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The Municipal Bond Interest Exemption: Comments On a Running Battle

Leon Cabinet

Ever since the enactment of the Revenue Act of 1913 there has been continued debate surrounding the exemption given to municipal bond interest. More recently a variety of alternatives to the interest exemption have been suggested in an effort to correct the alleged inefficiency of the present system. The author examines both the policy and the economics of the present system and the alternatives that have been proposed, and concludes that the best that can be hoped for from the current argument is a compromise that is wholly satisfactory to no one.

I. INTRODUCTION

"The spirit of liberty is the spirit which is not too sure that it is right. . . ."

L. HAND, *THE SPIRIT OF
LIBERTY* 190 (3d ed. 1960)

INTEREST PAID on state and local government obligations, known as "municipal bond interest," has been exempt from federal income tax since the enactment of the Revenue Act of 1913.¹ Since that time, and particularly during the last thirty years, the exemption of this interest item has been under sporadic, though increasingly heavy, attack. In 1942, the Treasury Department exerted enormous pressure in an attempt to win congressional support for a proposal to eliminate the exemption. This all-out effort proved futile as state and local governments successfully rallied to the defense of the exemption and fought off the treasury attack.² A Treasury proposal to eliminate the exemption only as to future bond issues was again urged upon Congress in 1951, but state and local governments once more prevailed.³ Finally, in 1969, a proposal to substitute a direct

THE AUTHOR: LEON CABINET (Ph.B., J.D., University of Chicago) is a Professor of Law at Case Western Reserve University and is admitted to the Oregon, Ohio, and Federal Bars and to practice before the Tax Court of the United States. His teaching specialty is *Federal Taxation*.

¹ Act of October 3, 1913, ch. 16, § II B, 38 Stat. 114, 167.

² *Hearings on Revenue Revision of 1942, Before the House Ways and Means Comm.*, 77th Cong., 2d Sess. Vols. 2 and 3 (1942).

³ *Hearings on Revenue Revision of 1951 Before the House Ways and Means Comm.*, 82d Cong., 1st Sess., Vol. 2, 903-1159 (1951).

federal subsidy for the exemption actually found its way into the House version of the Tax Reform Act,⁴ but was deleted from the final version of the Act. Thus, despite continuing attack, the municipal bond interest exemption has remained one of the most durable preferences in the Internal Revenue Code.

Nonetheless, the forces heretofore arrayed against the exemption are apparently being marshalled once again: on May 31, 1972, Congressman Wilbur D. Mills (D. Ark.), Chairman of the House Ways and Means Committee, introduced the "Tax Policy Review Bill of 1972," which plots the elimination of some 54 items of deduction, exemption, credit or allowance over a three-year period.⁵ Congressman Mills does not, of course, expect or even desire the elimination of all these preferences. His object is to force Congress to systematically review them and thereby set the stage for a reappraisal of the policies which they express and represent. Needless to say, municipal bond interest is on the list, and in view of the storms which have previously raged around this preference, it is reasonable to expect yet another tempest when congressional scrutiny is once more directed at it.

A great deal has been written and said about the municipal bond interest exemption, much of it in publications not widely read by lawyers. Furthermore, discussion in recent years has largely centered on the highly technical aspects of the subject, such as, the effect of the exemption or its elimination on state and local borrowing costs, the relation of lessened borrowing costs to revenue loss suffered by the federal government, or the nature of the market for state and local securities and its future prospects.⁶ It is not surprising, therefore, that the discussion of these matters has been left to economists, public administrators, and those having a particular interest in the financing of state and local governments. The same

⁴ H.R. 13270, 91st Cong., 1st Sess. (1969) (House version). The proposal was to allow the issuing governments to elect to forego the interest exemption in favor of a subsidized taxable bond. It was eliminated from the bill by the Senate Committee on Finance. *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 7, at 6720 (1969). The attack on all exempt securities, federal and state, was begun in earnest in the 1920's by Andrew W. Mellon, then Secretary of the Treasury, whose views were supported by Presidents Harding, Coolidge and Hoover. In 1938, President Roosevelt asked for extension of the taxing power to reach interest on all government obligations. Thus, in every decade since the enactment of the sixteenth amendment, the elimination of the exemption has been under persistent attack.

⁵ H.R. 15230, 92d Cong., 2d Sess. (1972).

⁶ See, e.g., D. OTT & A. MELTZER, *FEDERAL TAX TREATMENT OF STATE AND LOCAL SECURITIES* (1963); E. RENSHAW, *IMPROVING THE MARKET FOR MUNICIPAL BONDS*, 115 CONG. REC. 3578-80 (1969).

is true of the various alternatives which have been proposed as substitutes for the interest exemption. If the entire issue is to be raised again, however, then it is time that the muffled discussion taking place on the sidelines be brought out on the field, for in this discussion lawyers should not only be spectators, but participants as well.

II. THE PRESENT SYSTEM

A. *The Greeks and the Persians*

The opponents of the municipal bond interest exemption have advanced two major arguments in support of their position. First, they maintain that the exemption is in effect an inefficient federal subsidy to state and local governments. It acts as a subsidy by enabling those governments to cut their borrowing costs by issuing obligations at an interest rate lower than the going rate for taxable securities. It is the federal government, however, that bears the burden of this advantage because it can only be achieved by a loss of federal revenue. In other words, the federal revenue lost due to the exemption of the interest is the amount of the subsidy to the state and local governments. But the subsidy (so the argument goes) is "inefficient" because the state and local governments do not really save in borrowing costs the amounts which the federal government gives up in lost revenues. This "leakage" results from the fact that, in order to market all their securities, issuing governments must peg the interest at a rate high enough to attract not only high bracket taxpayers, but, since that limited market will become saturated, those in lower brackets as well. The resulting increase in borrowing costs, however, substantially reduces the benefit of the tax exemption to the issuing governments, while it increases the revenue loss to the federal government. The only winner in this process is the high bracket taxpayer who finds himself with more exempt interest income than would otherwise have been necessary to induce him to purchase the municipal bond.⁷ The argument pre-

⁷ D. OTT & A. MELTZER, *supra* note 6. The "leakage" can best be explained by the following example. Suppose that a 70 percent bracket taxpayer buys a taxable bond which pays \$100 in interest. The federal government would receive \$70, and \$30 would be net to the taxpayer. However, if the same taxpayer buys a municipal bond which pays \$75 in interest, the net to the taxpayer is \$75, the federal government loses \$70 in tax, but the municipal bond issuer gains only \$25, *i.e.*, the difference between what it would have to pay if the bond were taxable and the \$75 which is its actual interest cost. Forty-five dollars has "leaked" to the taxpayer, *i.e.*, the difference between the \$30 which he would have kept had he bought a taxable security, and the \$75 which

dictably concludes that, if we are going to subsidize the issuing government, then we at least ought to have an efficient subsidy, that is, one in which the issuing governments get what the federal government loses.

The second major argument of the opponents is that the exemption introduces an element of distortion into the federal income tax by giving an undue advantage to the high bracket buyer of municipal bonds. This is the familiar "tax equity" argument which is based upon the respectable proposition that a progressive income tax should not countenance leakages and preferences which erode the tax base and reduce its progressivity to the advantage of the wealthy.

Both these major arguments have been buttressed in recent years by prognostications as to expansion of state and local programs⁸ which, together with replacement needs, may cause the present \$10 billion of state and local debt to skyrocket to \$30 billion in approximately ten years. This rise means that there will be a tremendous increase in competition for the investment dollar as new state and local issues are marketed. Therefore, if the increased supply of tax exempts is to be successfully marketed, their interest rate must be increased.⁹ This can only exacerbate the inefficiency of the subsidy, and the end result of this trend may be to force state and local issuers to pay an interest rate on tax exempts which is approximately 80 percent of the rate paid on high grade taxable corporate securities.¹⁰ Moreover, the market for tax exempts is not an expanding one. On the contrary, high bracket taxpayers are becoming an increasingly smaller component of the market, apparently because many of these wealthy individuals are given to a far more aggressive investment posture than that represented by municipal bonds.¹¹ Furthermore, tax exempt organizations or corporations with limited income tax liability are not large buyers of such bonds,¹² and the com-

he keeps because he bought a municipal bond. It should be noted that a certain amount of leakage is necessary in order to get the taxpayer into the market at all. If he were to net only \$30, the amount necessary to achieve a perfectly efficient system, there would be no inducement to move into the municipal bond market.

⁸ HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE (Comm. Print 1959).

⁹ Surrey, *Federal Income Taxation of State and Local Government Obligations*, 36 TAX POLICY, Nos. 5-6, May-June, 1969, 3, at 5.

¹⁰ Surrey, *supra* note 9, at 6.

¹¹ Cf. Huefner, *Municipal Bonds: The Costs and Benefits of an Alternative*, 23 NAT'L TAX J. 407, 415 (1970).

¹² Surrey, *supra* note 9, at 5.

mercial banking industry, the largest remaining potential buyer, prefers to invest in loans rather than in tax exempt securities. Thus, the inescapable conclusion is that state and local governments may have to expand their sales to taxpayers with lower marginal rates, using increased interest as bait, and producing the concomitant undesirable results of further inefficiency and tax inequity.¹³

Against this formidable opposition, supported as it is by statistics and projections, stand state and local governments, represented by leagues of cities and counties, their public officials and fiscal officers. Their basic argument in defense of the exempt municipal bond is that the viability of our federal system depends upon fiscal independence of state and local governments. They maintain that the doctrine of intergovernmental tax immunity insures such independence and continues to be of pivotal importance in our federal arrangement. Consequently, even if it is true that the municipal bond exemption is "inefficient" as a subsidy and creates tax inequity, this may be the price we have to pay for independence of local government from federal control.¹⁴

It should be noted that the foregoing arguments offered by the defenders of the exemption are predicated on the supposition that the alternative to the exemption is simply its elimination. In fairness to the other side, it must be pointed out that the call for elimination of the exemption is tied to several alternatives involving its *replacement* with some form of direct subsidy to state and local governments, although this may not completely answer the question of control of funds, especially if the exemption is constitutionally based. These various alternatives are discussed below, but it should be noted that the state and local governments are just as strongly opposed to the subsidy alternatives as they are to total elimination of the exemption.

