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√ cc: Dr. Moore
M. Mackel
J. Glenwood

WHITE HOUSE STAFFING MEMORANDUM

DATE: 7/25/85 ACTION/CONCURRENCE/COMMENT DUE BY: ____________________

SUBJECT: TAX REFORM DEVELOPMENT

	ACTION	FYI		ACTION	FYI
VICE PRESIDENT	☐	☑	LACY	☐	☑
REGAN	☐	☑	McFARLANE	☐	☐
STOCKMAN	☐	☐	OGLESBY	☐	☑
BUCHANAN	☐	☑	ROLLINS	☐	☑
CHAVEZ	☐	☑	RYAN	☐	☐
CHEW	☐P	☐SS	SPEAKES	☐	☑
DANIELS	☐	☑	SPRINKEL	☐	☑
FIELDING	☐	☐	SVAHN	☐	☑
FRIEDERSDORF	☐	☑	THOMAS	☐	☑
HENKEL	☐	☐	TUTTLE	☐	☐
HICKEY	☐	☐	________	☐	☐
HICKS	☐	☐	________	☐	☐
KINGON	☐	☑	________	☐	☐

REMARKS:

Attached is a joint release by the tax writing committee and Treasury concerning the Joint Tax Committee's revenue estimates of the President's tax reform proposal.

RESPONSE:

David L. Chew
Staff Secretary
Ext. 2702

For Immediate Release July 25, 1985

STATEMENT BY HOUSE WAYS AND MEANS COMMITTEE CHAIRMAN DAN ROSTENKOWSKI, SENATE FINANCE COMMITTEE CHAIRMAN BOB PACKWOOD, RANKING MINORITY MEMBERS JOHN DUNCAN AND RUSSELL B. LONG, AND SECRETARY OF THE TREASURY JAMES A. BAKER, III

We have received the estimates of the Joint Tax Committee staff concerning the President's tax reform proposals. Much of the estimated revenue gap is explained by differences in economic and behavioral assumptions, honest estimating errors and the use of more recent tax and economic data not available to the Treasury Department's estimators when the President's proposals were announced. All revenue estimates, of course, are subject to continuing refinement.

While the Joint Tax Committee staff's total estimated shortfall over five years amounts to less than 1 percent of the total revenue collected -- and differs from the Treasury estimate by an average of less than $3 billion per year -- we are concerned by its possible perceptual impact on the drive for tax reform.

Therefore, we want to reaffirm that revenue neutrality remains a firm underpinning of tax reform. We agree that revenue neutrality is by no means out of reach, and recognize that no mark-up will begin in the Ways and Means Committee without a proposal from the Administration that is revenue neutral.

The Administration will work with the Joint Tax Committee estimators to refine their estimates, and will move quickly to assure revenue neutrality with further proposals as necessary. Any such proposals will be made available not later than September 1, thereby permitting mark-up to begin.

We remain completely committed to passing a tax reform bill that is revenue neutral. The process is on-schedule, and we remain confident that a bill will be sent to the President.

# # #

Received 2:52

THE WHITE HOUSE
WASHINGTON

Date: 7/25/85

TO: BERYL SPRINKEL

FROM: PAT BUCHANAN

- [ ] Action
- [x] Comment
- [ ] Let's Discuss
- [ ] FYI

Would you like to sign on this memo -- I've also asked Rollins and Svahn. Please call ASAP and let me know. (Ext. 2174)

K

File
Draft

THE WHITE HOUSE

WASHINGTON

DRAFT

July 25, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: PAT BUCHANAN

SUBJECT: OIL IMPORT FEES

There is no way an oil import fee can be considered as other than a new tax on the American people.

The economic effect of such a new tax would be to deny to American consumers and American businesses the benefit of falling oil prices -- and to reward banks, the oil industry and the Federal tax collector at the expense of people who gave Ronald Reagan 49 states relying upon his promise of no new taxes. The political effect of acquiesing in such a tax now would be to shred the President's credibility, and to give this political city, and the nation, the impression that the White House had capitulated to Congress.

Hang tough.

OK - conveyed to Nancy in PB's office 7-25-85 3:10 pm

Noted by BWS

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON D.C. 20503

July 29, 1985

OFFICE OF
THE DIRECTOR

MEMORANDUM FOR BERYL SPRINKEL

FROM: JOE WRIGHT

Thought you would be interested in attached analysis.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MEMORANDUM FOR: THE DIRECTOR/DEPUTY DIRECTOR

THROUGH: Donald Moran

FROM: Chuck Goldfarb CBG

SUBJECT: Draft Paper, "The Implications of Tax Reform for Infrastructure Financing and Capital Formation," Prepared by the Senate Budget Committee's Private Sector Advisory Panel on Infrastructure Financing

The Senate Budget Committee's Private Sector Advisory Panel on Infrastructure Financing has informally circulated a draft paper (attached at Tab A) which alleges that the President's tax proposal, if enacted in total, "would have a significant negative effect upon the ability of governments and the private sector to deal with the infrastructure problems now facing them." The paper is critical of the elements of the tax proposal involving:

- o Accelerated Cost Recovery System (ACRS);
- o Investment Tax Credit (ITC);
- o Deductibility of State and Local Taxes; and,
- o Tax-Exempt Financing.

The paper focuses primarily on the proposed changes in the criteria for qualifying for tax-exempt financing and their impact on solid waste disposal/resource recovery and wastewater treatment facilities, which tend to have greater direct private sector involvement than other infrastructure systems. The Panel does not provide quantitative analysis, but does make recommendations that would eliminate, modify, or weaken a number of the President's provisions.

It is important to note that the chairman of this advisory panel, Joe Giglio, also is the Senate appointee to the National Council on Public Works Improvement (Infrastructure Council) created under Title I of the Federal Capital Investment Program Information Act and mandated to prepare annual reports in each of the next three years on the state of the nation's infrastructure and on new financing mechanisms. On June 25, Giglio testified before the Senate Finance Committee, making basically the same arguments that appear in the paper. His testimony received a lukewarm reception from the three Senators present -- Packwood, Chafee, and Bentsen. It is possible, however, that the House would be more receptive to these arguments.

A number of infrastructure-related special interest groups have begun concerted lobbying efforts on the Hill to modify the tax proposal. The Private Sector Advisory Panel paper is not the best analytical piece produced by those interest groups, but it enjoys the implicit imprimatur of Senate Republicans. Furthermore, it takes a broad swipe at the tax proposal and raises most of the same arguments that appear in other studies. It therefore is a convenient vehicle to use to analyze the arguments being made by these interest groups.

Attached at Tab B is a critique of the Private Sector Advisory Panel paper. Although the Panel paper is filled with inaccurate statements, we have chosen not to respond to each such allegation (many of which are gratuitous), but rather to present the principal allegations and provide an OMB response to each. These responses have been coordinated with relevant budget examiner shops and the Fiscal Analysis Branch to assure agency-wide consistency.

