applied to the $50,000 tax-exempt income and it became taxable at as much as a 30% rate, the $15,000 tax would wipe out the taxpayer's benefit in having bought tax-exempts, and in fact he would be penalized $7,910 net.

Three other examples with larger amounts of tax-exempt income are shown in Exhibits 4, 5 and 6. These computations are based on approximate relationships, but they do help to answer the question of who gets the larger benefit from tax exemption, the borrowing municipality or the investor. It is not until we get to a holding of tax-exempts producing $200,000 of tax-exempt income that a taxpayer's advantage begins to equal the advantage to the municipality. Even with holdings producing one-quarter of a million dollars of tax-exempt income the advantage to the taxpayer is only nominally more than the advantage to the municipality.

Interestingly enough, when the minimum tax proposal is applied it would wipe out the taxpayer's benefit in the first two examples and would take away most of his advantage in the last two. The maximum advantage of tax-exempt interest to the individual taxpayer occurs when it is on top of at least $200,000 of <u>taxable</u> income. Exhibit 8 shows how this works out. Here the taxpayer does gain more than the municipality, but only one-third more. If it applied, the minimum tax would leave him some benefit, but less than 40%; it would probably <u>not</u> apply because of the large amount of income presently taxable.

What do these figures say about the minimum tax idea? They seem to say that it would have no impact where the advantage to the taxpayer is greatest (Exhibit 8), and that its impact on present non-taxpayers (Exhibits 4-7) would be so severe, as to reflect not <u>equity</u>, but a kind of retaliation. A fuller realization of this would further alienate individual investors, who would doubtless diminish their purchases of tax-exempt bonds, with the resulting adverse effect on the municipal market stressed in our previous testimony. Local government borrowing would then cost more, and the ultimate burden would fall on local taxpayers.

EXHIBIT 1

BENEFIT FROM TAX-EXEMPT INTEREST
Impact of Limited Tax Preferences

(Minimum Tax)

$50,000 from Tax-Exempts

$\$50M \times \frac{100}{70} = \$71,400$ Alternative Taxable Income

Tax on $71,400 = $20,490 = 40%

$71,400	
20,490	
$42,910	After Tax

Distribution of Benefit:

Municipality	$71,400	-	$50,000	=	$21,400
Taxpayer	50,000	-	42,910	=	$ 7,090
					$28,490

* * * * *

Should the $50,000 tax-exempt income become taxable at as much as 30% i.e. $15,000, the taxpayer's benefit would be wiped out and he would be penalized $7,910 net.

EXHIBIT 2

BENEFIT FROM TAX-EXEMPT INTEREST
Impact of Limited Tax Preferences

(Minimum Tax)

$125,000 from Tax-Exempts

$125M X $\frac{100}{70}$ = $170,500 Alternative Taxable Income

Tax on $170,500 = $82,560 = 46%

```
$170,500
  82,560
$ 95,940 After Tax
```

Distribution of Benefit:

Municipality	$170,500	-	$125,000	=	$53,500
Taxpayer	$125,000	-	95,940	=	$29,060
					$82,560

* * * * *

A 30% minimum tax on $125,000 = $37,500, more than wiping out taxpayer's gain of $29,060. - (In this case 35% minimum tax is possible, which would be $43,750.)

EXHIBIT 3

BENEFIT FROM TAX-EXEMPT INTEREST
Impact of Limited Tax Preferences

(Minimum Tax)

$200,000 from Tax-Exempts

$200M X 100/70 = $285,700 Alternative Taxable Income

Tax on $285,700 = $170,970 = 60%

$285,700
170,970
$114,730 After Tax

Distribution of Benefit:

Municipality	$285,700	-	$200,000	=	$85,700
Taxpayer	$200,000	-	$114,730	=	$85,270
					$170,970

* * * * *

Minimum tax of 30% on $200,000 = $60,000 - takes most of taxpayer's advantage. At 35%, which is likely, it would be $70,000.

EXHIBIT 4

BENEFIT FROM TAX-EXEMPT INTEREST
Impact of Limited Tax Preferences

(Minimum Tax)

$250,000 from Tax-Exempts

$250M X $\frac{100}{70}$ = $357,100 Alternative Taxable Income

Tax on $357,100 = $220,950 = 62%

$357,100
220,950
$136,150 After Tax

Distribution of Benefit:

Municipality	$357,100	-	$250,000	=	$107,100
Taxpayer	$250,000	-	$136,150	=	$113,850
					$220,950

* * * * *

Minimum tax of 35% on $250,000 = $87,500, which would take most of taxpayer's advantage.

EXHIBIT 5

BENEFIT FROM TAX-EXEMPT INTEREST
Impact of Limited Tax Preference

(Minimum Tax)

Gross Income includes over $200,000 Taxable

$70,000 Tax-Exempt Income

$100,000 Alternative Taxable Income

Tax on $100,000 = $70,000 = 70% = $30,000 After Tax

Distribution of Benefit:

Municipality	$100,000	-	$70,000	=	$30,000
Taxpayer	$ 70,000	-	$30,000	=	$40,000
					$70,000

* * * * *

A 35% tax on $70,000 = $24,500 which would leave some 39% of the taxpayer advantage.

But here the minimum tax would probably not apply because of larger amount of income presently taxable.

APPENDIX B

Additional Comment on Proposal for Allocation of Deductions

Further study of the allocation of deductions proposal indicates that this would affect many more taxpayers and thus might have even greater adverse market impact than the minimum income tax.[1] Investment in municipal bonds by individuals would be made less attractive, and more individuals would find in this another reason to shift their investment programs even more heavily toward the common stock area. This would risk a drastic reduction in the support for State and local financing supplied by individual investors, particularly during periods when buying by banks is reduced owing to credit restraint such as that now being applied by the Federal Reserve System. Furthermore, institutional investors might well anticipate a growing risk that the principle of allocation would in time be applied to them, to the detriment of their programs for investment in tax-exempts. Accordingly, we believe that this allocation proposal would also have a very serious effect on the municipal market.

The three principal categories of deductions which would be involved in this allocation are (1) contributions (2) State and local taxes, and (3) interest paid. The allocation proposal might have an adverse effect on charitable giving as well as on individual investment in the municipal market, risking major hardships in both of these areas in return for an uncertain minor gain in tax equity.

With current revenue needs of State and local governments at an all-time high, it would be unfortunate to downgrade in any way the present deductibility of State and local taxes. To do so would make it even more difficult for States and cities to raise taxes and hence tend to widen the gap between the taxing power of the Federal government on the one hand and that of State and local

* * * *

(1) Attached are some computations (Exhibits 1, 2 and 3) which indicate the reduction in the value of tax-exempt interest to an individual investor if all of the resulting increase in tax is charged against the tax-exempt income. In each case tax-exempt interest is assumed at ¼ of total income including taxable income. It is assumed that there are no other excluded items in order to highlight the impact on tax-exempt interest. It will be noted that the impact rises as the ratio of deductions to income rises.

governments on the other; the need today is for moves in the opposite direction.

With respect to the question of interest deductions we note that this is not a problem for the Treasury in relation to tax-exempt interest on State and local bonds. Section 265 of the Internal Revenue Code and the regulations thereunder already forbid the deduction of interest on loans to purchase or carry an investment in tax-exempt securities. Similarly disallowed are expenditures for investment management, or for custody or safe deposit box facilities insofar as they are incurred in the production of tax-exempt income.

EXHIBIT 1

EFFECT OF ALLOCATION OF DEDUCTIONS

$60,000 Taxable Income - before Deductions

$20,000 Tax-exempt Interest

A. $10,000 Deductions

	Subject to Tax	Tax (Joint Return)
$60,000 - $10,000 =	$50,000	$17,060
$60,000 - ($60,000 / $80,000 X $10,000) =	$52,500	18,325
		+$ 1,265

$20,000 Exempt Interest effectively reduced to $18,735 -
5% rate reduced to 4.68%
4½% 4.22%
4% 3.75%

B. $20,000 Deductions

	Subject to Tax	Tax (Joint Return)
$60,000 - $20,000 =	$40,000	$12,140
$60,000 - ($60,000 / $80,000 X $20,000) =	45,000	14,560
		+$ 2,420

$20,000 Exempt Interest effectively reduced to $17,580 -
5% rate reduced to 4.39%
4½% 3.95%
4% 3.51%

* * * *

Note referring to A. above: Using the method of computing benefits to borrower and taxpayer used in the attached discussion of the minimum income tax, benefit to the borrower was $8,570.00 and to the taxpayer was $6,880.00. Allocation of deductions would reduce the taxpayer benefit by $1,265.00 to $5,615.00.

EXHIBIT 2

EFFECT OF ALLOCATION OF DEDUCTIONS

$150,000 Taxable Income - before Deductions

$50,000 Tax-exempt Interest

A. $15,000 Deductions

	Subject to Tax	Tax (Joint Return)
$150,000 - $15,000 =	$135,000	$67,100
$150,000 - ($150,000 / $200,000 X $15,000) =	138,750	69,580
		+$ 2,400

$50,000 Exempt Interest effectively reduced to $47,600 -

5% rate reduced to	4.76%
4½%	4.27%
4%	3.80%

B. $60,000 Deductions

	Subject to Tax	Tax (Joint Return)
$150,000 - $60,000 =	$ 90,000	$39,180
$150,000 - ($150,000 / $200,000 X $60,000) =	105,000	48,280
		+$ 9,100

$50,000 Exempt Interest effectively reduced to $40,900 -

5% rate reduced to	4.09%
4½%	3.67%
4%	3.27%

EXHIBIT 3

EFFECT OF ALLOCATION OF DEDUCTIONS

$300,000 Taxable Income - before Deductions

$100,000 Tax-exempt Interest

A. $30,000 Deductions

	Subject to Tax	Tax (Joint Return)
$300,000 - $30,000 =	$270,000	$159,930
$300,000 - ($300,000 / $400,000 X $30,000) =	$277,500	165,230
		+$ 5,250

$100,000 Exempt Interest effectively reduced to $94,750 -

5% rate reduced to	4.73%
4½%	4.26%
4%	3.79%

B. $100,000 Deductions

	Subject to Tax	Tax (Joint Return)
$300,000 - $100,000 =	$200,000	$100,980
$300,000 - ($300,000 / $400,000 X $100,000) =	$225,000	128,480
		+$ 17,500

$100,000 Exempt Interest effectively reduced to $82,500 -

5% rate reduced to	4.13%
4½%	3.71%
4%	3.30%

* * * *

Note referring to B. above: Using the method of computing benefits to borrower and taxpayer used in the attached discussion of the minimum income tax, benefit to the borrower was $43,000.00 and to the taxpayer was $57,100.00. Allocation of deductions would reduce the taxpayer benefit by $17,500.00 to $39,600.00.

METHODOLOGY

Municipal Bonds - Table I

Two different investment procedures were used for two different periods of time. Roman numerals I and II represent investments made in the past ten years and Roman numerals III and IV represent investments made in the past five years. In I and III the full investment of $1,000,000 was made at the beginning of the respective 10- or 5-year period. In II and IV an equal proportion of the total $1,000,000 was invested at the beginning of each year.

For municipals, it was assumed that the bonds were 20-year bonds roughly equivalent to a Moody A and they they were purchased at par.

Column A is the Total Capital Worth (market value) of the municipal bonds as of the end of 1960. For II and IV this figure is a total of the market values of the bonds purchased in successive years.

Column B is the coupon rate for each of the bonds. It is based on a rounded Bond Buyer 20 bond average for the first of each year. Column C is the total interest received per bond at the appropriate coupon rate.

There is no tax on the interest income because municipal bonds are tax-exempt as to interest income, and no attempt was made to calculate the effect of state and local tax consequences.

Column D is a calculation of the tax credit that would be applicable if the bonds were sold. If these bonds were sold they would represent a capital loss. Assuming other capital gains, these capital losses would act to offset the capital gains. In a sense, there would be a tax credit at the same tax rate of 25%, to be subtracted from any taxes on capital gains, and this would reduce the capital loss on municipals.

Column P is Net Profit (+) or Loss (-) and is calculated by summing Columns C and D.

Corporate Bonds - Table II

This table is similar in many respects to Table I. It was assumed that the following bonds were purchased:

1.	1958 Aaa	Philadelphia Electric,	4 3/8's	Issued: Dec. '58;	Due: 1986
2.	1959 Aa	Conn. Light & Power,	4 7/8's	Issued: Jan. '60;	Due: 1990
3.	1960 Aa	Georgia Power,	4 7/8's	Issued: Nov. '60;	Due: 1990
4.	1961 Aa	Commonwealth Edison,	4 3/4's	Issued: Dec. '61;	Due: 2011
5.	1962 Aaa	Ches. & Pot. Tel.,	4 3/8's	Issued: Jan. '63;	Due: 2002
6.	1963 Aa	New England Power,	4 1/2's	Issued: Nov. '63;	Due: 1993
7.	1964 Aa	Texas Electric Service,	4 1/2's	Issued: Feb. '65;	Due: 1995
8.	1965 Aaa	Dallas Power & Light,	4 7/8's	Issued: Jan. '66;	Due: 1996
9.	1966 Aaa	American Tel. & Tel.,	5 1/2's	Issued: Jan. '67;	Due: 1997
10.	1967 Aa	Central Power & Light,	6 5/8's	Issued: Jan. '68;	Due: 1998

For I, $1,000,000 was invested in the Aaa Philadelphia Electric bond; for II, $100,000 was invested yearly in successive bonds (bonds nos. 1-10); for III, $1,000,000 was invested in the Aa New England Power bond; for IV, $200,000 was invested yearly in five successive bonds (bonds nos. 6-10).

Columns A through D are similar to the columns in Municipal Bonds, Table I. Column E is the income taxes payable annually on the dividend income. The tax rate was assumed to be a constant 50% over the period. The $100 deduction allowable on dividend income was disregarded, and no attempt was made to calculate the effect of state and local taxation.

Column F is the Net Profit (+) or Loss (-) and is calculated by adding Columns C and D and subtracting Column E.

Standard & Poor's Average of 500 Common Stocks - Table III

The same investment procedures were used here, again for the 10- and 5-year period. Prices were based on Standard & Poor's indices for 500 common stocks, while dividends represent the Standard & Poor's average yearly dividend for this same group of stocks.

Column A is the Total Capital Worth (market value) when the stocks were sold at the end of 1968. Column B is the Gross Profit, or Column A minus the initial investment of $1,000,000. Column C is calculated at the highest tax

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rate, 25% of gross profit for long-term capital gains. Column D is the additional 7.5% surtax necessary because the capital gains were realized in 1960.

Column E is cash dividends. The dividends paid varied each year as did the number of shares owned. The total dividend income (dividends per share times the number of shares owned) is shown for each year.

Column F is yearly income taxes paid on dividend income. As in Table II, the rate was assumed to be constant at 50%.

Column P is Net Profit (+) or Loss (-) and is figured by adding Columns B and E and subtracting Columns C, D, and F from this total.

Five Growth Stocks - Table IV

The same methodology was used here as that applied in Table III, only equal investments were made in five growth stocks: Xerox, Kodak, IBM, Avon, and Polaroid.

APPENDIX C
MUNICIPAL BONDS

TABLE I

Ten Years

		A	B	C	D	P = C + D
		Total Capital Worth (as of 12/31/68)	Coupon Rate	Total Interest Earned	Tax Credit	Net Profit (+) or Loss (-)
I. Investing $1,000,000 at one time Dec. 31, 1968		$790,000	3.40%	$340,000	-$210,000 capital loss + 52,500 tax credit - 157,500 net loss	+$182,500
II. Investing $100,000 each year 1959-1968	1959 -	79,000	3.40%	34,000	-$165,000 capital loss + 41,250 tax credit - 123,750 net loss	+$ 63,750
	1960 -	80,000	3.75	33,750		
	1961 -	81,000	3.40	27,200		
	1962 -	82,000	3.37	23,500		
	1963 -	83,000	3.00	18,000		
	1964 -	84,000	3.25	16,250		
	1965 -	85,000	3,10	12,400		
	1966 -	86,000	3.50	10,500		
	1967 -	87,000	3.75	7,500		
	1968 -	88,000	4.40	4,400		
	Total	$835,000	Total	$187,500		

Five Years

		A	B	C	D	P = C + D
III. Investing $1,000,000 at one time Dec. 31, 1963		$840,000	3.25%	$325,000	-$160,000 capital loss + 40,000 tax credit - 120,000 net loss	+$205,000
IV. Investing $200,000 each year 1964-1968	1964 -	$168,000	3.25%	$ 32,500	-$140,000 capital loss + 35,000 tax credit - 105,000 net loss	-$ 2,900
	1965 -	170,000	3.10	24,300		
	1966 -	172,000	3.50	21,000		
	1967 -	174,000	3.75	15,000		
	1968 -	176,000	4.40	88,000		
	Total	$860,000	Total	$102,100		

TABLE II

CORPORATE BONDS

	A Total Capital Worth (as of 12/31/68)	B Coupon Rate	C Total Interest Earned	D Tax Credit	E 50% Income Tax on Interest	P = C + D - E Net Profit (+) or Loss (-)
Ten Years						
I. Investing $1,000,000 at one time Dec. 31, 1958	$737,500	4.375%	$437,500	-$262,500 capital loss + 65,625 tax credit - 196,875 net loss	$218,750	+$21,875
II. Investing $100,000 each year 1959-1968	1959 - $ 73,750 1960 - 78,030 1961 - 76,800 1962 - 69,156 1963 - 69,979 1964 - 70,338 1965 - 69,558 1966 - 74,293 1967 - 81,004 1968 - 94,451 Total $757,359	4.375% 4.875 4.875 4.75 4.375 4.5 4.5 4.875 5.5 6.625	$ 43,750 43,875 39,000 33,250 25,950 22,500 18,000 14,625 11,000 6,625 $ 258,575	-$242,641 capital loss + 60,660 tax credit - 181,981 net loss	1959 - $ 21,875 1960 - 21,938 1961 - 19,500 1962 - 16,625 1963 - 12,975 1964 - 11,250 1965 - 9,000 1966 - 7,313 1967 - 5,500 1968 - 3,312 Total $129,288	-$52,694
Five Years						
III. Investing $1,000,000 at one time Dec. 31, 1963	$703,380	4.5%	$225,000	-$296,620 capital loss + 74,155 tax credit -$222,465 net loss	$112,500	-$109,965
IV. Investing $200,000 each year 1964-1968	1964 - $140,676 1965 - 139,116 1966 - 148,586 1967 - 162,008 1968 - 188,902 Total $779,288	4.5% 4.5 4.875 5.5 6.625	$ 45,000 36,000 29,250 22,000 13,250 Total $145,500	-$220,712 capital loss + 55,178 tax credit - 165,534 net loss	1964 - $ 22,500 1965 - 18,000 1966 - 14,625 1967 - 11,000 1968 - 6,625 Total $ 72,750	-$ 92,784

TABLE III

STANDARD & POOR'S AVERAGE OF 500 STOCKS

Ten Years	A Total Capital Worth (as of 12/31/68)	B Gross Profit	C 25% Capital Gains Tax	D 1968 Surtax (7.5%)	E Cash Dividends		F 50% Income Tax on Dividends	P = B-C-D+E-F Net Profit (+) or Loss (-)
I. Investing $1,000,000 at one time Dec. 31, 1958	$1,881,200	$881,200	$220,300	$16,523	1959 -	$ 32,602	$16,301	+$860,090
					1960 -	35,318	17,659	
					1961 -	35,681	17,841	
					1962 -	37,673	18,837	
					1963 -	40,028	20,014	
					1964 -	43,650	21,825	
					1965 -	47,816	23,908	
					1966 -	51,438	25,719	
					1967 -	52,706	26,353	
					1968 -	54,517	27,259	
					Total	$431,429	Total $215,716	
II. Investing $100,000 each year 1959-1968	$1,460,375	$460,375	$115,094	$ 8,632	1959 -	$ 3,260	$ 1,630	+$445,135
					1960 -	6,788	3,394	
					1961 -	10,248	5,124	
					1962 -	13,728	6,864	
					1963 -	18,089	9,045	
					1964 -	22,938	11,469	
					1965 -	28,243	14,122	
					1966 -	33,455	16,728	
					1967 -	37,903	18,952	
					1968 -	42,324	21,162	
					Total	$216,976	$108,490	

TABLE III (cont.)

STANDARD & POOR'S AVERAGE OF 500 STOCKS

Five Years

	A Total Capital Worth (as of 12/31/68)	B Gross Profit	C 25% Capital Gains Tax	D 1968 Surtax (7.5%)	E Cash Dividends	F 50% Income Tax on Dividends	P = B-C-D+E-F Net Profit (+) or Loss (-)
III. Investing $1,000,000 at one time Dec. 31, 1963	$1,384,431	$384,431	$96,108	$7,208	1964 - $ 32,125	$16,063	+$373,157
					1965 - 35,191	17,596	
					1966 - 37,857	18,929	
					1967 - 38,793	19,397	
					1968 - 40,123	20,062	
					Total $184,089	Total $92,047	
IV. Investing $200,000 each year 1964-1968	$1,220,666	$220,666	$55,167	$4,138	1964 - $ 6,425	$ 3,213	+$213,189
					1965 - 13,269	6,635	
					1966 - 20,420	10,210	
					1967 - 28,169	14,085	
					1968 - 35,377	17,689	
					Total $103,660	Total $51,832	

TABLE IV

FIVE GROWTH STOCKS

Ten Years

		A	B	C	D	E		F	P = B-C-D+E-F
I. Investing $1,000,000 at one time Dec. 31, 1958		Total Capital Worth (as of 12/31/68)	Gross Profit	25% Capital Gains Tax	1968 Surtax (7.5%)	Cash Dividends		50% Income Tax on Dividends	Net Profit (+) or Loss (-)
	Xerox -	$12,000,000	$11,800,000	$4,424,697	$331,852	1959 -	$ 12,874	$ 6,437	+$13,206,224
($200,000	Kodak -	973,309	773,309			1960 -	17,200	8,600	
in each	IBM -	1,016,190	816,190			1961 -	19,903	9,952	
stock)	Avon -	2,822,194	2,622,194			1962 -	25,016	12,508	
	Polaroid -	1,887,093	1,687,093			1963 -	34,037	17,019	
		Total	$17,698,786			1964 -	47,407	23,704	
						1965 -	62,459	31,230	
						1966 -	81,093	40,547	
						1967 -	104,087	52,044	
						1968 -	123,904	61,952	
						Total	$527,980	Total $263,993	
II. Investing $100,000 each year 1959-1968									
	Xerox -	$ 2,846,160	$ 2,646,160	$1,161,583	$ 87,119	1959 -	$ 1,264	$ 632	+$ 3,476,754
($20,000	Kodak -	476,836	276,836			1960 -	2,771	1,386	
each year	IBM -	538,335	338,335			1961 -	4,086	2,043	
in each	Avon -	877,316	677,316			1962 -	6,012	3,006	
stock)	Polaroid -	907,686	707,686			1963 -	9,394	4,697	
		Total	$ 4,646,333			1964 -	14,007	7,004	
						1965 -	19,719	9,860	
						1966 -	26,216	13,108	
						1967 -	34,161	17,081	
						1968 -	40,620	20,310	
						Total	$158,250	Total $ 79,127	

TABLE IV (cont.)

FIVE GROWTH STOCKS

Five Years

		A Total Capital Worth (as of 12/31/68)	B Gross Profit	C 25% Capital Gains Tax	D 1968 Surtax (7.5%)	E Cash Dividends	F 50% Income Tax on Dividends	Net Profit (+) or Loss (-)
III. Investing $1,000,000 at one time Dec. 31, 1963								
($200,000 in each stock)	Xerox -	$ 630,588	$ 430,588	$572,510	$42,938	1964 - $11,288	$ 5,644	+$1,720,233
	Kodak -	503,448	303,488			1965 - 14,730	7,365	
	IBM -	477,273	277,273			1966 - 18,082	9,041	
	Avon -	564,444	364,444			1967 - 21,904	10,952	
	Polaroid -	1,114,286	914,286			1968 - 25,280	12,640	
		Total	$2,290,039			Total $91,284	$45,642	
IV. Investing $200,000 each year 1964-1968								
($40,000 each year in each stock)	Xerox -	$ 377,076	$ 177,076	$263,166	$19,737	1964 - $ 2,258	$ 1,129	+$ 792,681
	Kodak -	318,134	118,134			1965 - 5,506	2,753	
	IBM -	377,685	177,685			1966 - 8,814	4,407	
	Avon -	376,047	176,047			1967 - 12,813	6,407	
	Polaroid -	603,720	403,720			1968 - 16,454	8,227	
		Total	$1,052,662			Total $45,845	Total $22,923	

Statement of Northcutt Ely
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General Counsel of
American Public Power Association

Before the

Committee on Finance

United States Senate

Re

Provisions Of H.R. 13270 Which Affect The Interest Paid By States And Political Subdivisions Upon Their Obligations

September 24, 1969

Contents

I. Statement

II. Brief on constitutional issues

III. Proposed amendments

I. INTRODUCTION: SUMMARY

My name is Northcutt Ely. I am a partner in the law firm of Ely and Duncan of Washington, D.C. My firm is General Counsel for the American Public Power Association. This Association speaks for about 1,400 local publicly owned electric systems in 47 States. I am accompanied by Larry Hobart, Assistant General Manager of the Association, and Richard D. Wilson, Chairman of its Committee on Taxation.

I am here today to testify on H.R. 13270 as passed by the House of Representatives August 7, 1969. I shall discuss three of its provisions which directly and adversely affect State and local governments. These are as follows:

1. Section 301. The Limitation on Tax Preferences contained in Section 301 would have the effect of directly imposing federal income taxes on a portion of the interest paid by States and local governments to their creditors who are individuals -- but not, in the present bill, corporate creditors. If a taxpayer receives more than half of his income from municipal bonds, he must pay income tax on that excess. These taxes would apply not only to new issues, but also to bonds outstanding, which were exempted from tax by federal law at the time when they were sold.

2. Section 302. The provisions for allocation of deductions -- such as interest paid on a mortgage, or property taxes paid on a house -- while continuing to allow these deductions in full in the calculation of the income tax to be paid by any taxpayer who does not own municipal bonds, would deny him a

portion of that same deduction if he receives tax exempt interest. The greater his tax exempt income, the greater is the tax he must pay on each dollar of taxable income, and the greater his total tax. The result is that a taxpayer who invests capital in municipal bonds would pay more tax per taxable dollar and more total tax than if he left that same amount of capital idle in his checking account. This provision applies to future bond issues, but not to issues outstanding.

3. Sections 601 and 602. These authorize federal subsidies to induce State and local governments to issue taxable bonds.

We offer amendments, annexed to this statement, to delete all three of these provisions. The effect would be to maintain the current tax-exempt status of municipal bonds, unchanged.

We are against Section 301, the Limitation on Tax Preferences, and Section 302, requiring allocation of deductions, because their combined effect would be to cripple the borrowing power of the States and their municipalities. The resulting increase in the cost of money would impose long-lasting inflation (for 20 years or more, depending on the life of the bond issue) upon the local ad valorem taxes which support such essentials as schools, and upon the cost of essential public services which are supported by rates and charges, such as water, power, and, in some cases, sewerage. This burden will fall with disproportionate effect on poor people, because the increases in the rents they pay, flowing from increases in property taxes, and increases in such unavoidable expenses as electricity and water bills, are substantial factors in their cost of living.

Beyond the policy questions, Sections 301 and 302, in our opinion, are unconstitutional. Protracted uncertainty, with attendant high borrowing costs, would continue to overshadow the financing of all essential local facilities for many years, until such time as the Supreme Court resolves these doubts. The constitutional issue is discussed in our annexed brief.

We are against Sections 601 and 602, the subsidy scheme. Just as Sections 301 and 302 would largely deprive local governments of the power of self-help, Sections 601 and 602 would burden the federal taxpayer with the consequences. The bill would transfer to the back of the federal taxpayer the consequences of local decisions to create debts, on which the bill would require the federal taxpayer to pay interest. The sequel, unavoidably, would be a tax revolt, which would result in the transfer to federal bureaus of the power to make those local decisions.

The combined result of these provisions of the bill will be to create a crisis in intergovernmental relations. This, more than the federal tax revenue involved, is the significance of this bill's demoralization of municipal credit, and its substitution of federal liability for the support of activities that are essential functions of State governments.

II. THE BILL CRIPPLES THE POWER OF THE STATES TO ISSUE AND SELL TAX-EXEMPT BONDS

The devastating effect which the mere consideration and passage of this bill in the House has already had on the borrowing power of local governments is readily documented.