B. *Subsidy — A Definitional Problem*

There is an initial problem with respect to the characterization of the exemption as a subsidy. We have been accustomed to thinking of a "subsidy" primarily as a direct payment by the government to somebody. In recent years, however, as a result of the discussion of tax preferences, loopholes, and leakages, our notions of a "subsidy" have been broadened to include not only direct government payments, but also those indirect government expenditures which

¹³ *Id.*

¹⁴ See Healy, *The Assault on Tax Exempt Bonds*, 36 TAX POLICY, Nos. 7-8, July-August, 1969, 2, at 8-9.

result from such preferences. Thus, for example, Professor Stanley Surrey, in a recent article concerning the use of tax preferences as incentives as opposed to direct subsidies, defined a "tax incentive" as any preferential provision in the tax law which induces activities or behavior in response to the monetary benefit available.¹⁵ In other words, virtually all preferential tax provisions are really tax expenditures and are therefore indirect subsidies.¹⁶ A typical example is section 116(j) of the Internal Revenue Code which grants highly favorable depreciation treatment for residential rental realty, intended, of course, as an incentive to investment in low and moderate income housing.

Professor Surrey realizes, however, that not all preferential tax provisions are related to voluntary taxpayer behavior and intended to influence it. He therefore qualifies his definition: "The only tax expenditures that are not tax incentives, as we are using the expression, are expenditures related to involuntary activities of taxpayers. Most such provisions are designed to provide tax reductions in order to relieve misfortune or hardship. . . ."¹⁷ For Professor Surrey, then, the definitional key is voluntary behavior as opposed to involuntary behavior. A tax preference which is unrelated to an attempt to influence voluntary behavior is not a tax incentive. A stock dividend of common stock on common stock is not, for example, subject to tax, because in the opinion of the Supreme Court such a dividend does not result in realization of income by the shareholder, and to tax it would be to tax his capital rather than his income.¹⁸ Thus, failure to tax stock dividends is neither an incentive nor a subsidy, but rather a theoretical or structural preference in that the present income tax system does not or cannot impose a tax on capital — a result of the judicial doctrine, perhaps of constitutional origin,¹⁹ that only realized income can be taxed. There is no "subsidy," as that term is used here, when the preferential treatment is required as a theoretical or structural component of the income tax, or by constitutional doctrine.

¹⁵ Surrey, *Tax Incentives, Conceptual Criteria for Identification and Comparison with Direct Government Expenditures*, in TAX INSTITUTE OF AMERICA, *TAX INCENTIVES* 3, 9 (1971).

¹⁶ Surrey has defined the term "tax expenditure" as "those special provisions of the federal income tax system which represent government expenditures made through that system to achieve various social and economic objectives." Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 706 (1970).

¹⁷ *Id.* at 712.

¹⁸ *Eisner v. Macomber*, 252 U.S. 189 (1920).

¹⁹ *See id.*

A "subsidy" or "incentive," on the other hand, will result from such preferences when it is a voluntary or deliberate concession on the part of Congress to some specific taxpayer group, or for some special kind of transaction, which indicates a congressional intention to benefit those taxpayers or to allow special treatment for that transaction.

It may be that the municipal bond exemption is a constitutional requirement of the tax system rather than a voluntary concession on the part of Congress, and if this is so, then the criticism of the exemption as a "subsidy" is erroneous. Unfortunately, the doctrine of reciprocal tax immunity has been given short shrift by the opponents of the interest exemption, possibly because of the voluminous literature on the subject accumulated in prior years, especially in previous skirmishes over municipal bond interest.²⁰ Much of this literature deals with the steady erosion of reciprocal tax immunity as a result of cases which have rejected its application to taxation of salaries of state employees by the federal government and taxation of federal employees by the states. Nevertheless, the venerable case of *Pollack v. Farmers Loan & Trust Co.*²¹ did hold, *inter alia*, that interest on municipal bonds was not subject to a federal income tax. It is entirely possible that when the sixteenth amendment was adopted and provided for a tax on income "from whatever source derived," the issue was settled in favor of taxability of municipal bond interest.²² Yet no sooner was the amendment adopted than an exclusion was immediately provided in the Revenue Act of 1913,²³ and the exclusion has been continued in every revenue act since then. As a result, the Supreme Court has never been called upon to determine the authority of Congress to tax municipal bond interest, although it has on several occasions ventured the opinion that the sixteenth amendment did not extend congressional taxing power to new subjects.²⁴

²⁰ See, e.g., Magill, *The Problem of Intergovernmental Tax Exemption*, 15 TAXES 699 (1937). In 1938, the Department of Justice made an extensive study of the constitutional aspects of taxation of government securities. The Department's findings are summarized in a letter to Randolph E. Paul. Letter from Samuel O. Clark, Jr. to Randolph E. Paul, April 14, 1942, in S. SURREY & W. WARREN, *FEDERAL INCOME TAXATION* 191 (1962). A later version of the Department's view may be found in *Hearings on Revenue Revision of 1951 Before the House Ways and Means Comm.*, 82d Cong., 1st Sess., pt. 2, at 915, 922 (1951).

²¹ 157 U.S. 429 (1895).

²² Magill, *supra* note 20.

²³ Act of October 3, 1913, ch. 16, II B, 38 Stat. 114, 168.

²⁴ See *Brushaber v. Union Pacific R.R.*, 240 U.S. 1 (1916); *Stanton v. Baltic Mining Co.*, 240 U.S. 103 (1916).

What, then, is the exemption of municipal bond interest? Can it be viewed as a subsidy in light of the doctrine of intergovernmental reciprocal tax immunity? If not, then perhaps the entire analysis of the inefficient operation of this "subsidy" is without meaning or relevance. It is not my intention in this article to discuss the advisability of a system of reciprocal tax immunity as a cornerstone of intergovernmental fiscal relations. I merely wish to point out that the opponents of the municipal bond interest exemption have glossed over a major definitional problem in proceeding to analyze this particular tax preference as just another subsidy. The inefficiency of the bond interest exemption as a way of subsidizing state and local capital expenditure programs may be an effective argument against reciprocal tax immunity in general or against its specific application to this area. But in these circumstances, and particularly in view of the great fears expressed by state and local officials concerning the independence and fiscal integrity of their governments, it is necessary that the emphasis of the argument be shifted and the first order of business must be a resolution of the status of the doctrine of reciprocal tax immunity and its relation to the municipal bond interest exemption. Such a discussion is markedly absent from current pronouncements by both sides.²⁵ This means that all of the old learning on the subject must be resurrected and the matter worked through to a final conclusion. It will not do to proceed with an analysis of the problem while a basic constitutional issue overhangs the entire matter, to say nothing of the internal definitional inconsistencies which such a procedure entails. Again, the problems of fiscal federalism have been left largely to the economists, who tend to see the issues somewhat more narrowly than lawyers, and whose emphasis is of necessity on economic aspects of state-federal fiscal relations.²⁶

C. *Subsidy — A Problem of Allocation*

While there is a serious definitional problem with the criticism of the municipal bond exemption as an inefficient subsidy, the supporters of the exemption may have an equally severe problem with their contention that reciprocal tax immunity provides a necessary cornerstone to federalism by insuring state and municipal financial independence. The issue is essentially one of the right to allocate funds, and the analysis must proceed with discussion of the compli-

²⁵ See Surrey, *supra* note 9; Healy, *supra* note 14.

²⁶ See, e.g., Pechman, *Fiscal Federalism for the 1970's*, 24 NAT'L TAX J. 281 (1971).

cations of reciprocal tax immunity, particularly in the realm of municipal bond interest. It may be helpful to begin such a discussion by considering the ways in which the interest exemption resembles the charitable contributions deduction in the problems it raises.

A deduction for a charitable contribution involves a sacrifice of federal tax revenues in an effort to increase charitable giving. It appears, however, that this indirect subsidization of charities is no more efficient than the indirect subsidization of state and local governments via the bond interest exemption. According to one study, the 1962 revenue loss from the charitable contributions deduction was \$2,195 million, while reliable estimates of extra giving induced by the deduction were only \$57 million in the same year.²⁷ If Professor Surrey's analysis of the municipal bond market is correct, then the loss of federal revenue from the interest exemption is not balanced by increased inducement to buy these securities; on the contrary the market is shrinking.²⁸ This being the case, the result of the charitable contributions deduction and the interest exemption is the same, to wit: a leakage of tax benefits to high bracket individuals which exceeds any benefit to state and local governments or to charitable institutions. The importance of this striking similarity of effect in the quantitative sphere is its implications for the qualitative or substantive analysis of the interest exemption. Under the present treatment of charitable contributions the federal government treats all charitable institutions as being equally deserving of its largesse and matches a taxpayer's contribution (in an amount determined by his surtax bracket) with a federal contribution. Presumably, this permits the taxpayer to choose where his own and the government's charity dollars will go. The same is true of municipal bond interest. All state and local projects financed by public borrowing are viewed as equally deserving and it is the taxpayer's investment choice which governs the flow of his investment dollars and the government's tax dollars into a particular local endeavor. Both the charitable deduction and the municipal bond interest exemption can thus be viewed as devices for decentralizing government expenditure decisions, and this feature is one of the major implications of reciprocal tax immunity. This method of decentralization presumably contributes to the democratization of the decision-making process as well.

If, however, we are to have a decentralized and democratic selec-

²⁷ M. Taussig, *The Charitable Contributions Deduction in the Federal Personal Income Tax*, 152 (1965) (unpublished thesis in New York University Law Library).

²⁸ See Surrey, *supra* note 9.

tion as to what state and local projects will be supported, based upon taxpayer choice, then two issues must be considered. First, just how decentralized and democratic is the choice which the taxpayer purportedly enjoys? Apparently, it depends upon his tax bracket. Under our present system, the wealthier or high bracket taxpayer gets the greatest advantage from the municipal bond interest exemption. His purchase of municipal bonds also calls forth the highest federal government "contribution" to the issuing state or local government of his choice. Therefore, just as in the case of charitable contribution, the issuing governments favored by the high bracket taxpayer get the larger government subsidy. The securities issued by these favored governments may or may not be appealing to the lower bracket or less wealthy taxpayer. Thus, it would seem that the lower bracket taxpayer, because of the smaller advantage he derives from the interest exemption, is forced to seek out the higher interest coupon, attached to the riskier bond, marketed by the smaller or less wealthy issuer. The choice, then, is not really as democratic as it would appear.

