LEVY INSTITUTE

Public Policy Brief

HIGHLIGHTS

No. 58A, December 1999

A New Approach to Tax-Exempt Bonds

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American taxpayers undoubtedly know that federal, state, and local governments help pay for sports stadiums. But how many fans know that, thanks to tax-exempt bond financing, up to a third of the subsidy winds up in the hands of investors in high tax brackets rather than in the stadium itself. It is doubtful that more than a handful of taxpayers are aware of how this subsidy operates, for the subject of tax-exempt municipal bonds is highly complex and is rarely discussed in the popular press.[1]

The current system of financing works this way. By exempting interest payments on municipal debt from federal income taxes, the federal government lowers the cost of borrowing to state and local governments. Purchasers of municipal bonds are willing to accept a lower rate of interest because they receive interest payments that are tax free. If the tax-exempt market did not exist, all municipal borrowing would have to take place in the regular markets for taxable bonds where interest costs are approximately 15 to 20 percent higher than in the tax-exempt markets (General Accounting Office 1995, 15).

There is general agreement that good public infrastructure—in such areas as transportation, environmental protection, health, public facilities, and education—improves productivity, strengthens economies, and makes for better quality of life. There is also general agreement that because of the public good flowing from such projects, it is appropriate for the federal government to subsidize them. However, rarely is it asked whether there are better ways to finance infrastructure investments than by tax-exempt bond issues. While we believe that a federal subsidy is necessary, the current system of providing that subsidy is both inefficient and inequitable and it excludes large institutional investors and foreign investors with their trillions of dollars of assets.

An alternative to the current system is a new security concept, the American global infrastructure security or AGIS, developed by the author and a group of municipal bond experts—Peter Imhoff and Mark Mayer, currently of the investment banking firm Warburg Dillon Read, and Eugene W. Harper Jr. and Jeffrey L.

The full text of this paper is published as Levy Institute Public Policy Brief No. 58.

The Jerome Levy Economics Institute is publishing this research with the conviction that it is a constructive and positive contribution to discussions and debates on relevant policy issues. Neither the Institute's Board of Governors nor its Board of Advisors necessarily endorses any proposal made by the author.

Piemont, currently of the law firm Squire, Sanders & Dempsey. The AGIS bond involves stripping the tax-exempt privilege from a tax-exempt bond, thus making the bond taxable, and selling that privilege separately in the financial markets.

Problems with the Current System of Tax Exemption

There are three main problems with the current system: inefficiency and inequitable transfer of wealth to high tax bracket investors, exclusion of potential assets, and lack of stable oversight.

An investor in the top tax bracket of 39.6 percent would be indifferent between purchasing a taxable bond yielding 8.3 percent interest (an average rate on taxable bonds from 1986 to 1995) from which 3.3 percent would go to taxes (8.3 x 39.6 = 3.3 percent) and purchasing a tax-exempt bond yielding 5.0 percent. Assuming all else equal, the taxable bond at 8.3 percent (on which the investor pays an *explicit* tax of 39.6 percent to the federal government) provides an after-tax yield equivalent to that of a tax-exempt municipal bond at 5.0 percent (on which the investor pays an *implicit* tax of 39.6 percent in the form of reduced interest). On a tax-exempt bond issued at 5.0 percent, the municipal government would save 3.3 percent in borrowing costs over a comparable taxable bond, while the federal government would lose 3.3 percent in tax collections. As far as taxpayers are concerned, the federal subsidy of municipal borrowings should be a wash.

However, what happens in the marketplace is not so straightforward; the actual average interest rate on *The Bond Buyer's* 20-bond index of tax-exempt municipal bonds between 1986 and 1995 was not 5.0 percent, but 6.8 percent. The reason is this. Most individuals holding municipal bonds are in relatively high tax brackets.[2] However, the amount of municipal borrowing each year outstrips the capacity and willingness of high-bracket taxpayers to invest in fixed-income securities such as municipal bonds. So issuers must increase the interest from what it would take to satisfy the high-bracket taxpayers to a yield that will attract also taxpayers in lower brackets (Michael 1990, 1672). Thus, although a disproportionate share of long-term tax-exempt bonds is held by investors in the highest tax brackets, the interest rate is determined by the marginal investors in a lower bracket (estimated by various analysts as low as 15.0 percent).

Taxpayers in lower tax brackets require higher yields on tax-exempt bonds in order to switch from taxable investments. For example, an investor in the 28.0 percent tax bracket would need a tax-exempt interest rate of 6.0 percent to receive a yield equivalent to that of a taxable investment at 8.3 percent. As the yield on municipal bonds rises to attract lower-bracket investors, investors in the higher tax brackets reap ever larger windfalls. For each 6.8 percent bond purchase by an individual in the 39.6 percent tax bracket, the federal government loses 3.3 percent in tax collections, but the municipality saves only 1.5 percent in costs. What happens to the missing 1.8 percent? It accrues to the rich bond purchaser who receives 6.8 percent interest instead of the 5.0 percent at which the bond would have been issued had there been sufficient investors at that rate. Average taxpayers nationwide are the ones paying for these windfalls to the wealthy.