There is only one area of criticism in the Panel paper that merits serious attention. The definition of "governmental use" in the Treasury proposal concerning tax-exempt financing may -- in some marginal cases -- discourage localities from using efficient private sector providers of solid waste disposal and resource recovery services. For both efficiency and political reasons, it would be worthwhile to review the proposed definition (though the Panel's recommended changes in this area are far too broad). The Treasury has attempted to limit the use of tax-exempt bonds based upon a definition of "governmental" versus "nongovernmental" use; the Panel paper sometimes refers to "public" versus "private" use, a more nebulous concept which is subject to much wider interpretation.

Otherwise, the Panel's criticisms are, on the most part, without foundation.

- Very few infrastructure projects currently take advantage of ACRS and ITC, and those few that would lose these advantages would gain from other elements of the tax proposal such as indexing depreciation for inflation, reducing the corporate income tax, and allowing a 10% corporate deduction for net dividends paid.

- The elimination of deductibility of State and local taxes will strongly affect only a small minority of taxpayers, and thus is unlikely to create broad taxpayer resistance to infrastructure spending.

- Eliminating the advance refunding of tax-exempt issues will not reduce the flexibility of State and local governments to make maximum use of available funds; it will simply eliminate their arbitrage gains.

Attachment

A

00011 D R A F T For Discussion Purposes Only

THE IMPLICATIONS OF TAX REFORM FOR INFRASTRUCTURE FINANCING AND CAPITAL FORMATION

INTRODUCTION

President Reagan released his Tax Proposals to the Congress for Fairness, Growth, and Simplicity (the "Tax Proposal") on May 28, 1985. The Tax Proposal would have a profound effect on the ability of state and local governments to finance needed infrastructure improvements at reasonable cost if enacted in its current form. It is generally agreed that this country needs to make a greater investment in its public capital assets or infrastructure at all levels. Such physical infrastructure is a necessary foundation for economic growth; without these necessities, the economy would falter and the quality of life and of public services would deteriorate. Nonetheless, investment in such public physical assets has declined in real terms over the last decade by nearly 30%. Where twenty years ago such investment was the equivalent of about 3.5% of the gross national product (GNP), it now has declined to a little over 2.0%. Estimates of what is required to be invested in such facilities through the rest of this century run into the trillions of dollars. Projections of the resources available under current financial arrangements fall short of this mark by hundreds of billions of dollars.

The changes included in the Tax Proposal will widen this disparity between projected needs and available resources. They will increase the total cost to state and local government of future investment in public infrastructure and decrease private sector interest in participating in such investments. If left uncoordinated and enacted simultaneously, changes in the following aspects of our national income tax system would have a significant negative effect upon the ability of governments and the private sector to deal with the infrastructure problems now facing them:

1. Accelerated Cost Recovery System (ACRS);
2. Investment Tax Credit (ITC);
3. Deductibility of state and local taxes; and
4. Tax-exempt financing for infrastructure.

After giving some general background information, this paper will discuss each of these features of the current and proposed tax system and will offer several proposals to mitigate the negative impact on capital investment in the nation's infrastructure.

BACKGROUND INFORMATION

Private sector interest in financing, constructing and operating public capital facilities was given a major boost by the Economic Recovery Tax Act (ERTA) that was adopted in 1981. That act accelerated business investment through various tax incentives including the Accelerated Cost Recovery System (ACRS) and enhancement of Investment Tax Credits (ITCs). The ACRS established a new depreciation system allowing much faster cost recovery of most depreciable property built after 1980. The ITC provided a one-time credit against income tax liability of ten percent of the value of qualified investment expenditures in the year the investment property is put into service, except for certain property which was limited to six percent of value. These changes were made to reverse the decline in the nation's capital stock caused by inflation.

Passage of ACRS and the ITC also increased private investment in physical public infrastructure. State and local governments have found that these tax advantages encourage private sector investments in public facilities. Through leasing arrangements, for example, private investors can obtain tax advantages which enable state and local governments to reduce acquisition costs to more manageable levels. Frequently, these exchanges also involve issuing tax-exempt industrial development bonds (IDBs).

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress revised sections of the tax code to prohibit the full use of ACRS on projects funded with IDBs. Importantly, wastewater treatment and resource recovery facilities were exempted from this restriction. Retaining ACRS for these facilities enhanced private-sector interest in participating in such investments.

The Deficit Reduction Act of 1984 put a cap on each state's annual issuance of IDBs (through 1986, $200 million or $150 per capita, whichever is greater). This Act also made projects financed with IDBs ineligible for full ACRS treatment, eliminating the exemption for wastewater treatment and resource recovery facilities provided two years earlier.

The Tax Proposal would, generally, eliminate the ITC and ACRS, would allow bond interest to be tax-exempt depending on the use of the facility involved rather than on its public purpose, would eliminate the deductibility of state and local taxes, and would prohibit advance refunding of tax-exempt bonds. These changes in the tax treatment of funds used for public purposes will significantly decrease the amount of such funds available for building and maintaining public physical assets.

CURRENT LAW AND TAX PROPOSALS

1. ACRS

Current Law: Under ACRS, all depreciable property is divided into five classes with recovery periods of 3, 5, 10, 15 and 18 years. Most personal property, including machinery and equipment, falls into the 5-year category; most real property falls into the 18-year category (unless it was placed in service on or before March 16, 1984). Regulated public utility property may be classed as 5, 10, or 15-year property depending upon its treatment under the pre-ACRS law.

In addition to providing recovery lives for property that are generally shorter than their actual economic lives, ACRS allows accelerated depreciation schedules. The result of these accelerated schedules is that the largest percentages of the total depreciation can be taken in the earlier years of the property's economic useful life. (This is known as the "declining balance" method; distributing depreciation equally over the asset's life is known as the "straight line" method.) The ACRS deductions are taken against the property's basis (cost), adjusted by subtracting one-half of any investment tax credit taken for the property. ACRS deductions are subject to "recapture" when the property is sold; that is, for most types of property, all previously allowed excess depreciation constitutes ordinary income rather than capital gain.

Property financed through tax-exempt industrial development bonds (except for multifamily housing) must be recovered through the straight line method of depreciation over the applicable ACRS life.

Tax Proposal: The Tax Proposal would replace ACRS with a Capital Cost Recovery System (CCRS) designed to group assets according to their useful economic lives and provide a uniform incentive for investment in depreciable assets. Under CCRS, depreciable property would be divided into six classes, with ACRS 5-year property reclassified into classes 2 through 5 (see Chart 1). Each class would be assigned a fixed annual depreciation rate ranging from 55% to 4%. The assigned rate would be applied against the indexed, inflation-adjusted, remaining, unrecovered basis of the asset. Under this approach, the tax-payer would never fully depreciate an asset. Therefore, the Proposal provides for a conversion to the straight line method which completes depreciation of the asset, with 100% depreciation in the close out year assigned to that asset class. Thus, for former five-year property which has been assigned to class 4, the taxpayer would depreciate 22% of the indexed basis each year until it reached the fifth year; at which point the depreciation would convert to a straight line method, with the asset being fully depreciated in the eighth year (see Chart 2).