This brings us squarely to the second issue: the allocation of the federal government's subsidy. Is it rational to allocate a federal subsidy to state and local governments based primarily upon the investment proclivity of the wealthy? Indeed, is it rational to make such allocation based solely upon *anybody's* investment decision, poor or rich? There is a respectable argument to be made that *any* choice in the allocation of federal funds, however imperfect, is better than direct government subsidy, or what may be worse, an expansion of the federal government's role in local matters. This closely parallels the arguments of the proponents of decentralized charitable giving, who also fear federal usurpation of a heretofore private function as a result of restrictive provisions governing the tax treatment of contributions.²⁹ The spokesmen for the interests of the state and local governments, as well as those who speak for private philanthropy make the point that private choice is conducive to creative and imaginative experimentation, while government control tends to be ponderous, unproductive and routine.³⁰ On the other hand, leaving the allocation of funds to investor choice puts the decision of what programs are to be carried out entirely in the hands of the state and local governments which are not necessarily models of creative

²⁹ See, e.g., Barlow, *The History of Philanthropy and the Impact of Tax Legislation*, 38 TAX POLICY, Nos. 4-5, April-May, 1971, 3.

³⁰ Broughton, *The Economic Functions of Foundations*, Foundation News, September 1964, at 1.

public administration. Indeed, there is no reason why they should be, since there are no consumers to be pleased and no market pressures to induce economy, efficiency, and innovation. Consequently, there is no guarantee that government — federal, state, or local — can necessarily provide better administration or wiser allocation of funds as a result of the exercise of taxpayer choice.

Furthermore, taxpayer choice in allocation of monies is more apparent than real, even for the high bracket taxpayer, as even state and local governments whose bonds enjoy an AAA rating are resorting to stratagems which render it difficult if not impossible for a bond purchaser to make rational investment choices. For example, in one populous midwestern state, the legislature has created a state agency authorized to issue bonds to finance private higher education facilities.³¹ The agency, however, cannot pledge the credit of the state. Under the statute, a private college or university may enter into an arrangement with the agency pursuant to which the agency will issue bonds to finance a building project for the school. If the facility is self-liquidating, like a dormitory or stadium, then the user fees will be put into a trust account to service the debt and ultimately to pay the bonds; if not, the facility may be mortgaged to the agency.³² The point of the elaborate arrangement is to make the state's borrowing power available to a private educational institution and, of course, to obtain a federal contribution to the project through the exemption of the interest paid on the bonds. When the municipal bond exemption is used in this way, even a fairly sophisticated taxpayer will have a difficult time unraveling the plot so as to be able to make a reasonable investment decision, to say nothing of choosing rationally among a variety of bond-funded local projects. He knows no more about the project than a contributor to a charitable organization generally knows about the object of his bounty. The contribution and bond purchase are, in the long run, the result of refined and sophisticated marketing techniques.³³

In theory, then, a laissez faire allocation of revenues based on informed investor choice is very appealing, but obviously, does not work well in practice. While we may look askance at allocation by the federal government, we ought to keep in mind that when the issue is the municipal bond interest exemption, it is the federal gov-

³¹ OHIO REV. CODE ANN. §§ 3377.01-.16 (Page 1972).

³² *Id.* at § 3377.07.

³³ J. CUTLIP, *FUND RAISING IN THE UNITED STATES: ITS ROLE IN AMERICA'S PHILANTHROPY* 531 (1965).

ernment's money that we are talking about. Generally, federal grants-in-aid to state and local governments are made pursuant to congressional appropriations expressive of national policy, and very few of these have no federal strings attached. In the future, it may be absolutely necessary to provide untied grants and "no strings" revenue sharing,³⁴ but such a shift will again be the result of federal policy. The exemption of municipal bond interest, however, results in a completely "no strings" subsidy of federal funds. The only justification for this departure from the usual policy that the federal government controls the spending of federal monies is the argument previously suggested: that this is not really a subsidy in the usual sense but simply the result of a constitutionally ordained limitation upon the federal taxing power.³⁵ If, however, the matter is open to congressional action, then it would seem that the legitimate claim for the right to allocate is still in the hands of the federal government and ought to remain there unless Congress decides to continue the present state of affairs. In that event, the evils attending allocation by taxpayer choice should be carefully considered.³⁶ As I have noted, there is much to be learned in this respect from our experience with charitable contributions.³⁷

In view of the foregoing, it is difficult to sympathize with the often advanced argument that elimination of the interest exemption is an attack upon the independence and integrity of state and local governments. It is not an attack upon state sovereignty or local government to suggest federal control of federal funds; nor is such an attack implied in the proposition that the federal government is not under obligation to put state and local governments in a better borrowing position than corporate borrowers — at federal expense. This is particularly true when no one is sure whether the exemption feature actually gives a municipal bond a significant advantage over its taxable competition.

In any event, the relation of the exemption to the allocation of federal revenues has not been extensively discussed in the current literature. The discussion presented here is intended merely to de-

³⁴ Pechman, *supra* note 26, at 286. A revenue sharing program has recently been enacted by Congress. See State and Local Fiscal Assistance Act of 1972, Pub. L. No. 92-512, 86 Stat. 919 (1972 U.S. CODE CONG. & AD. NEWS 4949).

³⁵ In this respect, the municipal bond exemption differs from the charitable deduction, the latter being the result of a congressional policy which can be altered by legislation at any time.

³⁶ See Keyserling, *Revenue Sharing: Its Implications for Present and Future Intergovernmental Fiscal Systems: The Case Against*, 24 NAT'L TAX J. 313, 315 (1971).

³⁷ See note 27 *supra* & accompanying text.

lineate the problem and to suggest that further study in this area would be helpful and productive.

D. *Efficiency and Equity — The Economic Arguments*

The writings of the economists on the subject of municipal bond interest lend great force to the description of economics as the " dismal science." It is difficult enough to follow economic arguments when economists agree, but to draw conclusions when they disagree is virtually impossible. And economists disagree on almost every issue in this area, from the viability of the future market to the inefficiency of the exemption itself. For example, Professor Surrey's statement that the market for municipal bonds is dwindling so rapidly that credit demands will overwhelm it is supported by the assertions of two very knowledgeable economists.³⁸ On the other hand Patrick Healy, Executive Vice President of the National League of Cities, maintains that the economists' assertions are based on factual errors. The economists had concluded that state and local governments were unable to find buyers for about half of the normal volume of new issues despite historically high rates of interest. Mr. Healy says that this may have been true in 1969, which was an abnormal year, but that long term borrowing fell off only 25 percent from projections.³⁹

The disagreement concerning the future of this market is due to uncertainty about the character of two of the market's major components. First, while everyone seems to agree that the commercial banks make up the most important single component of the municipal bond market,⁴⁰ and that municipal bonds are not a primary investment vehicle for commercial banks but occupy a tertiary position in their investment portfolios,⁴¹ no one is certain what commer-

³⁸ *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. pt. 4, at 2312 (1969) (Statement of E. F. Renshaw and D. J. Reeb).

³⁹ Healy, *Further Comments on Proposed Capital Financing Alternatives*, 37 TAX POLICY, No. 1-2 January-February, 1970, at 3 n.5.

⁴⁰ The Federal Reserve Board of Governors, in the *Federal Reserve Bulletin* of May 1968, calculated that as of December 31, 1967, 42.6 percent of all outstanding municipal bonds were in the hands of commercial banks. The FRB also calculated that commercial banks purchased 67 percent of all municipal bonds issued between 1963 and 1967. These calculations do not, of course, reflect the later course of events stemming from the credit crunch of 1969 and 1970 which resulted in commercial banks being net sellers of municipal bonds.

⁴¹ BANKERS TRUST CO., INVESTMENT OUTLOOK FOR 1970 (1970); Ackerman & Ott, *An Analysis of the Revenue Effects of Proposed Substitutes for Tax Exemption of State and Local Bonds*, 23 NAT'L TAX J. 397, 398 (1970); Galper & Petersen, *An Analysis of Subsidy Plans to Support State and Local Borrowing*, 24 NAT'L TAX J. 205, 209 (1971).

cial bank demand means, what effect it has on municipal bond yields, or what the future holds for this component of the market. Much depends on the course of inflationary pressure since it affects monetary policy, which, in turn, affects loan demand.⁴² There is considerable evidence that the demand for municipal bonds by commercial banks is relatively insensitive to market yields and depends largely on a number of other considerations, particularly the strength of loan demand.⁴³

Second, it is generally agreed that "household" owners of municipal bonds (which include individuals, trusts, and profit organizations) are another crucially important component of the market⁴⁴ — one which is more sensitive to yields, since the inducement to purchase municipal bonds exists only when the after-tax yield on taxable securities is less than the yield on tax-exempts. There is, however, considerable doubt about the actual composition of this component. Many high bracket individuals apparently prefer not to hold municipal bonds and, although it is generally the wealthy who do hold them, these holders probably represent a fairly wide range of surtax brackets.⁴⁵

Because of the uncertainty in much of the supporting data, it is difficult to choose between the pessimism of the opponents and the optimism of the proponents of the exemption with regard to prognostications of the future market for tax-exempt securities. The safest thing to be said is exemplified by the following quote from two distinguished students of the subject:

In summary, both theory and empirical analysis indicates that municipal yield (and credit flows, given the responsiveness of the supply of bonds) are jointly determined in the following way:

(1) by large exogenous shifts in the demand for these securities by the major institutional investors (mainly banks) and

(2) by the responsiveness of household investors who, collectively representing a continuum of marginal tax rates, will invest in tax-exempt securities until that point when the after-tax returns on comparable taxable and tax-exempt investments are equilibrated by the marginal tax-bracket investor.⁴⁶

Of course no one is sure just what causes "large exogenous shifts" in the holdings of commercial banks and what in the future may

⁴² Galper & Peterson, *supra* note 41, at 206.

⁴³ *Id.* at 209.