The House Ways and Means Committee published the Johnson Administration's tax reform proposals on February 5, 1969, and suggestions contained

in those proposals threw the municipal bond market into a serious decline. If two days before that day a bank -- note that I say bank, not individual -- had bought $1,000,000 of the high-grade corporate bonds composing Moody's corporate bond average, that portfolio would have been worth on September 4, 1969, $941,200. If the same bank on the same day had bought $1,000,000 worth of high-grade State and local bonds which compose the Weekly Bond Buyer's municipal bond average, this portfolio would have been worth on September 4 only $835,200. The drop in value of corporate bonds reflects the general increase of the cost of money in the market place. The yield on corporates had to rise 57 basis points, which is a say of saying 57 one-hundredths of 1 percent, to make it possible to market new corporate bonds of like quality. But the yield on top-grade municipal bonds had to rise from 4.91 to 6.37, some 146 basis points, or 1.46 percent to make similar new issues salable. The difference between the rate of increase in the yield on corporates and the yield on municipals, during the consideration of this bill during that period, is a fair measure of the market's appraisal of the effect of this pending legislation on the tax exemption of municipal bonds. Cost of money to municipals rose two and a half times as much (146 basis points) as cost of money to corporations on their bonds (57 basis points).

September 4 was selected for analysis because it was on that day that Secretary of the Treasury Kennedy testified before this Committee and recommended <u>against</u> application of the Limitation on Tax Preferences to municipal bonds. Since that date the municipal bond market has shown a marked improvement while the corporate market has further deteriorated. The corporate port-

folio has dropped another $11,800 in value. The corporate yield has consequently risen 12 more basis points to 7.56, as of September 18, the last date figures were available. Yet the municipal bond portfolio has increased in value by $12,900 since the date of Secretary Kennedy's statement opposing the inclusion of municipal bond interest in L.T.P., with a resultant drop in yield of 12 basis points to 6.25. These figures indicate alike the sensitivity of municipal financing to the ebb and flow of threats of federal taxation, and the continuing depression in the municipal bond market occasioned by the overall impact of this bill.

Such are the demonstrated consequences of this bill with respect to municipal bonds held by a bank or other corporate holder, even though the bill purports to tax only the interest paid to individuals, and individuals have been buying only about 10 percent of new issues in the last two years. The reason is obvious: The domino effect. The market has recognized that if this bill becomes law, no buyer of municipal bonds hereafter will be purchasing a stable contract. If the value of the individual's contract can be validly impaired retroactively, as this bill does, then so can a bank's contract with the same issuer, in some future bill. The buyer consequently capitalizes the expected tax, and adds its consequences to the yield that he demands. The helpless municipality pays the price.

The price, reckoned over the life of a bond issue, is staggering, both in the cost to those municipalities which can sell their bonds, and, more ominously, in the consequences to those municipalities which may be unable to sell their bonds.

State and local governments in 1968 issued $16.125 billion in bonds, tax

exempt under then existing federal statutes. It has been conservatively estimated that the debt service they would have to pay on an average 20-year bond issue would be increased, if this bill became law, by more than $220 million annually, or by more than $4.4 billion during the whole life of the bond. These are the consequences with respect to the bond offerings of a single year. But the Nation's municipalities, as a group, must sell bonds every year, not just one year, and do so in increasing amounts to maintain essential services to an expanding population. The true consequences of this bill in cost of money to States and local agencies is not just $4.4 billion, but an indefinitely large multiple of the costs attributable to the bond offerings of any single year.

By contrast, the Ways and Means Committee estimated that the Treasury would collect added revenues of only $40 million in 1970, and $85 million a year ultimately, from all five limitations on tax preferences lumped together -- State and local bonds, capital gains, appreciations in value of property donated to charity, excess depreciation, excess farm losses -- with no value at all assigned to the limitation on municipal bond interest. This is burning down the house to kill the cockroaches. Moreover, it is no longer asserted by the proponents of this bill that tax exempt interest shelters a single one of the 154 wealthy non-taxpayers who are the highly publicized targets of these five limitations on tax preferences. It is almost certain that the wrong house is being burned down.

III. CONSTRAINTS ON TAX-EXEMPT FINANCING OF ESSENTIAL PUBLIC SERVICES RESULT IN PERMANENT INFLATION OF THE COST OF THESE SERVICES, WITH THE BURDEN FALLING DISPROPORTIONATELY ON THE POOR.

The construction of public facilities to furnish essential public services -- schools, water, sewerage, electric power, fire and police protection, for example -- cannot be curtailed below the growth rate of the population, without consequences too obvious and too serious to require argument. Indeed, such construction, and the issuance of bonds to finance it, ought to expand at a rate greater than the rate of population growth, if the standard of living in the underdeveloped segments, the ghettos, of our environment is to be improved.

Consequently, state and local governments must go to market to finance their public works whether they want to or not; they cannot wait indefinitely for the market to improve. High interest costs, that is, costs of money inflated by the loss of tax exemption, result inevitably in the inflation of the costs of essential public services for the whole life of the bond issue. For example, a city which must pay, say, $12 million in interest over the 20 year life of a tax-exempt bond issue which it sells to finance schools will have to pay at least $18 million instead if the bond interest is taxable, or if the market, rightly or wrongly, judges that such interest will become taxable in the future. To pay the added $6 million, the city must increase its ad valorem taxes, with a resulting escalation of all living expenses affected by ad valorem taxes -- rents, for example. This is a regressive result. If the facilities so built are revenue producing, such as water or power facilities, the city must raise its rates for these services. Note here

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that power and water works require a large number of dollars of capital investment, that is, of borrowed money, to produce each dollar of revenue. The ratio of investment to annual revenue may be more than ten to one. Consequently an increase in interest from a rate of 6 percent to one of 8 percent, an increase of 2 percent, may require an increase in rates for water or power, of 20 percent or more. The ultimate burden of the loss of a municipality's tax exemption on its borrowing is reflected directly in the cost of essential public services which the citizen has no option to forego, and thus falls most heavily on those of its citizens least able to bear it. The inflation of costs of living thereby occasioned is near-permanent, coming into existence when the more costly money is borrowed to build the public works, and lasting the whole 20 to 30 years of the life of the bond.

So much for the more fortunate municipalities which are able to sell their bonds, at a price, even if they lose their exemption in whole or in part. The interest rates they must pay will rise to equal the rate which corporations must pay. Indeed, much of the spread between municipal and corporate rates has already been eroded, commencing when this so-called tax reform scheme was made public early this year. But some public agencies, if forced to issue taxable securities, would find them unsalable at any acceptable price. For example, who is going to buy a taxable bond of an obscure small school district or small town municipal power system, in competition with the corporate bond of a large company, perhaps a debt convertible into equity, except at a price greatly in excess of the corporate rate? Indeed, experts say that many of the annual issues that small public bodies customarily offer will be unsalable at any price if they are made taxable.

IV. THE BILL'S PROPOSED TRANSFER TO THE FEDERAL TAXPAYER OF THE CONSEQUENCES OF THE DESTRUCTION OF LOCAL CREDIT IS BAD PUBLIC POLICY.

The bill proposes a cure for the injury it does to municipal credit, in Section 601 and 602. The cure is worse, in some respects, than the disease incubated in Sections 301 and 302. The remedy offered is a subsidy to be paid by the federal treasury to any municipality which elects to issue taxable bonds. The subsidy is supposed to equal the difference in yield between taxable and non-taxable municipal bonds, fixed as a percentage of yield, within a stated range, the determination to be made by the Secretary of the Treasury. The report of the House Committee on Ways and Means says "there is no review of the advisability of the local project or of the issuer's ability to pay". Availability of the federal money would be assured by a permanent appropriation, avoiding annual review by the appropriation committees.

At least four things are wrong with this idea. In ascending order of importance, they are these:

(1) The "fixed percentage" of the yield constituting the subsidy "is to apply to all issues of taxable obligations" during the quarter of the year covered by the determination, nationwide. Manifestly, not all issues will fit this single Procrustean bed. What is the upper limit of the new taxable yield? The corporate rate? A small drainage district will have to pay more than that, if its bonds become taxable, for no one will buy them in competition with bonds of, say, U.S. Steel. What is the lower limit, to be subtracted from the upper limit to arrive at the spread which is to be offset by subsidy? Supposedly it is the rate payable on tax-exempts, but whose? Manifestly a subsidy required to make salable top-grade taxable municipals, or even

one determined by the average yield of all municipals, calculated as a percentage of the spread between taxable and non-taxable yields, will not be enough to enable the poor and small sisters to sell taxable bonds.

(2) The federal government must raise the money to pay several thousand municipalities many millions of subsidies each year. This federal obligation will continue for the life of the bond issue, a period to be determined by the local government. The effect will be twofold. First, an obligation is to be imposed on the federal treasury which is equivalent to a long-term federal bond, whereas current federal policy is to issue short-term securities. Second, the municipality's taxable bond is expected, by this scheme, to foresake the shelter of the unique tax-exempt market, and to compete in the market for the first time with corporates and federal securities. To the extent that the scheme works, the competition of this new municipal entry may well drive up the interest rates which the federal government and corporations must pay. In six of the last ten years, the net increase in municipal bonds outstanding was greater than the net increase in corporates or in direct federal government securities.

(3) If the House Committee's assurance that "there is no review of the advisability of the local project or of the issuer's ability to pay" really comes true, then the consequence will be that local governing bodies can and will commit the federal treasury to incur long-term debt service obligations, with a consequent increase in burdens on the federal taxpayer, without review or concurrence by Congress or by any federal executive agency. It is totally unsound to vest in local governments the power to appropriate federal money. Such is the effect of this proposal.

(4) More likely, the House committee's assurances against federal review of the advisability of the local project or of the issuer's ability to pay will not last very long. A taxpayers' revolt would be a certainty, if billions were added each year to the long-term federal debt load by non-reviewable decisions of local governments. The alternative would be a super P.W.A. of federal agencies to review the desirability of each of several thousand local projects each year, and the capacity of their sponsors to pay for them. Local decisions, now policed by the marketplace, would become national decisions, controlled by the policies and politics of distant federal administrators.

V. THE BILL'S PROPOSALS FOR LIMITATIONS ON TAX PREFERENCES, AND ALLOCATIONS OF DEDUCTIONS, AS APPLIED TO INTEREST ON MUNICIPAL BONDS, ARE UNCONSTITUTIONAL

The bill's effect, as demonstrated in Part II of this statement, has been and will be to impair the power of States and municipalities to borrow money, and to increase the cost to local governments of the money that they succeed in borrowing.

It does so in two ways.

The limitation on tax preferences directly subjects to federal taxation the interest paid by local governments on their obligations.

The allocation of taxpayers' deductions burdens the municipality's borrowing power in a more subtle, but equally effective way. The effect is that a taxpayer who owns no municipal bonds may deduct from his gross income,

for example, all of the local taxes that he pays on his home and all of the interest that he pays on his mortgage. But if he has income from municipal bonds in excess of a stated amount annually ($5000 if single, $10,000 if filing a joint return), he may not deduct all of that interest, but only a portion of it corresponding to the ratio between taxable income and total income. In consequence, such a taxpayer would pay more tax if he invested money in municipal bonds than he would pay if he left the same amount of capital idle in his checking account.

The House Committee regards this allocation scheme as producing revenue to the Treasury amounting to $205 million in 1970, rising to $460 million ten years later, but it does not say how much of this relates to municipal bond interest. To the extent that it does, it constitutes an added cost to municipalities which issue tax-exempt bonds, because the bond buyer capitalizes his expectation of taxation and adds that to the yield required to induce him to buy in competition with other taxable bonds.

A federal tax which directly increases the cost to the States and their political subdivisions of borrowing money, imposing a burden on the borrowing power at the amount of its exercise "is a tax on the power of the states, and on other instrumentalities to borrow money, and consequently repugnant to the Constitution" (Pollack v. Farmers' Loan and Trust Co., on rehearing, 158 U.S. 601, 630 (1895)). The argument is spelled out in the annexed brief.

So tested, both the limitation on tax preferences and the allocation of deductions, as applied to municipal bonds, are, in my opinion unconstitutional. Secretary Kennedy agrees that there are "constitutional doubts" as to the

former, but not the latter. It will take years of litigation, much of it outside the control of the States and their instrumentalities, to decide the constitutional issue if either the limitation on tax preferences or the allocation of deductions includes municipal bonds. For that same period of time all municipal financing will be chaotic. The issues sold during this period will have to pay interest rates which are dictated by the buyers' most pessimistic appraisal of the outcome which indemnify him for taxes he must pay even though the tax is finally declared unconstitutional. The then holder, whoever he may be, will reap a windfall, taxable only at capital gains rates.

VI. CONCLUSION

To the extent that local governments can and will carry their own burdens, it is in the national interest that they be permitted to do so. To the extent that their borrowing power is eroded by Federal taxation, or the threat of attempts at such taxation, whether constitutional or not, local governments are prevented from carrying their own burdens, and are driven to rely upon Federal assistance. This bill plainly contemplates this cause and this effect, and compels both. We vehemently disagree.

The Nation gets no benefit from disabling any State from providing essential public services to its own people at its own expense. We all suffer by such a process. This is true not only of the State whose borrowing power may be crippled by Federal taxation, or the threat of it, but of the Federal taxpayers who must ultimately pay for a greater share of local projects thus priced out of range of the State's borrowing power.

The Federal Treasury and the federal taxpayer suffer from the erosion of intergovernmental tax immunities, whether Federal or State.

This is not tax reform.

Attachments:

Brief: Taxation of the interest paid by States and their instrumentalities upon their obligations, as proposed in the "Tax Reform Act of 1969," would be unconstitutional.

Proposed amendments

Taxation of the Interest Paid by States and Their Instrumentalities upon Their Obligations, as Proposed in the "Tax Reform Act of 1969" would be Unconstitutional

Northcutt Ely
Ely and Duncan
General Counsel
American Public Power Association

1. Provisons of H.R. 13270, 91st Congress (The "Tax Reform Act of 1969") Taxing, Directly or Indirectly, the Interest Paid by States and Their Instrumentalities on Their Obligations

Section 301 directly taxes a portion of the interest paid to individuals by States and their instrumentalities on their obligations. Section 302 does so indirectly.

Limitation on Tax Preference (LTP)

Section 301 establishes a limit on tax preferences (LTP) which will apply to five items of income (infra). The House Committee Report[1] explains the scheme as follows:[2]

> "Under the limit on tax preferences provided by the bill, in the case of individuals, estates, and trusts, a 50 per cent ceiling is to be imposed on the amount of a taxpayer's total income (adjusted gross income plus the tax preference items) which can be excluded from tax. In other words, an individual is to be allowed to claim the exclusions and deductions comprising tax preference income only to the extent that the aggregate amount of these preferences does not exceed one-half of his total income. In order to confine the operation of the provision to individuals with substantial amounts of tax preference income, the limit on tax preferences is not to apply if an individual's total tax preferences for the year do not exceed $10,000 ($5,000 for a married person filing a separate return).
>
> "The application of the limit on tax preferences may be illustrated by the case of a taxpayer with $50,000 of salary and $150,000 of tax preference amounts. 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 his total income of $200,000)."[3]

1/ Report of the Committee on Ways and Means of the House of Representatives to accompany H.R. 13270, 91st Session, a bill to reform the income tax laws: House Report No. 91-413 (Part 1).

2/ Id., pp. 78-79.

3/ Id., p. 79.

Section 301 designates five tax preference items. The description of item (1) below is quoted from the House Committee report, p. 79. The other four are our summaries:

> "(1) Tax-exempt interest on State and local bonds. For the purpose of the limit on tax preferences, however, this tax-exempt interest is to be taken into account gradually over a 10-year transitional period, with one-tenth of such interest taken into account in the first taxable year beginning on or after Jan. 1, 1970, two-tenths in the second taxable year and so on, until 100 per cent of the interest is taken into account. The amount of tax-exempt interest otherwise taken into account for a year is to be reduced by the amount of any deductions allocable to the interest which are disallowed (under Sec. 265 (a)(1) as expenses related to tax-exempt income."

(2) The one-half of net long term capital gains which is excluded from income;

(3) Appreciation in the value of property donated to charity which is deducted as a charitable contribution but which is not included in gross income;

(4) Depreciation claimed for real property in excess of straight line depreciation;

(5) The amount by which farm loss computed under special farm accounting rules exceeds the loss calculated under normal accounting rules.

The Report continues (p. 79):

> "The amount a taxpayer is required to include in income is to be considered proportionately derived from each preference item."

The result, insofar as municipal bonds are concerned, is the imposition of a tax upon the interest paid by States and their instrumentalities to individuals, but not that paid to banks or other corporations. Section 301 applies to all outstanding bond issues, not merely to new ones.

The Report states the revenue effect of the Limitations on Tax Preferences as follows:[4]

> "It is estimated that the limit on tax preferences will increase tax liability by $40 million in the calendar year 1970 and by $85 million a year when the provision is fully effective. About half of the additional tax liability will come from taxpayers with incomes of $50,000 and over."

The Report makes no allocation of this amount among the five tax preference items, but, as we point out later, it is significant that the only items on which the tax is less in 1970 than "when the provision is fully effective" is tax-exempt interest on State and local bonds, indicating that this item is a substantial contributor to the increase of $45 million, and therefore probably a substantial contributor to the initial $40 million.

Allocation of Deductions

Section 302 provides for allocation of deductions between exempt and non-exempt income. The non-taxed items to which allocable deductions are to be apportioned are six in number. They include the same five as the LTP, plus (item 4), intangible drilling expenses, and similar items not involved here. The allocation would include tax exempt interest on bonds issued after July 12, 1969. Under a transition rule one-tenth of such interest would be taken into account for allocation purposes in the first year, two-tenths in the second, and so on, "until 100 percent of the interest on tax exempt bonds issued after July 12, 1969, would be recognized for allocation."[4a] Note that, unlike the limitation on tax preference (Sec. 301), which applies to past as well as future bond issues, the required allocation of deductions (Sec. 302) applies only to new issues after July 12, 1969.

4/ Id., p. 80.

4a/ Id., p. 83.

The Report of the Ways and Means Committee explains the allocation as follows:

> "The fact that an individual who receives tax-free income can charge the entire amount of his personal deductions to his taxable income gives him a double tax benefit. He not only excludes these tax preference amounts from his tax base but he also, by allocating his personal deductions only against his adjusted gross income, may reduce his tax payments on this taxable income . . . ."5/

* * * * *

> "To prevent individuals with tax preference amounts from reducing their tax liabilities on their taxable incomes by charging all their personal deductions to their taxable incomes your committee's bill provides that individuals (and estates and trusts) must allocate most of their itemized personal deductions proportionately between their taxable income (adjusted gross income less nonallocable expenses) and their tax preference amounts. Only the part of these personal deductions which is allocated to taxable income is to be allowed as a tax deduction and the personal deductions allocated to the tax preference amounts are to be disallowed. Tax preference amounts are taken into account only to the extent they exceed $10,000 ($5,000 for a married person filing a separate return) . . . ."6/

* * * * *

> ". . . The bill essentially requires allocation of any itemized deduction where it is reasonable to assume that a portion of the pertinent expense is met out of nontaxable income . . . ."7/

The coordination between the limitation on tax preferences (Sec. 301) and the required allocation of deductions (Sec. 302) is explained as follows:

> "Under the bill, individual taxpayers may be subject to the limit on tax preferences, as well as being required to allocate their deductions. The bill provides in effect that (1) such a taxpayer is to first apply the limit on tax preferences (that is, to add back to taxable income that part of nontaxable income in excess of 50 percent of total

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5/ Id., p. 80.

6/ Id., p. 81.

7/ Id., p. 81.

income), and (2) he then is to allocate deductions between gross income as modified in step (1) and the allowed tax preference items."[8/]

A note to the Committee Report illustrates the last statement as follows:

> "For example, suppose the individual has a taxable income of $30,000, a tax exempt income of $70,000, and $30,000 of personal deductions. Applying the limit on tax preferences 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.[9/]

From the foregoing, it is clear that the intended effect of Section 302, read in conjunction with Section 301, is that a portion of the personal deductions which a taxpayer might claim in full against gross income in calculating his taxable income if he received no interest on State of local bonds will be denied him if he does receive such interest. He thus pays a higher tax on his taxable income if he invests money in municipal bonds than he would pay if he kept the amount of that investment idle in his checking account.

The Ways and Means Committee Report calculates the revenue effect of Section 302 as follows:

> "It is estimated that the allocation of deductions between taxable income and tax preference amounts will increase revenue by $205 million in the calendar year 1970 and $460 million a year when the provision is fully effective. Almost all of this additional revenue will be collected from taxpayers with adjusted gross income of $20,000 or more."[10/]

The Committee gives no breakdown of these amounts among the six non-taxed items to which allocable deductions are to be apportioned, nor does it explain the disparity between these figures and the much more modest amounts of

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8/ Id., p. 83.

9/ Id., p. 83.

10/ Id. p. 83.

revenue expected from application of tax preference alone, $40 million to $85 million. 11/ It is notable, however, that tax exempt bond interest is the only item which is stated on a graduated ten-year scale in either the list of tax preferences (Sec. 301, p. 79 of the Report), or the list of items to which deductions are to be allocated (Sec. 302, p. 82, of the Report). The inference seems clear, therefore, that revision of tax liabilities occasioned by receipt of interest on State and local bonds is alone accountable for the projected increase in tax revenues (1) via the limitation on tax preferences from $40 million in 1970 to $85 million a year, 10 years later (Report, p. 80), and (2) via the allocation of deductions from $205 million a year in 1970 to $460 million a year 10 years later. It is a fair inference, therefore, that bond interest, hitherto tax exempt, is a substantial component of the tax revenue of $245 million from the combined effect of Sections 301 and 302 in 1970, as well as the total of $545 million 10 years later.

Comments of the Treasury Department

Secretary of the Treasury David M. Kennedy, on September 4, 1969, advised the Senate Finance Committee:

> "The House bill goes beyond the Administration's recommendations and includes interest on State and local bonds in the LTP. The Administration opposes this inclusion for the same reasons we gave on April 22--there are constitutional doubts as to inclusion as well as the possibility of adverse repurcussions in the market for State and local securities. However, we recommend as we did in April that the full amount of tax exempt interest be included in the Allocation of Deductions rule, without the 10-year phaseout contained in the House bill."

11/ Id., p. 80.

We concur with Secretary Kennedy's conclusion that there are "constitutional doubts"--in our view, doubts of the most serious magnitude--of the validity of the proposal to include tax exempt interest in the Limitations on Tax Preferences. In our opinion, there are equally serious "constitutional doubts" with respect to the validity of including tax exempt interest in the allocation of deductions. The reasons for our conclusion, in both respects, are stated below.

As a preliminary matter, however, it should be observed that, on the House Committee figures, the interest rate which States and municipalities must pay on their bonds will be much more severely burdened by the inclusion of that interest in the proposed allocation of deductions, which Secretary Kennedy favors, than by its inclusion in the limitations on tax preferences, which he disapproves because of constitutional doubts. Moreover, the Secretary would accelerate the impact of the burden attributable to the allocation of deductions, "without the 10-year phaseout contained in the House bill." As to the "possibility of repurcussions in the market for State and local securities," this has passed from possibility to grim reality during, and because of, the pendency of this bill.

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2. The Test of Constitutionality of Federal Tax Burdens on States and Their Instrumentalities

Neither the Federal nor State Governments can constitutionally impair the other's power of the purse, i.e., the other government's powers to raise money by borrowing or by taxation. These powers are essential to a government's existence. Taxation of interest which either government pays on its debts, measurable in the cost of money at the time the debt is incurred, is a direct burden on the power to borrow money, a constriction of the sovereign power of the purse which is as invalid constitutionally as a tax levied against the revenues which that other government receives from its own taxes.

So tested, both the proposed limitation on tax preferences and the proposed allocation of deductions are unconstitutional, because their burden upon the State's borrowing power is directly measurable in the added cost of borrowed money to the State at the instant when that debt is incurred.

The cases which establish this principle are discussed below, as are the cases which limit its application. None of those limitations or exceptions support the taxes proposed here. We are not concerned here with peripheral and remote effects of federal taxation on a state's activities, such as federal taxes on the income of state employees. Nor are we dealing here with federal taxation of capital gains, or with federal estate taxes, which may properly encompass municipal bonds because the effect of such taxation is too remote, in point of time, to be measureable in the cost of money at the moment when the borrowing power is exercised. The taxation proposed here would burden the borrowing power of the State to a readily measureable and extreme degree

simultaneously with the attempt at its exercise. Indeed, during the pendency of this proposed legislation the cost of money to States and their political subdivisions has risen two and a half times as much as the increase of cost of money to corporations in the same period. Such is the direct and measureable impact of the proposed tax.

3. The Cases

The only attempt by the Federal Government to impose a tax on interest paid by States and their political subdivisions was declared unconstitutional nearly 74 years ago, and the case which so decided, Pollock v. Farmers' Loan & Trust Co.,[1] has been repeatedly cited as good law ever since.[2]

The classic statement of the constitutional basis of the immunity of the States and their municipalities from Federal taxation of their bonds and interest paid thereon, made in the Pollock case, was this:

> "A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. Buffington v. Day, 78 U.S. 11 Wall. 115; United States v. Baltimore & O.R. Co., 84 U.S. 17 Wall. 322, 332."

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1/ 157 U.S. 429 (1895), affirmed on rehearing, 158 U.S. 601 (1895).

2/ See Plummer v. Coler, 178 U.S. 115, 117 (1900); South Carolina v. United States, 199 U.S. 437, 453 (1905); Farmers & Mechanics Savings Bank v. Minnesota, 232 U.S. 516, 526-527 (1914); Evans v. Gore, 253 U.S. 245, 255 (1920); Gillespie v. Oklahoma, 257 U.S. 501, 505 (1922), overruled on other grounds in Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938); Greiner v. Lewellyn, 258 U.S. 384, 386 (1922); Metcalf & Eddy v. Mitchell, 269 U.S. 514, 521, 522 (1926); Willcuts v. Bunn, 282 U.S. 216, 225, 226 (1931); Indian Motocycle Co. v. United States, 283 U.S. 570, 577 (1931); Chocteau v. Burnet, 283 U.S. 691, 696 (1931); Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 400 (1932); overruled on other grounds in Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938); Trinityfarm Construction Co. v. Grosjean, 291 U.S. 466, 471 (1934); Ashton v. Cameron County Water Imp. District No. One, 298 U.S. 513, 570 (1936); New York ex. rel. Cohn v. Graves, 300 U.S. 308, 315-316 (1937); Hale v. State Board, 302 U.S. 95, 107 (1937); James v. Dravo Contracting Co., 302 U.S. 134, 150, 153, 156 (1937); Helvering v. Mountain Producers Corp., 303 U.S. 376, 386 (1938); Helvering v. Gerhardt, 304 U.S. 405, 417 (1938).

"*** It is contended that although the property or revenues of the States or their instrumentalities cannot be taxed, nevertheless the income derived from State, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues from the States or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason, and that reason is given by Chief Justice Marshall in Weston v. Charleston (27 U.S. 2 Pet. 449, 468), where he said: 'The right to tax the contract to any extent, when made, must operate on the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this power depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely. *** The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution.' Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution." 3/

And on rehearing in the same case, the Court said: 4/

"We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution."

3/ 157 U.S. 429, 584, 585-586 (1895).

4/ 158 U.S. 601, 630 (1895).

Every case since 1895 which has touched the problem has accepted the Pollock case as good law, and this includes cases which have invalidated various claimed immunities of other sorts. Thus:

In Willcuts v. Bunn,[5/] which held a capital gain on the sale of municipal bonds to be subject to Federal taxation, the Court said:

> "In the case of 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. /Citing Pollock/ 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."

In Helvering v. Gerhardt,[6/] which held salaries of employees of the New York Port Authority taxable, the Court said:

> "*** It /the immunity/ has 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. /Citing Pollock/
>
> * * * * * * * *
>
> " The basis upon which constitutional tax immunity of a State has been supported is the protection which it affords to the continued existence of the State."

In Hale v. State Board,[7/] Mr. Justice Cardozo said that the "teaching" of the Pollock case was that:

> "*** an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in M'Culloch v. Maryland. ***"

5/ 282 U.S. 216, 226 (1931).
6/ 304 U.S. 405, 417, 421 (1938).
7/ 302 U.S. 95, 107 (1937).