The total dollar amounts involved are significant. On the approximately $144 billion in new long-term tax-exempt municipal bonds issued in 1996, using the same average interest rates as above, state and local governments saved about $2.2 billion in interest costs. Assuming an average tax bracket of 28.0 percent, the federal revenue loss was about $3.3 billion, of which $2.2 billion constituted the subsidy to the states and the remaining $1.1 billion went to investors. Applying the same ratios to the $1.3 trillion of outstanding municipal debt and the 1998 projected federal revenue loss of $22.0 billion, municipalities will benefit by $14.7 billion and $7.3 billion will go to investors. Thus, under the current system a third of the federal subsidy never reaches its intended recipient and there is an inequitable transfer of wealth from the average taxpayer to the wealthy bondholder.

A second problem with the current tax exemption lies in the composition of the market for municipal bonds. The tax exemption has produced an isolated and exclusively domestic municipal bond market that excludes large institutional investors with their huge pools of capital. U.S. Treasury and Internal Revenue Service rulings and the 1986 Tax Reform Act closed several tax-exemption loopholes and required interest on all municipal securities to be entered into corporations' computation of their minimum tax (Godfrey 1995). As a result, corporations and commercial institutions, especially banks, significantly divested themselves of municipal bonds. And so, given the fact that pension funds have never participated, the municipal bond market is patronized mainly by individuals and mutual funds as their proxies. In

contrast, other countries can and do make full use of private domestic and global capital markets and public-private partnerships to finance their public facilities.

Although public sector issuers and the municipal bond market have in general operated in exemplary fashion, some state and local governments have been investigated for arbitrage and private-activity bond abuses. Public sector borrowers do not face the same probing oversight by large financial institutions and global markets that corporate borrowers do. The involvement of institutional investors can provide stable, institutional oversight in the municipal bond market, which would go a long way in preventing ethical scandals such as the Orange County bankruptcy. Also, institutional investors, especially local pension funds, might well insist on proper maintenance of infrastructure facilities to protect their investment and as a service to their communities.

A Solution: The AGIS Bond

The AGIS bond is a promising approach to more efficient operation of the municipal bond market.[3] The idea is to create a taxable bond for sale in the regular capital markets, but one that contains a special tax-exempt benefit that can be stripped from the bond and sold separately to investors who are interested in tax sheltering but do not wish to buy a long-term municipal bond or an interest in a municipal bond mutual fund. The purchasers of the tax benefits receive an annual exclusion from gross income equal to what would otherwise be the tax-exempt interest on the bond and pay a price based on the after-tax present value of a stream of future annual exclusions. They apply against their annual taxable income an amount equal to the associated tax benefits. Municipalities can use the money they receive from the sale of the tax benefits to reduce the principal amount of bonds required to be issued to finance the desired level of capital expenditures.

By separating the two components of the municipal bond—tax exclusion and a fixed-income government security—the AGIS bond is competitive in two separate markets. Instead of trying to accommodate the much more limited group of investors that seek both components together, the AGIS bond sells a tax exclusion to people seeking a tax shelter and sells the cash flow to those seeking interest (and principal repayment) income through long-term fixed-rate securities. Decoupling the two components of the municipal bond also opens up the municipal bond market to a universe of interest-income seekers, not just U.S. pension funds and banks but foreign pension funds and global investors, who might well be interested in stable U.S. securities backed by state and local governments. Competitive bidding among these numerous investors could lower interest rate costs further to the issuing governments and their taxpayers. The inefficiency and inequity of the current system may thus be overcome.

The AGIS concept needs to be tested. State and local governments would not want to change unless it could be documented that they would not lose any of the benefits and privileges they now have and that their subsidy could actually be improved. One framework within which to test the validity of the AGIS concept is a one-time test program that expands the scope of existing tax benefits associated with municipal bonds, similar to the recently proposed Public School Modernization Act of 1999 (H.R. 1660) and the

An AGIS Bond Issue

How would an AGIS bond issue work in practice? Suppose the State of New York wished to raise $100 million through a 30-year bond issued at a tax-exempt rate of 5.9 percent (an average tax-exempt rate). That would provide purchasers with $5.9 million interest that is exempt from federal taxes annually. Now suppose the state offers a 30-year AGIS bond. Think of the AGIS bond as having two "coupons," which go to two separate groups of investors. Investors seeking tax shelters pay roughly $21 million for the tax-benefit coupons, which yield a stream of $5.9 billion annually in the form of exclusion from income over the next 30 years. Investors seeking interest income pay roughly $79 million for the cash-flow coupons, sold at discount from the $100 million face value because the actual interest on these bonds is taxable.