⁴⁴ The *Federal Reserve Bulletin* of May, 1968, showed households to be the holders of 34.7 per cent of all municipal bonds outstanding as of December 31, 1967.

⁴⁵ See text accompanying note 11 *supra*.

⁴⁶ Galper & Petersen, *supra* note 41, at 211.

influence such shifts; nor does anyone know for sure just who the household investors are, since they represent a "continuum of marginal tax rates."

If the reader is confused as to the underlying facts relied on to support assertions about the future of the municipal bond market that confusion is minor compared to what awaits him in the arguments over the "inefficiency" of the interest exemption as a subsidy. The opponents of the exemption, it will be recalled, maintain that the state and local governments do not save in borrowing costs what the federal government loses in tax revenues as a result of the exemption. Treasury Department figures place the annual revenue loss at \$2.63 billion, while the savings on interest costs to the state and local governments is estimated to be only \$1.86 billion.⁴⁷ This figure is arrived at by assuming that if municipal bond interest were taxable, the average marginal tax rate for the interest would be 45 percent, which is apparently the same average marginal tax rate applicable to the present holders of taxable securities.⁴⁸ If this assumption is correct, the reconstitution of the market in response to taxability of municipal bond interest would no doubt result in a very substantial loss to the treasury — and the amount of this loss is crucial in assessing the degree of "inefficiency" in the subsidy. The proponents of the exemption, however, have produced some evidence to indicate that the assumption is not warranted. A 1969 study by the Investment Bankers Association⁴⁹ concluded that if only taxable municipal bonds were available, there would be a redirection of funds away from such issues into the short term market. Relatively low bracket individuals and savings institutions would be attracted to the municipal bond market, while traditionally heavy buyers such as commercial banks, high bracket individuals and casualty insurance companies would reduce their holdings. As a consequence, the results of this study support an estimated marginal tax rate of 33.5 percent for holders of taxable municipal bonds in this reconstituted market. If we now assume a marginal tax rate of 33.5 percent rather than the Treasury's projected 45 percent, the conclusions as to "inefficiency" of the subsidy must be altered to some considerable extent. Moreover, this would also have a substantial

⁴⁷ Surrey, *The Tax Treatment of State and Local Government Obligations — Some Further Observations*, 36 TAX POLICY, Nos. 9-10, September-October 1969, 3, at 11.

⁴⁸ *Id.*

⁴⁹ INVESTMENT BANKERS ASSOCIATION, ECONOMIC COSTS OF ISSUANCE OF TAXABLE MUNICIPAL BONDS WITH A FEDERAL SUBSIDY (1969).

effect on the analysis of certain subsidy alternatives which are discussed below.⁵⁰

The reasons for the divergent conclusions reached by the Treasury and Investment Bankers Association are not entirely clear. It may be, as Mr. Patrick Healy suggests, that the Treasury Department assumptions are based on a 1963 study by the Brookings Institution which admittedly gave no consideration to certain factors which would materially affect its conclusions.⁵¹ The Investment Bankers Association study apparently did consider several of these factors.⁵² This may or may not account for the different results, but it certainly provides the proponents of the exemption with new ammunition for their statistical war with the Treasury.

Once again, the studies produced by the economists and market experts render it difficult to decide the validity of a key element in the interest exemption issue. Traditional wisdom has always had it that the exemption resulted both in an inefficient subsidy and in a windfall to the wealthy investor. The IBA study does not necessarily reject this proposition because it says nothing about the assumption of a 45 percent marginal tax rate for *present* large holders of *tax-exempt* municipals. However, it does show that the treasury would not necessarily regain the amount of revenue it is now "losing" through the exemption by eliminating the exemption and forcing *taxable* municipal bonds into the hands of low marginal rate holders. Thus, the efficiency of the subsidy may not be improved by elimination of the exemption.

This leaves for consideration the inequity or windfall argument.

⁵⁰ See text accompanying notes 64-72 *infra*.

⁵¹ The Brookings Institution summarized the factors as follows:

It was further noted that several factors would modify the calculations and should be further investigated: (1) no account was taken in the calculation of a possible general rise in interest rates—but the conferees were not in agreement that there would be such a rise; (2) equity investments other than corporate stock might be considered as alternative investments by high-income taxpayers, especially real estate purchasers; (3) United States government bonds that are acceptable at par in payment of estate taxes might become more attractive, and this would create nontaxable capital gains rather than taxable income for the purchaser; (4) the capital gains return in the calculation was based on an abnormal bull-market period; (5) the interest cost differential for municipals with and without the exemption may be larger than the ranges used in the computations; and (6) reciprocal state taxation of federal securities may increase the interest costs of the federal government. The net effect of all of these factors on the revenue estimate was discussed, but no agreement was reached. (footnote omitted).

D. OTT & A. MELTZER, *FEDERAL TAX TREATMENT OF STATE AND LOCAL SECURITIES* (1963) cited in Healy, *supra* note 39, at 6.

⁵² Healy, *supra* note 39, at 6.

Here, it seems, there can be no question that a shift to taxable municipal bonds will eliminate the inequity. Can it be, then, that the opponents of the interest exemption are not really so concerned about the inefficiency of the interest exemption as a subsidy, and that what they really care about is the fact that it is a double-barrelled inequity, to wit: a preference which benefits the wealthy, pure and simple, and a preference which (among many others) spoils the elegance and progression of the income tax by eliminating a normally taxable item of income from the tax base?

It is no secret that many tax authorities have advocated the elimination of so-called "back-door spending" through the use of tax preferences, credits, deductions and allowances.⁵³ Some writers take this position because they advocate the adoption for income tax purposes of the economists' definition of income — a definition so comprehensive that it would require the eradication of virtually all preferences of every kind and variety.⁵⁴ Their opposition to the municipal bond interest exemption is "neutral" in the sense that *any* departure from their proposed comprehensive tax base is viewed with hostility. Other authorities appear to oppose most vigorously those tax preferences which seek to foster some social or economic policy through "tax incentive" devices that offer monetary rewards to taxpayers who voluntarily go along with the scheme. Their position is that a direct government subsidy is a much more rational way to achieve social, economic or other national policies than are tax incentives.⁵⁵ Their opposition to the municipal bond interest exemption is more particular and emphatic than the neutral opposition of the exponents of the comprehensive tax base. The interest exemption is a tax incentive device offered to taxpayers on a voluntary basis to induce the purchase of tax exempt municipal bonds. It therefore partakes of the evils of all tax incentives: absence of public and congressional scrutiny, inequity of benefits, misallocation of resources, and constriction of the tax base.⁵⁶

Given an initial objection to any system of tax incentives, it now becomes considerably easier to understand much of the opposition to the interest exemption. The opposition does not exist merely

⁵³ See, e.g., Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970).

⁵⁴ HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE (Comm. Print 1959).

⁵⁵ See Surrey, *supra* note 15.

⁵⁶ *Id.*

because economic data and projections show that the particular subsidy is inefficient and promises to become progressively less efficient; it is a much more basic and thoroughgoing opposition which, it seems, transcends the issue of gains to the states and losses to the federal government. I would assume that even an efficient, indirect subsidy, if it qualifies as a tax incentive, would be as vigorously opposed. This is why it has been previously suggested that perhaps the argument over efficiency and its underpinnings of projections, assumptions, and prognostications is not what is crucial to these opponents of the exemption. What we are really talking about, again, is opposition to tax incentives as a way of implementing and pursuing a policy. That this is so is amply borne out by what Professor Surrey proposed as a substitute or alternative to the exemption: a taxable municipal bond with a direct federal subsidy to the state and local governments to make up for increased borrowing costs.⁵⁷

In analyzing the efficiency of the present subsidy, one cannot escape the feeling that for the opponents of the exemption this is a tail-wagging-the-dog sort of argument. It seems that the opposition to the interest exemption would be better served by applying the general arguments against tax incentives to this particular case. These, after all, are the telling arguments. Why, then, the reliance on the controversial and less effective side of the case? Professor Surrey himself has provided a partial answer to this question:

[I]n comparing the tax incentive technique with a direct expenditure technique, the comparison to be meaningful must involve *similar substantive programs*. There is no point to saying in a particular situation that a tax incentive is a more useful approach because it involves no government supervision over the details of the action to be induced, whereas a direct expenditure involves detailed supervision. This is not comparing a tax incentive with a direct expenditure — it is simply comparing a loosely controlled method of paying out government funds with a tightly controlled method. But we can have a loose or a tight method under the direct expenditure route. The meaningful choice is between a loosely controlled program and a tightly controlled program. . . .

The matter of what type of substantive program is best calculated to achieve the desired goal lies in the fields of cost-benefit and cost-effectiveness analyses. These methods are being utilized more and more to devise and test direct expenditures, and they should a priori be equally applicable to programs using a tax incentive technique.⁵⁸

Here is the crux of the problem. It will not do to simply use

⁵⁷ Surrey, *supra* note 9, at 9.

⁵⁸ Surrey, *supra* note 15, at 14.

general arguments in passing judgment on a particular tax incentive program as compared to a direct government subsidy of the same substantive program. This can only be done meaningfully if we use econometric techniques of cost-benefit and cost-effectiveness. In the case of municipal bond interest, Professor Surrey is practicing what he preaches. He has emphasized the importance of the economic studies which purport to measure the cost-benefit and cost-effectiveness of the exemption and he concludes that this is a poor incentive device. In other words, he is driven by his own reasoning to accept and rely upon econometric studies which, in this case, have produced some divergent results. Even if one accepts, *arguendo*, Professor Surrey's notion that econometric studies "and the like" should be utilized as a methodological approach to a comparison of incentives and direct subsidies, one would hesitate to make so important a comparison on the basis of conflicting results.

The argument against the exemption is more convincing when Professor Surrey points out the inequity of this incentive and emphasizes the fact that it gives state and local government an unfettered call on federal revenues.⁵⁹ I am not quite certain that the only difference between the exemption and his alternative proposal for a direct subsidy is that the former does not appear in the federal budget while the latter would, but it is certainly a more appealing argument.