In James v. Dravo Contracting Co.,[8] which upheld a 2-percent tax imposed by the State of West Virginia upon gross receipts received by a contractor for work performed for the Federal Government, Mr. Chief Justice Hughes (for Justices Brandeis, Stone, Cardozo, and Black) said:

> "*** [The doctrine of immunity with respect to Government bonds] recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' [citing Pollock] and which would directly affect the Government's obligation 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. ***"

In New York ex rel. Cohn v. Graves,[9] the Court said:

> "It is by a parity of reasoning that the immunity of income-producing instrumentalities of one government, State or National, from taxation by the other, has been extended to the income. It was thought that the tax, whether on the instrumentality or on the income produced by it, would equally burden the operations of government. [Citing Pollock, et al.]"

In Helvering v. Mountain Producers Corp.,[10] the Court held that a lessee under an oil and gas lease of State school lands was not entitled to immunity, as a State instrumentality, from Federal taxation in respect of income derived from operations under the lease, overruling earlier cases. But then, citing the Weston and Pollock cases, the Court said:

8 / 302 U.S. 134, 152-153 (1937).
9 / 300 U.S. 308, 315-316 (1937).
10/ 303 U.S. 376, 386 (1938).

"*** 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, *** "

The cases cited, other than the Pollock case, were decided after enactment of the 16th amendment, and, we believe, tacitly reinforce the assurance in Peck v. Lowe 11/ that this amendment "does not extend the taxing power to new or excepted subjects."

What accounts for the durability of this doctrine, in a period which has seen what one writer calls a "waning of intergovernmental tax immunities" 12/ in other areas?

The reasons are so fundamental as to have passed from the law into everyday speech:

> "The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States (Texas v. White) 13/
> *** the power to tax involves the power to destroy (M'Culloch v. Maryland)." 14/

Although the Constitution contains no limitation upon the power of either the Federal or State Governments to tax the other, such a limitation is necessarily implied, to invalidate any tax of either sovereignty which adversely affects the continued existence of the other. (The immunity may be broader than this, but that does not concern us in the resolution of the present issue.) In Chief Justice Marshall's view, intergovernmental immunity was a constitutional necessity:

11/ 247 U.S. 165, 172 (1918); cf. National Life Insurance Co. v. United States, 277 U.S. 508, 521 (1928); Stanton v. Baltic Mining Co., 240 U.S. 103, 112 (1915).

12/ "*** The Constitution itself does not change. It is merely occasionally misunderstood, often by lawyers and professors and occasionally even by judges, especially earlier judges." (Powell, "The Waning of Intergovernmental Tax Immunities," 58 Harvard Law Review 633, 642 (1945)).

13/ 7 Wall. (U.S.) 700, 725 (1869).

14/ 4 Wheat. (U.S.) 316, 431 (1819).

"***We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve." 15/

In considering the constitutional power of the Federal Government to tax the interest paid by States and political subdivisions upon their borrowings, we are dealing with a direct obstruction to the power to borrow money, a power essential to their existence. The States' borrowing power is not only "clogged," but may be made absolutely impossible of exercise by increase of interest costs beyond certain points, because many projects' revenues from tolls or local taxes cannot be increased in the ratio required to sustain the inflated debt service resulting from loss of exemption from Federal taxes. The many cases which turned on the question of whether or not the tax burden there involved fell upon a State or upon an individual, or whether, even though it fell directly on a State, it was or was not consequential in amount or did or did not affect an essential governmental

15/ Id. at 429-430.

function,[16] are all peripheral to the problem now presented. The burden here is direct, its consequences are crushing, the borrowing power thus obstructed is governmental and essential.

16/ The indirect relation of the tax to any demonstrable burden on the public agency resulted in sustaining taxes on shares of corporations holding Government bonds, in Van Allen v. The Assessors, 3 Wall. (U.S.) 573 (1866); National Bank v. Commonwealth, 9 Wall. (U.S.) 353 (1870); Schuylkill Trust Co. v. Pennsylvania, 296 U.S. 113 (1935); taxes on franchises of corporations holding Government bonds or deposits, in Society for Savings v. Coite, 6 Wall. (U.S.) 594 (1868); Provident Institution v. Massachusetts, 6 Wall. (U.S.) 611 (1868); Hamilton Mfg. Co. v. Massachusetts, 6 Wall. (U.S.) 632 (1868); Home Insurance Co. v. New York, 134 U.S. 594 (1890); Manhattan Co. v. Blake, 148 U.S. 512 (1895); Flint v. Stone Tracy Co. 220 U.S. 107(1911); estate or inheritance taxes on transfer of Government bonds, in Plummer v. Coler, 178 U.S. 115 (1900); Greiner v. Lewellyn, 258 U.S. 384 (1922); Blodgett v. Silberman, 277 U.S. 1 (1928); taxes on capital gain from sale of Government bonds, in Willcuts v. Bunn, 282 U.S. 216 (1931). See also Denman v. Slayton, 282 U.S. 514 (1931). In all these cases, the impact of the tax became perceptible for the first time long after issuance of the bonds, fell on a restricted number of bondowners, and was thus incapable of translation into any calculable direct burden on the public agency at the time its borrowing power was exercised. The essential character of the borrowing power was therefore not in issue.

Logically, the questions of (1) directness of the burden, and (2) essentiality of the function which is burdened, ought to be considered in that order, because if the burden is so indirect as to be inconsequential the question of essentiality is not reached. This was the rationale of Helvering v. Gerhardt, 304 U.S. 405 (1938) (sustaining a Federal tax on income of employees of the Port of New York Authority), but Helvering v. Powers, 293 U.S. 214 (1934) (sustaining a Federal tax on salaries of trustees operating a street railway for a municipality), went at it in the opposite order.

In general, the directness of the burden was the issue primarily considered in the following cases: Helvering v. Gerhardt, 304 U.S. 405 (1938) (supra); Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938) (sustaining a Federal income tax on mineral lessee of State school lands, and overruling Gillespie v. Oklahoma, 257 U.S. 501, Burnet v. Coronado Oil & Gas Co., 285 U.S. 393); Willcuts v. Bunn, 282 U.S. 216 (1931) (sustaining a Federal tax on capital gain resulting from sale of State securities); Metcalf v. Mitchell, 269 U.S. 514 (1926) (sustaining a Federal income tax on consulting engineers under contract with State); Greiner v. Lewellyn, 258 U.S. 384 (1922) (State bonds owned by a decedent held properly included in the net value of estate for Federal estate tax purposes); Flint v. Stone Tracy Co., 220 U.S. 107 (1911) (held that a Federal franchise tax measured by corporate income may include income from tax-exempt municipal bonds). Similar rulings in the converse situation upholding State taxes levied on Federal employees, contractors, or persons holding Federal property are United States v. Detroit, 355 U.S.
(Footnote continued next page.)

(Footnote 16, continued from previous page.)
466 (1958), Detroit v. Murray Corp., 355 U.S. 489 (1958), United States v. Township of Muskegon, 355 U.S. 484 (1958), Alabama v. King & Boozer, 314 U.S. 1 (1941), James v. Dravo Contracting Co., 302 U.S. 134 (1937) (all upholding various types of State taxes on Federal contractees); Esso Standard Oil v. Evans, 345 U.S. 495 (1953) (State tax levied on storer of gasoline for Federal Government); Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939) (sustaining a New York State tax on the income of an employee of the Home Owners' Loan Corporation, a Federal instrumentality, overruling or limiting Collector v. Day, 11 Wall (U.S.) 113, (1871), New York ex rel. Rogers v. Graves, 299 U.S. 401 (1937) ("so far as they recognize an implied constitutional immunity from income taxation of the salaries of officers or employees of the National or a State Government or their instrumentalities"), and limiting Dobbins v. Commissioners of Erie County, 16 Pet. (U.S.) 435 (1842); Educational Films v. Ward, 282 U.S. 379 (1931) (State franchise tax based on net income of corporation including income from Federal copyrights upheld); Plummer v. Coler, 178 U.S. 115, 117 (1900) (State inheritance tax measured by the value of U.S. bonds transmitted upheld). Snyder v. Bettman, 190 U.S. 249 (1903), and United States v. Perkins, 163 U.S. 625 (1896), sustained the reciprocal right of the State and Federal Governments to tax legacies to the other.

The essentiality of the function affected was given primary consideration in the following: New York v. United States, 326 U.S. 572 (1946) (State sale of bottled mineral waters subject to Federal excise tax); Allen v. Regents of the University System, 304 U.S. 439 (1938) (admission to State athletic contests subject to Federal admissions tax); Brush v. Commissioner, 300 U.S. 352, 370 (1937) (New York municipal water system an essential State function immune from Federal taxation); Helvering v. Powers, 293 U.S. 214 (1934) (salaries of trustees appointed by State to operate business enterprise (street railway) subject to Federal income tax); Ohio v. Helvering, 292 U.S. 360 (1934), and South Carolina v. United States, 199 U.S. 437 (1905) (State owned or operated liquor business subject to Federal excise tax); Weston v. Charleston, 2 Pet. (U.S.) 449 (1829) (invalidating a city tax upon "stock of the United States"); United States v. Baltimore & O. R. Co., 17 Wall. (U.S.) 322 (1873) (supra). See also Commissioner v. Shamberg's Estate, 144 F. 2d 998 (2d Cir. 1944), certiorari denied, 323 U.S. 792 (1945) (dictum that New York Port Authority is essential governmental activity).

Another class involves State taxes which were struck down because of the paramount character of the Federal function which they would have burdened: Osborn v. United States Bank, 9 Wheat. (U.S.) 738 (1824); M'Culloch v. Maryland, 4 Wheat. (U.S.) 316 (1819) (invalidating a State tax on bank notes issued by a Federal bank).

A class of cases must be recognized in which a Federal tax was sustained as ancillary to a delegated Federal power, e.g., relating to foreign commerce or the protection of the national currency, irrespective of the directness of the burden on the State or the essentiality of the function of the State thereby affected: Trustees of University of Illinois v. United States, 289 U.S. 48 (1933) (denying a State immunity from Federal customs duties on imports); Veazie Bank v. Fenno, 8 Wall. (U.S.) 533 (1869) (sustaining a prohibitively high tax on State bank notes).

The proposed allocation of deductions is not saved by the insurance cases which have dealt with formulas for allocation of income and deductions between reserves and shareholders' equity.

The effect of the formula in Section 302 of this bill is that a taxpayer who has both taxable income and tax exempt income from interest on municipal bonds pays a higher income tax than he would if he had kept idle, in his checking account, the capital which he invested in municipal bonds. This is because, if he owned no municipal bonds, he could claim the full amount of his personal deductions, such as taxes he pays on his house and interest he pays on his mortgage, theft and casualty losses, charitable contributions, medical expenses, etc., from his gross income in calculating his net taxable income, whereas if he buys municipal bonds and receives interest thereon he can no longer deduct those same expenses, but only a portion of them. The amount of deductions so denied him would be determined by the relative amounts of his taxable income and his non-taxable income. The portion of his expenses on which he is denied a deduction increases as he buys more tax exempts. Since he pays taxes on his taxable income in progressively higher brackets as either (1) his net income increases, or (2) his deductions from a constant gross income decrease, the effect of decreasing his deductions as a consequence of buying municipal bonds is the same to the taxpayer as though a progressively higher income tax were being levied directly against each increment of the interest he receives from municipal bonds.

That this scheme will constitute a substantial tax burden on the buyer of municipal bonds, hence a substantial deterrent to purchase by indivi-

duals of municipal bonds is demonstrated by the Ways and Means Committee Report. At p. 83 it projects a tax revenue for 1970 of $205 million annually in consequence of the allocation of deductions, for 1980 a tax revenue from this source of $460 million, the increase of $255 million being due in its entirety, apparently, from the progressively greater denial over a 10-year period of deductions in consequence of the income received from interest on municipal bonds.

This presents almost the exact reverse of the case of United States v. Atlas Life Ins. Co.[17] There a formula which required both taxable and tax exempt income to be allocated between reserves and stockholders' equity was sustained. The Court said (p. 250):

> ". . . Under the 1954 formula investing in exempt securities results in a lower total tax than investing in taxable securities and the tax rate per taxable dollar does not increase."

P. 251:

> ". . . In the last analysis Atlas' insistence on both the full reserve and exempt-income exclusions is tantamount to saying that those who purchase exempt securities instead of taxable ones are constitutionally entitled to reduce their tax liability and to pay less tax per taxable dollar than those owning no such securities. The doctrine of intergovernmental immunity does not require such a benefit to be conferred on the ownership of municipal bonds."

Here, no one contends that one who purchases taxable securities is entitled to pay "less tax per taxable dollar than those owning no such securities." What we find unconstitutional in Section 302 is its requirement that those who purchase exempt securities shall pay more tax per taxable dollar than those owning no such securities who receive the same taxable income. Such is the consequence of allowing greater deductions, in calculating the taxable dollar,

17/ 381 U.S. 233 (1965).

to those who own no exempt securities than to those who do own exempt securities.

Compare National Life Ins. Co. v. U.S.,[18/] which invalidated a formula which, the Court said in Atlas, supra, had the result "that a company shifting its investments from taxable to non-taxable securities would have lowered neither its taxable income nor its total tax." Section 302 would produce an even more drastic result. If it becomes law, an individual shifting his investments from cash to non-taxable securities will increase both his taxable income and his total tax.

18/ 277 U.S. 508 (1928). See also Missouri Ins. Co. v. Gehner, 281 U.S. 313 (1930), restricted in Denman v. Slayton, 282 U.S. 514 (1931), and Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934).

PROPOSED AMENDMENTS TO H.R. 13270

Northcutt Ely
Ely and Duncan
General Counsel
American Public Power Association

TITLE III

Explanation of Proposed Amendments

These amendments delete provisions of section 301, Limit on Tax Preferences for Individuals, Estates, and Trusts, and section 302, Allocation of Deductions which would otherwise include in those sections the interest earned by a taxpayer on bonds issued by state and local governments.

AMENDMENTS TO TITLE III

P. 166, line 24:	Strike all commencing with "(C) Interest" through line 12, page 167.
P. 167, line 13:	Change "(D)" to "(C)".
P. 167, line 20:	Change "(E)" to "(D)".
P. 168, line 22:	Strike all commencing with "(5) Transitional" through line 2, page 169.
P. 171, line 9:	Change "(D)" to "(C)".
P. 174, line 6:	Strike all commencing with "(to" up to but not including the colon on line 7, page 174.
P. 175, line 18:	After "(B)" strike the comma and insert "and".
P. 175, line 18:	Strike the "and" following "(C),".
P. 175, line 19:	Strike "(D),".
P. 175, line 21:	Strike all commencing with "(B) Interest" through line 2, page 176.
P. 176, line 3:	Change "(C)" to "(B)".
P. 176, line 20:	Change "(D)" to "(C)".
P. 178, line 6:	Strike "s" making the word "amendments" singular.
P. 178, line 7:	Strike all commencing with "(1) Section 265" through line 23, page 179.
P. 179, line 24:	Strike "(2)".

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TITLE VI

Explanation of Proposed Amendments

These amendments delete provisions authorizing the Secretary of the Treasury to subsidize interest expenses of state and local governments electing to subject their bond issues to federal taxation. They also delete provisions establishing permanent annual appropriations to finance the deleted federal interest subsidy.

AMENDMENTS TO TITLE VI

P. 317, line 19:	Strike all commencing with "(a) Election" continuing through line 14, page 318.
P. 318, line 15:	Change "(b)" to "(a)".
P. 318, line 22:	Change "(c)" to "(b)".
P. 319, line 5:	Change "(d)" to "(c)", strike the "s" following "date" making it singular, and strike all commencing with "The amendments" through "section" in line 8, page 319.
P. 319, line 8:	Change "(b)" to "(a)".
P. 319, line 10:	Strike all commencing with "Sec. 602" and continuing through line 14, page 321.

SUMMARY OF PRINCIPAL POINTS INCLUDED IN STATEMENT ON H.R. 13270 BY RICHARD D. WILSON, GENERAL COUNSEL CONSUMERS PUBLIC POWER DISTRICT OF NEBRASKA BEFORE THE SENATE FINANCE COMMITTEE SEPTEMBER 24, 1969

Provisions of H.R. 13270 regarding taxation of municipal bond interest will increase the relative burdens of the lower income individual and will complicate the Federal income tax system. Such provisions will increase the costs of local governments, and those local governments will pass on the increases to their inhabitants. Such services as water, bridges, electricity, toll roads, and other public services will increase in cost. Those costs are significant to the lower income individual, but they are insignificant to the individual with a high income. These increased costs will not be balanced by increased Federal revenues because bond buyers will increase the interest rates based on the possibility of broadened Federal income taxation rather than on the narrow provisions of H.R. 13270.

Many local projects may cease to be feasible and this will increase facilities that must be provided by the Federal Government or hurt the lower income individual by taking away facilities he needs.

The new complications introduced by these provisions are pointed out, and a Federal income tax subsidy is opposed because of the additional Federal controls and regulations which will be required.

STATEMENT ON H.R. 13270
BY RICHARD D. WILSON, GENERAL COUNSEL
CONSUMERS PUBLIC POWER DISTRICT OF NEBRASKA
BEFORE THE SENATE FINANCE COMMITTEE
SEPTEMBER 24, 1969

Consumers Public Power District is a political subdivision of the State of Nebraska owning and operating electric generating, transmission and distribution facilities extending to virtually all parts of Nebraska except the Omaha area. In making this statement today, I am also authorized to state that Omaha Public Power District, Loup River Public Power District, Central Nebraska Public Power and Irrigation District and Nebraska Electric Generation and Transmission Cooperative Inc., all public organizations engaged in providing electric service in Nebraska, concur in opposing provisions of H.R. 13270 relating to taxation of the interest paid on State and local government obligations. My client, Consumers Public Power District, sold $286,000,000 in revenue bonds to the public last year; Omaha Public Power District, Loup River Public Power District, and Central Nebraska Public Power and Irrigation District have large amounts of revenue bonds outstanding,and the financing of projects required for providing essential public service in Nebraska will require

additional bonds to be sold by some or all of them in the future. In connection with this proposed legislation, I am also chairman of a Task Force of American Public Power Association to advise it on provisions relating to interest paid on local government bonds.

Provisions of H.R. 13270 which relate to taxation of interest on State and local government bonds might be summarized as follows:

> Title III, Section 301. - Provisions in this Section would result in the payment of income tax on interest received from State and local government bonds in certain cases. This may be referred to as the limited tax preference provision.
>
> Title III, Section 302. - In this Section there are provisions which would require certain individual taxpayers to allocate part of their personal deductions against their income from State and local government bonds so that their receiving such income would result in their paying a higher income tax than if they had not received that income. These provisions

are referred to as allocation of deductions.

Title VI, Sections 601 and 602. - There is provision for a State or political subdivision to elect to issue bonds the interest from which will be taxable, and the United States will pay an interest subsidy so as to reduce the interest payments made by the State or a local subdivision. This has been referred to as the interest subsidy provision.

We urge that the provisions for including interest paid on State and local government bonds in the limited tax preference and in the allocation of deductions as well as the provisions for an interest subsidy should be eliminated from this legislation. Why? Because the result of these provisions will not be tax reform, but will be a shifting of the over-all cost of government from those with higher incomes to those with lower incomes and will also be new tax complications rather than simplifications.

There can be no doubt that passage by the Congress of a law that results in placing a Federal income tax on interest

from State and local government bonds will substantially increase the interest that will have to be paid by the State and local political subdivisions, and the States and local government subdivisions will, in turn, have to exact more from their local inhabitants. This will raise the cost primarily of services provided by local government, which cost burdens the small taxpayer, not the large. For example, charges for electricity supplied by local governments are an insignificant item to the rich, but they are a much more significant item in the budget of a poor person. These new tax provisions would necessarily increase the charges for electricity made by local political subdivisions. By the same reasoning they would also increase the charges for water, parking, bridges, toll roads, parks, schools, fire departments and other items financed by the issue of bonds. Amounts paid by the lower income taxpayer for such local government services are substantial relative to his income, but they are negligible relative to the income of a rich man. Thus, the poor man is hurt.

Will the lower income taxpayer be helped by increased Federal income tax paid by wealthy holders of local government bonds? No. First of all, the increased revenue to the United

States Treasury will be far less than the increased cost to State and local governments. If the United States imposes the taxes now included in H.R. 13270, thereafter every purchaser of State and local government bonds, regardless of whether or not H.R. 13270 taxes him, will require a higher interest rate due to the fact that if the United States has started the income taxation of local government bonds on a narrow basis, it can be expected in the future to broaden the scope of that taxation. Therefore the political subdivision will be paying and passing on to its inhabitants a cost based on the fear of what the United States will do in the future, and the cost will be far larger than any possible increased tax return to the United States.

Second, increased interest rates paid by the State and local government subdivisions can be expected to force the United States to finance and construct some of the facilities which are now provided by local governments so that any increase in Federal income tax will be more than offset by increased Federal construction expenditures. For example, in my own experience, public power districts in Nebraska have financed and constructed a large electric transmission grid extending into all parts of the State, and the United States

Bureau of Reclamation uses that transmission grid to deliver electricity from its generating plants rather than having the United States construct its own transmission grid in Nebraska. The feasibility of financing, and therefore the ability to construct, some of these necessary lines can be lost if interest rates must be paid on the basis of interest subject to income taxation. In the same way the feasibility of financing and constructing bridges, roads, other transportation facilities, sewage treatment facilities and public buildings may be lost if interest rates on municipal bonds go up to the rate necessary to sell bonds on which the interest is subject to Federal income taxation. That hurts either the Federal Government, who must step in and supply the necessary facilities, or, if the United States doesn't do it, it hurts the lower income taxpayer who needs and will not have the public facilities.

The foregoing reasons why the limited tax preference with respect to municipal bonds and the allocation of deductions hurt the lower income taxpayer all assume that if Congress taxes municipal bond interest, the penalty to the local government will be only increased costs. However, in many cases the penalty may be the elimination of ability of the local political subdivision to borrow at all. If an investor

has a choice between the bonds of an established national corporation and of a local and perhaps small municipality, under the present laws some have chosen the bonds of the local municipality, but if the tax consequences are the same, there is no reason to believe that the investor will buy any local government bonds at feasible interest rates for many of the projects which are now being constructed by political subdivisions.

At least in part, the purpose of a tax reform bill should be to simplify the tax structure. The municipal bond interest provisions contained in this Bill will greatly complicate the tax structure. Take for example the provisions for allocation of deductions. The forms and taxpayer calculations will require these additional determinations and calculations:

1. Does taxpayer have "allocable expenses"?

2. Do the allocable expenses exceed the limits set in H.R. 13270?

3. What is the amount of taxpayer's allowable tax preferences?

4. Are some of the amounts included in 3 excludable as interest from obligations issued before July 12, 1969?

5. What is taxpayer's section 277 fraction?

6. In the particular tax year under consideration, what percentage of the municipal bond interest is to be considered (this varies from 10 to 100 per cent)?

In a similar way, the limited tax preference provisions will add great complications and not simplification to the income tax laws.

It may be asked why local governments should oppose the option to issue taxable bonds and have the Federal Government pay an interest subsidy. First, I would like to point out that even under H.R. 13270 the election by the local government must be made "at such time, in such manner, and subject to such conditions as the Secretary or his delegate by regulation prescribes". Thus, the Federal Government is commencing its control over State and local government financing, and as the States and local governments continually increase Federal costs by increasing their issuance of bonds, it is certainly reasonable to expect increasing control by the Federal Government. No need for a Federal subsidy of local government bonds has been shown, such a subsidy will increase the Federal bureaucracy, and we

oppose it. A Federal subsidy will not help the individual with a lower income - it will only increase Federal complications and controls.

For the foregoing reasons, as well as the doubts as to constitutionality and many additional reasons presented by others, we respectfully urge that provisions relating to interest on municipal bonds be eliminated from H.R. 13270.

THE UNITED STATES OF AMERICA

IN THE SENATE FINANCE COMMITTEE
SEPTEMBER 24, 1969

STATEMENT BY GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA, BEFORE THE SENATE FINANCE COMMITTEE ON BEHALF OF THE STATE OF SOUTH CAROLINA, THE MUNICIPAL ASSOCIATION OF SOUTH CAROLINA, REPRESENTING APPROXIMATELY 256 MUNICIPALITIES IN OUR STATE, AND THE SOUTH CAROLINA ASSOCIATION OF COUNTIES, COMPOSED OF MOST COUNTY OFFICIALS IN SOUTH CAROLINA, OPPOSING CERTAIN PROVISIONS OF H. R. 13270 DEALING WITH TAX EXEMPT STATUS OF INTEREST ON STATE AND MUNICIPAL AND POLITICAL SUBDIVISION BONDS.

PRINCIPAL POINTS OF STATEMENT

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6. Secondary bond market irreparably damaged . . . .Page 4
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First, I want to express my appreciation to this Committee for an opportunity to be heard in opposition to the proposed legislation now pending before this Committee dealing with tax exempt status of interest on state, municipal, and political subdivision bonds.

I am appearing on behalf of the State of South Carolina, the Municipal Association of South Carolina, representing approximately 256 municipalities in our State, and the S. C. Association of Counties, composed of most county officials in South Carolina. We are grateful for an opportunity to express to you our profound opposition to these detrimental proposals.

We urge this Committee to delete from H. R. 13270 all proposals that would impair the exempt status of the interest on state and local government bonds, including the following provisions of H. R. 13270:

OBJECTIONS TO SPECIFIC PROVISIONS OF THE BILL

(A.) The inclusion of such interest in the base of the limit on tax preferences as proposed by Section 301.

(B.) The inclusion of such interest in the base for the allocation of deductions as proposed by Section 302.

(C.) The taxation of interest on all "arbitrage bonds" without a statutory definition as proposed by Section 601 (B).

(D) The taxation of the interest on all otherwise exempt obligations in exchange for a preferred "federal subsidy" as proposed by Title IV.

SUBSTANTIAL INCREASE IN TAX BURDEN OF LOCAL TAXPAYERS

Under the guise of reducing taxes for almost every citizen, this so-called tax reform bill written by the House Ways and Means Committee and passed by the U. S. Congress now pending before this Committee will substantially increase the taxes of almost every local taxpayer in South Carolina and the Nation if these proposals become law. These provisions of this bill will do significant and irreparable damage to the taxpayer of this Country and to the market for public securities. Proof of this fact can be seen today in the chaotic bond market caused by just the threat of such legislation.

STRIKE AT THE SOVEREIGNTY OF THE STATE

Furthermore, such proposals strike at the very heart of the sovereignty of the several States, for if the ability of the States to borrow money is impaired, curtailed or destroyed by the Federal Government, the States would be reduced to mere districts in a very short time.

TAX EXEMPT STATUS DESTROYED
BY MINIMUM TAX PROPOSAL

The minimum tax proposal as it applies to the individual

taxpayers has a single, very simple and disastrous effect. It destroys the tax exempt status of state, municipal and political subdivision bonds. If this provision is enacted into law, the tax exempt bonds we have issued and now outstanding will become taxable, and any further securities we issue will be taxable. For if a bond can be taxed in the hands of any investor, it is no longer a tax exempt security. The impact this will have on the market for state and local bonds cannot be determined with mathematical preciseness, but it will certainly be severe.

ALLOCATION OF DEDUCTIONS DAMAGES TAX EXEMPT STATUS

The proposal relating to allocation of deductions between taxable and tax exempt income for individual taxpayers will also damage the sale of our securities. Although the proposed provision applies only to individuals, the principle is very simple. When it has once been applied to individuals, corporate investors are going to be very apprehensive that the same principal will be applied to them. Once the camel's nose is under the tent, it's difficult to stop him. Again, the impact of the proposed provision may not be great, but the real impact is complete destruction of tax exemption and of the tax exempt market and the confidence of

investors in our securities.

This provision which proposes changing the tax treatment of realized gains on bank bond portfolios from capital gains to ordinary income cannot be considered separately from these other two provisions. First, if there still are tax exempt securities, this provision would apply to them; and, secondly, since there is a strong possibility that a large share of state and local borrowing will somehow be done in taxable form, we will be very dependent on the market for taxable government securities.

SECONDARY BOND MARKET IRREPARABLY DAMAGED

What will be the effect of this provision on that market?

By limiting the attractiveness of capital gains the proposed treatment of long-term bond profits will unquestionably restrict the willingness of commercial banks to purchase intermediate and long-term bonds. Bankers all over the State tell me that this, in effect, completely destroys the secondary market in state and municipal bonds.

It will make no difference whether the securities are taxable or tax exempt if capital gains are to be taxed as ordinary income. The risk of buying bonds will outway the gain, and the gain will not be worth the risk.

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The capital gains provision would also impair and curtail the functions of the market by putting an end to tax swapping by commercial banks. I am told that this accounts for perhaps 50% of the volume of trading in U. S. Government securities, away from treasury bills and perhaps 40% of the trading in state and municipal bonds. If this amount of activity is removed from the bond market, a substantial amount of capital committed to our securities would be removed. This would reduce the marketability of our securities.