CHART 1

Table 7.01-4

CCRS Asset Classes

CCRS Class	Classification of ACRS Property 1/	Depreciation Rate 2/	Recovery Period 3/
Class 1	3-year property	55 %	4
Class 2	Trucks, Buses, and Trailers Office, Computing, and Accounting Equipment	44 %	5
Class 3	Construction Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, and Instruments	33 %	6
Class 4	5-year, 10-year, and 15-year public utility property not assigned to Class 2, 3, or 5 -- E.g., Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Communications Equipment, Fabricated Metal Products, and Railroad Track and Equipment	22 %	7
Class 5	Railroad Structures, Ships and Boats, Engines and Turbines, Plant and Equipment for Generation, Transmission and Distribution of Electricity, Gas and Other Power, and Distribution Plant for Communications Services	17 %	10
Class 6	18-year property; 15-year low-income housing	4 %	28

Office of the Secretary of the Treasury May 28,1985

1/ Items of property are assigned to CCRS classes under rules described in the text of the General Explanation.

2/ The depreciation method switches from a constant declining-balance rate to the straight-line method in the year of service in which the straight-line method produces greater depreciation allowances than the declining-balance rate would, assuming a half-year convention for computation of the straight-line method.

3/ The recovery period is the number of years over which cost recovery is computed under the straight-line method. A consequence of assuming a half-year convention for purposes of computing depreciation rates under the straight-line method is that depreciation schedules cover one year more than the recovery periods.

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CHART 2

Table 7.01-2

Capital Cost Recovery System Depreciation Schedule
(as a Percent of Inflation-Adjusted Basis) 1/

Year	Class 1	Class 2	Class 3	Class 4	Class 5	Class 6
1 2/	27.5	22	16.5	11	8.5	2.00
2	55	44	33	22	17	4.00
3	55	44	33	22	17	4.00
4	67	44	33	22	17	4.00
5	100	67	40	29	17	4.08
6		100	67	40	18	4.26
7			100	67	22	4.44
8				100	29	4.65
9					40	4.88
10					67	5.13
11					100	5.41
12						5.71
13						6.06
14						6.45
15						6.90
16						7.41
17						8.00
18						8.70
19						9.53
20						10.53
21						11.76
22						13.33
23						15.38
24						18.18
25						22.22
26						28.57
27						40.00
28						66.67
29						100.00

Office of the Secretary of the Treasury May 28, 1985

1/ A half-year convention is assumed for purposes of determining the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method. Consequently, the depreciation schedules cover one year more than the recovery period for each class.

2/ First-year allowance shown assumes an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention. Actual allowance in first year would vary depending on when asset is placed in service.

As under present law, taxpayers could continue to expense up to $5,000 worth of personal property in lieu of using CCRS. First year allowances would be prorated for the number of months the property is placed in service. The Tax Proposal would eliminate the special capital gains rate for depreciable assets; therefore, recapture would no longer be an issue. CCRS would be in effect for property purchased on or after January 1, 1986.

The proposed change in depreciation will affect the financing of public facilities, because ACRS applies to most of the tangible property in such facilities. A significant portion of public physical assets currently qualify as five-year recovery property. For example, 80-90% of the cost of a wastewater treatment project typically qualifies for a five-year ACRS deduction. Under the proposed CCRS, these depreciation schedules would be lengthened for most equipment to 7 to 10 years. Depreciation schedules keenly affect private sector interest in "full service contracts," under which governments sign long term agreements with private firms to build, own and operate such traditional public facilities as wastewater treatment plants and solid waste disposal units. Under the Tax Proposal, private sector investors would reduce their equity investment and/or seek higher user fees to increase cash flow in order to receive a rate of return sufficient to justify such an investment.

2. Investment Tax Credit

Current Law: Current law provides a tax credit for investment in certain types of depreciable property, generally personal property and other tangible property, not including buildings and their structural components (there is a credit for rehabilitated buildings). In most cases, the ITC equals 10% of the costs, except where ACRS classifies the property as 3-year property, which generally receives a 6% ITC. The ITC is subject to recapture, and one-half of it must be subtracted from the asset's basis before depreciation. The amount of tax liability that may be offset by ITCs in any year is limited to $25,000 plus 85% of tax liability in excess of $25,000.

A wastewater treatment facility provides an example of how the ITC operates in the case of a public capital facility. "Other tangible property" for such a facility must meet two tests to qualify for ITC. First, the structure can be expected to be replaced when the equipment it houses is replaced: second, the structure cannot be economically used for another purpose. In general, 80-90% of the cost of a typical wastewater treatment facility will qualify for the 10% ITC.

Normally, the ITC is claimed in the first year that a facility is in service. For projects with a construction period greater than 24 months, however, the ITC can be claimed on a progress expenditure basis. Although land does not qualify for the ITC, land improvements, including roads, excavation and concrete, may qualify. Therefore, the costs not qualifying for an ITC would typically be a relatively small portion of the total cost of some public physical asset such as a wastewater treatment facility.

Tax Proposal: The Tax proposal would repeal the ITC on property purchased on or after January 1, 1986. The fiscal impact of this change would vary from one facility or project to another. The National Resource Recovery Association estimates that, without the ITC, municipal disposal costs will rise between 10% and 20% per ton of refuse.

3. Deduction for State and Local Taxes

Current Law: Individuals who itemize their tax deductions are currently allowed to deduct certain state and local taxes, regardless of the purpose for which they were incurred. These taxes include real and personal property taxes, income taxes, and general sales taxes. Other state and local taxes, such as gasoline, cigarette and alcohol taxes, admission taxes, and occupancy taxes, are deductible only if incurred in carrying on a trade, business or income-producing activity.

Tax Proposal: The Tax Proposal would not allow individuals to deduct any state or local taxes unless they were incurred in carrying on a trade, business or income-producing activity. The current deduction for state and local taxes not incurred in this manner would be eliminated for all taxable years beginning on or after January 1, 1986. In addition, state and local taxes (other than income taxes) that are incurred in carrying on an income-producing activity would be aggregated with employee business expenses and would be deductible subject to a threshold.

Eliminating the deductibility of state and local taxes will increase taxpayer resistance and will make it harder for state and local governments to maintain or increase current tax rates at a time when some other revenues, especially federal grants, are declining. At the same time, the cost of borrowing for state and local government enterprises is likely to increase, due to such actions as curbing the tax-exempt status of municipal debt therefore more and more pressure is placed on general obligations debt ceilings and property taxes. These mounting revenue and financing pressures are already causing governments to accept poorer debt structures and deteriorating balance sheets. In 1984, one major bond rating service downgraded almost 2 1/2 times as many units as it upgraded. This trend portends further disincentives for increasing investment in public physical assets.

Loss of deductibility will amplify the adverse impact of the new restrictions to be imposed on the use of tax-exempt bonds for infrastructure. As discussed below, the impact will be most acute for small local governments whose citizens are most affected by tax increases.

4. Tax-Exempt Financing for Infrastructure

Current Law: Interest on state and local governmental bonds issued to fund public projects has traditionally been tax-exempt, as provided in Section 103(a) of the Internal Revenue Code. In addition, certain other bonds issued by state and local governments may be tax-exempt. These other bonds include: industrial development bonds (IDBs), which, although used to finance the activities of a private business, will be tax-exempt if they qualify as small issues (until 1986) or if they are issued to finance certain exempt activities; mortgage subsidy bonds; student loan bonds; and bonds issued to benefit tax-exempt institutions, primarily not-for-profit health care facilities and private educational institutions. Exempt activities for which IDBs currently may be used include wastewater treatment, resource recovery, and mass transit facilities.