A critical appraisal of the Surrey approach to the interest exemption points up some of its difficulties. We begin with the proposition that all tax incentives share certain inherent evils. But when we compare a particular tax incentive with a similar substantive program effected by a direct subsidy, we are comparing loosely controlled programs (incentives) to tightly controlled ones (subsidies). A meaningful choice between the two can only be made on the basis of econometric and like studies which examine the cost-effectiveness of each type of substantive program. Only this tells us which route to take to achieve our policy goals. In other words neither the good nor the evils of tax incentives, as opposed to subsidies, are important or meaningful elements in choosing between the two methods of achieving a policy goal. A loose versus a tight program of control is the only meaningful issue.

If the econometric analysis indicates that the proper choice is a tight program, then there must be a direct subsidy. If, however, a loose program is preferable, then there is a further choice to be

⁵⁹ See Surrey, *supra* note 15.

made: which loose program is best. It is at this point that the relative efficiencies of the loosely controlled direct subsidy and the exemption become important. But as we have seen, the data on efficiency is at best inconclusive, thus statistical analysis is of no help in making the second decision. In order to resolve the problem, one must rely on general arguments which militate against the use of tax incentives, even if, in the long run, a loosely controlled subsidy may be no more efficient than the incentive. This brings us full circle to the argument that all incentives are inherently bad, or at any rate, inherently worse than loosely controlled subsidies.

If we apply the general arguments concerning tax incentives to the municipal bond interest exemption, the bill of particulars would be something like this: (a) The effectiveness of the exemption is at best unmeasurable and at worst less than acceptable; (b) The exemption is buried in tax detail and hence obscured from public and congressional view; (c) The exemption favors the high bracket taxpayer; (d) The exemption rewards a taxpayer who might otherwise buy municipal bonds anyway; (e) The exemption fosters misallocation of resources, and distorts normal investment choices; (f) The exemption narrows the tax base. Granted, this is a damning indictment and it may well be that each and every particular is largely true (except, perhaps, the statement that the exemption is obscured from congressional and public view). But if the choice is between the exemption and a totally uncontrolled subsidy, I am not sure that several of the same arguments could not be levelled against such a subsidy. A "no strings" subsidy does nothing to alter the allocation of government revenues. It is doubtful that the public or Congress (particularly when both are in a tax reform mood) would be more aware of a direct expenditure than of a well publicized interest exemption, and econometric studies have not conclusively shown anything except that it is difficult to measure the effectiveness of the exemption. Finally, the exemption does narrow the tax base, but until such time as the issue of reciprocal tax immunity is resolved by the Supreme Court or by a constitutional amendment, this narrowing must be treated as a constitutional limitation on the taxing power of Congress.

Even if the exemption were an ordinary preference or incentive, one might suggest that its narrowing of the federal tax base is no more culpable than the narrowing resulting from the exemption of social security, or from the medical expense deduction, although, the exemption's opponents would hasten to point out that one does

not incur doctor bills just to get a deduction or grow old to get social security.⁶⁰ But there are many other preferences which operate by voluntary taxpayer choice, such as the split income provisions for married taxpayers, the use of trusts and anticipatory assignment to deflect income, and the choice of taxable periods and accounting methods. Professor Boris Bittker has suggested that these latter preferences are often ignored because they are considered to be "structural" or theoretical components of any income tax system but that they are tax incentives just the same.⁶¹ It has been previously suggested that the municipal bond interest exemption might be in the same category by virtue of the doctrine of reciprocal immunity which is thus built into the tax system as a component structural member.⁶²

Perhaps the only argument against the exemption which can be explained and justified is one which is not entirely rational: that in a progressive tax system, there is something basically unfair about an arrangement which gives the wealthy a broad opportunity to avoid tax on investment income. It is concededly a gut argument based on notions of fairness and responsibility in the imposition of tax burdens. In this respect, the entire debate about the exemption reminds one of Blum & Kalven's now famous discussion of the case for progressive taxation.⁶³ After analyzing the various traditional rationales for progression they decided that the case was a very uneasy one and that, ultimately, its only solid defense was the feeling of the American public that it is a fair system of distributing the income tax burden. The same is largely true of the case against the exemption of municipal bond interest. It is an uneasy case if it relies solely on rational objections.

III. THE ALTERNATIVES TO THE EXEMPTION

A. *The Proposals*

The opponents of the exemption realize full well that its total elimination would put state and local governments in a difficult position. There is some evidence which indicates that such a course might well result in higher interest costs to those governments if

⁶⁰ See Surrey, *supra* note 16, at 712 n.6.

⁶¹ Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, NAT'L TAX J. 244, 250 (1969).

⁶² See text accompanying notes 18-24 *supra*.

⁶³ Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. R. 417 (1952).

the costs paid by issuers of taxable securities.⁶⁴ Be that as it may, it is clear to everyone that long term borrowing is a crucial part of the development programs of all state and local governments and that somehow the federal government must aid those governments in their bond financing efforts.⁶⁵ This leads us to a consideration of the alternatives which have been proposed to replace the interest exemption. The basic proposition is that one or a combination of these alternatives will substantially improve state and local borrowing capacity, even in the absence of the exemption. There are three major proposals: (a) a direct subsidy to state and local governments which elect to issue taxable securities; (b) the creation of a federally chartered and sponsored financial institution which will issue its own taxable securities and lend to state and local governments at favorable interest rates (hereafter referred to as the "Ur-bank Plan"); and (c) a direct subsidy to tax-exempt organizations to induce them to invest in state and local securities.

Probably the best publicized alternative of the three which we will consider is the one which proposes that a direct federal subsidy be paid to those state and local governments which agree to give up the interest exemption and simply issue taxable securities in competition with other taxable issuers through the usual marketing techniques. This is the familiar proposal to which we have previously adverted and which appeared in the House version of the Tax Reform Act of 1969.⁶⁶ Under this proposal, the federal government would pay to the issuing governments between 25 and 40 percent of the interest cost of a taxable issue. This payment would be a completely "no strings" subsidy without federal control or review, so that all allocation decisions would remain with the issuing governments. The proponents of the plan anticipate that the savings to the treasury resulting from the issuance of taxable securities by state and local governments will be sufficient to support the subsidy. Treasury Department figures (based on a 45 percent average marginal tax rate for present holders of municipals) indicate a loss of \$2.63 billion and an assumed saving to state and local governments of only \$1.86 billion. It has been estimated that if municipal bond interest were taxable, the direct subsidy could be as high as 45

⁶⁴ LEBENTHAL & CO., INC., HOW THE PROPOSED TAX ON MUNICIPAL BONDS WOULD AFFECT THE AVERAGE INDIVIDUAL INVESTOR AS SET FORTH IN H.R. 13270 (1969).

⁶⁵ Surrey, *supra* note 9, at 9.

⁶⁶ H.R. 13270, 91st Cong., 1st Sess. (1969).

percent without any loss to the treasury.⁶⁷ If we accept these figures and assumptions, this plan has the advantage of simplicity, ease of administration, and the absence of any major disruption in present borrowing procedures.

The Urbank Plan (Urban Development Bank) is based on models which are not entirely new in concept, but its application to the support of the municipal bond market is novel. This plan would have the federal government establish and sponsor a lending institution which would have the authority to issue its own taxable securities at going interest rates and to relend the proceeds of its own borrowings to state and local governments at preferential rates. The difference between the rate of interest paid by the Urbank and the amount charged to state and local governments would be made up by a federal subsidy to the Urbank.⁶⁸

The third proposal is to induce tax-exempt organizations, primarily public retirement funds, to purchase state and local bonds by offering a direct subsidy to these funds, that is, a subsidy to the *investor* rather than to the issuer of the bonds. Since tax-exempt investors receive no benefit from the municipal bond interest exemption, they have been a very minor element in the municipal securities market. The purpose of this subsidy proposal is to draw these exempt public retirement organizations and their large financial resources to the municipal bond market in order to widen and expand it. The plan could, of course, be extended to cover tax-exempt private pension and profit sharing plans as well as the public retirement funds. An important feature of this proposal is that municipal bonds would remain tax-exempt and thus there would be no need to disrupt current marketing procedures.

All three of these proposals are direct subsidy plans. From an economic and credit market point of view they have several important common features, but for the time being some general observations are in order. First, to those opponents of the interest exemption whose primary object is tax equity — taxation of high income taxpayers at high marginal rates — the third proposal is probably not quite as interesting as the others. The only effect of this proposal is to broaden the market for tax-exempt municipal securities by extending a monetary benefit to potential investors who are already favored by a total exemption from income taxes. It is pos-

⁶⁷ Surrey, *supra* note 47, at 11-12.

⁶⁸ A proposal for an Urbank was submitted by President Johnson in 1969, and legislation to effect its establishment was introduced by Senator Sparkman. S. 409, 91st Cong., 1st Sess. (1969).

sible, however, that if the immense resources of retirement funds are drawn to the municipal bond market, the number of tax-exempt securities available to high bracket individuals will be decreased and they may be forced into fully taxable investments. If this happens, then tax equity will be improved and so will the efficiency of the interest exemption, since the "leakage" to high bracket taxpayers will be restricted. On the face of it, this would appear to satisfy the objections which have been raised. It is difficult, however, to imagine a subsidy proposal which is more like a straightforward tax incentive than this one. It offers a monetary reward for doing voluntarily what the retirement funds could be doing anyway. It gives the federal government no voice in the allocation of the subsidy, and while it may bring some high bracket income back into the tax base, this result is predicated on some rather tenuous assumptions concerning long term credit flows.

The proposed direct federal subsidy to state and local governments, coupled with the optional issuance of marketable securities, seems to be the alternative of choice among many of the opponents of the interest exemption. It is strongly favored by Professor Surrey.⁶⁹ In requiring the issuance of taxable securities on an optional basis, it avoids entanglement with the doctrine of reciprocal tax immunities. It also has the advantage of taxing all holders of taxable bonds and thus avoiding leakage to high bracket holders. As in the other plans, the increased revenue from the broadened tax base will presumably pay for the subsidy, thus rendering it more efficient as well as more equitable. Unfortunately, there is some severe disagreement concerning the mathematics of this proposal. It will be recalled that the Treasury's estimate of revenue loss from the exemption was \$2.63 billion, based on an average marginal tax rate of 45 percent for present municipal bond holders, while the savings to state and local governments is \$1.86 billion. If taxable municipals are issued, then the composition of the market is likely to be changed in two ways: high bracket individuals will give up municipals for other investments, whereas lower bracket taxpayers will move in, thus lowering significantly the average marginal tax rate of municipal bond holders (to approximately 25 percent according to the IBA study⁷⁰). Mathematically, it does not seem possible to have a subsidy in excess of the marginal tax rate of investors holding exempt securities and still avoid a loss to the treasury. If we assume

⁶⁹ Surrey, *supra* note 9, at 9-10.