These three proposals must be deleted from this bill if the vitality of the market for our securities is to be preserved.

INVESTOR CONFIDENCE SERIOUSLY JEOPARDIZED

First, the interest on outstanding state and local bonds must remain tax exempt. It is unthinkable that the U. S. Government would flagrantly breach the faith with investors who have furnished billions of dollars for state and municipal needs in complete confidence that they were buying tax exempt bonds. But beyond this, if state and local governments are going to continue to issue securities that offer some tax exemption, the rate of interest we pay on these securities is going to be directly related to the level to which outstanding issues trade in the secondary market. If complete tax exemption is maintained

on outstanding state and municipal securities, they will trade in the highest level, and we will be able to sell new issues under most favorable terms in the market place.

BREACH OF FAITH BY U. S. GOVERNMENT

Conversely, if outstanding issues are taxed, investors' confidence will be so heavily damaged that we cannot expect to sell under any favorable terms new issues of state and municipal bonds with whatever amount of tax exemption we may have left. Investors' confidence in this market is an extremely necessary factor in this whole matter. There is no question in my mind that the confidence of the investor is a key factor in this entire scheme of things.

As you gentlemen know, the tax balance is somewhat akin to the balance of nature. One arbitrary action to relieve a so-called tax inequity has a far-reaching effect on many other aspects of the tax spectrum. Thus, by changing the tax laws, these proposals which appear fairly simple on the face, the resulting effect is a substantial increase in local taxes for almost every taxpayer in our State and in this Nation.

In considering this problem, there are two types of securities, tax exempt securities and taxable securities. If our bonds are liable for one dollar of federal income taxes in the hands of any investor, our bonds are no longer tax exempt - simply stated, they are taxable. They will be regarded by all investors as taxable, and when we go to market we will borrow on these securities at

taxable rates. If we are going to retain the right to borrow effectively in the tax exempt market, then state and local securities must be exempted from the minimum income tax proposed for individuals in this bill.

BASIC PURPOSE OF TAX EXEMPT STATUS

I think we should pause for a moment and consider the basic purpose of the tax exempt status of state and municipal bonds in the first place. The purpose of the exemption was to sell these securities at the lowest possible cost to the given political entity, thereby keeping to a minimum the cost to the taxpayers. In order to do this, these securities of necessity had to be attractively priced so as to be saleable and marketable. This arrangement has worked extremely well for decades and I see no valid reason for changing it.

FREE ENTERPRISE SYSTEM HAS WORKED

The sale of our securities to operation of the free enterprise scheme of things has paid big dividends to all the taxpayers of this Country. The fact that it has worked so well seems to upset some officials in high government circles. I have long felt that if a system is working well, why disturb it. There are plenty of areas in government which need far greater attention than this matter. I would suggest that the

government energies be directed toward those areas and leave the tax exempt status of state municipal bonds alone.

A MEANS OF TAX SHARING

Another thought which I would like to share with the Committee concerns tax sharing in the several States. We have seen and read in the news media about the mood of Congress concerning this matter. I would submit to you that one of the best and direct methods of tax sharing with the several States is to leave the tax exempt status of state and municipal bonds as we now know it under existing law. What useful purpose could be accomplished by the Federal Government's subsidizing the cost of issuing taxable bonds? There are many, many reasons which are quite obvious to most people for opposing any federal subsidy arrangement. We know from past experience of all the red tape, unnecessary reports, unwarranted priorities and controls which would result if such a system were adopted. In my judgement, the present law relating to tax exempt status of state and municipal bonds, in effect, provides in a sense a tax sharing consideration for the taxpayers of this Country.

PAYING TAX BY ACCEPTING LOWER YIELD

Moreover, investors who purchase state municipal bonds are, in effect, paying a substantial tax by virtue of accepting a lower

yield from investing in these securities. Conversely, these investors could invest the same funds in taxable securities and receive a much higher yield. Thus, it can be argued with considerable merit that by purchasing state and municipal securities, investors are, in effect paying income taxes by accepting the lower yield.

In order to support an alleged need for tax reform in this particular area, some facts should be presented to prove the case. With all the discussion by the news media and others, about 154 persons not paying any income tax on income earned in 1967, not one scintilla of evidence has been shown to prove that one single state or municipal bond was held by any one of these individuals. I submit to you, gentlemen, that no case has been made to justify or warrant any wholesale tampering with or modification of the tax exempt status of state and municipal bonds. The devastating effect this helter-skelter, headlong rush by the House Ways and Means Committee and the Congress to remove or modify the exemption on interest earned on state and municipal bonds has had on the bond market need not be described in words. One has only to look at the chaotic bond market today for proof of this fact. If this is not satisfactory evidence and proof to you, gentlemen, then I do not know how to prove the case. The confidence

of investors in state and municipal bonds has been destroyed, and the only way to restore it is for the Senate and Congress to reject all snippings at the tax exempt status of these securities.

BIG PRINT GIVETH AND SMALL PRINT TAKETH AWAY

This is another case of the big print giveth and the small print taketh away. The big news media headlines giveth tax reductions for almost all citizens, but the small print in the tax bill relating to tax exempt status of interest on state and municipal bonds taketh away with increased tax burdens for local taxpayers.

We respectfully urge this Committee, the Senate and Congress to reject all proposals relating to removing or tampering with the tax exempt status of interest on state and municipal and political subdivision bonds, and to put an end to this detrimental legislation once and for all.

Respectfully submitted,

GRADY L. PATTERSON, JR.
State Treasurer
South Carolina

PART B—ADDITIONAL STATEMENTS

STATE OF NORTH CAROLINA
GOVERNOR'S OFFICE
RALEIGH 27602

ROBERT W. SCOTT
GOVERNOR

September 19, 1969

Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
2227 New Senate Office Building
Washington, D. C.

Dear Senator Long:

Please accept this written statement in lieu of my appearance before your Finance Committee in opposition to certain portions of the Tax Reform Act of 1969 (HR 13270).

I strongly oppose any action by Congress which would impair the tax exempt status of State and local bonds, and advocate early resolution of the provisions of the Act relating to the taxation of interest from securities issued for bona fide public purposes.

As Governor of North Carolina, I have been highly encouraged by the Administration's stated purpose of strengthening State and local governments; however, the proposals which would remove the tax exempt status of bonds issued by these governments proceed directly away from this stated purpose. It is apparent that the recent dramatic increases in interest rates have been accelerated by the proposals before the Congress to remove the tax exempt status and to retroactively tax the interest which has been earned by investors. The confidence of these investors has been seriously shaken, and the ability of State and local governments to secure acceptable financing for capital improvements has resulted in a greater tax burden being passed to the tax-payers at the local levels. I have serious doubts regarding the constitutionality of such retroactive tax measures, and a great concern for the financial plight in which our cities and counties find themselves because of investor apprehension over this proposed Congressional action.

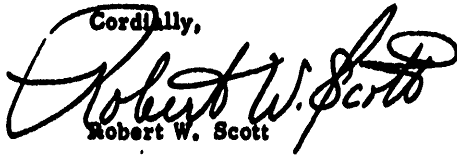
North Carolina has made it a habit to have good government. We have kept our fiscal house in order at the State level, and have promoted and encouraged strong and self-sufficient governments at the municipal and county levels. My administration is dedicated to positive and responsible action in support of strong local government. Maintenance of responsible and effective local governments will be possible only to the extent that the Congress preserves the independence of fiscal policies at each level of government. The proposals to remove tax exempt status from these State and local bond issues will weaken the foundation of local government financing.

We are deeply concerned about the effect of proposed changes with respect to the reduction in the allowable deduction of charitable contributions to educational institutions and charities. Our institutions of higher learning, as well as our charitable organisations, depend in large measure upon such contributions for their operating revenue and their building programs. Recent figures show that private institutions are receiving in the neighborhood of 8 3/4 million dollars annually from contributions. Public four year colleges and universities are receiving about one-half that amount. Our General Assembly has recently appropriated $350,000 for the current biennium for additional support in the medical schools of two private universities, Wake Forest University and Duke University. Even with all of the support that can be given from the various levels of government the need is increasing, and the removal of inducements to contributions poses a serious blow to the hope that public and private colleges and universities will be able to continue their mission at the present levels of operation. Elimination of the present tax advantages, particularly those relating to unlimited contribution deductions, transfer of income to charitable organisations by means of the two-year trust, use of present market value in determining the amount of deductions for donations, and permitting deductions for the use of property, will necessarily curtail the flow of funds to these institutions from private sources. Loss of such substantial sources of funds, in many of our private institutions, would be disastrous; it would cripple our effort to provide a wider and more comprehensive educational base for our citizens.

We join in the concern that our growing needs require ever increasing governmental support. However, in keeping with the President's statement that cooperation of all levels of government in partnership with private enterprise is essential to our effort to meet these needs, we suggest that removal of tax exemption on local governmental bonds, and removal of the inducements for contributions to institutions of higher learning will result <u>not</u> in cooperative

partnership, but in increasing the importance of local governments, and the enlargement of federal direction over local governmental affairs. We urge that degree of cooperation of which the President has spoken; we suggest that it will be possible only if local and State governments are left with independence of fiscal policy sufficient to meet their share of the cooperative endeavor.

Cordially,



Robert W. Scott

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STATEMENT OF
HON. TOM BEVILL, MEMBER OF CONGRESS
BEFORE THE SENATE FINANCE COMMITTEE
(Title VI of H.R. 13270)
Wednesday, September 24, 1969

Mr. Chairman, distinguished Members of the Committee, I appreciate the opportunity of appearing before you today to express my opinion with regard to Title VI of H.R. 13270 which passed the House on August 7, 1969.

As you know, state and local bond financing has long been granted tax-exempt status. With this assistance, state and local governments have been able to attract more favorable interest rates from investors, making it easier for them to move forward with many improvements; improvements such as new and expanded water and sewer systems, more and better streets, additional recreational facilities and improvements to hospitals.

Although I voted for passage of H.R. 13270 in the House, I am on record as opposing that portion of the bill dealing with state and municipal bonds. It is my best judgment that if this House-passed provision is allowed to remain in the bill, it will critically damage the ability of state and local governments to finance improvements at rates they can afford to pay.

It is also quite possible, that should H.R. 13270 be enacted with Title VI intact, there would be, for state and local governments, long periods of litigation placing the municipal bond market in jeopardy.

A great deal of attention has been focused on the need to eliminate glaring loopholes in our present tax laws which allow individuals or groups to escape paying any taxes despite the fact that they have sizable incomes. It has been implied

that many wealthy individuals avoid paying taxes by investing in state and municipal bonds.

This assumption was clearly disproven by Mr. W. E. Tinsley, Executive Director, Municipal Advisory Council of Texas, writing in the August, 1969 issue of the Alabama Municipal Journal.

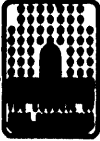
Mr. Tinsley declares that the public is being misled. The fact is that relatively few persons with large incomes who escaped paying any income taxes in 1967, the year in which most of the instances occurred, held more than relatively small amounts of municipal bonds.

Over the past several months, I have received thousands of letters from responsible state, county and municipal leaders expressing their deep concern and forceful objection to the removal of the tax-exempt status which is now afforded these bonds.

At this particular time in our history, most state and local governments are severely pressed to provide adequate services for their citizens. Any disruption of vital programs could only be detrimental to their growth and development.

It is my earnest hope that some long-overdue tax relief for our low and middle-income families will come from this legislation. I respectfully submit, however, that removal of the tax-exempt status on state and local bonds can only add to the burden of the average taxpayer.

Thank you!



THE COUNCIL OF STATE GOVERNMENTS
WASHINGTON OFFICE
1735 DeSales Street, N. W., Washington, D. C. 20036 • (202) 737-9717

Statement of

The Honorable Francis B. Burch

Attorney General of the State of Maryland

Member, Executive Committee
National Association of Attorneys General

To The

Finance Committee
United States Senate

On

H. R. 13270
Tax Treatment of State and Local Bonds

September, 1969

HEADQUARTERS: IRON WORKS PIKE, LEXINGTON, KENTUCKY 40505

STATEMENT OF FRANCIS B. BURCH,
ATTORNEY GENERAL OF THE STATE OF MARYLAND
ON BEHALF OF
NATIONAL ASSOCIATION OF ATTORNEYS GENERAL
TO THE FINANCE COMMITTEE OF THE
UNITED STATES SENATE, SEPTEMBER, 1969

I am Attorney General of the State of Maryland. I am a member of the Executive Committee of the National Association of Attorneys General which I represent here. Our Association consists of the chief law officers of each of the 50 States and also of the Territories.

Our Association is proud that in 1938 it fathered the Conference on State Defense, which is the coalition of the national organizations of state and local governments and of the respective executive, fiscal and law officers of the States and local governments. They join together at our invitation to preserve the exemption of state and local government institutions from federal taxation.

Each time in the past three decades when attempts were made to withdraw the tax exemption of state and local government bond income, we have appeared here by one of our number and protested. We are gratified that the announcement of the present hearings contains no proposal for the withdrawal of this exemption on a non-optional basis. We are committed to resist any such attempt.

We agree with the fiscal and economic position of the other state officers' associations represented on this panel. But as the chief law officers of the States, our special competence is as to the legal aspects of proposals in this field. In 1939 the State Attorneys General of that day submitted a brief to this Committee asserting the unconstitutionality of any federal tax on our bond interest without state consent. (Incidentally, the present Chief Justice of the United States Supreme Court was one of the signatories — he was then Attorney General of California). We commend that brief to you and submit that nothing has happened in the intervening 30 years

to change its conclusions.

I know that law is a prediction of what a court will do in fact and that some good lawyers do not predict as we do. But we submit that any retreat from the doctrine of the reciprocal constitutional immunity from the federal and state governments' taxation of each other reached its high water mark in 1938. From then on the trend has been toward increasing reaffirmation of reciprocal constitutional immunity.

It remains true that the Supreme Court unanimously held unconstitutional any federal taxation of state and local government bond interest in Pollock v. Farmer's Loan & Trust Co., 157 U. S. 429. From that proposition the Court has never retreated.

Cases in the 1930's imposed a qualification on the general doctrine of immunity, when it was sought to apply it to the profits of construction contractors and tenants and the salaries of public officers. (James V. Dravo Contracting Co., 320 U. S. 134; Helvering v. Mountain Producers Corp., 303 U. S. 376; Helvering v. Gerhardt. 304 U. S. 405). The qualification, in the case of governmental functions, is that the immunity cannot be claimed unless the tax in question threatens to burden the conduct of state and local governments unduly. As for bond interest, it is unquestionable that income tax would constitute such an undue burden.

Indeed, I must note that for that reason, among others, we will be supporting a modification by the Congress of its mislabeled definition of industrial development bonds in the Revenue and Expenditures Control Act of 1968. That matter, we understand, will be the subject of separate hearings and we will be back with our suggestions at that time.

You will note that as I stated our legal opinion it was that state and local government bonds may not be taxed by the Federal Government without State consent. Conversely, if a State consents, Congress may lawfully tax its bonds and those of its municipalities. If, then, the enumerated

proposals on the Committee's agenda under this subject are unequivocally kept optional for each state, it will avoid the stated constitutional obstacle.

We have one qualification, however. It is addressed to any proposals which might make it optional to individual municipalities to trade the exemption of their bonds for a promise of a federal interest subsidy. For that to be legally possible the state of which the municipality is the agency must give its authorization by state statute.

The constitutional immunity inheres in the sovereignty of the States. In the case of political subdivisions, it is derived from their nature as state instrumentalities. Thus the cities may not themselves yield the immunity unless their respective states consent.

This is illustrated by the two Federal municipal bankruptcy act cases, which involved the bonds of political subdivisions. The first municipal bankruptcy act was held unconstitutional because it did not call for state consent to federal adjustment, in bankruptcy, of municipal obligations. Ashton v. District No. 1, 298 U. S. 513. When the act was amended to require state consent, it was upheld. United States v. Bekins, 304 U. S. 27.

It is difficult to exclude policy considerations from legal appraisals. That is why we caution you against the dangers of federal control of state and local policies in the area of exclusive state and local responsibility. The two proposals identified by your press release can hardly avoid these dangers.

They both call for taxation of our obligations, directly in the first proposal and indirectly in the second, with the Federal Government paying the additional cost of borrowing on a taxable basis.

With the Federal Government called on to make annual appropriations for this purpose, no one can be certain that sooner or later conditions will not be attached, andthat these conditions reflecting the Federal policy of the

moment, would not displace state and local government policy in matters that the Tenth Amendment to the Constitution reserves to the States.

We also frankly fear lest any plan subvert state and local governments free access to the conventional tax exempt any market. Any option to the States in a tax proposal will be a real option only if the private tax-exempt market continues viable and strong.

We note that the states' constitutional immunity rests upon a policy judgement by the Supreme Court that taxation of state and local government borrowing can weaken the States as independent sovereignties and as the repository of local self-government in this country, and that such weakening violates the constitutional framework of our federal system.

That policy is at least as valid for you gentlemen, as legislators. The Congress is well advised to stop far short of the line of rupture which forces the Court to intervene to preserve the federal system.

As we appraise these two identified substitutes for or supplements to tax exempt borrowing, we ask if they are worth the risk. As to the first proposal -- direct taxation with federal subsidy -- we are convinced the risk is too great. As to the second proposal -- indirect borrowing through a subsidized federal institution - you must understand that we continue skeptical. The proponents have an uphill fight to avoid the dangers I have mentioned. If they cannot avoid those dangers, the plan would be unacceptable.

In marketing our obligations through these conventional channels we have had a minimum of delay. For example, in Maryland, our 1968 First Series was approved by the Board of Public Works (consisting of our Governor, Comptroller and Treasurer) on July 3, 1968 and the sale was held only 13 days later on July 16 with the settlement held on August 14. Our 1969 First Series was approved December 17, 1968 and the sale was held January 21, 1969 with settlement on February 19. We cannot expect such expedition if Federal administrators must be added to the processing of our bond issues particularly if we have to negotiate differences in viewpoint.

Delay at best postpones the realization of needed public works. Sometimes it can be very costly in money as well. For example, the 1968 issue I mentioned produced a net interest cost to the State of 3.9491% in the July, 1968, sale. The 1969 issue, only six months later, cost us 4.3254%.

Testimony of

G. T. Blankenship
Attorney General
State of Oklahoma

For the consideration of the
United States Senate Finance
Committee

September 22, 1969

This is a statement for the consideration of the United States Senate Finance Committee on certain aspects of the tax bill currently under advisement. I wish to thank the Chairman and members of this committee for the opportunity to express my views.

To give an indication of the extent to which Oklahoma would be affected by certain of the proposals, consider the following:

Oklahoma has an annual appropriated budget of approximately $200,000,000.00. During the years of 1967 and 1968 the State and its various political subdivisions issued in excess of $250,000,000.00 in bonds for building schools, public health facilities, court houses, water and sewage systems, colleges, school buses, other public buildings, and myriad other public works projects which amount to more than 62% of our appropriated budget each year. This type of financing is definitely increasing

because of the problems a state or political subdivision continually faces in raising an ever-increasing amount of revenue to meet the need and demand for an ever-increasing number of services. It is then quite proper to project that within relatively few years the bond financing technique will equal or exceed in amount appropriated expenditures.

No one can seriously doubt that the effective removal of the tax exempt feature of municipal bonds would have a catastrophic effect on the financing of public works in my state. The mere consideration of this bill by the Congress has already caused increased interest costs to the states, and in some instances has apparently caused bond offerings to fail for want of a single bid from a buyer.

In many states, and in my own, the legislators are having to give consideration to changes in legislation to raise the established maximum interest rate, with all the attendant delays, because in many instances the chaos resulting from concern over this tax bill makes present interest limitations totally unrealistic, and renders it unlikely that the bonds could be sold. We are thus already in fact suffering the effects of the tax bill.

There are many philosophical, political, and policy considerations which mitigate against these tax proposals.

The first is that our Senators and Congressmen are elected by the people of their states to be the people's

representatives in Washington, and have the attendant duty to represent the interests of their states. To pass such a measure with such drastic adverse effects on the states, especially without any significant monetary gàin (but with substantial increase in the national government's power) is contrary to the fundamental tenets of federalism.

It cannot be seriously advocated by any student of government that the projects imperiled by this bill in 50 different states with significant variations in laws, institutions, geography, and economies, can be better administered on a national level. Local administration is axiomatically more responsive to local needs. It would be extremely impractical to implement the interest subsidy proposals for the simple reason that to determine the amounts of subsidies within the proposed percentages allowable requires either arbitrary, or practically administratively impossible, evaluations of "micro" government on the "macro" governmental level. The effect then is an effective step toward the crippling, or destruction, of a highly responsible (local) and correlatively more efficient and effective municipal financing system grounded on 100 years of experience. The proffered substitute is an untried, unproven, briefly considered proposal, the expressed intention of which is to "get" some tax avoiders, most of whom are taking greatest advantage of other tax preferences, rather than mainly exploiting the exemption on income from municipal bonds.

Let us consider alternatives facing the states. The most drastic possibility is the potential collapse of the present municipal bond market, forcing states into competition with corporate bonds at a correspondingly higher interest cost, at a time when we can least afford it.

Another is initially an indirect Federal subsidy (i.e. reimbursement) followed eventually by direct Federal subsidy (for the project itself) with the attendant bureaucratic interference with local programs, the net result being that state and local government will be less rather than more responsible, which is not desirable.

Another alternative is the concept of advance funding, forcing the states to operate on a cash-in-hand basis. The states would then be placed in a position of curtailing services for years to accumulate enough cash to finance projects in a time of spiraling inflation, and labor and material costs.

There are legislative alternatives available for the Congress. Among these are the so-called Urbank, and the proposed Municipal Bond Guarantee Corporation. Evaluation and criticism of these proposals have already been made. A serious and critical suggestion was offered by the Honorable Norbert T. Tiemann, Governor of Nebraska, that any proposal in this area be studied carefully. I think that proper evaluation would necessarily involve the private as well as governmental sector. The considerations are too significant to lack proper thorough examination.

The inclusion of municipal bond income in gross income to determine a minimum income tax or for the limit on tax preference would seem ultimately to work a tremendous hardship on local government without necessarily removing any inequities in income tax assessment. That is, a persuasive argument can be made that the buyer of tax exempt bonds takes them with less interest cost to the issuing government (then less tax dollars) in exchange for the reduction in his income tax liability; if the tax exempt feature is removed, such bonds will not be sold without increasing the income to the purchaser (to offset his tax liability) and thereby directly increasing the amount of tax money needed to be spent to pay the higher interest costs, thus placing the increased tax burden on the middle-income taxpayer who supplies the vast bulk of tax dollars. The effect, then, of removing the tax exemption feature of municipal bonds is to place another indirect tax on the ordinary taxpayer.

There are significant constitutional questions to be raised concerning the attempt to place an income tax on municipal bond interest. Our United States Supreme Court has thwarted one such prior attempt in the Pollack v. Farmers' Loan & Trust Company case.

The Court maintained that position in National Life Insurance Co. v. United States. See also Macallen v. Massachusetts.

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If this proposal is adopted the states will be forced into an unwanted posture. If the national government could constitutionally abrogate state sovereignty by taxing municipal bond income, cannot the states in turn tax the income on federal securities? Will the effects of this proposal work so drastically on the states that they will be forced to bring about explicit constitutional protection? The implications of this legislation are too profound to warrant adoption without extensive inquiry being made into methods by which the hardship would be worked upon the states and the taxpayers could be avoided, and the interests of the people be protected.

STATEMENT BY LOUIS J. LEFKOWITZ, ATTORNEY GENERAL OF THE STATE OF NEW YORK — LOCAL BOND INTEREST PROVISIONS OF H.R. 13270 PRESENTED TO THE U. S. SENATE FINANCE COMMITTEE, MONDAY, SEPTEMBER 22, 1969

This statement is addressed to the provisions of H. R. 13270, now being considered by this honorable body, which drastically alter the tax treatment of interest on state and municipal bonds.

As Attorney General of the State of New York I wish to state my strong opposition to these provisions on the following grounds:

1. Taxation of the interest on state and local bonds operates on the power to borrow before it is exercised. However this tax is imposed and whatever guise it takes, it is a tax on the power of the states and their instrumentalities to borrow money and is consequently repugnant to the United States Constitution. The power to tax, as our Supreme Court stated early in our history, is the power to destroy. Any impairment of the direct execution of the powers of a state, in particular, of the power to raise monies required for the fulfillment of sovereign obligations and the exercise of sovereign functions, is in my view clearly unconstitutional. Furthermore, it is my opinion that any infringement of the preferential nature of state and local debt would undermine the traditional and undoubted power of the states and their municipalities, reserved

to them by the 10th Amendment to the Constitution, to deal independently with state and local policies and problems and the needs of their citizens.

2. In addition, this altered tax treatment would impose an intolerable burden on the ability of states and local governments to finance capital programs. Since, under such legislation, the State and its agencies, as well as the municipalities, would be in direct competition with private, non-exempt bond issues, it is apparent that the interest rate on public bonds would rise to the level of that commanded by the private issues. Clearly, such an eventuality would frustrate billions of dollars of local and State capital projects except at a doubling or tripling of cost. Such a result, in the face of the existing financially straitened circumstances in which the State and its cities are already operating, would inevitably bring about the cancellation of many necessary programs. Our citizenry evince an unwillingness to pay more in State and local taxes than they now pay; we are already faced with what amounts to a tax revolt. Both on the State and local levels we are presently operating under austerity budgets. To create a situation in which even more of the burden is thrown upon the State and its cities is inconceivable.

3. As a practical proposition I suspect that the additional income tax which would inure to the federal government would be less than the additional costs which would be imposed

upon the State and cities, so that if the federal government were to assume "in lieu" subsidies to cover the differential in cost, it would find itself paying out a greater sum than the amount it receives as a result of the altered tax treatment of tax exempt interest. Moreover, if consideration be given to the costs of administering such an "in lieu" program plus the inevitable frictions and delays which relate to such a program, it is apparent that any "net" revenue to the national government would be questionable if not non-existent. I must note also that such subsidization implies a greater and greater centralization of power in Washington and less and less freedom in local and State control over what are essentially non-federal projects.

In summary, federal incursions of this character into the area of state and local powers are constitutionally unjustifiable. Of equal importance, is the inescapable fact that they would render raising of funds by the states and municipalities even more difficult, if not impossible, at a time when the requirement for such funds is almost overwhelming. For all of the foregoing reasons, I respectfully suggest that the provisions relating to the tax treatment of interest on state and local bonds should not be enacted.

This statement will be supplemented by a memorandum of law dealing with the constitutional aspects of the proposed

legislation. Our memorandum will be filed on or before October 1, 1969.

Dated: September 19, 1969

LOUIS J. LEFKOWITZ
Attorney General of the State of New York

STATEMENT FOR U. S. SENATE COMMITTEE ON FINANCE

By

MARY EVELYN PARKER, TREASURER, STATE OF LOUISIANA

INTRODUCTION

I am submitting this statement as Treasurer of the State of Louisiana and also as Chairman of the Louisiana State Bond Commission which has the statutory responsibility of issuing all state and state agency municipal bonds. Our primary concern is the consideration now being given by the committee to those provisions of H. R. 13270 which directly and indirectly affect the interest income of municipal bonds, specifically Sections 301 and 302 of the bill.

The State of Louisiana and its political subdivisions have traditionally relied upon the existing constitutional concept of intergovernmental immunity in issuing municipal bonds for its capital improvements. I say without reservation that each and every aspect of state and local programs of education, health and transportation have benefited from the tax exempt feature of municipal bonds and the future progress of these programs is dependent upon the continuation of our ability to finance such projects through the issuance of fully tax free bonds.

Complete exemption is and has historically been the rule of our land and we believe that long established rules should not be abandoned except for good reasons which are conspicuously absent in the present proposals.

SECTIONS 301 AND 302 OF THE BILL

Reasons Given For Tax Reform Bill

We have analyzed the justifications presented in the House passed Tax Reform Bill and conclude that the majority of them are not applicable to municipal bonds, and where purported to be, the reasons are based on erroneous presumptions.

The arguments advanced in the majority report that tax reform is essential as a matter of justice and taxpayer morale, to prevent misallocation of resources and to redirect investment toward employment

efforts certainly cannot be applicable to municipal bonds. It can be said conclusively that justice is now served by the capital improvements made possible through tax exempt bonds for the benefit of taxpayers and to restrict these programs would reduce taxpayer morale rather than enhance it. It can also be stated conclusively that tax exempt bonds have not resulted in a misallocation of resources or the misdirection of investments for there is little question that no programs exist that are more important to the welfare of our nation than education, health and transportation which are the areas where the majority of these monies have been expended. Investments in municipal bonds make possible public improvements and at the same time the funds provide employment for many people and benefit the community, the state and the nation as much, if not more than those funds invested in so-called unsheltered areas.