There is an annual per-state volume cap on IDBs and student loan bonds equal to the greater of $150 per capita or $200 million through 1986 and $100 per capita or $200 million after 1986. Furthermore, property financed with IDBs must be depreciated by the straight line method over the applicable ACRS life.

Advance refunding of most tax-exempt bonds (IDBs and mortgage subsidy bonds are the primary exceptions) is permitted under current law. Advance refunding involves issuing bonds and using the proceeds to retire the previously outstanding bonds before the latter reach their stated maturity date. Current law does not classify a transaction in which the retirement of the outstanding debt takes place within 180 days of the sale of the refunding bonds as an "advance" refunding.

Tax Proposal: For many years controversy has existed as to what activities are "private" or "public" under Section 103. The Tax Proposal recommends that all "private activity bonds," the proceeds of which are used for "private purposes," be made taxable. It defines private activity bonds as bonds used to finance student loans, capital projects for private nonprofit hospitals and universities, industrial parks, multifamily housing, sports and convention centers, airports and docks, sewage and waste disposal facilities, pollution control projects for private companies, and mass transit commuting facilities, among others.

General obligation bonds, the proceeds from which are generally used to finance "traditional government functions," will continue to remain tax-exempt. However, a bond would have to pass each of two new tests to be tax-exempt. First, no more than 1% of the bond proceeds may be used in a business by a taxable entity and no more than 1% of the debt service may be secured by payments derived from taxable business activity. For example, in a multi-modal transportation center, no more than 1% percent of the debt service could be secured with rental payments from any private bus, trucking or shipping company. If rental payments from any of these sources exceed 1% of the debt service, the bonds would be taxable.

Second, facilities financed with tax-exempt bonds must be available for actual use by the general public on the same basis as a private user. Precise definitions have not been determined but an airport provides an example. Parts of the airport that are open to the general public (main concourses, parking lots, etc.) would clearly be eligible for financing with tax-exempt securities. However, special access roads for freight terminals to be used almost exclusively by trucking companies, or terminal and hangar facilities used by the private airlines, neither of which could be used by the general public, would not be eligible for tax-exempt financing. Because the "use" of runways taxings, and gates is mixed, such assets may also not be eligible for tax-exempt financing.

An exemption would allow tax-exempt financed facilities to be used by a non-governmental entity under a short-term management contract. For example, a solid waste disposal facility serving the general public could be financed with tax-exempt bonds if it were owned by a city and operated by the city or by a private operator under a one-year contract. If the proceeds were made available to a non-governmental entity to construct a privately owned solid waste facility, however, or if the city signed a long-term management contract with a private contractor, the bonds would not be tax-exempt. Allocation rules would be provided for facilities where the uses were partly public and partly private.

The tax exemption would be preserved for bonds which finance ordinary government operations and government buildings, unless more than 1% of such a building is leased to a non-governmental entity. Certain IDB requirements under current law, such as reporting requirements, would be extended to all tax-exempt bonds, and other restrictions, such as the prohibition on federal guarantees of tax-exempt debt, would be retained.

All advance refundings of tax-exempt bonds would be prohibited. Refundings would be permitted only if the refunding transactions occur immediately after refunding bonds are sold. These prohibitions would apply to all obligations issued after January 1, 1986.

Discussion of the changes included in the Tax Proposal can be divided into three general categories: (i) limitations on the projects for which tax-exempt bonds can be issued, (ii) additional limitations on advance refundings and the investment of bond proceeds; which will drive up the effective cost of debt; and (iii) structural changes in the tax code which alter marginal tax rates and will change the composition of the investor universe for tax-exempt bonds.

(i) Limitations on the issuance and use of tax-exempt bonds

The Tax Proposal would generally cause tax-exempt interest rates to increase, even though the proposal includes numerous restrictions which would reduce the supply of tax-exempt bonds. The Tax Proposal assumes the effect of decreasing supply would more than offset the changes in demand. This simplified analysis ignores the critical fact that tax-exempt debt must compete with all alternative investments and not just other municipal bonds. This cross-market competition puts a "floor" under the rate for municipal bonds which would otherwise be determined by supply and demand within the tax-exempt market. The Tax Proposal's changes to supply will not offset the general upward pressure on tax-exempt interest rates.

The most radical change contained in the Tax Proposal, with regard to infrastructure financing, is the elimination of the tax exemption on all bonds which involve "non-governmental use." The definition of non-governmental use includes the use, directly or indirectly, of more than 1% of a facility by any private person or business, regardless of the need for the service provided. The proposed change from exempting bonds with "public purpose" to exempting only those bonds which avoid "non-governmental" use will impede many types of infrastructure financing.

One example in which tax-exempt bonds have been used by a private entity for a public use is in the construction of resource recovery plants. Resource recovery is now a successful partnership between private industry and government which provides a critical public service. Private companies can participate in the construction and operation of multiple plants around the country. The scale upon which such companies operate allow for certain economies and a greater accumulation of expertise. In addition, risk can be shared between the public owner/operator. Private companies also can take advantage of certain expenses, such as depreciation, which increase the economic value of the plant to the private participants. When a government then adds the benefits of tax-exempt bonds, the result is a reduction in the costs to users of protecting the environment. The Tax Proposal would substantially alter the economics of this relationship.

Wastewater treatment efforts would also be impacted. Pretreatment of commercial and industrial wastes prior to discharge into a sewer system is an effective technique for reducing demands on the main treatment facility. Clearly, this benefits the public at large. However, the pretreatment facility is not available to the general public and could not be financed with tax-exempt bonds.

There are also many instances where private entities use government owned facilities to provide a service which augments the amenities of a government facility. Turnpikes and toll roads are one example. Private companies lease publicly owned facilities in order to provide the traveling public with fuel, food and rest. Under the Tax Proposal, such convenience facilities would either have to be government owned and operated, or financed with taxable debt.

The Tax Proposal does permit the extension of a governmental service, such as roads, water and sewer, to benefit a private individual, provided that access and price are the same as are available to the general public. This requirement to establish a uniform pricing and use structure for all users of a system will impose higher costs on all users by limiting the ability of a government to influence use and load management through favorable pricing.

Water supply and wastewater treatment are two areas where the restriction on pricing could impede the financing of repair and rehabilitation on existing systems, particularly small systems in rural areas. One of the criteria used to evaluate the security of a water or wastewater financing is diversity of the service area. If a service area has one or more large, dominant users, the security rests, in part, on the stability of those large users. In order to increase security, many issuers have entered into agreements which require a large user to pay a fixed percentage of the annual principal and interest on bonds. Annual charges for operating and maintenance expenses would be added to the fixed payment. The general public would pay a single annual charge. Since the public does not have equal access to the facilities, any future financing for upgrading of treatment standards, or rehabilitation of plant and equipment, could not be financed with tax-exempt bonds.

The Tax Proposal is also unclear on who is a user. For example, a state water authority sells water to local systems for resale to customers. Who are the users for determining eligibility for tax-exempt financing? Is it the local governments? If the users are the customers, then the tax-exemption would be denied if any customer had signed a contract providing for a two tiered payment, as previously mentioned, and used more that 1% of the facility. But which facility? The local water system, or the state water system? If the search for use reaches to the lowest level, it could become impossible to finance facilities which are used for the traditional government functions of water supply and sewage treatment.