The State of New York would receive the full $100 million payment at an effective payable interest rate *lower* than 5.9 percent because the tax benefit would be bid down to an efficient level—the benefit to the highest marginal rate taxpayer. The exact price to the investors and the exact interest rate would be determined by underwriters in an iterative, computer-assisted process and would depend, among other things, on market interest rate levels and the spread between taxable and tax-exempt rates at the time.

Highway Innovation and Cost Savings Act (H.R. 869). Or, the AGIS proposal could be adapted, in a pilot program fashion, to cover a major, but limited, sector such as transportation, health care, or housing. The AGIS market would not supplant the tax-exempt market; the tax-exempt market would remain as an alternative and a check on the efficiency of the new process.

How are the major players likely to react to this approach? Presumably, most state and local governments would ultimately recognize it is in their interest to offer AGIS bonds rather than tax-exempt bonds since it reduces their borrowing costs or, at least, leaves them no worse off than before. Municipalities obtain the full federal subsidy and they retain full control over the bond issuance. Also, with the implementation of a stripped tax benefit, state governments and those local governments that have an income tax might be expected to begin taxing the interest on their own municipal bonds.[4] This would make their borrowings consistent with the national level, generate additional income for them, and ensure that in-state public pension plans could invest in their bonds.

At the federal level, reactions might be mixed. The Treasury is generally hesitant to create additional forms of tax benefits. However, unlike other tax-benefit transfers, the AGIS proposal would reduce or eliminate windfall gains, thus improving the efficiency and equity of the existing system. Moreover, it would not substitute a direct cash subsidy, which might have an impact on the budget appropriation process. On the other hand, there may be some concern in Congress that the AGIS bond would encourage even more bond issuance (a laudable outcome if it results in beneficial infrastructure investment), thereby raising costs to the federal government.

Among the public, there may be some concern about the symbolism of a new tax-exclusion security marketed to high-bracket taxpayers. The fact is, though, that the highest tax brackets are *already* reaping a windfall; with the AGIS approach, they would at least be paying for the benefits they currently receive gratis. The real beneficiaries of the AGIS bond are the ordinary taxpayers who have been transferring approximately a third of the subsidy into the pockets of the wealthy.

Finally, there may be legitimate concerns about the size and liquidity of the municipal bond market. In the first few years that state and local governments issue taxable bonds, will potential buyers be reluctant to bid, fearing that if they wished to trade, the market might be too "thin" to respond quickly at realistic prices? Several factors militate against this. Approximately 50 percent of new bond issues are enhanced by municipal bond insurance, creating, in effect, an easily understood AAA credit; this should considerably ease even a major influx of taxable municipal bonds into the market. Furthermore, enough taxable bonds have already been issued, for a variety of reasons, to create an alternative market. There is thus little doubt that a major and fully efficient taxable bond market could bloom, even as the tax-exempt bond market continued to exist.

Conclusion

This paper does not argue against favorable tax treatment of municipal bonds, only against the current form of the exemption. The AGIS bond proposal would:

- Open the heretofore isolated and exclusively domestic municipal bond market to a large array of domestic and foreign individual and institutional investors in the regular domestic and global capital markets
- Increase the number of bidders and thereby produce a more competitive market for municipal securities, which is likely to reduce interest rates, bringing down government costs for infrastructure
- Create institutional investor and capital market oversight of the issuing governments and municipal bond offerings
- Assure that the full federal subsidy goes to state and local governments, instead of a third of it being siphoned off by wealthy taxpayers
- Allow municipalities (state and local executives and legislatures) to retain full control over the timing and costs of bond offerings

With the emergence of large pension funds, entry of private firms into infrastructure financing, and several municipal bond scandals, the arguments against the current form of tax exemption of municipal bonds have never been so strong; with a recent Supreme Court finding against its constitutional protection, the legal argument for maintaining it has never been so weak. Federal legislation to allow a test of AGIS bonds would begin to tackle a long-standing inefficiency in the municipal bond market and move that market in a healthy direction.

Notes

1. This paper uses the standard terminology by which *municipal bonds* and the *municipal bond market* (muni bonds and market) refer to the financing of state and local governments and their agencies and authorities and of other facilities such as public hospitals and universities.
2. Among the 3 million individuals who reported receiving tax-exempt interest in 1994, 71 percent had an adjusted gross income of $50,000 or over and 15 percent reported an adjusted gross income of $200,000 or over (Internal Revenue Service 1996, Table 2.1). The data report receipt of tax-exempt interest.
3. I am indebted to Messrs Imhoff, Mayer, Harper, and Piemont for this section.
4. All states except the District of Columbia already tax out-of-state municipal bonds.

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Acknowledgments

I would like to thank three people who played key roles in the writing of this brief. Eugene Harper, Esq., not only developed the concept of the American global infrastructure security, he edited many drafts of the brief, wisely advising me every step of the way. Ajit Zacharias, the editor of the brief at the Levy Institute, became a municipal bond expert of high order and his comments and editing clarified important sections of the brief. Gilah Langner aided me, as she has in the past, with superb writing and research.

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No. 58A, December 1999

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