The argument advanced that it is believed that the tax preference of municipal bonds permits a minority of high income individuals to escape payment of taxes resulting in a loss of revenue greater than the advantage it affords state and local governments is erroneous. First, of course, no loss has occurred in federal tax revenue since the federal government cannot lose that which it never had. Secondly, no evidence has been presented that the additional tax collections would be greater or even equal to the savings in interest to state and local governments. In addition, we feel that investors in municipal bonds have been taxed and that the tax was paid by the investor at the time of the issue through the sacrifice of interest income. Tax exemption of municipal bonds is a tax prepayment which has the great advantage of saving the cost of collection and results in what we feel to be meaningful tax sharing.

Undesirable Effects of The Bill

To use an over-quoted principle, "The power to tax is the power to destroy." The pending proposals have created the most chaotic municipal bond market in history and resulted in the increase in interest rates in what we believe to be in excess of 1%. If the bill is adopted in its present form we feel that the interest rates will soar another 1 1/2% or 2%. These increased costs have delayed many local programs and in some cases the increased cost will no doubt make the project prohibitive. Louisiana has scheduled for sale $15,000,000 in Capital Improvement Bonds

on September 30, 1969. Because of the pending proposals and our 6% interest limitation, it now appears that no bids will be received on these bonds. Louisiana and its political subdividions during the next two year period will need in excess of $600,000,000 for planned capital outlay and this financing can only be accomplished through the issuance of municipal bonds. The pending proposals if adopted would without question delay and thereby destroy these programs as they were originally conceived.

Constitutional Questions and Alternative Proposal

We contend that short of a constitutional amendment, Congress has no right to tax municipal bonds without the consent of the states. The constitutionally mandated doctrine of reciprocal immunity which is designed to permit the free functioning of federal, state and other local governments without interference from the others is valid and is violated by both the provisions of the bill which require that municipal bond interest be included in the base of the minimum tax and those provisions that require that itemized deductions be allocated between taxable and tax exempt income. The result is a direct tax and an indirect method of taxing the resources of state and local government and this power to tax has not been delegated to the United States by the constitution and is prohibited without the consent of the concerned governmental unit. These constitutional questions, which I have perhaps over simplified would probably take years to settle and could cause substantial delays in capital improvement programs. Because of the chaotic conditions which would occur during this period, we think that the question should be settled now by exempting municipal bond interest from Sections 301 and 302 of the bill.

In the alternative, if two-thirds of the members of the United States House of Representatives and Senate feel that there is some justification for removal of the tax exempt feature of municipal bonds, we would suggest that a constitutional amendment be adopted and submitted to the states for ratification. There is little question but that such an amendment would fail to receive the required three-fourths vote necessary for ratification. This would, however, give the states, and thus its citizens, an opportunity to voice an opinion and make the decision rather than relying on the U. S. Supreme Court.

SECTIONS 601 AND 602 OF THE BILL

The alternative of issuing taxable bonds and receiving an interest subsidy is certainly no answer to the admittedly higher interest cost which will result from the other provisions of the bill. The ability to issue tax exempt bonds for local building programs is one of the very few areas of local government functioning which the states have been able to retain. The federal interest subsidy is no more than another step in what appears to be a continual effort on the part of our national government to encroach upon the sphere of action of our state and local governments. Our local programs should not and cannot become more dependent upon our federal government.

CONCLUSION

Those aspects of Sections 301 and 302 of H. R. 13270 which will restrict the tax exempt feature of municipal bonds will be of no benefit and would have the effect of increasing the cost of and deterring needed capital improvement programs. In addition, Sections 601 and 602 relating to federal interest subsidies would complicate and increase the cost of these programs and are extremely undesirable.

Interest income received on municipal bonds should be specifically excluded from the provisions of Sections 301 and 302 of the bill, and Sections 601 and 602 of the bill should be deleted.

State of North Carolina
Department of the Treasurer
Raleigh

September 16, 1969

EDWIN GILL
STATE TREASURER

Honorable Russell B. Long, Chairman
Committee on Finance, United States Senate
2227 New Senate Office Building
Washington, D. C.

Subject: H.R. 13270, Tax Reform Act of 1969

Dear Senator Long:

Please accept this written statement in lieu of my appearance before your Committee in opposition to that portion of the Tax Reform Act of 1969 which relates to the tax exempt status of State and local bonds.

As Treasurer of North Carolina and ex officio Director of Local Government, I wish to state my opposition to any effort on the part of the Congress to directly or indirectly tax interest on State and municipal bonds.

The mere fact that Congress is considering taking such action has literally brought chaos to the market for our securities. It has taken many years to build up the confidence of the investing public in our bonds, and it would be tragic if this confidence were undermined and even destroyed by the well-intentioned action of Congress taken in the name of tax reform.

Actually the removal of this exemption, in whole or in part, will mean ultimately a heavier tax burden upon the people of our State, our counties, our cities and our towns. In fact, it is estimated that, exclusive of the increased cost to the State, there would be approximately $25 million annual additional interest cost to our local governments, which would be the equivalent of an ad valorem tax levy of between 15-20¢ per $100 valuation.

Recently much has been said about the *New Federalism*, which, as I understand it, would offer a true partnership between the national government and the fifty States. In my judgment, to take from the State and local governments this very precious privilege of tax exemption, would strike a blow at local pride and initiative, and would really violate the proposed spirit of such *New Federalism*. I believe that Congress should preserve the exempt status of our State and municipal bonds as a great traditional privilege which has been a part of our inheritance as declared in the landmark case of *M'Culloch vs Maryland*, which preserved the fiscal independence of the States and municipalities.

To: Honorable Russell B. Long September 16, 1969
From: Mr. Edwin Gill

Due to the very high interest rates that we are now experiencing, in part because of this threat to our exempt status, I hope for an early resolution of this matter by Congress. In my opinion, prolonged debate serves to strengthen the fears of potential investors. Incidentally, the retroactive effect of this proposed legislation is, in my judgment, morally and constitutionally indefensible.

I wish to endorse the briefs that are being filed in behalf of the States and local governments by the National Association of State Auditors, Comptrollers and Treasurers, the National Association of Counties, the League of Cities-Conference of Mayors, Inc., and other organizations concerned with Federal-State relationships, including, of course, the National Governors' Conference.

Respectfully submitted,

Edwin Gill, Treasurer
State of North Carolina
and ex officio
Director of Local Government

EG/jg

(See following page for Powers and Duties of Treasurer of North Carolina)

THE STATE TREASURER

STATE OF NORTH CAROLINA

(Summary of Powers and Duties)
1969

The State Treasurer is a Constitutional officer of North Carolina *elected by the people* for a term of four years running concurrently with the term of the Governor.

The State Treasurer is actually the State's banker, serving as the chief financial officer of the State. He receives and disburses the funds of the State, administers the bonded indebtedness program and serves as investment officer for all State funds. In addition, he has certain supervisory functions over local government finances. The State Treasurer also advises with the General Assembly and the Governor at all times concerning the financial condition of the State and its fiscal policies.

The State Treasurer is, under the Constitution, a member of the Council of State and of the State Board of Education. By statute, he is ex officio Chairman of the Local Government Commission, the Banking Commission, the Tax Review Board, the Retirement Systems for Teachers and State Employees and Local Governmental Employees. He is also an ex officio member of the Law Enforcement Officers Benefit and Retirement System.

The present incumbent, Edwin Gill, has served in this capacity since 1953. Mr. Gill began his service in State government in 1929 as a member of the General Assembly and has served in many capacities since that time, including seven years as Commissioner of Revenue of North Carolina.

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER

STATEMENT BY COMPTROLLER MARIO A. PROCACCINO
OF NEW YORK CITY ON H.R. 13270
RELATING TO TAX-EXEMPT SECURITIES
BEFORE
THE UNITED STATES SENATE
COMMITTEE ON FINANCE

September 22, 1969

Gentlemen:

As Comptroller of The City of New York, I urge the amendment of H.R. 13270 relating to hitherto tax-exempt municipal securities. This bill imposes two new taxes on individuals receiving interest on state and municipal bonds. One is a "minimum tax" plan which applies to outstanding bonds; the other denies the municipal bondholder his full personal deduction otherwise allowable.

I am opposed to any proposal that would affect unfavorably or destroy the tax-exempt status for municipal bonds for many reasons:

First - The constitutionality of this proposed legislation is very questionable. I am afraid that any litigation that would eventually reach this decision would carry through many years. During this time, investors in municipal bonds, uncertain of the final outcome, would manifest interest only if a high yield gave them a protection against the probability of these bonds being taxed.

Secondly - It will deter corporations, banks and institutional investors from investing in municipal bonds. They would justly feel, "The individual investor now, we will be next."

Thirdly - It will be disastrous to the capital construction program of New York City. Our bonds will require such a high interest rate that the municipal taxpayer may find it most difficult to meet the resulting growth in real estate tax burden. Also, the investors may be so disillusioned, or so fearful, that they may not invest in the bonds of our City, or any city, but choose instead other forms of investment than state or municipal bonds.

In the year 1968-1969, New York City issued over $500 million in serial bonds for the following municipal purposes:

Purpose	Amount	
Schools and Colleges.	$ 89.9	(millions)
Transit	81.6	"
Health Services	51.6	"
Water Supply.	17.7	"
Docks and Piers	10.2	"
Recreational and Cultural	24.1	"
Public Safety (Police, Fire). . . .	44.2	"
Streets and Sewers.	59.5	"
Housing Development, Urban Renewal, Model Cities	48.7	"

This is the general pattern of bond issuance of this City. H.R. 13270 would cause a drastic reduction in the construction of new schools, colleges, hospitals, health centers, police precinct houses, fire houses, parks, streets, sewers, transit lines, docks and piers, and their major rehabilitation or re-construction, in our City. Rehabilitation and rebuilding of our slums through neighborhood conservation, model cities program or neighborhood development renewal would also suffer.

It is estimated that eliminating the tax-exempt status of municipal bonds would increase the market interest rate two percent. The threat embodied in H.R. 13270 has already pushed up rates one per cent. In arriving at my estimate of increase in cost, it may well reach 1-1/2 per cent, but I will apply 1 per cent.

Thus, borrowing in one year of $500 million for such vital capital improvement would involve at least $5 million in added interest costs the first year. With an average life of 7 years for the bonds issued, the House bill would add about $35 million in interest over the life of just one year's issue. Over a period of 10 years, estimating a new issue of $500 million each year, which provides no increase in expenditure, the additional burden would be an extra $350 million for capital improvements.

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Such a burden would practically stifle New York City's proposed transit improvement plan of new lines to areas in desperate need of such lines in Brooklyn, Bronx, Queens and lower Manhattan. The total capital cost of this program is $1.4 billion, of which the City would spend $800 million.

Faced with increased costs of construction, the added cost of interest on bonds to finance these improvements will price this program out of reality.

Loss of this program will not only affect seriously our City's total economy and hurt all the City's taxpayers, but it also will cut down the return in added taxes to the Federal Government which a more prosperous community can generate.

In addition to the bonds mentioned, New York City has sold approximately $2.8 billion in Notes in 1968-69, for the following purposes:

1) $719 million in Revenue Anticipation Notes, pending the receipt of federal and state aid, and about $1,427 million in Tax Anticipation Notes.

Under H.R. 13270, the added interest cost for these short-term borrowings with an average maturity of 6 months would cost New York City's taxpayers about $11 million extra a year. These costs must be charged to the Expense Budget which

is subject to a tax-incurring limitation, and provides for operational expenses. This can only result in a serious cut in City services, affecting the number of police, teachers, hospital and health services and services in other vital areas. Our City desperately needs more funds in these areas, not less. At this time of "the crisis of the cities," we need more help from the Federal Government, not such destructive action as H.R. 13270 which would worsen the fiscal plight of our City, and every other city in their efforts to provide adequate services.

2) We also sold $615 million in Bond Anticipation Notes, for the support of middle income housing. The increase which H.R. 13270 requires in the interest cost of these Notes results in higher rents for middle income tenants. They had to absorb some $6 million annually in added interest because of the threatened loss of the tax exemption on these bonds.

3) On August 20, 1969, the City sold over $215 million of Bond Anticipation Notes, with maturities of up to one year, at annual interest costs of 7.43 percent and 7.48 percent, depending upon the term of the Notes, the highest in the City's history for short-term obligations. We attribute this shocking rate largely to the pendency of H.R. 13270.

4) About $87 million for Urban Renewal Notes were sold for the rehabilitation of many of our City's rundown areas. Even though the Federal Government is aiding with Model Cities and Neighborhood Development funds, this is far from enough. The City must contribute not only its share of the aided programs but much more to make even a dent in what must be done.

These added interest costs from taxing city bonds must be borne by our already over-burdened taxpayers. The only alternative is to reduce vital public services. Every taxpayer, renters as well as property holders, would share in this burden, no matter how modest his means.

The House bill provides for a limit on tax preferences which would apply to bonds outstanding. But the holder of these bonds has already paid, by accepting reduced interest income, for his tax exemption. In buying these bonds he gave up the opportunity of investing his money in higher paying corporate securities. If an investor cannot be certain of his return at the time of commitment, he will certainly consider possible adverse future changes in tax status. Here those dangers are so fully apparent that his loss of confidence would reflect itself in the higher yield of the securities. This is why the market is reacting so violently to the pendency of this bill.

Many people have been led to believe that the tax-exempt securities were added to the "tax-reform" package because of about 154 individuals with adjusted gross incomes of $200,000 or more, who paid no tax in 1966. However, an examination of these tax returns indicated that the tax-free income was achieved by other tax shelters, and not by the use of tax-exempt municipal bonds.

The House bill provides an option for state and local government issuers to receive a "subsidy" if they agree to issue their bonds on a fully taxable basis. However, the Secretary of the Treasury is given the authority to determine the rate of this "subsidy." The floor under the amount he can select (25% of the taxable rate after 5 years) is actually lower than the benefit which states and cities have enjoyed in issuing their bonds - some 30% to 35% in the past few years.

How can New York City or any other city, state, or other local government sensibly base its financing on such an escalating uncertainty?

Why should a City be compelled to gamble its present and future development and urban renewal on a promised subsidy that could eventually evaporate? Particularly when it involves added administrative costs on the city.

Due to the inability of state and local governments to finance projects at reasonable interest costs, many of them have cut back and deferred bond issues at a time when there are great needs for additional schools, hospitals, transit, air pollution and other capital needs. Projections have been made that the potential costs to state and local governments over the life of estimated issues of $19.5 billion would increase interest costs by over $2.5 billion. It cannot be deemed true reform to thrust this on our local and state taxpayers, with attendant increase in regressive local tax burdens and reduced essential services.

Gentlemen, I have been listening with hopeful expectation to reports about Washington's concern about the plight of urban communities. This plight is real and Federal concern is fully justified. But how can we square that concern with such a destructive measure as the curtailment of tax exemption for our City's bonds?

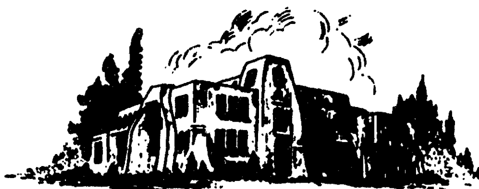
I urge that your Honorable Body continue its deliberations on real tax reform, particularly in tax relief to middle and low-income persons. But I strongly believe that in the interest of those same persons, the exemption of interest on municipal securities must be preserved. The huge financing burdens that state and local governments are faced with for much needed improvements should not be jeopardized by the uncertainty into which the municipal bond market has been thrust by this bommerang "tax reform" with its inevitable additional

interest costs that will have to be borne for the most part by over-burdened taxpayers of modest means.

I know that your Committee will give the most serious evaluation to this proposal and its effect on the capital development and renewal efforts of New York City.

I express my appreciation to your august Body for this opportunity to submit this presentation. I offer you my cooperation in any area relative to this most important issue.

JOHNNIE BOWMAN, Chairman
JOHN R. MEANS, Commissioner
KEN MONK, Commissioner
MILDRED BRANCH, County Clerk
EMMA T. WHITE, Probate Judge



RAMON "RAY" ANAYA, Sheriff
MARGIE ALEXANDER, Treasurer
JUANITA S. GRUBB, Assessor
JOHN W. LEWIS, JR., Surveyor

Eddy County

CARLSBAD, NEW MEXICO

September 16, 1969

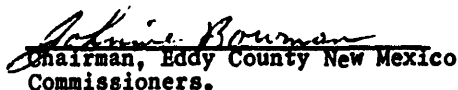
Mr. Tom Vail, Chief Council
Senate Finance Committee
2227 New Senate Office Building
Washington, D.C. 20000

Dear Mr. Vail:

As Chairman of the Eddy County New Mexico Board of Commissioners, we respectfully urge you to prevail upon the Senate Finance Committee to maintain the status quo on the tax free feature as to interest on city, county, state and school bonds, or other obligations of these entities. In these instances, where debt is created by the people of an area affected, they voluntarily pay the bill, and the tax free feature on interest is the principal factor in the sale of the bonds which provide needed capital for various local needs. Any change in this self-government feature will more than double local costs and retard local development by many decades.

Again, let me say that we urge the preservation of our American Heritage by allowing people of this Country to create constructive debt on themselves without having the interest on their obligations being taxed.

Respectfully submitted,



Chairman, Eddy County New Mexico
Commissioners.

JB/mb

Office of the

Board of Wayne County Auditors

1236 City-County Building
Two Woodward Avenue
Detroit, Michigan 48226

ARTHUR A. SUMERACKI
CHAIRMAN
RICHARD H. AUSTIN
VICE-CHAIRMAN
JOHN F. WILLIAMS
SECRETARY

CHARLES H. SANSON
EXECUTIVE SECRETARY
LOUIS G. BASSO
DIRECTOR OF BUDGET & FINANCE
STANLEY J. MOLENDA
DIRECTOR OF ACCOUNTING

September 18, 1969

Senate Finance Committee
2227 New Senate Office Building
Washington, D. C.

Attention: Mr. Tom Vail,
Chief Counsel

Gentlemen:

Sections 601 and 602 in Title VI of the Tax Reform Act of 1969 (H.R. 13270), by means of a direct interest subsidy from the Federal Treasury, propose to alter the traditional and time-tested method of financing state and local governments by means of tax-exempt bonds.

Local units of government should not be hampered by more Federal red tape in raising the funds required to finance their capital improvement programs and meet their daily problems effectively and in timely fashion. It is well known that the financial resources available to local governments are at best limited, due to the fact that prime sources of tax revenues are preempted by the Federal and state governments. Local units and school districts have traditionally relied heavily on tax-exempt bond issues to fund costs of needed streets, sewers, parks, schools, and other necessary improvements.

For example, Wayne County government, through its several agencies, has issued or assisted in the issuance of approximately $300 million in public improvement bonds; and proposes, within the next three years, to issue an additional $300 million necessary to the construction and expansion of public facilities, including sanitary drains, sewer interceptor systems, waste disposal plant projects, airport facilities, water mains, hospital and other construction, and many diverse improvements.

It is the firm belief of the members of the Board of Wayne County Auditors that without the aid of tax-exempt bonds the citizens of Wayne County would have been, and will be, denied the beneficial use of many millions of dollars worth of facilities, and that the County's ability to construct further improvements will be substantially impaired. If local units cannot economically market their issues, or can only do so at very high

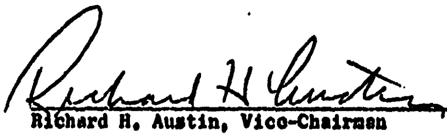
(cont'd)

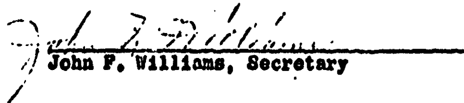
interest rates due to the shrinkage in demand for municipal bonds, it can only have the effect of hampering expansion and discouraging local development.

In view of the foregoing, the members of the Board of Wayne County Auditors strongly urge that the tax exemption on municipal bonds be continued as at present.

Very truly yours,

Arthur A. Sumeracki, Chairman


Richard H. Austin, Vice-Chairman


John F. Williams, Secretary

BEVERLY BRILEY, MAYOR

Metropolitan Government of Nashville and Davidson County

JOE E. TORRENCE
DIRECTOR OF FINANCE

308 COURTHOUSE
NASHVILLE, TENN. 37201

September 18, 1969

Finance Committee of the United States Senate
2227 New Senate Office Building
Washington, D. C.

Gentlemen:

There will be few times in the history of our country when a legislative effort on the part of our national government will be as adverse to local and state government as certain provisions of H.R. 13270, the measure now before your committee for consideration. It is not so much the exact extent to which this bill removes the tax-exempt status of state and municipal bonds as it is the irreparable harm that would be done to our traditional governmental system and balance. The inference of bad faith that would be established by such action could literally wreck all the current programs which aim at the promotion of inter-governmental relations. Efforts thereafter to establish strong local and state government credit ratings would be an exercise in futility, and further control of the Federal Government over local and state affairs would be assured.

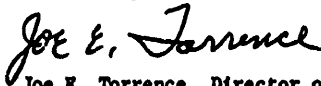
Everyone knowledgeable about public finance knows that to remove the tax exempt status of our bonds means one of two things. We will either have to abandon our capital outlay programs, which are dependent upon our ability to market our obligations at reasonable debt service costs, or be put in a position of subservience in this area of our operations. Surely, for the sake of the democratic process, you will not want to see the Federal bureaucracy take over control of our local functions to this extent.

Let's look at the present system. What is so wrong with us having our tax exempt bonds? It affords a better approach to financial relief for us than anything suggested in the way of a Federal program in fifty years of ever-increasing growth of power by the central government. Our bond purchasers buy our obligations and in so doing they forego an opportunity to get a higher interest rate in the taxable market. We know they have an

incentive for doing this and that's fine with us, because we are getting a better concession in the transaction than the buyer. It saves us from thirty-five to forty percent on our debt service costs annually. Keep in mind, all this advantage coming our way without any element of the Federal Government having to be involved to any any degree. It would be a major mistake to have the municipal bond market abolished.

Submitted herewith and attached hereto are several statements from state and local government officials relative to their views on H.R. 13270 as it pertains to tax-exempt bonds. Please include these in my testimony.

Yours truly,



Joe E. Torrence, Director of Finance,
Metropolitan Government of Nashville
and Davidson County
President, Tennessee Municipal Finance
Officers Association
Vice-President, Municipal Finance
Officers Association of the
United States and Canada

September 15th Meeting
Third National Bank Building

STATEMENT BY MAYOR BEVERLY BRILEY

SENATOR GORE, CONGRESSMAN FULTON, LADIES AND GENTLEMEN:

As Mayor of Metropolitan Nashville, I am this morning hosting a conference on an issue of extreme importance to state and local governments here, and throughout the United States.

As you well know, I have, for a number of years, been quite active in both the National League of Cities and the National Association of County Officers. This meeting here today is jointly sponsored by the Tennessee Municipal League and the Tennessee County Services Association. Representatives are here from various other organizations and civic groups who have a vital interest in the continued effective operation of state and local government services in Tennessee.

We are here to discuss the implications of certain provisions of the Tax Reform Act of 1969, as it applies to federal-state-local relations. Some provisions of this Tax Reform Act are needed. There are, however, certain provisions in this Act relating to tax exempt state and local bonds, which will have serious negative effects on our economy and upon state and local government ability to plan and implement community facility programs.

Local governments across this country have their backs to the wall. They are beset by tremendous backlogs of community facility needs in urban and rural areas. Additional community facilities are required to meet federal government programs and goals in the areas of stream pollution, slum clearance, housing, and many others. Local governments are already hard pressed by inflation.

The tax structure available to state and local governments is controlled by their Constitutions and general state laws. In Tennessee, we are at the local level restricted primarily to the property, sales and consumer taxes. It is our belief that taxing the interest on state and municipal bonds will merely result in shifting the impact of the federal tax to the local taxpayers through higher interest rates on state and local government bonds. This will mean that the homeowner will have to pay the extra property tax in order that the bond purchaser will have the extra interest earnings to pay the federal tax. The issue of constitutionality of taxing State and local government activities will result in expensive and prolonged litigation. We feel that this Federal tax measure shifts the responsibility for paying federal taxes from the much broader and more effective federal tax system to existing local tax systems that are already over-burdened. Many local governments are facing taxpayer revolts even in areas where the services are vitally needed. Mr. Average "Tax Revolt" American is not asking for reforms in

federal tax law to increase his costs for schools, hospitals, roads and other community facilities or to increase his sales and property tax. We at the state and local government level see the result of the increased interest costs on our bonds to be either higher state and local taxes or reduced public services, or both.

It has been suggested that this problem created for state and local governments by this unwarranted action on the part of the United States House of Representatives can easily be solved by some system of subsidy by the Federal Government. In the light of our experience with other Federal programs and the constant lack of adequate funding, we cannot agree with this point of view. It is also evident that a Federal subsidy in this area would increase the possibility of Federal control over traditional state and local government functions. It is my opinion that our Congress, and right now more particularly our Senate, must be convinced to leave our tax exempt bonds completely out of this tax bill if we are to preserve our Federal system of government under new Federalism, creative Federalism, cooperative Federalism or any other term or slogan.

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PRESENTATION BEFORE FORUM ON TAXATION OF STATE AND MUNICIPAL BONDS

by Governor Buford Ellington
State of Tennessee
September 15, 1969

In my judgment, the subject to be discussed in this meeting today -- federal taxation of state and municipal bonds -- is the most important matter presently being discussed as relates to federal-state-local relationships. There has been much said in recent times of the new Federalism which encompasses a partnership between the federal, state and local governments. There are many things being discussed which are directed toward the improvement of this partnership and the new Federalism.

It is my judgment that there is no program or proposal including that of tax sharing which could overcome the damage that would be brought about by the passage of HR 13270, the so-called Tax Reform Act of 1969, as the act relates to the taxation of interest on state and municipal bonds.

I say this as one governor among fifty governors who at our recent Governors' Conference unanimously went on record against this proposal. It is not our intent to be against tax reform. On the contrary, we strongly support tax reform. But to raise the cost of government at the state and local level in the name of tax reform at the federal level is no reform at all. It may give satisfaction to some who can say they participated in taxing the wealthy when in reality such action results in additional taxation of the average citizen by state and local governments through increased property taxes, sales taxes and the like.

The consequences of this legislation are obvious and are already being felt. We know the results -- the inability on the part of many of our local governments to market their bonds and the extremely high cost being experienced by those

governments that can still find a market, but at rates almost comparable to corporate taxable bonds.

The demands of our people at the state and local level for services and the pressures being exerted at the federal level on state and local government to meet these needs have never been so great as now. The necessity for improving our streets and waterways, purifying our air and water, upgrading educational facilities, building and staffing hospitals and the like must be met.

The state and local governments are willing to accept responsibilities in meeting these needs. However, I predict that if this legislation is enacted in its present form or in any form which removes the tax exempt status of our bonds, state and local governments will be forced to turn to the Federal Government for funds with which to meet these needs. With this will come the federal control which is always attached.

The suggestion by some that the Federal Government recognizes the resulting increased cost and, therefore, will appropriate funds to state and local governments to meet it is wishful thinking at the least. In no way can this be presumed to be the solution to the problem.

Again, the proposals being made do not constitute true reforms. The burden must ultimately fall on the average citizen in the states and Nation, particularly homeowners who will be forced to pay increased property taxes.

I shall not attempt to discuss constitutionality except to say that if this action which has heretofore been presumed to be contrary to our Constitution is taken, then the powers of the states under the Constitution will be further impaired.

State and local governments in Tennessee annually issue approximately $300,000,000 in tax exempt bonds to finance capital needs and improvements. It is estimated that the present outstanding state and local debt carries an average interest rate of four per cent. Assuming that if this legislation is passed and state and municipal bonds are placed on the same basis as corporate bonds, we can expect an estimated increase of fifty per cent in our interest cost. In dollars, this will amount, over the life of the bonds, to an additional sum in excess of $100,000,000, which state and local taxpayers will have to pay. This is the additional amount as it relates to one annual issue. It is obvious that this dire result would be compounded from year to year.

Where will the money to finance these increased interest costs come from? It can only come from taxes levied by the state and local governments and paid by homeowners and citizens of average income -- not the wealthy.

I have not attempted to discuss the content of this legislation. I am expressing my opinion that the results of its passage will affect every citizen in our State, and require increased state and local taxes. I cannot too strongly express my opposition to this legislation. I hope the citizens of our State will understand the significance of this matter and that state, county and city officials here and throughout the Nation will do everything they can to inform the people concerning the serious threat confronting us.