(ii) Limitations on advance refundings and the investment of bond proceeds

Advance refunding is a widely used cash management practice. It is usually undertaken to accomplish one or both of two goals: to reduce interest costs and to gain flexibility in using funds.

Bond indentures typically place restrictions on how revenues generated by bond-financed facilities may be expended. They require operating costs and debt service obligations, principal and interest, to be paid. Often they require other reserves, usually to cover upcoming debt service payments. Requirements placed on revenues in excess of these amounts vary widely from bond issue to bond issue.

A financially successful state turnpike can be used to illustrate the significance of advance refunding. The outstanding turnpike bonds may have indenture requirements the toll system can readily meet, but any excess revenues may be limited to generating interest earnings for the turnpike. By refunding the outstanding bonds with an issue that has more flexible indenture requirements, the excess revenues might be used to leverage other bonds, to sustain a revolving loan fund or to serve other transportation infrastructure purposes. Without the refunding, limitations set sometime earlier and not due to expire for years to come would restrict the level of physical investment the turnpike revenues could sustain.

In addition to eliminating advance refundings, the Tax Proposal calls for rebating to the U.S. Treasury all arbitrage earnings on nonpurpose obligations acquired with the proceeds of tax-exempt bonds (subject to certain "temporary period" exceptions). Furthermore, the rate at which proceeds of tax-exempt bond issues can be invested will be constrained to the yield on the bond issue without regard to the costs associated with issuing of the bonds.

Eliminating advance refundings would further limit the supply of tax-exempt bonds in the market. It will prohibit an issuer from refinancing outstanding indebtedness to get more favorable interest rates and thereby increase debt service requirements. Eliminating arbitrage earnings will increase issuers' net debt service costs and eliminate recovering the costs of issuance over the life of the bonds. These increases in the annual debt service requirements of issuers will raise the cost of infrastructure financing.

(iii) Structural changes affecting investors in tax exempt bonds

The essence of tax reform is the modification of the rate structure to lower marginal income tax rates. Tax-exempt debt must compete with taxable fixed income investments to attract investors. Since an investor does not pay taxes on valid state and local government debt, investors will pay a higher price for these bonds (that is, accept a lower interest rate). Lowering marginal tax rates will change the point at which an investor will become indifferent between taxable and tax-exempt securities. For example, under current law, an investor in the top marginal tax bracket (50%) would be indifferent to 10% tax-exempt debt as opposed to 20% taxable debt of comparable credit quality and terms. Under the Tax Proposal, this trade off would occur at a 15.4% taxable yield. Clearly, lowering marginal tax rates would make tax-exempt debt less attractive, reduce the pool of potential investors, and drive up interest rates, assuming the same level of supply.

The Tax Proposal includes other changes which will affect the demand for tax-exempt debt. Elimination of the deduction for interest paid by financial institutions to purchase municipal bonds will increase the cost of funds for commercial banks which hold such debt. This will act as a strong disincentive to purchase new issues of municipal bonds since banks tend to dominate the market for intermediate maturities (5-15 years). Lowering demand will raise interest rates for these maturities.

Property and casualty companies are major buyers of municipal bonds, particularly those bonds with maturities of twenty years or greater. The Tax Proposal would make tax-exempt bonds a less attractive investment vehicle for fixed income investment by requiring these companies to allocate a portion of their tax exempt income to policyholder reserves. Whether the absence of these buyers will add to the upward pressure on rates caused by the reduction of commercial bank holdings remains to be seen.

The Tax Proposal will curtail or modify most aspects of current law that allow sheltering of outside income through such provisions as eliminating the deduction for interest expense and applying the "at risk" doctrine to most investments. Demand for the tax exempt bonds may increase somewhat for investors who are no longer able to shelter income due to the proposal's elimination from the tax code of most existing tax shelter provisions.

The overall impact of these structural changes in current tax law on tax-exempt interest rates is uncertain. However, certain trends can be identified. First, the reduction in marginal income tax rates will increase short term tax-exempt interest rates. To attract and keep investors, the tax-exempt funds must be competitive on an after-tax yield measure. For any level of general short term rates, tax-exempt rates will have to increase if lower marginal tax rates are in effect.

Second, intermediate term interest rates will also rise, given the pressure created by higher short term rates lifting the yield curve and the reduction in holdings of tax-exempt bonds by commercial banks.

Finally, long term rates will probably remain stable or increase slightly. The relationship between interest rates and length of the debt (the "yield curve") would theoretically indicate that long term rates (16 years and over) will need to rise as well. However, the general upward pressure from short and intermediate term rates together with a decline in demand by property and casualty insurers need not necessarily raise rates immediately, because long term interest rates have been relatively flat over the last several years.

CONCLUSIONS AND PROPOSALS

Taxpayers want to feel that the tax and fee burdens they bear are commensurate with the value of the benefits they believe they are receiving from public facilities and services. Facility costs will depend in part on how well a facility is managed and on how much it costs to construct, with the latter heavily influenced by the cost of capital. The interest exemption on state and local bonds and the deductibility of state and local taxes directly affect the interest rates governments must pay on their bonds and voters' perceptions of how much burden taxes and service fees constitute. As that burden rises, for whatever cause, there is less incentive to invest in public capital facilities, particularly when direct personal benefits are less obvious than general social ones.

Financial resources will be generated more easily if public expenditures leverage private spending as well. Here, again, the tax laws are vitally important because they can help or hinder private sector participation. Frequent or sweeping changes do not engender the confidence and stability that private investors require before committing their resources. Because the tax changes that will encourage private sector participation will probably restrict short-term national tax collections, deficit reduction efforts can run counter to the goals of improving the public physical asset base, enhancing tax equity and simplifying the tax system. The following policy ideas could serve to mitigate some of this conflict.

1. The definition of "government use" could be expanded to include infrastructure facilities which provide a public good regardless of the use of the facility. For example, the 1% rule could be kept at the current level of 25% in aggregate, instead of the proposed 1% by any single user. Access by the general public could be defined as the use of a system for the benefit of the general public, not use of each component by the general public. Pricing by classification of customers could also be left to the discretion of the state and local governments without violating the access provision. Grandfather provisions could be included to protect those existing systems which could otherwise be unable to issue tax-exempt bonds.

2. A redefinition of "public purpose" which would include privately owned municipal water, sewage and solid waste disposal plants as in Section 216(a) of TEFRA could be developed, and projects meeting this definition could be exempted from the changes in ACRS and the repeal of ITC. Such facilities might be depreciated by the straight-line method using ACRS lives, as under current law, or might be permitted full ACRS treatment as they were before 1984.

3. Alternatively, continuing ACRS and ITC benefits for privately owned resource recovery plants and sewage treatment facilities which serve the public good could be provided under an environmental use provision.

4. Current 5 year property that is part of such "public purpose" facilities could be placed in CCRS Class 1 or Class 2 so they could retain shortened depreciation lives.

5. If IDBs are taxable, simple exceptions for waste water treatment facilities and solid waste (resource recovery) facilities might be enacted.