⁷⁰ INVESTMENT BANKERS ASSOCIATION, *supra* note 49.

an annual growth rate of 8.7 percent in the volume of municipal borrowing, together with a federal subsidy of 40 percent of the aggregate interest costs of the taxable securities, then by 1975, the cost of the subsidy to the treasury will be about \$4.04 billion. A substantial recomposition of the municipal bond market in the direction and manner indicated by the IBA study would make it unlikely that the cost of the subsidy to the treasury could be covered by increased tax revenues.⁷¹ Instead of an inefficient tax incentive we would then have an inefficient subsidy, although the equity of the tax would be improved by forcing high bracket holders into a taxable position whether they hold municipal bonds or shift to other taxable investments.

Professor Surrey deals with this argument as follows:

But for the moment assume some loss — for the sake of argument, since I would accept the Treasury data. Why does that loss mean the provision is inadvisable? The federal government is now paying \$25 billion annually in grants to state and local governments. . . . In this light, why is a "loss" to the federal government an argument against the House alternative — isn't revenue sharing, aren't grants, a "loss"?⁷²

We must agree with Professor Surrey that grants-in-aid and revenue sharing are "losses" in the sense that they are simply expenditures to the treasury. But then *all* federal subsidies are "losses" in this sense. If we are willing to concede that a switch from tax-exempt municipals to taxable municipals may result in a loss to the treasury, then the only significance of the argument about the "inefficiency" of the present exemption is that one of the primary beneficiaries of the present system is the high bracket taxpayer who is not the intended object of the bounty. Thus, one strongly suspects that the real concern behind the choice of this alternative is the elimination of the tax inequity represented by the incentive and not its efficiency or inefficiency. Professor Surrey is prepared to accept a subsidy which is a "loss" to the treasury, even if it is a completely loose subsidy which shares some of the basic flaws of the incentive, to resolve what appears to be a gut issue of tax fairness. There is nothing wrong with such a position if it is clearly and expressly stated.

The Urbank Plan is really a variation of the direct federal subsidy proposal, except that instead of having state and local governments issue taxable securities for sale directly to the investor, a new financial intermediary is interposed between investor and issuer

⁷¹ Healy, *supra* note 39, at 8-9.

⁷² Surrey, *supra* note 47 at 12.

The federally chartered intermediary will become the investment vehicle because the ultimate investor will buy only the Urbank's taxable securities and only the Urbank's credit will be available to him. In turn, the Urbank will be the underwriter of state and local issues. Since this underwriting will be done upon terms and conditions specified by the Urbank, it will replace the conventional capital market as the allocator of funds to state and local issuers. In theory, the Urbank will reduce the cost of borrowing to the state and local issuers and at the same time broaden the market for state and local issues. The federal subsidy will be paid to the Urbank to fund the spread between the interest rates which the Urbank will pay on its own securities and the preferential interest rates which will be paid by the state and local issuers.

There are some significant differences between this proposal and the direct subsidy plan. The latter is essentially a "loose" subsidy in the sense that it would leave unaltered the present scheme of allocation of credit on the basis of investor choice in the capital market without federal control. The Urbank proposal bears the seeds of a more tightly controlled system of allocation through a federally chartered intermediary which will lend upon its own terms and conditions. Depending upon what those terms and conditions are, it may well have a life and death influence over state and local borrowing. Like the direct subsidy plan, this proposal fosters tax equity by eliminating the exemption, but its ultimate cost to the treasury is questionable and so, therefore, is the efficiency of the subsidy. Unlike the direct subsidy though, this plan calls for a whole new ballgame regarding the allocation of long term credit to state and local programs by the direct interposition of a federally sponsored agency to make long term loans to state and local governments. It should be noted, however, that under the Urbank Plan, the state and local governments would still have the option of issuing conventional exempt securities or borrowing from the Urbank at the subsidized low interest rate.

B. *The Economics of the Alternatives*

In examining the economic and market effects of these three proposals, there are some basic similarities to be noted. First, all three will continue to depend upon the investing public to supply a flow of long term credit to state and local governments. Thus, given no basic change in monetary policy, any expansion of the market for state and local securities, whether taxable or nontaxable, will inevi-

tably affect the availability of credit to other credit seekers. In other words, success in expansion of the municipal bond market spells trouble for other borrowers. The very attempt to expand the market for municipals implies a decision that the credit requirements of some borrowers will not be met.⁷³ Furthermore, the curtailment of credit to other sectors may involve some unpredictable benefits and costs. It seems advisable, then, before proceeding along these lines to attempt some assessment of what dislocations will occur and what their effects will be. While such a study is far beyond the scope of this article, one could reasonably conjecture that state and local industrial revenue bond sales would probably suffer considerably as a result of the expansion of the market for general obligation bonds, as would some of the smaller utility issues.

The second common feature of these plans is that they are not intended to *totally* displace the interest exemption. Thus, as previously noted, neither the Urbank Plan nor the direct subsidy plan requires state and local governments to issue solely taxable securities. In both plans, the issuing governments would presumably elect the subsidy or use the Urbank scheme only as long as borrowing costs under these alternatives are less than those incurred in the issuance of tax-exempt bonds. The very existence of the option to use either tax-exempt bonds or subsidized taxable bonds, however, hopelessly complicates the process of predicting the cost of the subsidy. It will be recalled that in our prior discussion of this matter, attention was focused on the marginal tax rates of *all* buyers of exempt bonds.⁷⁴ But these studies may be totally irrelevant in a market where there are both taxable and nontaxable securities. The question is who will switch to taxable investments, and to what extent, since, clearly, some investors will remain with tax-exempt issues, while others will leave the tax-exempt market.

Two analytic techniques have been used in recent years to determine whether a shift from tax-exempt to taxable bonds will result in treasury receipts that match the required subsidy. The two differ radically in approach and method and, as one might expect, they produce contradictory results. The "empirical" approach consists of an analysis of recent investors in municipal bonds, their tax brackets and the probable tax effects to those investors of a shift to taxable investments. The basic assumption in this approach is that the marginal investor — the lower bracket purchaser of municipals —

⁷³ Galper & Petersen, *supra* note 41, at 213.

⁷⁴ See text accompanying notes 48-50 *supra*.

will be the first to leave the tax-exempt market in favor of other investments. The major study using this technique is that prepared by the staff of the Joint Economic Committee of Congress (JEC) in 1968,⁷⁵ which concluded with the optimistic view that a direct subsidy alternative could produce sufficient revenues to fund the subsidy. Another study using a similar empirical approach is the previously described IBA study,⁷⁶ which arrived at the opposite conclusion.

The other technique is the "mathematical" method employed by the staff of the Federal Reserve Board (FRB) in its study of the subsidy proposals.⁷⁷ This study employs algebraic analysis to show that the amount of the subsidy required for the new taxable securities will be precisely the same percentage of the interest cost as the marginal tax rate of the new marginal buyer of tax-exempt securities. It assumes that the marginal buyer of tax-exempt securities is the buyer who realizes the same after tax return that he would have realized on taxable securities of the same risk. In other words, the marginal buyer will buy tax-exempts at an interest rate which is the same as the rate on taxable bonds, discounted by the percentage of his marginal tax rate. Once this marginal buyer has been squeezed out of the tax-exempt market, the new marginal buyer of tax-exempts will have a higher marginal tax rate than the old marginal buyer who has now switched to taxable investments. The increased revenue resulting from this forced shift of the old marginal buyer will therefore be less than the cost of the subsidy.

In order to explain these contradictory results, let us take the proposed optional subsidy plan as a model to see how the two approaches outlined above would operate. We begin with the basic elements of this proposal: that state and local governments have the option of issuing either subsidized taxable securities or tax-exempt securities. The interest rate paid on tax-exempt securities will be less than the going market rate on all taxable securities. The interest rate paid on the new taxable municipals will be less than the going rate on taxable instruments and also less than the going rate

⁷⁵ *Hearings on Public Facility Requirements Over the Next Decade Before the Subcomm. on Economic Progress of the Joint Economic Comm. on Public Facility Requirements Over the Next Decade*, 90th Cong., 2d Sess. 75-93 (1968).

⁷⁶ See note 49 *supra*.

⁷⁷ *An Analysis of the Cost and Revenue Implications of the State and Local Borrowing Subsidy Plans Found in H.R. 15991 and S. 3170*, in *Hearings on Financing Municipal Facilities Before the Subcomm. on Economic Progress of the Joint Economic Comm.*, 90th Cong., 2d Sess., at 360-63 (1968).

on bonds which are presently tax-exempt. Since the subsidized cost of issuing taxable bonds is less than the unsubsidized cost of issuing tax-exempts, the state and local governments should respond by issuing more taxable bonds. The effect of an increase in the supply of taxable securities is to raise the going rate of interest on taxable securities generally (due to competition among issuers), but the effect of the subsidy is nevertheless a decrease in the interest costs of state and local issuers which induces greater borrowing. The increase in the interest rate on taxable issues restricts borrowing by taxable issuers. According to the JEC analysis, the high bracket taxpayer responds to the product of a restricted supply of nontaxable municipal bonds and increased interest on taxable municipals, by switching his investments out of tax-exempts and into taxable municipals (and other taxable issues). This redirection raises enough revenue to pay for the subsidy, provided that it is indeed the high bracket investor who does the switching, and provided further that the hypothetical investor does in fact switch to a form of investment which does not shelter his income to any substantial extent.⁷⁸ The JEC further argues that over 90 percent of recent purchasers of tax-exempt municipals are in a 48 percent marginal tax bracket. If we extrapolate and assume a 48 percent marginal tax rate for all present holders, then, according to the JEC study, a forced switch of only 5 to 20 percent of current holders of tax-exempts into taxable investments would be required for increased tax collections to cover the cost of the subsidy.⁷⁹

The FRB study offers some startlingly different conclusions. If the assumption is made that the investor compares the after-tax yield of taxable and tax-exempt securities of similar risks, then the first investor to switch to taxable instruments in the event of a downward movement of interest rates on tax-exempts will be the investor with the lowest marginal tax rate, the marginal investor. If we again use the direct subsidy plan as an example, then the institution of a subsidized low interest rate on new taxable municipals will cause marginal investors to leave the exempt market. This result is due to the fact that, as state and local governments opt for

⁷⁸ An investor who is forced out of the exempt municipals market has any number of alternatives. He could for example, buy equities which would put him in a position to realize capital gains. This would appear to be an acceptable alternative to the exemption. It should be noted, however, that commercial banks do not have the same investment flexibility as individual investors and that their choices may be limited to other, fully taxable and unsheltered investments. This emphasizes the importance of the composition of the municipals market, both at present and under a subsidy scheme.