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PRESENTATION BEFORE FORUM ON TAXATION OF STATE AND MUNICIPAL BONDS

William R. Snodgrass
Comptroller of the Treasury
State of Tennessee
September 15, 1969

It shall be my purpose to briefly present the major provisions of HR 13270, known as the Tax Reform Act of 1969, and the significance on the market of these provisions. Also, I shall briefly present how this will affect the State of Tennessee in its present and future plans.

The act referred to would partially tax interest from municipal bonds and purposes to establish a Federal Interest Subsidy Program for state and local bond issuers who may elect to waive the tax exempt feature of their bonds. Presently interest received by the holder of state and local bonds is exempt from Federal income tax. The legislation proposes that individuals pay taxes on at least half of all their earnings from this source with a ten-year transitional period applicable to full enforcement. An individual's total tax free income must exceed $10,000 before these rules apply.

Also, under the present law, an individual is allowed to charge all his personal income tax deductions entirely against his taxable income. The bill, however, requires individuals to charge their deductions against both taxable and tax free income in the same proportion that the one source of income bears to the other. However, again, an individual's tax free income must exceed $10,000 before the provision would apply. Interest from new municipal bond issues is included in the list of tax preferences against which an individual would now have to charge a portion of his deductions. The bill does provide a transition rule which would gradually work municipal bond interest into the preference category over a ten-year period. The market for municipal bonds shall

certainly be impaired by these provisions. Congress could eventually eliminate the tax exempt feature altogether. If enacted, there would be a breach of faith to present holders of municipal bonds and certainly potential investors would lose confidence in the security of municipal bonds as investments. The psychological effects of the impairments, although limited at this time, certainly reach to corporate investors who, although not affected by the current provisions, would loose confidence in the tax exempt quality of their investment. The logical result would be that all present investors in municipals bonds would demand higher interest rates as hedges against future tax losses if indeed they still found municipal bonds attractive investments at all.

Why should a corporate investor or an individual investor buy municipal bonds at a rate to any degree less than corporate bonds when the advantage of taking less could be eliminated by another act of Congress?

A purchaser of state and local government bonds in prior years has accepted a lower interest rate in reliance on his expectation that the interest would not be taxed, and the amount he has thus paid for his exemption is 30% to 35% of the interest he could have received on an equally secure private taxable obligation.

This thirty to thirty-five percent is equal to the highest tax rates proposed by HR 13270 on other forms of income labeled as "tax preferences" by the bill.

Therefore, there is absolutely no argument in tax equity for subjecting state and local government bond interest to the "tax preference" treatment proposed for sheltered income which has <u>not</u> thus made a contribution to the cost of government.

It has been presumed that the tax exemption of municipal securities is derived from the foundations of our Federal system of government as provided in the Constitution. Certainly the passage of this act in taxing a portion of the interest from tax exempt bonds will be challenged in the courts, resulting in years of litigation. During this time the

tax status of municipal bonds would be unknown and bond investors would certainly be unlikely to invest until the issue is resolved. Certainly they would demand comparable rates to corporate bonds. For all practical purposes, there would be no market for municipal bonds as such.

Over the nation we are talking about some twenty billion dollars a year in bonds which are now being purchased mainly by banks, insurance companies, and individuals. The largest portion is being purchased by banks for themselves or for their trust accounts. If the benefit of tax exemption is removed and the reasons for investment by banks largely eliminated, a real question presents itself as to where these long-term funds will be obtained to finance the needs of state and local government.

I believe it can be safely said that many of our local units of government would be unable to finance their needs in the open market. The proposal that the Federal Government would be willing to provide funds in one manner or another is unacceptable as it would be a further encroachment on the independence of our local governments and could further erode our Federal system, not to mention the dependability of such generosity in future years.

The proposal for an alternative capital financing mechanism to encourage states and their political subdivisions voluntarily to relinquish the privilege of tax exemption is provided. Under this specific subsidy provision, a state or local government could choose for a particular bond issue a fixed percentage interest subsidy to be paid for by the Federal Government. The subsidy would go directly to the issuer as a cash payment or the state or local government could elect to have the Federal Government supply separate interest coupons which would be attached to the bond along with the issuers coupon. The state or locality would then issue its bonds as taxable securities. The Secretary of the Treasury would administer these provisions, and he would determine and publish the fixed percentage of interest yield which he determines is necessary for the purpose of the program. The

fixed percentage would range from 30% to 40% from date of enactment to January 1, 1975. Thereafter it could range between 25% and 40%, as would be determined by the Secretary of the Treasury.

While it may be now said that there would be no review of the advisability of the local project or the issuers ability to repay, it is hard to imagine that these considerations would not at some time be added. An annual appropriation required by the Congress to provide these funds and the agreement by the Federal Government to pay a subsidy on an individual issue binding for life of the issue is a lot to expect. This is simply not the answer to the problem.

For all practical purposes, activity in the municipal market has virtually ceased. It would be impossible now for scores of communities across the state to receive acceptable bids for their bonds.

During the next year and a half, the State of Tennessee will be in the market with $200 million presently authorized and unissued General Obligation Bonds and more than $100 million School Bond Authority Revenue Bonds for Higher Educational institutions - a total of more than $300 million. These funds are for financing programs now under way - highways, hospitals, penal facilities, educational, recreational, and other facilities. Much of this has already been borrowed through temporary financing.

The additional cost on this financing would approximate $6 million each year for an average life of fifteen years or a total of $90 million during the life of these bonds.

Our needs for capital construction will continue. It is obvious what the cumulative effect would be.

Just how much of this kind of tax reform can taxpayers of Tennessee and our nation afford?

It's pretty clear that this "soak the rich" bill as it relates to state and local government bonds, is soaking all the taxpayers rather thoroughly already.

Statement by
J. Wiley Bowers, Executive Director
Tennessee Valley Public Power Association
at Public Hearing on Monday, September 15, 1969
Concerning Proposed Federal Taxation of Municipal Bond Interest
Third National Bank Building, Nashville, Tennessee

My name is J. Wiley Bowers. I am Executive Director of the Tennessee Valley Public Power Association, a regional association composed of the municipally and cooperatively owned electric utility systems which purchase electric power at wholesale from the Tennessee Valley Authority for retail distribution to more than 2 million electric consumers in parts of seven states.

On behalf of the Tennessee Valley Public Power Association, and especially the 108 municipally owned electric utilities in the Valley, I am appearing to protest vigorously against the efforts by the Federal Government to impose an unwise "boomerang" tax on State and municipal bond interest.

This tax proposal -- billed as tax "reform" to prevent tax abuse by the rich -- can actually boomerang, and prove costly to the middle and lower income people who can least afford the higher electric rates and electric service delays that could result from passage of this tax measure.

Our position on this part of the proposed tax bill is easy to understand: we oppose _any_ change in the historic immunity of State and municipal bond interest from Federal taxation. The system that

has been in effect over the years worked well, with no bureaucratic red tape, and with great benefit to States and local governments which provide essential public services.

Why the sudden rush to change this historic principle, and to substitute a more complicated, more expensive method? There are <u>hundreds</u> of subsidies to special interest groups through present Federal tax laws. Why should the Federal Government single out States and local governments as primary victims of "tax reform?" These local units of governments -- including municipally owned electric utilities -- must provide essential public services. We believe that the Federal Government should not attack other levels of government through the Federal tax laws, but should focus instead on strengthening local government.

We know that the investor-owned lobbying organization, Edison Electric Institute, has hired Mortimer Caplin, former director of the Internal Revenue Department. This was reported in the <u>Sacramento Bee</u>, a highly respected newspaper. The Bee stated and I quote: "Caplin was hired to develop a legislative plan to slap a federal tax on publicly-owned electric systems."

We have every reason to believe the investor-owned utilities are working behind the scenes with regard to H.R. 13270, under the Federal subsidy alternative of H.R. 13270.

The local government must give up its ability to seek its own financing in the market. Local flexibility in deciding when and on what to borrow is traded for the specter of federal management. It is difficult to believe the Treasury will let itself be bound to subsidize each and every local issue at any moment with no review of the purposes for which localities wish to borrow.

The Secretary of the Treasury will decide which bonds will qualify under what conditions for the Federal subsidy. The net result would be the extension of Federal involvement in heretofore local affairs.

Once established, the Federal interest subsidy program and regulations issued thereunder would be susceptible to constant change by Congress.

The municipally owned electric systems in the Tennessee Valley have assets of more than four-fifths of a billion dollars. Each year they need additional capital to finance the power facilities to serve a growing demand. They _must_ have the capital, because the people _must_ have electric power. Our society would cease to function without an adequate supply of electric power.

An increase in borrowing costs will tend to increase the cost of electricity. We don't want higher--cost money; we don't want the Federal Government approving bond issues to our systems; we urge

the Congress to reject this strange proposal which would mess up a perfectly good method of Federal assistance to States and local governments.

Our municipal electric systems see no need to change the historic immunity of municipal bond interest from Federal taxation; and we urge the Congress to maintain the present system intact.

Statement by: Jack Ramsay

Nashville Conference
September 15, 1969

PARTIAL ELIMINATION OF TAX EXEMPT STATUS

OF INTEREST FROM MUNICIPAL BONDS

SENATOR GORE, MRS. GORE, MR. LEE SMITH, MAYOR BRILEY, MR. BARRY, FELLOW PUBLIC OFFICIALS AND DISTINGUISHED GUESTS-----.

AS CHAIRMAN OF THE SHELBY COUNTY COMMISSION--REPRESENTING ALL OF THE CITIZENS OF SHELBY COUNTY, TENNESSEE--I AM--ALONG WITH ALL LOCAL OFFICIALS IN TENNESSEE--AND ACROSS THE NATION--GRAVELY CONCERNED--WITH THE PARTIAL ELIMINATION OF THE TAX EXEMPT STATUS OF INTEREST--FROM MUNICIPAL BONDS--UNDER THE PROVISIONS OF THE "TAX REFORM ACT OF 1969 - (HR 13270)"-AS PASSED BY THE U.S. HOUSE OF REPRESENTATIVES--ON AUGUST 8, 1969--OVER THE STRENUOUS OBJECTIONS AND PLEAS--OF LOCAL GOVERNMENTS.

ALL OF THE PROVISIONS--OF THIS ACT--WHICH EITHER DIRECTLY OR INDIRECTLY INCLUDE THE INTEREST STATUS ON STATE OR LOCAL GOVERNMENT SECURITIES--WOULD HAVE AN ADVERSE EFFECT ON THE SALE OF MUNICIPAL BONDS--ALREADY--THE THREAT OF SUCH LEGISLATION IS BEING KEENLY FELT IN THE BOND MARKETS--WITH ONLY THE CLOUD OF THIS LEGISLATION--OVERHANGING THE MUNICIPAL MARKET--AT THIS TIME--THE BOND BUYERS' INDEX--STANDS AT OVER SIX PERCENT (6%)--THE HIGHEST IN HISTORY--THE ATTRACTION OF MUNICIPAL BONDS ON THE OPEN MARKET WOULD CERTAINLY BE IMPAIRED BY

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THESE PROVISIONS--PRESENT AND POTENTIAL INVESTORS--WOULD CERTAINLY LOSE CONFIDENCE IN THE SECURITY OF MUNICIPAL BONDS--AS INVESTMENTS--THEREFORE--ALL INVESTORS--IN MUNICIPAL BONDS--WILL DEMAND HIGHER INTEREST RATES--TO REPLACE TAX LOSSES--IF INDEED--THEY STILL FOUND SUCH BONDS--ATTRACTIVE INVESTMENTS--AT ALL--TELL ABOUT THE RETIRED DOCTOR.

THE IMPACT OF THE HIGHER BORROWING COSTS--(AT LEAST ONE PERCENTAGE POINT INCREASE ANTICIPATED)--AND THE POTENTIAL INABILITY TO EVEN SELL MUNICIPAL BONDS--WILL BE BORNE--BY THE STATES AND LOCAL GOVERNMENTS--DUE TO PRESENT ECONOMIC CONDITIONS--THE INCREASED PRESSURE ON ALL TYPES OF MUNICIPAL FINANCING--INCLUDING THE RISE IN BOND INTEREST--WILL PUSH THE COST OF CAPITAL FINANCING--FOR URGENTLY NEEDED PUBLIC WORK--FAR BEYOND LEGAL OR ECONOMIC LIMITS--STATE AND LOCAL GOVERNMENT FINANCING COSTS--USING A THIRTY-YEAR BOND ISSUE AS AN EXAMPLE--COULD INCREASE AS HIGH AS ONE-THIRD OF THE AMOUNT OF THE ISSUE WITH STATE AND LOCAL GOVERNMENTS--IN TENNESSEE--ISSUING APPROXIMATELY THREE HUNDRED MILLION IN BONDS ANNUALLY--THIS LARGE INCREASE--AS THE RESULT OF THIS ACT--WOULD HAVE TO BE FINANCED THROUGH INCREASED LOCAL TAXES--CREATING A HARDSHIP ON THE CITIZENS OF ALL CITIES AND COUNTIES--PARTICULARLY THE SMALL HOME OWNERS--THIS IS CONTRARY TO THE ORIGINAL PURPOSE OF

TAX EXEMPTION OF MUNICIPAL BONDS--WHICH WAS TO ENABLE STATE AND LOCAL GOVERNMENTS TO BORROW AT THE LOWEST RATE OF INTEREST--THUS BENEFITING THE SMALL TAXPAYERS.

TO SUMMARIZE--I MUST SAY--THAT IF THIS ACT--IN ITS PRESENT FORM--IS PASSED BY THE SENATE--AND IS SIGNED BY THE PRESIDENT--IT WILL SERIOUSLY EFFECT AND DISRUPT--STATE AND LOCAL GOVERNMENT CAPITAL FINANCING--CURTAIL URGENTLY NEEDED PUBLIC WORKS AND SERVICES--OR THROUGH THE PAYMENT OF FORCED HIGHER INTEREST RATES--ON MUNICIPAL BONDS--TO POSSIBLY ATTRACT INVESTORS--SHIFT THESE INCREASED COSTS--IN THE FORM OF ADDITIONAL REAL ESTATE TAXES--TO THOSE LEAST ABLE TO PAY--THE OVERBURDENED HOME OWNER.

WE-CONCERNED WITH THE INTEREST OF ALL CITIZENS OF TENNESSEE--DO RESPECTFULLY REQUEST--THE U.S. SENATORS FROM TENNESSEE--THE HONORABLE ALBERT GORE AND THE HONORABLE HOWARD BAKER--TO USE ALL OF THEIR POWER AND INFLUENCE TO CORRECT THESE INEQUITIES--AS THEY PERTAIN TO STATE AND LOCAL GOVERNMENT MUNICIPAL BOND FINANCING--IN THE "TAX REFORM ACT OF 1969."

THANK YOU---------.

FEDERAL TAXATION OF MUNICIPAL BONDS KNOCKOUT BLOW

By Mayor Leonard Rogers, Knoxville

President, Tennessee Municipal League

At Municipal Bond Conference, Sept. 15, 1969 - Nashville

We in city halls are shocked by House of Representatives approval of a tax reform bill levying federal taxes on our municipal bonds. The resulting 50 per cent increase in interest rates and destruction of the normal municipal bond market are truly the knockout blow destroying the financial ability of our towns and cities to finance services to their people.

In playing the popular game of taxing the rich, the House rushed headlong, without a chance for us to testify at hearings, into taxing municipal bond interest through both a minimum tax and allocation of deductions.

Tragically, these misguided taxes don't hit the rich but do soak the local taxpayers of over-burdened and totally inadequate local property, sales, water and sewer taxes. How often have local taxes increased as federal taxes decreased over the last 25 years? Not only are local taxes strained, but the Congress has promised big and appropriated little for urban programs ranging from housing to sewerage plants. Unprecedented inflation, and increases in construction costs for water and sewer projects of as much as 25 per cent in the last two years, have severely reduced the purchasing power of our limited income. Then, we find ineffective efforts to control inflation through tight money, resulting in the highest general interest rates for both government and private borrowers in the history of our republic.

And now comes the knockout financial blow to cities - this tax bill. The mere threat of taxation has shoved up our bond interest rates 1 to 1½ percentage points; final passage will push rates 2 per cent higher for large cities, over 3 per cent for small towns.

We in local government are not impressed by another promise in this tax bill -- that if we go along with letting the Congress exercise the power to tax our bonds, they will provide enough money to pay interest subsidies so cities will be better off than ever before! This is what the Congress said three years ago when we went along with federal control of clean streams with the promise of a billion Federal dollars this year to build sewage treatment plants; but the budget offers are only one-fifth

of this big promise! And, the people and the city government of Knoxville do not want some Washington bureaucrat directing what bonds the city issues or how much we spend for every city project ~~wheelbarrow and pigeon at the city fair grounds~~.

In summary, let me say that our municipalities are issuing new bonds at a rate exceeding $125 million a year now and will have some $1½ billion of these bonds outstanding in another 15 years, all subject to the extra interest rate of at least 2 per cent or $30 million annually.

Obviously, these increases in local interest costs will have to come out of increases in local taxes on property, sales, etc.

This is indeed a fight of our state and local taxpayers against the highly theoretical and as yet unproven claims of some that a rich few are escaping taxation through municipal bond tax exemption. We can seriously question this, and, in fact, claim that it is not so when investors in municipal bonds could get interest rates at least 50 per cent higher if they bought comparable and taxable corporate bonds. Municipal bond investors already are paying a 30 to 40 per cent "in-lieu-of tax" in the form of lower interest rates to our state and local government treasuries. The effect of this tax bill is to transfer these "in-lieu-of tax" payments into the Federal Treasury and to add the dangerous feature of federal control over the purposes and volume of state and municipal bonds which they are willing to subsidize with federal interest payments

We in Tennessee would be foolish to place our reliance upon the Congress to provide a 30 to 40 per cent interest subsidy for the bonds of our city-owned electric, gas, water and other utility operations. This would be placing our low-cost electricity and gas, etc., in the lion's jaw of the private utility lobby which for 35 years has made repeated attacks upon TVA and cheap power in the Tennessee Valley.

The reason we would be foolish to do this is quite simple: Tennessee has more city-owned electric, gas and other utility operations than any other state in the union by far. Thus, we cannot expect Congressmen representing these other states, relying upon privately-owned utility companies, to provide this promised 30 to 40 per cent interest subsidy for our city electric, gas and other bonds which would not benefit their states and districts.

For example, in Tennessee 99 per cent of the electric power is provided through city-owned facilities, but in the rest of the country

MORE

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the power facilities are 80 per cent privately-owned. We would benefit from the interest subsidy; they would not, and yet they would pay most of the taxes required. We can be sure that the private electric companies -- as they have time and again -- will mount an expensive campaign to convince the Congress they should not subsidize our interest rates and our low-cost electricity with the tax dollars of the other 80 per cent of the country which does not secure similar benefits.

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TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE
SENATE OF THE UNITED STATES
CONCERNING CERTAIN PORTIONS OF HOUSE BILL 13270

-by Robert B. McLeaish, Jr.

My name is Robert B. McLeaish, Jr., and I am the County Auditor of Hidalgo County, Texas. Professionally, I am an attorney-at-law, licensed to practice law in the State of Texas, also before the United States District Court, and before the Tax Court of the United States, and I am also a Certified Public Accountant. Hidalgo County is primarily a rural county, located in South Texas and having a population, according to the last federal census, of 180,904.

I requested of Chief Counsel, Tom Vail, the opportunity to offer testimony to this Honorable Committee since I am deeply concerned with what I consider to be the adverse economic impact that will be felt by my county and others in similar circumstance if that portion of House Bill 13270, which deals with the tax exempt status of municipal and local governmental bonds should be passed into law.

May I briefly give some background on Hidalgo County and the economic status of its citizens. According to Sales Management Survey of Buying Power, published June 10, 1968, and reflecting 1967 figures and estimates, our population of slightly more than a hundred and eighty thousand persons live in approximately 43,400 households and had an effective buying power of $236,629,000. We are further informed by this same source that the per household income is $5,452, on the average. Many of the problems of this County are similar to those of other counties, as well as cities, across these United States. As an example, we find ourselves constantly in the position of having to market our governmental bonds for the purposes of constructing needed capital improvements. In years past, this County has marketed many bonds for the purposes of acquiring rights-of-way and constructing roads and bridges.

As a result of the fierce blow that this County suffered in September of 1967, when Hurricane Beulah descended with such devastating force, our citizens have become increasingly aware of the need for more adequate drainage facilities. Our engineers have made preliminary surveys indicating that the total cost of additional drainage structures for the local government alone should be

slightly in excess of ten million dollars. With an overall tax valuation of only a little over two hundred million dollars in the County, the issuance of an additional $10,000,000 in bonds would indeed place a heavy burden on the local taxpayers. However, should we be forced to pay in the neighborhood of eight per cent instead of the four and a half or five per cent that we could logically have expected to pay only a few short months ago, the burden then becomes insupportable for our typical family with an annual income of $5,452. The difficulties that we are commencing to face are two-fold; not only does the interest rate appear to esculate with each new release of congressional intentions but it becomes increasingly necessary to pay off our securities over a shorter period of time, thus further esculating the annual requirements on an issue and thus increasing, perhaps to the breaking point, the tax rate on a group of low income individual property owners.

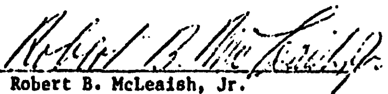
Perhaps this plight would not be so great were it only limited to the citizens of Hidalgo County; however, conversation with fellow county officials across the State of Texas leads me to believe that most others face essentially the same problem. It is quite apparent that since individual investors have been notified of the congressional wish, or at least the wish of some Congressmen, to do away with the tax exempt market altogether, buyers of new local government taxable bonds are extremely hesitant to invest in bonds of more than a year or two, preferring to place their investment money in equities securities or in investments with tax shelters that may still be around in other fields, such as real estate or minerals.

As evidence of the effect that legislation in this field would have on the market, the Weekly Bond Buyer, a very reputable publication in the securities field, has estimated that since early July when the Ways and Means Committee opened hearings on its final proposals, investment yields on new issues of local government AA-rated bonds have risen by about seventy-five basis points (from about 5.50 per cent to 6.25 per cent) while yields on similarly rated corporate bonds have risen by only about ten basis points (from 7.95 per cent to 8.05 per cent). In other words, the rise in interest rate on municipal securities cannot be attributed to inflation alone.

Before the recent activities on the part of the House Ways and Means Committee we had an orderly market for municipal and local government bonds in this country. Now we do not. Furthermore, hard experience has taught those of us at the local level that creation of a new bureau is not the answer to our problems. We have learned that programs can and will be seriously delayed by payment delays resulting from excessive "red tape," differing versions of ground rules on the part of verious officials within the same department and apparently sometimes a simple failure to perform the work necessary to expedite payment. It is a sad fact that many of the best intentioned and apparently worthwhile programs authorized by a generous and benevolent Congress are frequently thwarted by the combination of operational inefficiency and disorganization of a lethargic group of bureaucrats.

Let me assure you that in speaking on behalf of the individual property owners of my own county I feel that I am seeking to preserve a benefit conferred on the people and created by the Constitution and that should not be tampered with. I do not believe that immediate rejection of any proposal seeking to do away with tax immunity on local government bonds would impede tax equity. Those persons who purchase municipal bonds for the most part pay a price in the form of lower interest for the tax immunity received. I wish to assure you that I am not a representative of private special interests but that I speak only on behalf of my local government and its many thousands of lower income taxpayers and speak against the formulation of policies which strike at the financial stability of my level of government and its ability to serve the people without undue federal controls and domination.

I further wish to express my appreciation for this opportunity to present this testimony to this Honorable Committee.



Robert B. McLeaish, Jr.

COUNTY OFFICIALS

O. A. LOOSE, COUNTY AUDITOR
TED W. MANDERFELD, COUNTY TREASURER
ALEEN CHRISTIANSEN, REGISTER OF DEEDS
CARL A. WITT, CLERK OF COURT
WILLIAM B. MATHER, JR., JUDGE OF PROBATE
ERVIN E. WENKAUF, SHERIFF
ROBERT J. BERENS, CO. ATTORNEY
HELEN R. SCHROEDER, SUPT. OF SCHOOLS
FRED HENNING, COURT COMMISSIONER
DR. O. S. FESENMAIER, CORONER

HARVEY SUEDBECK, HIGHWAY ENGINEER

DONALD R. MOLL, COUNTY ASSESSOR

COUNTY COMMISSIONERS

ROBERT J. BERG, NEW ULM, 1ST DIST.
CLARENCE TAUER, HANSKA, 2ND DIST.
ALBERT ALFRED, NEW ULM, 3RD DIST.
LEO A. HOFFMANN, SLEEPY EYE, 4TH DIST.
ARTHUR M. MOE, SPRINGFIELD, 5TH DIST.

REGULAR SESSIONS
FIRST TUESDAY AFTER FIRST MONDAY IN JANUARY AND SECOND MONDAY IN JULY

GENERAL TERMS OF COURT
SECOND MONDAY IN MAY AND FIRST MONDAY AFTER THANKSGIVING

LAWRENCE G. PEICHEL, COUNTY AGT., SLEEPY EYE

BROWN COUNTY

NEW ULM, MINN. 56073

Sept. 16, 1969

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

RE: Tax Exempt Status of Municipal Bond Interest

Dear Sir:

Brown County, Minnesota, is located in the South Central part of the state about 100 miles Southwest of the Twin Cities. The population is approximately 30,000 and the county seat is New Ulm.

There is an excellent balance between agriculture and business in the County which provides a very stable and growing economy. About 95.7% of the county's 392,320 acres is in farm land. There are about 1,733 farms in the County averaging about 216 acres in size. The average price for farm land is about $270 per acre.

New Ulm, the county seat, has the greatest part of the commercial activity in the county, employing about 5,000 people. Some of the largest employers are Minnesota Mining and Manufacturing, Kraft Foods, B. F. Goodrich and International Milling.

A substantial growth in industrial development is somewhat indicated by the 476 homes built during the last 7 years. A Sales Management Survey listed the 1966 effective buying income per household at $7,322.

The balance of bonded indebtedness in Brown County, Minnesota, on January 1, 1969, is summarized as follows:

4 major school districts	$5,354,000
Local improvements (3 cities and 2 villages)	2,790,392
Farm Drainage Systems	1,798,000
Total	$9,942,392

The original total of this bonded indebtedness was:

4 major school districts	$6,454,000
Local Improvements	3,621,227
Farm Drainage Systems	2,241,000
Total	$12,316,227

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REGULAR SESSIONS
FIRST TUESDAY AFTER FIRST MONDAY IN JANUARY
AND SECOND MONDAY IN JULY

GENERAL TERMS OF COURT
SECOND MONDAY IN MAY AND FIRST MONDAY
AFTER THANKSGIVING

LAWRENCE G. PEICHEL, COUNTY AGT., SLEEPY EYE

BROWN COUNTY

NEW ULM, MINN. 56073

The net interest rates on these issues range from 2.3% for December, 1962, issues to 4.33% for June, 1968, issues with repayment schedules from 10 to 25 years.

The August Bond Buyers Index soared to 6.25% as an interest rate on high quality tax exempt bond issues. Using this guide line, we have conservatively estimated that a 2.5% higher interest rate on the Brown County bonds now in force, would have cost our local taxpayers and drainage system owners an additional $4,292,000 in interest.

The Board of Brown County Commissioners has directed me to inform the United States Senate Finance Committee that they are in opposition to the proposed removal of the present tax exempt status of the interest income on municipal bonds.

Sincerely yours,

Otis A. Loose

Otis A. Loose
Brown County Auditor

STATEMENT OF HENRICO COUNTY BEFORE SENATE FINANCE COMMITTEE ON H. R. BILL NO. 13270

Mr. Chairman and Honorable Members of the Senate Finance Committee:

I am Linwood E. Toombs, Chairman of the Board of Supervisors of the County of Henrico, Virginia. I am here to present our views relating to certain provisions in House Bill No. 13270.

Henrico County is an urban county adjacent to the City of Richmond and has a population of approximately one hundred and sixty five thousand citizens. Our County maintains its own system of schools, highways, utilities, recreation, welfare and the countless other services required to meet the needs of an expanding population.

Our current debt, represented by long-term bonds, is $43,020,500. In addition we have an additional $15 million authorized, but as yet unissued, to provide required new schools and classrooms, and $5 million to complete the firm financing of water and sewer programs now almost completed. The $20 million

represents a current need and does not include the many unscheduled future capital improvements, such as highways, parks and library facilities and office space to adequately serve our citizens. For many months we have delayed issuing our authorized bonds in the hope that the interest rates on municipal bonds would decline as a result of measures taken by the Federal Government to combat the inflationary trend which has so adversely affected the cost of borrowing.