6. Should any tax exemption for IDBs be retained, privately owned resource recovery plants and sewage treatment facilities could be exempt from any caps on states' issuance of IDBs.

7. Advance refundings could be permitted on the same basis as currently implemented in the law.

Tab B: The Principal Allegations in the Draft Paper, "The Implications of Tax Reform for Infrastructure Financing and Capital Formation," Prepared by the Senate Budget Committee's Private Sector Advisory Panel on Infrastructure Financing, and OMB Responses to these Allegatons.

I. ACRS and ITC

Panel Allegations:

- The proposed change in depreciation will affect the financing of public facilities because ACRS applies to most of the tangible property in such facilities. A significant portion of public physical assets currently qualify as five-year recovery property. For example, 80 to 90% of the cost of a wastewater treatment project typically qualifies for a five-year ACRS deduction. Under the proposed CCRS, these depreciation schedules would be lengthened for most equipment to 7 to 10 years.

- Depreciation schedules keenly affect private sector interest in "full service contracts," under which governments sign long term agreements with private firms to build, own, and operate such traditional public facilities as wastewater treatment plants and solid waste disposal units. Under the tax proposal, private sector investors would reduce their equity investment and/or seek higher user fees to increase cash flow in order to receive a rate of return sufficient to justify such an investment.

- The tax proposal would repeal the ITC on property purchased on or after January 1, 1986. The fiscal impact of this change would vary from one facility or project to another. Normally, the ITC is claimed in the first year that a facility is in service. For projects with a construction period greater than 24 months, however, the ITC can be claimed on a progress expenditure basis. Although land does not qualify for the ITC, land improvements, including roads, excavation and concrete, may qualify. Therefore, the costs not qualifying for an ITC would typically be a relatively small portion of the total cost of some public physical asset such as a wastewater treatment facility. In general, 80 to 90% of the cost of a typical wastewater treatment facility will qualify for the 10% ITC.

- The National Resource Recovery Association estimates that, without the ITC, municipal disposal costs will rise between 10% and 20% per ton of refuse.

Panel Recommendations:

- o "Public purpose" should be redefined to include privately owned municipal water, sewage, and solid waste disposal plants (as in Section 216(a) of TEFRA), and projects meeting this definition should be exempted from the changes in ACRS and the repeal of ITC. Such facilities might be depreciated by the straight-line method using ACRS lives, as under current law, or might be permitted full ACRS treatment as they were before 1984.

- o Alternatively, ACRS and ITC benefits should be maintained for privately owned resource recovery plants and sewage treatment facilities that serve the public good under an environmental use provision.

- o Current 5-year property that is part of such "public purpose" resource recovery plants and sewage treatment facilities should be placed in CCRS Class 1 or Class 2 so they could retain shortened depreciation lives.

OMB Response:

- o The Panel paper misleadingly implies that a significant share of infrastructure projects would be affected by the ACRS and ITC elements of the tax proposal.

  -- In fact, there are relatively few privately owned and operated infrastructure systems that earn income that is subject to taxation and therefore could benefit from ACRS and ITC under current law.

  -- ITC has never been available for privately owned property leased to State and local governments. Prior to the enactment of DEFRA, some private owners avoided this restriction by entering into "service contracts" with State and local governments rather than leases. Under these arrangemnts, governments contracted for a service to be provided by the owner rather than for use of the property itself, thus enabling the owner to take advantage of ITC. DEFRA narrowed this loophole by providing criteria for determining whether such "service contracts" were actually leases and therefore ineligible for ITC. Some infrastructure facilities did meet these criteria.

  -- DEFRA disallowed the use of ACRS for privately owned property leased to State and local governments, with several exceptions that included only selected sewage and solid waste disposal facilities. In particular, DEFRA prohibited the use of ACRS for resource recovery facilities that are funded through IDB's.

- The Panel paper discusses the proposed changes in ACRS and ITC in a vacuum, but omits mention of the investment incentives in the tax proposal from (1) indexing the basis for depreciation to the rate of inflation; (2) reducing the corporation income tax rate; and (3) allowing a 10% corporate deduction for net dividends paid.

  -- Treasury has performed an analysis of the effect of the tax proposal on the effective corporate tax rate on returns to new investment which indicates that the tax package as a whole (excluding changes in the criteria for tax-exempt financing) would significantly reduce the effective tax rate on the sum of structures and equipment (inventories would be minimal for infrastructure-type investments) if the inflation rate is 5% or higher. (See Table 1.) The effective corporate tax rate would fall significantly for structures, but increase for equipment. Although utility-type infrastructure projects are relatively equipment-intensive compared to other investment projects, there is no indication that their effective tax rates would rise, except under very low inflation rate situations.

- The National Resource Recovery Association estimate that, without the ITC, municipal disposal costs will rise between 10% and 20% per ton of refuse is preposterous on its face. If there were no capital costs for structures and land and if there were no cost for labor, fuel, and other inputs, repeal would be expected to raise the cost of refuse disposal by 10% in the long run. Since refuse disposal requires these other inputs as well, the disposal costs would rise by significantly less than 10%, not taking into account the other elements of the tax proposal.

- The Panel provides no justification for providing Federal tax breaks for infrastructure investment, which must be borne by all U.S. taxpayers, rather than funding these costs through user fees or local taxes.

II. Deduction of State and Local Taxes

Panel Allegations:

- Eliminating the deductibility of State and local taxes will increase taxpayer resistance and will make it harder for State and local governments to maintain or increase current tax rates at a time when some other revenues, especially Federal grants, are declining. At the same time, the cost of borrowing for State and local government

Table 1

Effective Corporate Income Tax Rates on Equity Financed Investments
Returns to Capital Distributed Equally Between Dividends and Capital Gains 1/

	All 2/ Capital	Equipment and Structures	Equipment	Structures	Inventories 3/
Pre-1981 law 4/					
at 10% inflation	48	48	31	53	46
ACRS 5/					
With investment tax credit					
at 10% inflation	41	40	20	45	46
at 5% inflation	35	31	-4	39	46
Without investment tax credit					
at 5% inflation	41	39	41	39	46
RCRS					
With 50% dividend relief 6/	26	26	25	26	27
Capital Cost Recovery System With 10% dividend relief 7/	25	22	17	24	32

Office of the Secretary of the Treasury — May 28, 1985

1/ Assumes a 4 percent real return after corporate tax. Assumes two-thirds of capital gains deferred indefinitely, and the remaining third taxed at the given statutory rate less the applicable exclusion. The effective tax rate at the entity level may be lower than reported here on leveraged investments, depending on the degree of debt finance and the relation between the interest rate on debt and the rate of return on the investment.
2/ All capital includes equipment, structures and inventories.
3/ Assumes LIFO accounting with no reduction in inventories and inventory prices rising with inflation.
4/ Assumes 46 percent corporate statutory tax rate and 60 percent capital gains exclusion. Assumes sum of years digits depreciation over 9 years and 10 percent investment credit for equipment and 150 percent declining balance over a 34.4-year life for structures.
5/ Assumes 46 percent corporate tax rate and 32.7 percent personal tax rate with 60 percent capital gains exclusion. Assumes 5-year depreciation schedule with half-basis adjustment for equipment and 18-year schedule for structures.
6/ RCRS with 50% dividend relief refers to the cost recovery system and dividend relief proposals contained in the Treasury Department's report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984. Assumed tax rates are given in footnote 7.
7/ Assumes 33 percent corporate rate with 50 percent capital gains exclusion. Assumes 10 percent corporate deduction for net dividends paid. Deviations in economic depreciation rates among assets may slightly alter tax rates.

enterprises is likely to increase, due to such actions as curbing the tax-exempt status of municipal debt. Therefore more and more pressure is placed on general obligations debt ceilings and property taxes. These mounting revenue and financing pressures are already causing governments to accept poorer debt structures and deteriorating balance sheets. In 1984, one major bond rating service downgraded almost 2 1/2 times as many units as it upgraded. This trend portends further disincentives for increasing investment in public physical assets.