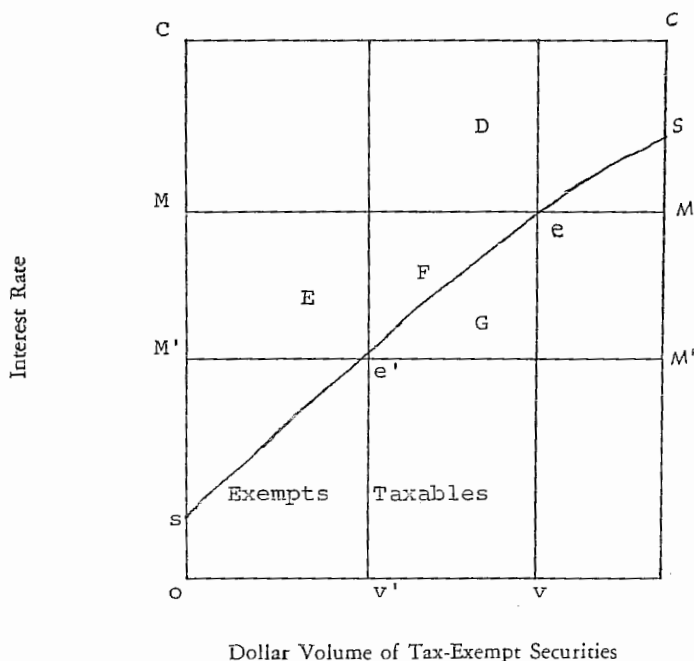
⁷⁹ Huefner, *supra* note 11, at 412.

taxable bonds, the supply for tax-exempt securities is lowered, while the supply of taxable securities is increased. The relatively high bracket investor can squeeze out the lower bracket marginal investor by bidding up the price of new issues of tax-exempt securities. In other words, the high bracket taxpayer will still be willing to purchase higher priced tax-exempts (with a lower after tax yield), but the low bracket investor will not. Ultimately, a new equilibrium will be established such that, of a given volume of municipal borrowing, a lesser portion of the total will consist of tax-exempt securities and a larger portion will consist of taxable securities, the exact division depending upon where the subsidized interest rate for new taxable municipal issues is pegged. Issuance of new tax-exempts will continue until their interest cost to state and local borrowers equals the unsubsidized portion of the interest cost of the new taxable bonds. Since some high bracket investors will continue to buy tax-exempt bonds, they will continue to receive the benefit of the exemption, though it will be worth less than before. Their advantage reduces the amount of new revenue to be gained by the subsidy scheme. The cost of the subsidy will equal the subsidized interest rate on new taxable issues multiplied by the volume of taxable bonds. The increase in tax collections will result from taxes now paid by those investors who were squeezed out of the exempt market, the marginal or low bracket investor. Mathematically, however, the FRB study shows that the tax liability of investors switching to taxable securities cannot match the cost of the subsidy because, as previously stated, the amount of the subsidy will be the same percentage of the total interest cost (of the new taxable issues) as the marginal tax rate of the lowest bracket buyer of new exempt issues.⁸⁰ Given the two FRB assumptions that investors act rationally and compare their after tax yields on exempt and taxable bonds and that there is a continuum of marginal tax rates, the FRB conclusion would follow regardless of the point at which the federal subsidy is pegged.

While the FRB analysis indicates that there will be some net treasury loss as a result of the subsidy, it also indicates that some of the "leakage" or windfall to investors in exempt municipals will be reduced. Thus, the overall equity of the system is increased, at least to some extent, in the sense that after the subsidy puts the new system in motion, only the very, very rich will gain any advantages from it.

⁸⁰ One analyst has explained the FRB approach in geometric terms as follows:

The JEC's empirical approach is intended to show simply in recent years, only fairly high bracket taxpayers, that is, taxpayers above the 48 percent bracket, have been purchasers of tax-ex:



- V—present dollar volume of tax-exempt securities.
- M-M—interest rate on exempt municipals.
- e—equilibrium point for exempt municipals at present.
- v¹—dollar volume of tax-exempt securities where their interest costs the non-federal income on the subsidized municipals.
- e¹—equilibrium point for exempt municipals when states also sell federal subsidized taxable municipals.
- M¹-M¹—the state or local interest cost on subsidized taxable municipals.
- C-C—interest rate on taxable securities.
- S-S—supply curve on investment funds.

At the present time, by assuming a rational comparison of pretax and aftertax yield an equilibrium point *e* is established at a given interest rate *M-M* for tax-exempts. However, taxable municipals are now issued, the lower bracket investor is forced out of the exempt market into the taxable market until a new equilibrium is established at point *e¹* at a given subsidized interest rate for taxable issues *M¹-M¹*. The dollar volume of securities is now divided between exempts and taxables. The areas *D*, *F*, and *G* represent the amount of the federal subsidy. The areas *D*, *F*, and *G* represent additional collections as marginal investors are forced into taxable issues. The net federal cost is represented by area *G*. The benefit to state and local issuers is represented by area *F*, and *G*. Obviously, federal collections are not equal to the cost of the subsidy, "loss" being area *G*. Note, however, the reduction of high bracket leakage represented by areas *E* and *F*. See Heufner, *Municipal Bonds: The Costs and Benefits of an Alternative*, 23 NAT'L TAX J. 407, 410-411 (1970).

municipal bonds. The study further shows that a federal subsidy of as low as one-third of the present interest cost of tax-exempt municipal bonds will provide funds to the issuers at a total interest cost which is less than is now being paid for most exempt bonds, and that its effect would be to cause a switch of relatively high bracket taxpayers to the taxable market.

The reader will perhaps have noted that the JEC concept of an empirical analysis is not at all incompatible with the FRB concept of an algebraic analysis predicting the behavior of marginal investors who act rationally. If we go along with the FRB's basic assumption that there is a predictable order in which prior marginal investors will leave the exempt market, then at any given level of interest rates for exempt and taxable securities, and at a given volume of municipal borrowing which remains constant, a curve can be plotted which will represent the supply of investment funds at various rates of interest for tax-exempt securities, all of which will, of course, be below the going rate on taxable securities. It can then be shown that the substitution of an interest subsidy on taxable securities will cause marginal investors to leave the exempt market until a new equilibrium point is established at which only those investors will remain in the exempt market who, because of their high marginal tax rate, continue to benefit from the exemption. The volume of municipal exempt borrowing will be curtailed and taxable borrowing will be expanded, but the rational behavior of marginal investors accounts for the character of the supply curve and explains the conclusion that there will be a net loss to the treasury.

As noted previously, implicit in the FRB analysis is an assumption that the holders of exempt bonds represent a continuum of marginal tax rates. The JEC's empirical data concerning the character and tax brackets of prospective investors, however, would give the FRB's supply curve a totally different character. If we accept the JEC projection of an average marginal tax rate of 48 percent or more for all present investors in tax-exempts, then the supply curve must be different, the equilibrium points will shift and the ultimate results as to treasury cost and composition of the market will have to be altered and will tend to support the JEC conclusion that in-

creased tax revenues will support the subsidy without loss to the treasury.

One analyst of the FRB and JEC studies has suggested that their contradictory results could possibly be harmonized by a consideration of two factors which the FRB study neglected. First, there is the premium interest which is presently paid by issuers of tax-exempts who are little known and whose bonds are therefore riskier. In a shift to taxable securities, a fair portion of the federal subsidy to such higher risk issuers will consist of this interest premium which will now be recovered in part by imposition of a tax on the investor in these securities. Since the interest premium demanded by the market is generally in excess of the actual losses on higher risk bonds, the combination of a tax on the interest and a reduction of cost to the issuers results in savings in excess of the subsidy. This, again, would tend to shift the FRB results closer to those obtained by the JEC through what is essentially a correction of a market imperfection.⁸¹ Second, there is the fact that a premium is presently paid by issuers of tax-exempts to induce lower bracket taxpayers to invest in municipal bonds. A shift to taxable securities would eliminate this premium on the theory that taxable municipal bonds would become a portion of the general market of all taxable securities and would attract any investor "naturally" interested in this type of security.⁸²

Despite the embellishment of the FRB study by a consideration of these "premium" items, it appears that we really do not know enough about either one to be able to predict with any reasonable degree of certainty what will happen in a shift to taxable municipal bonds. Presumably, the Urbank Plan (under which a new federally guaranteed taxable security would be issued) would eliminate the risk premium presently paid by local governments. Thus the importance of the premium may be central to the issue of the choice of a particular subsidy plan. But not enough is generally known about the role and relative importance of the risk premium. As to the premium paid for inducing lower bracket taxpayers to purchase taxable municipals, we cannot be at all certain that, given a choice between taxable municipal securities and other taxable investments,

⁸¹ *Id.* at 411.