During this period a further deterrent to the improvement of our borrowing costs has risen as a result of proposals in the House of Representatives Bill No. 13270 which is now before this Committee for study and recommendation. This Bill, a "Tax Reform Bill", contains provisions which would both directly and indirectly tax the interest earned on obligations of State and local Governments. As a result, rather than seeing bond interest rates decline, we have seen higher and higher rates - to such an extent, that under our legal interest ceiling of six percent - it may now not ever be possible to sell our securities

on todays' market.

Gentlemen, we, like untold hundreds of other local governments, are in a very real dilemma. How do we raise the funds required to provide educational facilities - facilities which are needed in the immediate future? How do we secure permanent financing for utility improvements which have, or are now being installed through temporary financing arrangements? These are questions for which we do not now have answers but which must soon be solved.

The Minimum Income Provision or, Limit on Tax Preferences, included in H. R. Bill No. 13270, would result in a direct tax on interest earned on State and local obligations whenever the aggregate of certain preferred income excluded a specified tax formula. This, Gentlemen, is a complete change in the traditional treatment of such income, and is to say the least, on questionable legal grounds. In this respect, we are advised that the Attorney General has expressed doubt as to its legality. The Court tests which would be inevitable

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H. R. Bill No. 13270

if this becomes law would place a cloud over the municipal bond market, with a further increase in the already burdensome interest rates.

In addition, because of the retroactive feature by which the interest on approximately 120 billion in outstanding municipal and State bonds would become taxable to some extent, the holders of these obligations would suddenly find the value of their holdings materially decreased. Since these bonds were purchased at a price to yield a specified return on a non-taxable basis, the purchasers of these bonds were willing to accept a lesser yield. Now, however, the holder will find that the return has decreased, and may decide that further retention of the investment would be unprofitable. In such event, we could very well see the market flooded with existing issues which would provide competition to the new issues which must be marketed to provide the capital to construct new State and local public institutions, schools, utilities, highways and the magnitude of other public improvements required by our expanding populations. No one can possibly foresee the harm and confusion which will

result if this Bill is passed with its provisions to tax the income of State and local bonds. As I indicated earlier, there is in our minds serious doubt concerning the Constitutional authority for this proposed legislation. The fact that, this time, the law would apply only to individuals is of small comfort. For if the Congress has the right to impose this tax at all - then the next move would lead to the taxing of commercial banks and the other financial institutions holding the bulk of State and local tax exempt obligations. Herein lies the real danger - and here is where the harm has already been done as now reflected in bids on our obligations.

Henrico County is not a depressed economic area. Rather, we have a healthy economy, little unemployment, and a "double A" credit rating by Moody's Investors Service. Our bonds have been eagerly sought by purchasers who have generally recognized our stability by competitively pricing our obligations at interest rates below normal market conditions. But not today! Today, with the very real threat of direct and indirect Federal taxation of the interest on

bonds such as ours, the bond purchaser is now unwilling to accept the normally lower interest return historically accorded State and local bonds inasmuch as he may now also be required to pay Federal tax on this income. Consequently, he can no longer afford to accept a lower yield municipal obligation and is now offering to buy only at much higher interest rates. As we understand House Bill No. 13270, Title III includes provisions which would impose a direct tax on interest earnings from State and local obligations through a "Minimum Income Provision" known as the "Limit on Tax Preferences", and provisions to indirectly tax these earnings through the "Allocation of Deduction Provision."

It is not our intention to go into the details of these provisions. However, it is clear that the net result of these would be to impose a Federal tax on the obligations of both State and local obligations.

We are told that this is a "Tax Reform Bill", that loopholes of many kinds have been closed. We are first to commend the Congress for this action and we quarrel not with the intent of this Bill. We oppose only one thing - the proposal -

the very right of the Federal Government to impose taxes - either directly or indirectly on the income of our State and local obligations.

Gentlemen, why have the purchasers of our obligations been willing to buy our securities at low interest yields? The answer is obvious - they are tax free! Because of this they will accept a lower return. Who has benefited? Again the answer is obvious - the average taxpayer and property owner in our communities. They have benefited in the lower property taxes required to pay the interest on these obligations.

Now, if our obligations became taxable, with the inevitable higher interest rates which State and local governments will be required to pay - who will be the ultimate loser? Not the future bond purchaser - he will price his bid to reflect the taxable feature. No, it will be the average taxpayer and property owner who will suffer through the increased local tax levies required to pay the higher interest rate. The burden has merely shifted to the already over-taxed average citizen.

In view of this inescapable conclusion, we request that you strike from this bill all measures in Title III which would in any way, directly or indirectly, place a Federal tax on the interest of State and local obligations.

Title VI of the Bill contains a provision whereby the Secretary of the Treasury is given authority to pay a subsidy to those State and local governments who elect to give up their tax exemption status and issue fully taxable bonds. This subsidy in the beginning would be from 30 to 40 percent of the interest charges, but in five years, would be reduced to as low as 25 percent.

We are told that the normal relationship of municipal bonds to corporate bonds, on the average, runs from 30 to 45 percent lower for municipals. If this be true, in a very short time the subsidy would be below the lowest ratio. In addition, in our own case in the County of Henrico, one favorable credit and the respect for our bonds in the market, has in most instances, resulted in rates below the averages for similar bonds. Consequently, even if an equitable formula can be devised to compensate local government for higher interest

costs on taxable bonds, we doubt that we would receive a payment equal to the advantage previously enjoyed.

I would like, with minor changes and additions, to echo the recent comments made by the Executive Director of the Municipal Finance Officers Association.

1. We are not here to defend the special interests of wealthy individuals; instead, we are here to defend interests of the average citizen and taxpayer from the increased local taxes required to meet the higher interest costs on State and local obligations which will result from taxing the interest earnings on such obligations.
2. We are not seeking to preserve a benefit conferred by Congress; rather we are here to seek a continuance of benefits stemming from the Constitution of the United States by preserving the right of State and local governments to issue tax-free obligations.
3. We are not attempting to oppose provisions of this Bill whereby individuals would be subject to a minimum tax, nor a system of allocating

deductions; but we are here to oppose the inclusion of interest on State and local obligations from being included in any of these Sections.

4. We are not here to impede "tax equity"; on the other hand, we are here to oppose tax inequity which we firmly believe would result since the purchaser of such obligations has already made tax payment "in kind" through the acceptance of lower interest earnings.

5. We are not here to represent any special interests; we speak for Government - State and local - and the millions of average citizens who make up these governments - who will be adversely affected through the higher taxes each will be required to pay to State and local governments to meet the vastly increased interest costs which will result if this Bill is approved as now proposed.

6. We implore you to remove all provisions in this Bill which would, in any way, directly or indirectly, result in a Federal tax on the interest earned on State and local obligations, both existing obligations, or those

which may be issued in the near future.

And finally, it seems to us that a proposal which would say to the many purchasers of our bonds, that even though they purchased a tax exempt obligation at a low interest yield in good faith, and even though these bonds bear legal opinions attesting to the fact that they were tax exempt under all existing legislation, now through retroactive Federal legislation these investments are now taxable, that somehow this cannot but undermine the public's very faith in the integrity of Government.

I thank you for this opportunity to present our views on this most vital issue.

COMMONWEALTH OF VIRGINIA

COUNTY OF FAIRFAX

FAIRFAX, VIRGINIA 22030

BOARD OF SUPERVISORS
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CARLTON C. MASSEY
COUNTY EXECUTIVE
JOHN V. BERBERICH, III
DEPUTY COUNTY EXECUTIVE

TELEPHONE CR 3-2000

September 19, 1969

Chairman
Committee on Finance
United States Senate
Washington, D. C.

Dear Mr. Chairman:

This is in reference to Mr. Vail's telegram of September 9, 1969, in which the County of Fairfax was advised to submit its views relative to tax reform in written form. We appreciate this opportunity to outline the problems encountered by a rapidly-growing urban county in meeting its capital funds needs--and to provide our views as to the impact of the tax reform proposals on our financing of required improvements.

Our presentation is in three parts: A short discussion of Fairfax County's recent and projected near-term growth, the capital funds needs generated by that growth, and finally, our views and recommendations relative to the tax reform proposals and their effect on our principal form of long-term financing--municipal bonds.

The following table illustrates the growth that has taken place in Fairfax County within the past 19 years:

	1950	1960	1969 (est.)
Population	98,557	262,482	432,482
Public School Membership	13,278	59,983	130,300*
Households	26,558	62,743	116,501
Assessed Property Valuation	$123,353,798	$470,849,300	$1,454,742,832
Long-term Bonded Debt (general obligation)	-0-	$ 42,450,310	$ 208,765,000

* 27 percent of total population.

It is expected that, by 1975, population will exceed 580,000, there will be an additional 30,000 public school students, and that long-term debt will exceed $350 million.

Thus, Fairfax County is an excellent example of a community which has been confronted with a requirement to provide, within a very short period, the necessary governmental services infrastructure. This could only be done by incurring long-term debt--for, otherwise, tax rates would have had to be prohibitive.

Were it not for the ability to sell its bonds in an established market the County, today, would not have:

- 119 elementary, 18 intermediate, and 19 secondary schools.
- Appropriate governmental facilities including courts space, a jail, and offices for the administrative staff.
- 1,278.61 miles of sanitary sewers plus 8 treatment plants.
- 6 public library buildings, including one headquarters facility and 5 branches.
- 4,433 acres of parks.
- A 770 bed hospital and two modern public health centers.

It is proposed that, during the 1970-1975 period, Fairfax County will be required to sell $195.1 million in bonds--just to keep up with the schools and other facility needs. If the market does not exist, the County will be faced with:

- An inability to meet Potomac River water purity standards.
- A classroom space shortage of massive proportions.
- Delay, if not default, in its ability to share in the cost of the planned Washington Area rapid transit system.
- Failure to meet health facility needs.
- Termination of the parks program.
- Serious reductions in the planned public library program.

It is for the above reasons that the existence of a municipal bond market--one which charges minimal interest rates--is essential to the health and well-being of the citizens of Fairfax County. This is not to say that the County is committed to any specific type of market; but, rather, that continuation of the present disrupted conditions and excessive interest rates makes it extremely difficult, if not impossible, for local government to meet its valid needs.

We understand that the major points of concern with the present municipal bond market, on the part of the Federal Government, are:

- The fact that the interest on municipal bonds is not subject to the Federal income tax provides a tax shelter for certain wealthy individuals.

- The stated loss of income to the Federal Government, as a result of the interest non-taxability feature--and the statement that the benefits of tax-free interest to State and local governments are less than the losses incurred by the Federal Treasury.

We are not qualified, nor do we think it appropriate to make recommendations relative to Federal tax policy. However, we would cite the following as disadvantages inherent in the House-passed bill:

- The municipal bond market, today, is established with well-channelled avenues of marketing, specialized agencies to do the marketing, and defined markets. The House-passed bill has already disrupted these marketing approaches, will obviously throw the present mechanism completely out of kilter, provides for no new mechanism, and leaves local governments in a 'limboesque' position until such time as economic forces create a new mechanism.

- The creation of dual markets (i.e., local choice as to retention of the tax-free advantage or receipt of a Federal subsidy) requires the issuing jurisdiction to make a decision as to whether to enter into competition with corporate and Treasury sales; or to stay within a severely contracted tax-free market. Neither has the advantages of the current protected market-place.

- The concept of creating an urban development bank has the severe disadvantage of requiring State and local governing bodies to submit each and every project to Federal review; with the probable loss in time and the possibility of loss of local autonomy.

We should add that we recognize both the concerns expressed by Federal authorities rê the tax advantages--and would cite our belief that the present municipal bond rating system tends to penalize localities such as Fairfax--where rapid growth causes a consonant increase in debt--but where debt is controlled to maintain a relatively low ratio with wealth (about 10 percent in our case).

In conclusion, we would recommend retention of the present tax-free interest procedure; recognizing its deficiencies; but accepting it as a

working means of providing funds for those needs which are properly the concern of local government.

It has been a pleasure to provide these views. We would be happy to provide any amplification the Committee desires.

Sincerely,

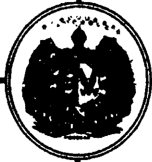
Carlton C. Massey
County Executive

ccm:gjk/lw

HAROLD C. WILLIS
ASSOCIATE JUDGE 1ST DISTRICT

W. FRED SCHAEFFER
PRESIDING JUDGE

OTTO KINSER
ASSOCIATE JUDGE 2ND DISTRICT



County of GREENE State of Missouri

SPRINGFIELD, MO. 65802

OFFICE OF
W. FRED SCHAEFFER
PRESIDING JUDGE

September 18, 1969

Honorable Russell B. Long, Chairman
Members of the Senate Finance Committee

Due to the large number of witnesses requesting time to testify on tax reform measures in your current hearings, Tom Vail, Chief Counsel for your Committee has advised me to submit a written statement. We appreciate the consideration that is being granted us.

My name is W. Fred Schaeffer. I am Presiding Judge of the Greene County Court, Greene County, Missouri. I am also President of the Association of County Judges of Missouri.

I strongly oppose the action of the House of Representatives in H.R. 13270, the "tax reform" legislation which includes the interest local governments pay to individual investors in their bonds. Under both the Limit on Tax Preference formula and the Allocation of Deductions Rule, local government will suffer. We in local government are continually faced with a shortage of funds, the resistance to an ever increasing tax on Real Property, and now with the adverse pressure of the House action, the Tax Exempt market continues to deteriorate rapidly.

Our county has a great number of elderly and retired citizens, the most of whom are on fixed incomes. We are also in a fast growing area which is continually faced with the need for capital improvements of governmental facilities. The most practical means of financing is by bond issue and without tax exempt bonds we are in serious trouble.

We recognize that the intent of this legislation is to reduce inequities among taxpayers. We do not believe that it is the intent of this legislation to jeopardize the preferential character of local government bonds. Indications are that our cost of local bonds as of this date would exceed 6.25% which is above the legal limit in Missouri.

We realize that there is no easy solution to the problem of alleviating the financial burdens of the states and their local governments. It is also important that the market for state and local government securities is not destroyed by well meaning attempts to equalise taxes.

It is our earnest hope that your Committee will in its deliberations find a way to avoid taxing local bonds.

As stated, I am also President of the Association of County Judges of Missouri. This Association held its 49th annual meeting on September 11 and 12, 1969 in Jefferson City. The matter of tax exempt bonds was discussed with this group by our State Treasurer, the Honorable William E. Robinson. The Association passed the following Resolution and asked that it be made a part of my statement to your Committee:

Whereas, it is essential that any government have the power to tax and to borrow to support necessary services; and

Whereas, the freedom of the Federal Government and the States from taxation by the other is part of the genius of our federal system; and

Whereas, this freedom necessarily encompasses the immunity of State and local government obligations from Federal taxation and a similar immunity of Federal obligations from State and local taxation; and

Whereas, as measures for tax reform or the raising of additional revenue, proposals have been made to amend the Federal tax laws to close certain "loopholes", or to bring about a greater measure of equity among taxpayers; and

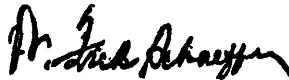
Whereas, these proposals include one to enact a minimum income tax and another to set a maximum amount of income that could be exempted from tax, enactment of either of which, if they include interest paid on local government obligations, would pose a serious problem; and

Now, Therefore, Be It Resolved by the Association of County Judges of Missouri at their annual meeting September 11, 1969, that it reaffirm its support for the reciprocal freedom of the States and the Federal Government from taxation by the other; and

Be it further resolved that it petition the Finance Committee of the Senate of the United States to refrain from enacting legislation which would make more difficult and more costly the performance of their responsibilities by local governments, and endanger the market for local securities; and

Be It Further Resolved that copy of this resolution be sent to the Finance Committee of the Senate and to all members of Congress from this State.

Respectfully submitted,



A Statement by the Delaware River Port Authority
Camden, New Jersey*

Prepared for the United States Senate Finance Committee - September 22, 1969

An immediate and primary impact of the tax reform legislation presently being considered by the Senate Finance Committee would be the impairment of the attraction of municipal bonds in the open market including the fear that Congress might eventually eliminate the tax exempt feature altogether. If enacted, a breach of faith to municipal bondholders would occur and certainly these investors will lose confidence in the security of municipal bonds as investments. The net result would be that all investors in municipal bonds would demand higher interest rates as a hedge against tax losses if, indeed, they still found municipal bonds attractive investments at all. Following this would be the impact on states and localities who would be faced with higher borrowing costs and the potential inability to sell bonds. This could well lead to the pushing of capital financing costs for urgently needed public works beyond legal or economic limits.

In its quest for tax reform, Congress through its apparent attempt to tax a very small number of individuals who receive substantial interest from tax exempt bonds, is in effect shifting the tax burden of higher financing costs to millions of local tax payers-voters whose property and other taxes will have to be increased to meet these new and added costs.

The Delaware River Port Authority is a public corporate instrumentality of the Commonwealth of Pennsylvania and the State of New Jersey created in 1931 under the name of Delaware River Joint Commission, by Compact between said Commonwealth and State, and consented to by the Congress of the United States.

* Submitted by C. W. McWilliams, Secretary and Deputy Executive Director

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Its purpose in being is to exercise an essential governmental function which includes, among other things, the establishment, construction, operation and maintenance of railroad and other facilities for the transportation of passengers across any bridge or tunnel owned or controlled by the Authority, the improvement and development of the port district for port purposes, cooperation with all other bodies interested in development or use of the Delaware River, construction acquisition, operation and maintenance of other bridges and tunnels across or under the Delaware River, promotion as a highway of commerce of the Delaware River, the establishment, maintenance, rehabilitation, construction and operation of a rapid transit system between points in New Jersey communities within a 35 mile radius of the City of Camden and points within the City of Philadelphia, Pennsylvania, and the performance of such other functions which may be of mutual benefit to the Commonwealth of Pennsylvania and the State of New Jersey insofar as concerns the promotion of the Delaware Valley.

The attached map shows existing facilities operated by the Delaware River Port Authority and proposed sites for new projects (the numbers shown correspond with those shown on the map).

9. Benjamin Franklin Bridge--a Bridge across the Delaware River between Philadelphia and Camden, New Jersey. Opened for traffic in 1926.

1. Walt Whitman Bridge--a Bridge across the Delaware River between South Philadelphia and Gloucester, New Jersey. Opened for traffic in 1957.

5. Chester-Bridgeport Ferry--a ferry operation across the Delaware River between Chester, Pennsylvania and Bridgeport, New Jersey. Operated by the Authority since May, 1965.

14. Rapid Transit System--a high-speed transit facility between Philadelphia and Lindenwold, New Jersey, a distance of 14.5 miles. Opened for passenger traffic in January, 1969.

4. Chester-Bridgeport Bridge--a Bridge across the Delaware River between Chester, Pennsylvania and Bridgeport, New Jersey to replace the Chester-Bridgeport Ferry. Scheduled completion September, 1972.

12. Philadelphia-Pennsauken Bridge--(called Delair Bridge on map) a Bridge across the Delaware River between Philadelphia and Pennsauken, New Jersey. Scheduled completion September, 1972.

13. Improvements to Existing Facilities--improvements to existing and construction of new approaches to the Benjamin Franklin and Walt Whitman Bridges. New Centralized Maintenance Building.

The Authority at present enjoys a strong and healthy financial condition. It's revenues adequately cover the combined costs of operation, maintenance and debt service. As of August 31, 1969, the outstanding bonded indebtedness aggregated $140,000,000. These Bonds were sold on April 23rd of this year at an average interest cost of 5.623% in order to accomplish one half of our financing program. The purpose of this financing program is principally to construct two new bridges across the Delaware River to prevent traffic congestion from

strangling the economic well-being of the Delaware Valley. The proceeds of these Bonds provided moneys which, together with other funds available, were sufficient to (1) refund the then outstanding $65,054,000 1953 Bonds, (2) redeem the then outstanding $60,000,000 1968 Notes issued for construction of the Rapid Transit System, (3) provide the balance to pay the remaining costs of the Rapid Transit System increment now nearing completion, (4) pay a portion of the cost of constructing the Chester-Bridgeport Bridge and the Philadelphia-Pennsauken Bridge, and (5) to provide funds for certain other projects and financing costs. Additional bonds in the amount of approximately $140,000,000 were expected to be issued later this year or thereafter to pay the remaining cost. Because of the deteriorating market conditions for tax-exempt municipal bonds caused in part by the clouds of uncertainty created by the proposed tax reform bill, we have determined to delay permanent financing pending more stable market conditions.

The principal and interest for these Bonds are payable solely from the tolls and fares charged for the use of the facilities of the Authority. The Authority has no power to levy or collect taxes. Our Financial Advisors, Drexel Harriman Ripley, Incorporated and Elkins, Morris, Stroud & Co., have advised us that if $140,000,000 of bonds were sold today, the interest cost to the Authority would approximate 6.75%. Add to this the possibility of a greater interest cost to the Authority because of this legislation affecting the tax exempt status of our outstanding and proposed Bonds, we are of the opinion that the individual user of our facilities -- the daily commuter -- would

have to bear the burden in the form of higher tolls and fares. In addition, any substantial lessening of revenues and/or increase in construction costs would have a marked effect on our now existing toll and fare schedules in order to raise the necessary funds to complete our financing program.

The attached tabulation attempts to point out statistically the statement concerning the daily commuter's use of our facilities.* It is necessary to make some basic assumptions in order to draw certain conclusions. These are (1) that the Estimated Net Revenues available for Bond Service will be substantially as projected by our Traffic Engineers, Coverdale & Colpitts, in the Authority Official Statement dated April 23, 1969 (copy attached), (2) that $140,000,000 will be adequate to complete our financial program, (3) that the proposed bonds would all be issued as of January 1, 1970, and finally, (4) that in order to successfully market the proposed bond issue, bond service coverage would have to approximate 1.30 times bond service in 1973 (the assumed first full year of operation of all facilities).

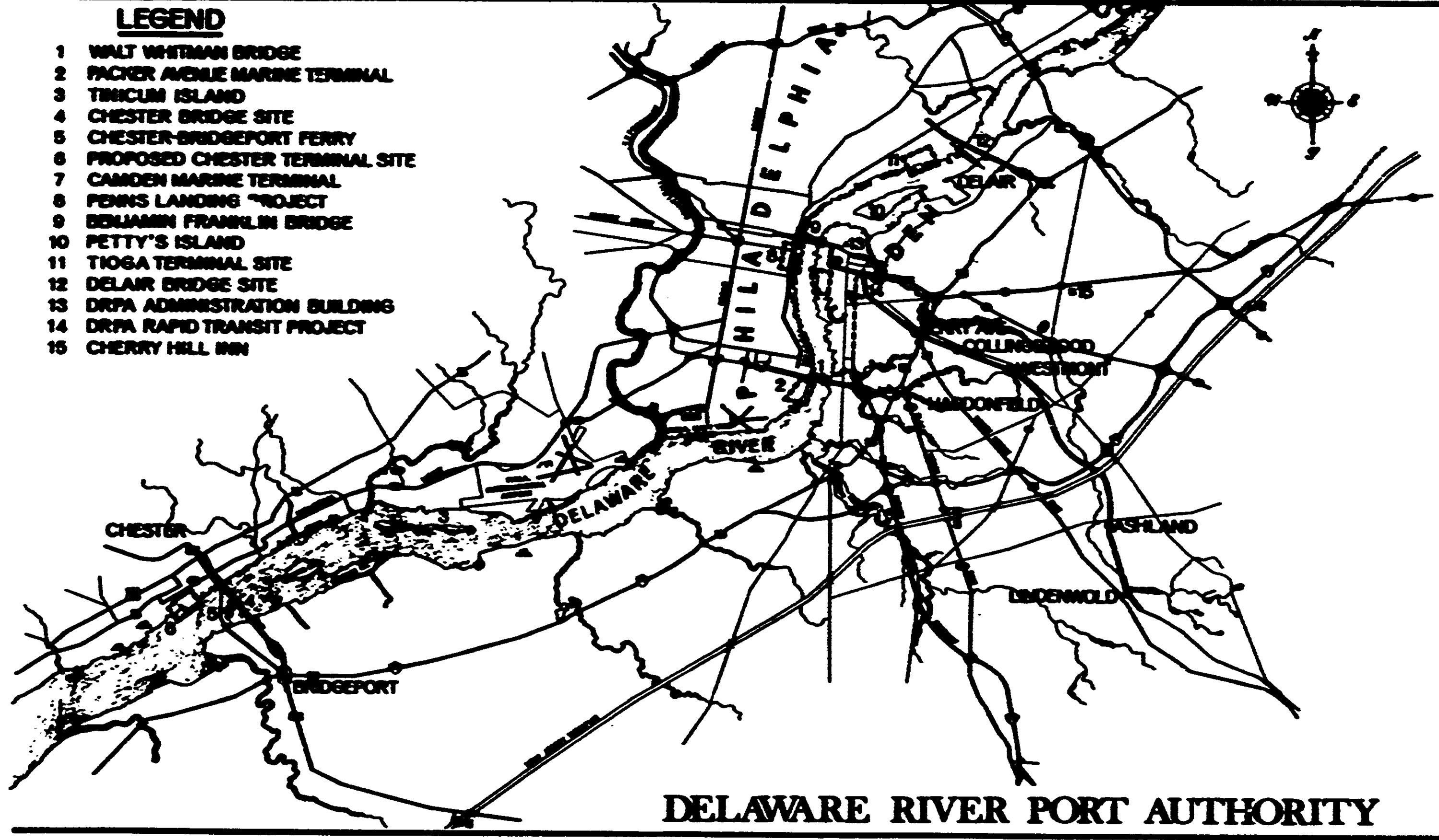
Assumption A is taken directly from the Official Statement used to sell our Bonds last April. This was our best judgment at the time as to the effect of a Second Series Bonds on bond service coverage. Since that time, as previously stated, market conditions have deteriorated. Assumption B shows bond service coverage following the issuance of bonds in a bond market as it exists today. It is our opinion that if the Federal Government makes inroads upon heretofore tax-free bonds, the interest rates will further deteriorate. Assumption C shows bond service coverage in a bond market as it might exist if tax exemption

* The tabulation referred to was made a part of the official files of the Committee.

is seriously impaired.

To bring Assumption C up to the standards of bond service coverage shown in Assumption B, namely 1.29 times bond service in the anticipated first full year of operation of all facilities (1973), approximately $3,000,000 in additional revenues annually would have to be raised. Coverdale & Colpitts, Traffic Engineers to the Authority, have estimated that a 10% across the board increase in tolls would have to be implemented in order to establish revenues at the desired level.

Notwithstanding the fact that projects of the Authority already started may be affected, it is the Authority's conclusion that higher interest rates due to infringement upon the tax-exempt status of interest on municipal bonds will result in the individual user -- the daily commuter -- paying higher tolls and fares.