- Loss of deductibility will amplify the adverse impact of the new restrictions to be imposed on the use of tax-exempt bonds for infrastructure. The impact will be most acute for small local governments whose citizens are most affected by tax increases.

Panel Recommendations: None.

OMB Response:

- The panel's assessment of taxpayer resistance is overstated:

  -- Only 1/3 of all taxpayers itemize their deductions.

  -- Because of the proposed increase in the personal exemption (to $2,000) and the reduction in marginal tax rates, only high income itemizers in high tax States will realize a tax increase under the President's tax proposal.

  -- To the extent that implementation of the tax proposals would result in a less distorted allocation of capital and hence greater growth, there is likely to be reduced demand for other State and local services and an increase in the tax base, thus freeing up resources for infrastructure.

- The Panel's claim that "some [State and local] revenues, especially Federal grants, are declining" is at best misleading.

  -- State and local total receipts on a NIPA basis rose 11.2% from 1983:1 to 1984:1 and rose an additional 7.1% from 1984:1 to 1985:1.

  -- State and local own-source receipts rose 12.4% and 7.6% in these two years. After inflation, these are still significant increases.

-- Federal grants (nominal outlays) proposed in the FY 1986 budget would be higher in each year, 1985 through 1990, than they were in 1984. The estimate for 1985, $107 billion, is almost $10 billion higher than the 1984 total.

o Many infrastructure projects are financed by user fees and therefore would not be affected by the proposed elimination of deductibility of State and local taxes.

III. Tax-Exempt Financing

a. Limitations on the Issuance and Use of Tax-Exempt Bonds

Panel Allegations:

o The most radical change contained in the tax proposal, with regard to infrastructure financing, is the elimination of the tax exemption on all bonds that involve "non-governmental use." The definition of non-governmental use includes the use, directly or indirectly, of more than 1% of a facility by any private person or business, regardless of the need for the service provided. The proposed change will impede many types of infrastructure financing.

-- One example in which tax-exempt bonds have been used by a private entity for a public use is in the construction of resource recovery plants. Private companies participate in the construction and operation of multiple plants around the country. The scale upon which such companies operate allows for certain economies and a greater accumulation of expertise. In addition, risk can be shared between the public owner and private operator. Private companies also can take advantage of certain expenses, such as depreciation, which increase the economic value of the plant to the private participants. When a government then adds the benefits of tax-exempt bonds, the result is a reduction in the costs to users of protecting the environment. The tax proposal would substantially reduce the profitability of this relationship.

-- Wastewater treatment efforts would also be affected. Pretreatment of commercial and industrial wastes prior to discharge into a sewer system is an effective technique for reducing demands on the main treatment facility. Clearly, this benefits the public at large. However, the pretreatment facility is not available to the general public and could not be financed with tax-exempt bonds.

-- There are also many instances where private entities use government owned facilities to provide a service that augments the basic services of a government facility. Turnpikes and toll roads are one example. Private companies lease publicly owned facilities in order to provide the traveling public with fuel, food, and rest. Under the tax proposal, such convenience facilities would either have to be government owned and operated, or financed with taxable debt.

-- The tax proposal does permit the extension of a governmental service, such as roads or water and sewer systems, to benefit a private individual, provided that access and price are the same as are available to the general public. This requirement to establish a uniform pricing and use structure for all users of a system, however, will impose higher costs on all users by limiting the ability of a government to influence use and load management through favorable pricing. Water supply and wastewater treatment are two areas where the restriction on pricing could impede the financing of repair and rehabilitation on existing systems, particularly small systems in rural areas. For example, rural areas often need the assurance of maintaining one or two major users in order to obtain attractive financing for water or wastewater facilities. In order to gain that assurance, many issuers have entered into agreements that require the large users to pay a fixed percentage of the annual princcipal and interest on bonds. Annual charges for operating and maintenance expenses are added to the fixed payment. The general public pay a single annual charge. Since the public does not have equal access to the facilities, any future financing for upgrading of treatment standards, or rehabilitation of plant and equipment, could not be financed with tax-exempt bonds.

-- The tax proposal also is unclear on who is a user. For example, a state water authority sells water to local systems for resale to customers. Who are the users for determining eligibility for tax-exempt financing? Is it the local governments? If the users are the customers, then the tax-exemption would be denied if any customer had signed a contract providing for a two tiered payment, as previously mentioned, and used more than 1% of the facility. But which facility? The local water system, or the state water system? If the search for use reaches to the lowest level, it could become impossible to finance facilities that are used for the traditional government functions of water supply and sewage treatment.

Panel Recommendation

- The definition of "government use" could be expanded to include infrastructure facilities that provide a public good regardless of the use of the facility. For example, the 1% rule could be kept at the current level of 25% in aggregate, instead of the proposed 1% by any single user. Access by the general public could be defined as the use of a system for the benefit of the general public, not use of each component by the general public. Pricing by classification of customers could also be left to the discretion of the State and local governments without violating the access provision. Grandfather provisions could be included to protect those existing systems that would otherwise be unable to issue tax-exempt bonds.

- "Public purpose" could be redefined to include privately owned municipal water, sewage, and solid waste disposal plants.

- If IDBs are taxable, simple exceptions for waste water treatment facilities and solid waste (resource recovery) facilities might be enacted.

- Should any tax exemption for IDBs be retained, privately owned resource recovery plants and sewage treatment facilities could be exempt from any caps on states' issuance of IDBs.

OMB Response:

- Given the basic principle underlying the tax proposal -- promoting efficiency by according alternative investment options equal (neutral) tax treatment -- the burden rests heavily on any interest group to demonstrate that a particular class of investment projects has such significant public good aspects that it merits a subsidy, that the Federal government is the appropriate level of government to provide the subsidy, and that the tax code offers the most efficient way to provide that subsidy. The Treasury's tax proposal takes a narrow view of "governmental use" in order to place the burden properly on the beneficiaries of tax-exempt status to prove that such status is justified.

  -- As a starting point, any investment project that competes directly with other projects that are financed by taxable bonds should not get tax-exempt status.

-- Similarly, infrastructure projects that provide strictly local benefits generally do not merit Federal subsidy. As part of Federal, State, local comity, the Federal government may agree to provide tax-exempt status to those basic local projects that are accorded such high local priority that they are financed by general obligation bonds bearing the full backing of the locality, but such subsidization should not be expanded beyond the most basic, highest priority projects.