⁸² There is considerable controversy and confusion over who is "naturally" interested in this kind of security. Commercial banks have the least choice and may therefore be forced to avail themselves of this kind of investment, but individuals are much more flexible. Again, it is a question of the composition of the market. Clearly, the crucial issue is how the market is divided between flexible and more or less captive investors.

prior investors in tax-exempt municipals will be "naturally" attracted to similar taxable municipals.⁸³

It depends in great measure on who the present investors really are. It should be noted that the question of the composition of the present market for tax-exempt bonds is crucial for both the FRB and JEC studies, since both base their results on a common question, to wit: who will no longer buy tax-exempts when the shift to a subsidized taxable bond is effected? It is their contradictory answers to this question that make the results of the two irreconcilable. The JEC study bases its answer on empirical evidence as to who present investors are, concluding that they are primarily high bracket individuals and banks. A shift to taxable bonds will therefore cause these high bracket taxpayers to stop purchasing tax-exempts. The prognostications as to the behavior of banks are fraught with difficulty, as municipal bonds have never been their investment of choice. There is evidence which suggests that the tax-exempt municipal market is "segmented," with banks dominating the long term market.⁸⁴ In the long run, what banks will do depends upon extrinsic factors such as the availability of money and the general economic conditions. This is all too well illustrated in the behavior of banks during the tight money period of 1969-70 when they were net sellers of municipal bonds. Nor may it be assumed that individuals, whether in high or low brackets, will automatically shift to taxable bonds when given the opportunity, for there are, after all, numerous taxable investments with considerable allure when compared to a taxable bond. High bracket investors may well prefer the tax shelters offered by high depreciation or interest deductions, and shift in that direction. We do not, at present, have any real appreciation of what criteria control these investment choices. These serious defects in the JEC study result from the emphasis on the issue of who will no longer buy tax-exempts and the de-emphasis of the question of who will buy the new taxable security.⁸⁵ A consideration of this question was the underlying principle of the empirical IBA study, which as we have indicated, shows that prospective buyers of municipals will not be in as high a bracket as suggested by the JEC

⁸³ See INVESTMENT BANKERS ASSOCIATION, *supra* note 49.

⁸⁴ R. ROBINSON, POSTWAR MARKET FOR STATE AND LOCAL SECURITIES, (1960).

⁸⁵ Heufner, *supra* note 80. This author suggests that this is an important distinction because the buyers of taxable bonds will include many investors who are tax-exempt or whose tax liability is small. The composition of the market for the new taxable issues is, of course, crucial in determining whether the new tax revenues will or will not cover the cost of the subsidy.

study and the Treasury. Had the JEC study concentrated its empirical study on who will purchase *taxable* bonds, it might have agreed that, based on such empirical data, the anticipated tax revenues could not support the subsidy.

The FRB study suffers from the assumption that investors will act rationally. If it had also turned its attention to the question of who would buy the new taxable bond, it would have been forced to note that many investors in low tax brackets and many nontaxable investors such as pension funds are significant present holders, indicating that they do not behave rationally. They prefer, perhaps, to trade off the lower municipal bond yield against certainty of return and stability, real or imagined. And they may continue to do so in the future, since we cannot predict what choice will be made by the individual investor. And while banks do not have as wide an investment choice as individuals, their actions are subject to the influence of extrinsic factors.

All in all, this indicates that neither the JEC nor FRB study conclusively proves anything concerning the results of a shift to a federal subsidy, at least not in terms of its superior efficiency. The general consensus among the various analysts who have commented on the subsidy proposals seems to be that there is a good chance that the subsidy will cost less than the exemption, but no one is sure.⁸⁶

It appears to be no easier to gauge the possible effects of the subsidy on the equity of the system. From the perspective of the FRB and JEC studies, which look at who will no longer buy tax-exempts, it appears that the issue is in question. The FRB position is that marginal buyers will not buy tax-exempts, but these are the lowest bracket taxpayers among the present holders of tax-exempts. There is sufficient doubt about the JEC's conclusions as to the composition of the market to accept its view that the entire market consists of high bracket taxpayers. From the perspective of the IBA study, which looks at prospective buyers of the subsidized taxable bond, the empirical evidence is that the new buyers will comprise a group of investors in an average tax bracket of about 33 percent. None of these problems bode well for increased equity.

While these cost benefit studies have addressed themselves to the question of efficiency and equity with contradictory and largely inconclusive results, they do not even approach the question which Professor Surrey would like to have answered in relation to a choice between a loosely or a tightly controlled subsidy. The alternatives,

⁸⁶ Heufner, *supra* note 80; Galper & Petersen, *supra* note 41 at 232.

as the reader will observe, propose only a partial substitute for the exemption and leave undisturbed the power of the state and local governments to determine the allocation of their borrowing proceeds and thus the federal funds which are expended in the subsidy. It seems that these studies are precious little comfort to the opponents of the exemption. To those opponents who base their opposition on the general ground of the undesirability of tax incentives, they are not particularly relevant. The question of whether the subsidy is preferable to the exemption is not rooted in empirical or mathematical analyses directed primarily to questions of cost.

The defenders of the exemption have been quick to seize upon the inconclusiveness of the studies and upon those aspects of particular studies which favor their position. They appear, however, to use the economic analyses more as make-weight arguments than as serious objections to the subsidy, and thus they are, perhaps, more realistic in approaching the basic issue than are the opponents of the exemption. They also see the fundamental question as a visceral one: a deeply rooted conviction that federal money means federal control. Mr. Patrick Healy, for example, sees as the core of the problem the "... distrust of state and local officials of central government power, particularly when it is allied with the power of the purse string."⁸⁷ The fact that \$25 billion in federal grants is now accepted and used by state and local governments does not alter the basic conviction that tax exemption for municipal bond interest is essential to preservation of the status quo in state-federal relations. Apparently, the freedom to borrow is felt to be a cornerstone of those relations and the subsidy proposals are viewed as an intolerable control on borrowing freedom. For state and local officials, reciprocal tax immunity as it affects municipal bonds is as strong a gut issue as the equity of the tax system is for opponents of the interest exemption.

IV. CONCLUSION

There are two very strong arguments for the elimination of the municipal bond interest exemption: (a) the favoritism toward high bracket taxpayers which distorts the equity of the income tax system and narrows the tax base; (b) the possible misallocation of federal funds and the distortion of normal investment choice. These arguments may be irrelevant, however, for two reasons. First, the doctrine of reciprocal tax immunity may require us to accept this exemp-

⁸⁷ Healy, *supra* note 39, at 10.

tion as a constitutional limitation on the power of Congress to tax. If so, then it is essentially a structural component of the income tax and thus immune from both general and particular arguments against tax incentives: it ceases to be a "tax incentive" as that term has been defined by the leading opponents of tax incentive devices. That it is essential that the issue of reciprocal tax immunity be resolved first.

The suggested alternatives to the exemption, particularly the direct subsidy proposal and the Urbank Plan, are apparently centered around the problem of reciprocal tax immunity. They give the state and local governments the option of issuing either tax-exempt securities or federally subsidized taxable securities. The alternatives are aimed primarily at two further objections to the interest exemption: the inefficiency resulting from lost federal revenues—a loss not compensated or balanced by commensurate cost reductions to state and local governments — and the inequities which favor the wealthy investor. The justification for the substitution of the exemption with some form of direct subsidy depends upon cost-benefit and market studies such as those recently made by the FRB, the JIB and the IBA. Unfortunately, the results of these studies are contradictory and inconclusive. For this reason, the arguments concerning the inefficiency of the exemption lose much of their force. It has not been shown that any of the alternatives would result in bringing treasury costs into balance with savings to the state and local governments. While the proposed subsidies may result in eliminating some of the present favoritism to the high bracket taxpayer there is much evidence to indicate that the extent of this correction is far from certain.

The opponents of the interest exemption have shown a willingness to accept an inefficient subsidy in place of the present inefficient exemption. Since the subsidy alternatives would permit the issuance of tax-exempt bonds on an optional basis as well as a "no strings" subsidy on taxable bonds, it seems that they are not concerned with the manner in which the federal subsidy is allocated. One can only conclude, then, that the major objection to the exemption is the inequity of its operation in favor of high bracket taxpayers. In other words, it is not the rational arguments which are persuasive (and not well supported by cost-benefit and market studies), but the basic, deep-rooted conviction that the present system is unfair. It is questionable, however, whether the proposed alternatives will substantially eliminate the unfairness.

The proponents and defenders of the exemption have also based their defense upon a dual argument. They have used to advantage those various cost-benefit and market studies which show the proposed subsidy alternatives to be no more efficient and no more conducive to tax equity than the current exemption. Their major argument, however, is the not quite rational fear of federal domination of state affairs through control of state and local borrowing and allocation of the federal subsidy. The result is a head-on collision of two powerful forces: the politically popular and entirely understandable drive for tax equity based on notions of fairness, and the equally understandable fear on the part of state and local governments of the intrusion into their affairs of an ever growing central government.

The alternatives which have been proposed as substitutes for the exemption will not be very helpful in resolving this conflict. A direct subsidy to retirement funds may expand the market for tax-exempt municipals, but if it drives anyone out of the exempt market it will be the marginal investor. The same is true of the direct subsidy which will give the state and local governments a choice between exempt bonds and subsidized taxable bonds. Thus, these two schemes do not necessarily foster tax equity, and, though they involve a "no strings" subsidy, they do not allay the fear of federal control. The Urbank Plan may not result in greater tax equity and it implies some federal control of the terms and conditions of state and local borrowing. This might satisfy the opponents of the exemption but it would be anathema to state and local governments.

A pure solution to the equity problem requires total elimination of the exemption, but the supporters of the alternative proposals have adopted a conciliatory attitude. They are willing to settle for a smaller measure of tax equity and leave to the states and local governments an unrestricted right to expend the federal subsidy as they see fit. The state and local governments have taken a much harder line: to assure a federal "hands off" policy, they would perpetuate a very unpopular tax injustice. The state and local governments are being less conciliatory, and they must accept an alternative to the exemption. If they do not, and if they persist in pushing the question of reciprocal tax immunity to the Supreme Court in the specific context of the exemption, they may indeed find the way cleared for total elimination of the exemption, and even a victory for them in the courts might be short lived. In the push for tax reform, a constitutional amendment extending the taxing power

to municipal bond interest is not unthinkable. Enlightened self-interest, therefore, requires an accommodation with the public clamor for tax reform. Nevertheless, the weakness of the case both for and against the exemption must be admitted, and any compromise solution must be recognized for what it is — the conciliation of two visceral and intensely political points of view, and not the victory of sweet reason.