LEGEND
1 WALT WHITMAN BRIDGE
2 PACKER AVENUE MARINE TERMINAL
3 TINICUM ISLAND
4 CHESTER BRIDGE SITE
5 CHESTER-BRIDGEPORT FERRY
6 PROPOSED CHESTER TERMINAL SITE
7 CAMDEN MARINE TERMINAL
8 PENNS LANDING PROJECT
9 BENJAMIN FRANKLIN BRIDGE
10 PETTY'S ISLAND
11 TIOGA TERMINAL SITE
12 DELAIR BRIDGE SITE
13 DRPA ADMINISTRATION BUILDING
14 DRPA RAPID TRANSIT PROJECT
15 CHERRY HILL INN
PHILADELPHIA
CAMDEN
DELAIR
COLLINGSWOOD
WESTMONT
HADDONFIELD
ASHLAND
LINDENWOLD
CHESTER
BRIDGEPORT
DELAWARE
RIVER
DELAWARE RIVER PORT AUTHORITY

DELAWARE RIVER PORT AUTHORITY
ESTIMATED BOND SERVICE COVERAGE UNDER VARIOUS ASSUMPTIONS
(000'S OMITTED)

YEAR	Estimated Net Revenues Available For Bond Service(1)	Assumption A: First Series Bonds P & I (2)	Assumption A: Second Series Bonds P & I (3)	Assumption A: Total Bond Service	Assumption B: First Series Bonds P & I (2)	Assumption B: Second Series Bonds P & I (4)	Assumption B: Total Bond Service	Assumption C: First Series Bonds P & I (2)	Assumption C: Second Series Bonds P & I (5)	Assumption C: Total Bond Service	Bond Service Coverage Assumption A	B	C
1970	$21,219	$ 7,741	$ 8,050 (6)	$15,791	$ 7,741	$ 9,450 (6)	$17,191	$ 7,741	$11,900 (6)	$19,641	1.34	1.23	1.08
1971	21,336	7,741	8,050	15,791	7,741	9,450	17,191	7,741	11,900	19,641	1.35	1.24	1.09
1972	21,783	7,741	8,050	15,791	7,741	9,450	17,191	7,741	11,900	19,641	1.38	1.27	1.11
1973	22,222	7,741	8,050	15,791	7,741	9,450	17,191	7,741	11,900	19,641	1.41	1.29	1.13
1974	23,526	8,741	8,050	16,791	8,741	9,450	18,191	8,741	11,900	20,641	1.40	1.29	1.14
1975	24,915	9,817	8,050	17,867	9,817	9,450	19,267	9,817	11,900	21,717	1.39	1.29	1.15
1976	23,985	9,086	8,050	17,136	9,086	9,450	18,536	9,086	11,900	20,986	1.40	1.29	1.14
1977	24,682	9,560	8,050	17,610	9,560	9,450	19,010	9,560	11,900	21,460	1.40	1.30	1.15
1978	25,542	10,304	8,050	18,354	10,304	9,450	19,754	10,304	11,900	22,204	1.39	1.29	1.15
1979	26,278	10,828	8,050	18,878	10,828	9,450	20,278	10,828	11,900	22,728	1.39	1.30	1.16
1980	26,920	11,266	8,050	19,316	11,266	9,450	20,716	11,266	11,900	23,166	1.39	1.30	1.16
1981	27,388	11,668	8,050	19,718	11,668	9,450	21,118	11,668	11,900	23,568	1.39	1.30	1.17
1982	28,080	11,935	8,050	19,985	11,935	9,450	21,385	11,935	11,900	23,835	1.40	1.31	1.18
1983	28,604	12,274	8,050	20,324	12,274	9,450	21,724	12,274	11,900	24,174	1.41	1.32	1.18
1984	28,985	12,476	8,050	20,526	12,476	9,450	21,926	12,476	11,900	24,376	1.41	1.32	1.18
1985–2008	29,827	7,086 (7)	10,300 (7)	18,500	7,085 (7)	11,940 (7)	19,025	7,086 (7)	13,866 (7)	21,951	1.56	1.48	1.36

(1) From Official Statement Dated April 23, 1969, Page 21

(2) Actual

(3) For Purposes of Illustration the Second Series Bonds are assumed to be $140,000,000 5 3/4% Term Bonds Dated November 1, 1969 and due January 15, 2008.

(4) For Purposes of Illustration the Second Series Bonds are assumed to be $140,000,000 6 3/4% Term Bonds Dated January 1, 1969 and due January 15, 2008.

(5) For Purposes of Illustration the Second Series Bonds are assumed to be $140,000,000 8 1/2% Term Bonds Dated January 1, 1969 and due January 15, 2008.

(6) Interest only for the years 1970 through 1984.

(7) Level Bond Service at assumed or actual rates for the years indicated.

September 17, 1969

STATEMENT OF THE
JEFFERSON COUNTY BOARD OF EDUCATION
BEFORE THE SENATE FINANCE COMMITTEE
ON THE TAX REFORM BILL

September 17, 1969

by

Richard VanHoose, Superintendent

Jefferson County Public Schools
Jefferson County, Kentucky

Mr. Chairman and Members of the Senate Finance Committee:

As superintendent of the Jefferson County Public Schools, Louisville, Kentucky, I am in a position to evaluate the need for tax-exempt municipal bonds. Our school district has grown from 47,000 to 89,000 students during the past ten years. Our building program has been financed almost entirely through school construction revenue bonds. Jefferson County bond sales during the past five years:

1965	$ 3,250,000
1966	10,570,000
1967	13,975,000
1968	12,815,000
1969	16,950,000

At the present time we have a total of $69,000,000 in bonds to be paid over the next twenty-five years. Even this accelerated construction program financed through bonds has left us with unmet needs for our student population.

Our last $3,150,000 bond issue sold in August for 6.6 per cent. We feel that the interest rate reflected anxiety caused by the threat to the tax-exempt status of municipal bonds. We have another $1 million issue scheduled for sale later this month, and we are concerned by the severe deterioration of the bond market. The State of Kentucky has a 7 per cent interest rate ceiling.

We have difficulty in marketing our bonds because of the large number issued in recent years. While school construction revenue bonds are acceptable in local areas, our sources of marketing have reached the limit which they may hold of Jefferson County School Revenue Bonds. This makes it necessary for us to go outside the State of Kentucky to sell our bonds. It is difficult enough to sell to "home folks." You can imagine our problem when we try to place these bonds elsewhere, especially without a tax exemption feature. There does not seem to be any broad public support for taxing municipal securities. The appeal is primarily an emotional one to tax a few of the millionaire income class.

One of the few current advantages enjoyed by local governments is the tax-exempt status of municipal bonds. Destruction of this financial resource would constitute a serious problem for schools and other institutions for which local and state governments are responsible. I respectfully ask the Finance Committee to give thoughtful consideration to preserving the present tax-exempt status of municipal bonds to allow local governments to seek minimum cost financing of long-term projects.

Statement by Frank M. Whiston
President of the Chicago Board of Education
to the
Senate Committee on Finance

Mr. Chairman and Members of the Senate Committee on Finance:

I am Frank M. Whiston, President of the Chicago Board of Education. It is a pleasure to have this opportunity to present my views on certain sections of HR-13270, the Tax Reform Act of 1969.

The sections of HR-13270 with which I am primarily concerned are those which would affect the tax-exempt interest on certain governmental obligations. The Chicago Board of Education annually markets over $148,000,000 in tax anticipation warrants and we expect the Public Building Commission of Chicago to sell $140,000,000 in bonds over the next two or three years to finance construction of our school buildings. Hence our vital concern as to the marketability of these instruments and the interest rate that will be required.

It is my conviction that Section 301, dealing with the limit on tax preferences, and Section 302 on the allocation of deductions, would seriously impair the marketability of our tax warrants and bonds and require much higher interest rates. The added cost of borrowing would be a severe burden on the already strained finances of the Board of Education and of course would result eventually in higher taxes for property owners.

It is also my belief that these proposed changes will result in lengthy litigation. During the several years the matter would be in court the tax status of municipal obligations would be unknown and the market for our tax warrants and bonds would be totally disrupted. This would leave the Chicago Board of Education in financial chaos.

The provision in Section 601 for the issuance of taxable bonds and the interest subsidy provided in Section 602 are considered impractical and costly ways of overcoming the difficulties created by Section 301 and 302.

In conclusion I wish to indicate my complete opposition to Sections 301, 302, 601, and 602 of HR 13270 and request that they be eliminated from the Senate version of the Tax Reform Act of 1969.

Thank you for the opportunity to present this statement.

September 19, 1969

Position Statement -- SCHOOL DISTRICT NO. 1 CITY AND COUNTY OF DENVER*
State of Colorado

H. R. 13270

Removing the tax exempt feature from Municipal Bonds, as proposed in H. R. 13720, will greatly increase problems in meeting the capital construction needs in School District No. 1, City and County of Denver.

There is ample evidence being presented by others which shows beyond a doubt that the proposed action will be detrimental to the sale of bonds by our district.

Our Municipal Bond dealers, financial Advisors, and bond attorneys inform us that the proposed action will have adverse effects on sale of school bonds by our district not only now but for several years to come. Recent experiences of our neighboring school districts furnish direct evidence to support this probability and the non-tax exempt status of such bonds has not yet become a fact.

We do not feel that the tax subsidy plan can adequately compensate for the increased cost to the local taxpayers. The uncertainties connected with this proposal as well as the complex system of controls and administration make it undesirable.

We believe that the total tax exempt status of school bonds should be retained and that in order to insure marketability and lower cost to the local taxpayer they should not be subject to the tax preference and allocation of personal deductions provisions in the bill.

Because of constitutional questions raised by this proposal and the expected litigation to ensue, the municipal bond market will be doomed to chaos for several years with a resultant cost to local taxpayers of additional millions of dollars.

Capital construction in our school district has experienced severe delay because of serious problems arising out of plans for integration. We now need to begin a capital construction program to meet the following needs: (a) replace 26 old buildings located in the core city, 18 of which were built prior to 1900; (b) build 14 new schools in recently annexed areas of the city where there are now no schools; (c) building and conversion of buildings to meet requirements for vocational and other present day educational needs of 96,000 children. At present day costs, this program would amount to more than $130,000,000.

In view of the foregoing conditions, it seems almost a certainty that a tax on interest received from school building bonds will create serious disruption and uncertainty, if not practically insurmountable obstacles, in carrying out future planning for capital improvement programs in our school district. We believe the provisions in this bill relating to the tax on income from municipal bonds will have a boomerang effect on local tax burdens for the average taxpayer.

Finally, if our school district were authorized to sell bonds today, our statutory limit of 6% interest cost prohibits the sale of such bonds in today's market where the municipal bond index is 6.33%.

9/12/69

* Submitted by William G. Berge, President, Board of Education, and Robert D. Gilberts, Superintendent.

Statement by President Robert R. Martin of Eastern Kentucky University on behalf of the American Association of State Colleges and Universities and the National Association of State Universities and Land-Grant Colleges, to the Committee on Finance of the U.S. Senate concerning H.R. 13270, September 23, 1969.

Mr. Chairman; members of the Committee:

My name is Robert R. Martin, I am President of Eastern Kentucky University in Richmond, Kentucky. I am also chairman of the Committee on Federal Relations of the American Association of State Colleges and Universities and a member of the Association's Board of Directors. This statement is submitted on behalf of the American Association of State Colleges and Universities and the National Association of State Universities and Land-Grant Colleges. The combined membership of these two associations is 372 colleges and universities located in the 50 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Island. They enroll approximately three and a half million students, or about half of all the college students in the nation.

The Associations presenting this statement have previously joined with the American Council on Education and others in testimony covering major points in HR 13270 of interest to higher education. While we concur generally in the position taken by the American Council on Education, we feel that the gravity of the proposals in HR 13720 with respect to state and municipal bonds was inadequately emphasized in that statement, and for this reason present additional testimony on this point.

We also wish particularly to emphasize the concern of these two Associations---which was expressed in the American Council's testimony---over the proposed tax on the income of private

foundations. We oppose the imposition of such a tax, and support the proposal that, instead of a tax, a registration or similar fee be prescribed adequate to cover the cost of enforcement of existing laws and regulations.

The colleges and universities in our two Associations have experienced enrollment increases in the past decade that have resulted in enormous demands for additional physical facilities. During this period of time, state governments and institutions of public higher education have had to rely primarily on long-term borrowing as the source of funds to meet these capital needs. General obligation bonds and/or revenue bonds have been issued by the states or by the institutions to provide funds for necessary academic, service and housing facilities. Such bonds, being exempt from taxation by the Federal Government, have been readily marketable and have enabled the institutions to provide the facilities necessary for the academic and other programs required by the increasingly large number of young men and women seeking the advantages of higher education.

I do not believe it is an overstatement to say that the result will be "catastrophic" if the bill passes in its present form. In fact, the threat of passage has already seriously damaged markets for this type of bond.

To illustrate, I cite the experience of Eastern Kentucky University. Since 1960, Eastern Kentucky University has issued and marketed several series of its Consolidated Educational Buildings Revenue Bonds, aggregating $21,400,000, which were sold in the open market and purchased by private investors. In July, 1969,

the University offered a series of such bonds in the amount of $7,400,000 for the purpose of constructing needed academic facilities. For the first time in the history of the Commonwealth of Kentucky, no bids were received for the purchase of bonds offered by a state agency. I am informed by a respected municipal bond dealer that the threat of passage of H.R. 13270 was the sole contributing factor for the market decline during the week that this issue of bonds failed to attract a bid.

Under Sections 301 and 302 of the proposed Income Tax Reform Act of 1969, the tax exempt status of state and muncipal bonds is negated, not only on future issues by these agencies but on existing issues. With reference to existing issues, the provisions of these two sections will, in my opinion, be a serious breach of faith by the United States Government. These bonds were purchased under the assumption of tax exemption and lower interest costs were realized by the seller of the bonds due to tax exemption. I am informed that bonds issued by state and municipal government agencies have been tax exempt from the original enactment of the income tax laws until the present date. If Sections 301 and 302 become law, then earnings from such bonds will become liable to taxation and the owner will have no recourse for the resultant or potential loss of income. Obviously, the bondholder will unavoidably conclude that the state and municipal bonds are not good investments. Further, the potential purchaser of state and municipal bonds will be forced to conclude that, if such bonds can be made subject to taxation on the basis proposed by Sections 301 and 302, then subsequent legislation can make such bonds fully taxable. Accordingly, interest rates will rise markedly and the marketability of state and

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municipal bonds will be seriously jeopardized. Further the provisions of these sections constitute an attempt, by indirection, to provide for federal taxation on state and local governmental units.

Proponents of H.R. 13270 have pointed to Sections 601 and 602 as protection for state and municipal agencies in this matter in view of the potential effects of Sections 301 and 302. However, what appears to be a choice between the sale of taxable or tax-exempt bonds by the agency is in reality no choice whatsoever. An analysis of the effect of H.R. 13270 upon the bond market would have to conclude that the bill in its present form would make it necessary for public institutions of higher education to look to the Federal Government for federal financing of physical plant needs. The proposed subsidy will not attack the problem of debt capacity under parity formulas to which existing debt has committed the institutions. Further, a serious question arises regarding the determination of the amount of interest subsidy. Here, I am advised by a municipal bond dealer, whose qualifications I respect, who stated that he was unable to find a single individual in his business who does not believe that the result of the bill will be higher interest costs to issuers, even after the federal subsidy. Additionally, the imposition of federal regulations and "red tape" will seriously impair the flexibility and efficiency of capital financing by public institutions of higher education.

Under existing federal statutes and regulations, state and local governments have had the ability to operate freely, without federal interference or intervention, in the incurrence of long term debt. Admittedly, state colleges and universities have used federal

assistance in this field at one time or another. However, when such federal assistance was used, the Federal Government was free to accept or reject this assistance under the prevailing rules. The provisions of H.R. 13270 are such that, in my opinion, this freedom will disappear. State colleges and universities will be forced to apply to the Federal Government for assistance or pay rates of interest that would be economically prohibitive. While the bill proposes a subsidy without regulation, experience in the field of federal assistance leads us to conclude that the outcome would be otherwise.

I have offered no opinion or comment concerning the remainder of the Act. Certainly, I subscribe to the concept of tax reform to the end that the burden of taxation is equitably distributed among the citizenry. I must strongly protest, however, the efforts of proponents of the Income Tax Reform Act of 1969 to use the concept of "tax reform" to disguise an attack upon the treasuries of states and municipalities. Such action is contrary to the fundamental conception of the relationships between states and municipalities on the one hand and the Federal Government on the other. I implore you on behalf of public colleges and universities of the Nation to leave for states and municipalities the freedom from federal taxation of bond issues in order that these colleges and universities may continue, with freedom from federal interference, to develop their institutions with the diversity and uniqueness that has been the hallmark of higher education in the United States.

STATEMENT OF THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA CONCERNING THE TAX-EXEMPT STATUS OF MUNICIPAL BONDS*

The Metropolitan Water District of Southern California is a public corporation organized under the laws of the state of California to furnish supplemental water at wholesale for municipal and industrial use to cities and other public agencies. The District now serves most of the coastal plain of Southern California. It has a population of more than 10 million living in 121 cities and in various unincorporated areas including the metropolitan areas of Los Angeles, Orange County and San Diego.

Southern California, a semi-desert area, has experienced the greatest influx of people in the world's history during the past three decades in which it has become one of the great urban complexes in the world. This amazing and unprecedented growth placed tremendous pressure on public officials to continue furnishing the most basic commodity for this dynamic and expanding economy, namely, water. The natural distribution of waters in California has never coincided with population and industrial demands, a problem characteristic of most of the southwestern United States. The difficulties of meeting this growth and attempting to plan for the future involved enormous costs and from a practical standpoint could only be accomplished by spending vast amounts of funds requiring long term financing.

In addition to the major water resource works already constructed in Southern California with municipal bonds, the voters

*Presented to the Committee on Finance, United States Senate, by Joseph Jensen, Chairman, Board of Directors, September 23, 1969

of the Metropolitan Water District authorized the sale of $850,000,000 in general obligation bonds in 1966 as part of a financing package for the construction of $1,250,000,000 in new works for the distribution of additional water within our service area. These bonds are in addition to the $1,750,000,000 in bonds authorized for the California State Water Project, the world's largest water project which will meet Southern California's needs until close to the turn of the century. As of this time, Metropolitan has yet to sell $665,000,000 worth of its bond authorization, while the state has $600,000,000, which are unsold.

These figures quite accurately reflect the enormous costs to state and local governments of financing just one of their essential services in the west under the unprecedented growth pressures experienced since World War II. Today in California, public agencies have over $2 billion in bonds awaiting sale for the construction or betterment of water supply systems. In most instances, the added flexibility of long-term financing has permitted public agencies to do a more comprehensive and more efficient planning and construction job in the development of their water resources. Piecemeal planning and construction, quite frequently caused by practical financial restrictions, has usually resulted in a poorly balanced use of available resources and in the long run more expensive development.

Sections 301 and 302 of the House Tax Reform bill, H. R. 13270, will clearly have an immediate impact on the costs of long-term municipal financing. The far-reaching effect of the

minimum income tax and allocation of deductions proposals is unquestioned. Investors, of course, handle their portfolios in large part based on the tax consequences of their decisions and the question is not whether this will increase the cost of issuing municipal bonds but rather how much. The other distinct possibility is that investors will seek other more profitable investments, thus limiting the supply of funds for municipals and so in effect driving up interest costs as competition between municipal agencies increases in a narrower market.

The other effect of these proposed changes is to undermine the confidence of investors who will not be specifically affected by these amendments but who are afraid that they represent a trend which will eventually include them. They can only view municipals as an investment with much less certainty of return than that upon which they have come to rely. Their reaction may well be the same, i.e., either they will look elsewhere for investment potential or reflect their concern in the bids they make for these securities. Also, until the constitutional issues raised by some of the proposed amendments are resolved by the courts, investors will be reluctant to consider municipals.

From the standpoint of Metropolitan and other public agencies, these reactions will cost money - a great deal of money - which must be passed on to taxpayers or water users. Metropolitan must sell the $665,000,000 balance of its current bond authorization to complete its construction program and an increase of one percent in the interest rate of these bonds will result in

an added cost of somewhere around $275,000,000. An increase of 2-1/4 per cent will result in an increase equivalent to the principal amount.

This added cost to Metropolitan will not be for the investor's benefit. The investor is demanding a higher interest rate to maintain his rate of return in the face of changes in the tax law and the added interest cost to state and local agencies which investors will demand will equal what investors expect they would face in additional federal income tax.

Obviously, we are opposed to the inclusion of interest on municipal bonds in these two provisions. We do not feel the Federal government's need for additional revenue needs to be at the expense of local taxpayers. The almost miniscule number of individuals who escape a portion of income tax because of ownership of municipal bonds is not adequate reason to impose much higher costs on local government, the most greatly troubled level in our entire government structure today.

The alternatives to the tax-exempt bond which have been proposed in connection with tax reform so far fall into three general groups. The House bill provides for a no-strings-attached subsidy for those public agencies willing to issue fully taxable bonds. The other two have been generally lumped into the "urban bank" approach and some type of guarantee system.

These latter two involve Federal surveillance and regulation of local capital projects in order to obtain the financing offered. We do not agree with this. We do not feel

that having to accept Federal approval of our construction programs is an alternative to our reluctance to go into a more costly bond market. Some areas of state and local government need Federal assistance to develop needed programs in accordance with national policy but we feel this should be a conscious decision by Congress to aid in a particular field with established standards and a recognition of need rather than as an only alternative for paying higher interest rates. We do not feel that the Federal government's need for additional funds as stated by the Treasury Department is adequate justification for making local public projects into a Federally supervised program.

The no-strings-attached subsidy provided in the House bill has more merit from the standpoint of local agencies and is more consistent with Treasury's arguments that its objection to tax-exempt bonds is in large part based on loss of revenue. However, we cannot agree with such an approach when it must go hand in hand with a major deterioration of our traditional financing market, leaving as an alternative one which is untried and subject to constant change by future Administrations and Congresses. If the direct subsidy approach, which we believe will prove far more costly than current estimates indicate, proves unacceptable or is altered by Congress at some future time, then state and local agencies are left without recourse as their traditional market will have already been substantially altered or eliminated.

The Metropolitan Water District is opposed to any

legislative proposals which will eliminate or curtail the tax-exempt status of municipal bonds, reduce or impair their marketability, increase interest costs or otherwise adversely affect the municipal bond market.

STATE OF NORTH CAROLINA
LOCAL GOVERNMENT COMMISSION
RALEIGH, N. C. 27602

EDWIN GILL, CHAIRMAN AND
DIRECTOR OF LOCAL GOVERNMENT
HARLAN E. BOYLES, SECRETARY
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September 18, 1969

Honorable Russell B. Long, Chairman
Committee on Finance, United States Senate
2227 New Senate Office Building
Washington, D. C.

Subject: H.R. 13270, Tax Reform Act of 1969
Senate Finance Committee Hearings Beginning September 23, 1969

Dear Senator Long:

This statement is in opposition to that portion of the Tax Reform Act of 1969 relating to the tax exemption presently afforded state and local bonds under Section 103 of the Internal Revenue Code. Said opposition is based primarily upon the following contentions:

1. That the principle of tax immunity of the states and local governments is vital to the preservation and continuation of their capacity and ability to serve the people of their community.

2. That the proposed amendment is contrary to the long and well established policy of Congress to uphold the reciprocal freedom of the states and the Federal government from taxation by each other.

3. That the fear of the investor that Congress will remove or modify the tax exempt status of state and local bonds is a plague to the municipal bond market and is serving to increase disproportionately the cost of using borrowed funds in providing the public facilities so critically needed.

4. That the State of North Carolina through its self administered program of fiscal responsibility is providing for its people the best possible government at the lowest possible cost.

We mention with pride the well established objective of the State of North Carolina is to promote and encourage strong and self-sufficient local government. We think the North Carolina way of providing funds for valid public purposes is unique and far superior to the proposals that heretofore have been submitted to the Congress. We think the North Carolina approach supports the new direction of strengthening Federal-state relations and we therefore take the liberty of presenting a brief description of the State's program of public finance.

The Local Government Act of 1931 gives the State of North Carolina through the Local Government Commission, which functions as a division of the Department of the State Treasurer, the responsibility of approving and supervising the issuance of bonds or other evidences of indebtedness by the local units of government. This responsibility involves working with the representatives of the local units and other agencies of the State and Federal governments in planning the projects to be financed and finally serving as issuing agency for the bonds and notes.

In administering the provisions of the Local Government Act, the Commission examines the necessity and expediency of the local bonds or notes as proposed, the adequacy of amount and the ability of the issuing unit to make repayment.

The Commission's supervision assures investors that correct procedures have been followed and that the fiscal data presented in the offering circular is based upon reliable sources. The local units benefit through lower interest costs that result from the underwriter's knowledge of Commission standards and the uniformity of offering procedures.

The Local Government Act carefully spells out the procedural requirements to be followed in the issuance of bonds by a local unit. Briefly, the Act provides that before any local unit may issue its bonds or notes, the unit's governing board must file an application with the Local Government Commission requesting its approval of the issuance of the proposed bonds or notes. In the event the bond proposal is required by the Constitution or by the statutory law to be submitted to the voters of the unit for approval, such application must be filed at least forty days prior to such election. Notice of the unit's intent to file the application must be published at least ten days before filing the application with the Commission.

The law provides for objections by private citizens and public hearings by the Commission on proposed bond issues, but under the law no bond or notes is valid unless it bears a signed certificate to the effect that its issuance has been approved under the provisions of the Local Government Act.

North Carolina, being one of the thirteen original states, has a tradition of local self-government. It is believed to be unprecedented for the General Assembly of North Carolina to have adopted a measure centralizing in Raleigh the degree of authority over the financial affairs of its counties, cities, towns and other political subdivisions. In fact North Carolina is among four states--along with Michigan, Louisiana and Virginia--that assists or oversees the borrowing operations of its local units. The Virginia Commission does not offer aid or advice unless requested by the locality, but in North Carolina the units are required by law to proceed through the Local Government Commission.

The local governmental organizations in North Carolina having authority to issue bonds and notes include 100 counties, 425 municipalities and 263 special taxing districts for a total of 788 units of local government. As of June 30, 1969 the bonded indebtedness of the local units exceeded $1 billion while the bonded indebtedness of the State of North Carolina was almost $500,000,000 making the combined indebtedness of the State and its local subdivisions in excess of $1.5 billion.

The states and local governments throughout the nation rely heavily on bond issues to finance capital improvements. In North Carolina, the state and local governments have generally followed the practice of borrowing for prudent and necessary purposes and at times when borrowing was considered economically wise. A study of the trend of state and local debt shows that North Carolina and its local units of government have followed a well-balanced program--using both pay-as-you-go and borrowed capital. On a per capita basis, North Carolina ranks 48th among the fifty states in state and local indebtedness.

The immunity of the states and local governments from Federal taxation is vital to the preservation of our dual sovereignty which characterizes our system of government. As important as the interest savings may be to local governments, and as important as the revenue loss may be to the Federal government because of the tax-exempt character of municipal bonds, these factors are secondary to the preservation of the sovereignty of our states and the integrity of our local governments.

Those who purchase municipal securities do so with the full understanding that the interest received from such securities is exempt under existing Federal income tax laws. To levy an income tax retroactively would seriously damage investors' confidence in the integrity and good faith of the Federal government. Furthermore, unless there is an early and decisive conclusion to the threat of Congressional action neither present investors in municipal bonds, prospective investors, nor banks and other institutions that purchase municipal obligations for their portfolios would have sufficient confidence in the tax exempt status of municipal bonds to take a chance on future investment in such securities. Once this principle is breached, there is theoretically no limit to the extent to which the interest could then be taxed by succeeding Congresses. This would, of course, result in a total collapse in the market which would unquestionably force the states and municipalities to seek financial relief from Washington.

If the tax exemption on interest from municipal and state bonds were eliminated, the cost of public works to the taxpayer would increase. Investors would continue to buy the bonds. They are the most secure of investments, but they would demand a higher interest rate to compensate in part at least for the taxes levied on the interest. The local property taxpayers would foot the bill.

Honorable Russell B. Long
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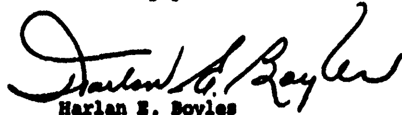
There can be no doubt that financial relief is sorely needed by the states and their subdivisions, but the proposals presently before the Congress would appear to create more problems than they solve. The economists today are saying that in the years to come local governments will be one of the major "growth industries". Through the years the objective of the State of North Carolina has been to encourage local units to assume full initiative and responsibility allowing the role of the State to be mainly that of advisor and counselor.

Stability goes to the heart of character and the legislatures of the State of North Carolina have given our people and our bondholders a stable fiscal policy.

Sincerely yours,



Harlan E. Boyles
Deputy State Treasurer and
Secretary of Local Government Commission

HEB/fms

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To Hon. Senate Finance Committee
2227 New Senate Office Bldg.
Washington, D. C.
Attn: Tom Vail, Chief Counsel

Statement of County Officers Association of the State of New York, representing fifty-six counties outside New York City, to be included in report of public hearings held before Senate Finance Committee September 23, 1969.

Re: H. R. 13270 Income Tax Reform Bill

This Association opposes that part of the above bill which would tax interest on state and municipal bonds and notes as part of the income of the individual holders of such obligations.

1. The threat to tax this formerly exempt income has already increased the interest rate by almost 2% when a purchaser for the obligations is found.

2. Such increase has to be borne by local property owners already overburdened with taxes to maintain local governments.

3. Removing the exemption of interst on state and local obligations will not accomplish the purpose of the bill, i. e. to tax the income of wealthy people and plug loopholes in the income tax law.

4. Desirability of municipal bonds and notes has been destroyed and will not be made desirable by the proposed flexible subsidy which places control over the activities of municipalities in the federal bureaus.

5. Such a tax has been declared unconstitutional by the United States Supreme Court.

Re: H. R. 13270 Income Tax Reform Bill

This Association wholeheartedly supports the position of the National Association of Counties to which organization and its speakers before your Committee on September 24, 1969 reference is hereby made for amplification of this statement.

Respectfully submitted,

County Officers Association
of the State of New York

By
Executive Director