-- At the same time, there is increasing recognition that the private sector can perform some quasi-public functions more efficiently than the private sector can -- e.g., can better accommodate risk, can take advantage of scale economies or accumulated knowledge -- and that it is important to make sure that the tax laws do not skew the choice of public vs. private provider in favor of an inefficient public sector option. This could occur if the public sector option receives tax-exempt financing but the private sector alternative does not. (On the other hand, the private company might enjoy depreciation write-offs and other tax incentives not available to the public provider.)

o The trend toward greater private involvement in resource recovery activities is strong. Of 128 plants in operation or under construction, 42% are privately owned and 64% privately operated. Of 41 plants currently in the planning or projection stage, 68% will be privately owned and 82% privately operated. Clearly, in the absence of changes in the tax laws, this industry would become increasingly privatized. It is therefore important to review the impact of the tax proposal on the public/private choice.

o In attempting to define criteria for tax-exempt status, the tax proposal may have set overly restrictive standards in areas where both public and private solutions exist and compete, or where a public/private partnership would be efficient. As a result, the proposal may create incentives to choose inefficient public solutions, particularly in two infrastructure areas -- solid waste disposal/resource recovery and wastewater treatment. It is appropriate to review, and where necessary modify, the proposed criteria to assure that they do not inefficiently distort decisions toward or away from either public or private options. If any modifications are needed, they should be constructed as narrowly as possible to avoid creation of unintended loopholes. The Panel's recommendations clearly are far too broad.

-- The specific proposed criteria that merit further review include:

- the 1% rule, which would exclude tax-exempt debt financing for projects if more than 1% of the proceeds are "used" directly or indirectly by any person other than a State or local government. Thus, facilities that would dispose of the public's solid waste but would be owned, operated, or used (e.g., by a commercial purchaser of energy) by private persons would be ineligible for tax-exempt financing.

- the major exception to the 1% rule, which would allow tax-exempt financing of facilities used by a private person only if the facilities were available for use by the general public on the same basis. Under this exception, roads, sewers, and other systems serving the general public could be financed on a tax-exempt basis, but construction of a resource recovery facility tied by wires or pipes to a private company that would be its energy customer could not be so financed, even if waste disposal services are offered to the public.

- the rule explicitly prohibiting tax-exempt financing for projects that have long term management contracts with private persons. Under this proposal, use of performance based operating contracts to effectively protect the community from technological risk would prohibit tax-exempt financing. Only short-term management contracts of up to one-year would be allowed. Thus municipalities might receive performance guarantees for construction of a publicly owned facility, but would be faced with long term operating performance risks that would be difficult to cover adequately in a year-to-year management contract.

o To some extent, the solid waste disposal/resource recovery issue is regional or local, rather than national, in scope. The northeast is running out of sites for land fills and therefore is actively seeking resource recovery alternatives. This is not yet the case for the rest of the nation. As a result, some southwestern Congressmen have not been receptive to the appeal of lobbyists from the northeast for tax-exemption in this area. This is soon likely to change, however. The new standards mandated by RCRA amendments will add substantially to the costs of using land fills for solid waste disposal, thus imposing costs on localities that currently are borne by the Federal government through Superfund and other programs. Under RCRA, resource recovery techniques become relatively more attractive alternatives to land fills, even if the former must be financed without the aid of tax-exempt bonds.

- o The Panel's concern with pretreatment facilities for commercial and industrial wastewater appears to be misplaced. According to officials in EPA's Office of Policy Planning and Evaluation, virtually no pretreatment facilities now in operation were funded using tax-exempt bonds. Rather, corporations rely on their own bond offerings or internal financing. These pretreatment facilities are tied directly into other operational facilities, and corporate managers choose to avoid the hassle, delay, and financial disclosure requirements associated with tax-exempt financing.

- o There is no justification for providing tax-exempt financing for highway fuel, food, and rest stops. These facilities compete with off-highway facilities and users should bear the full costs.

b. Limitations on Advance Refundings and the Investment Bond Proceeds

Panel Allegations:

- o The elimination of advance refundings would unduly restrict the ability of State and local governments to minimize interest costs and use available funds flexibly. That flexibility is necessary given existing restrictions imposed by bond indentures on how revenues generated by bond-financed facilities may be expended. A financially successful state turnpike can be used to illustrate the significance of advance refunding. The outstanding turnpike bonds may have indenture requirements the toll system can readily meet, but any excess revenues may be limited to generating interest earnings for the turnpike. By refunding the outstanding bonds with an issue that has more flexible indenture requirements, the excess revenues might be used to leverage other bonds, to sustain a revolving loan fund, or to serve other transportation infrastructure purposes. Without the refunding, limitations set sometime earlier and not due to expire for years to come would restrict the level of physical investment the turnpike revenues could sustain.

- o The elimination of advance refundings would further limit the supply of tax-exempt bonds in the market. It would prohibit an issuer from refinancing outstanding indebtedness to get more favorable interest rates and thereby increase debt service requirements. Eliminating arbitrage earnings would increase issuers' net debt service costs and eliminate recovering the costs of issuance over the life of the bonds. These increases in the annual debt service requirements of issuers would raise the cost of infrastructure financing.

Panel Recommendation:

- o Advance refundings should be permitted on the same basis as currently implemented in the law.

OMB Response:

- o Contrary to the repeated allegation in the Panel paper, advance refunding of tax-exempt bonds is not prohibited under the tax proposal. It is still allowed "if the proceeds of the refunding bonds are used immediately to retire the prior bond issue" instead of being kept for a while to earn arbitrage interest by being invested in taxable securities. Thus State and local governments would continue to have the flexibility to make optimal use of available funds and market conditions; they simply would lose the arbitrage subsidy.

  -- In the case of the turnpike, refunding to take advantage of less onerous bond indentures would be possible as long as the proceeds of the refunding bonds were used immediately to retire the prior bond issue.

- o Arbitrage has two undesirable consequences: (1) it may be used for activities ineligible for tax-exempt bond financing, since arbitrage is not subject to the use limitations applicable to proceeds of tax-exempt bonds; and (2) it increases the volume of tax-exempt bonds, thus bidding up tax-exempt interest rates and hence the costs of financing essential infrastructure projects.

c. Structural Changes Affecting Investors in Tax Exempt Bonds

Panel Allegations:

- o Interest on tax-exempt bond issues will rise as a result of the President's tax proposals, despite the reduced supply of tax-exempt issues, because of other tax changes that will significantly reduce the demand for tax-exempt issues. These changes include:

  -- lower marginal tax rates that reduce the interest rate differential at which investors will be indifferent between taxable and tax-exempt securities, thus reducing demand for short term tax-exempt maturities.

-- elimination of the deduction for interest paid by financial institutions to purchase municipal bonds, thus reducing the demand of commercial banks, which currently are major purchasers of intermediate (5 to 15 year) tax-exempt maturities.

-- the requirement that property and casualty insurance companies allocate a portion of their tax-exempt income to policyholder reserves will reduce insurance company demand for long term (20 years or greater) tax-exempt maturities.

Panel Recommendations: None

OMB Response:

o The Panel provides no quantitative analysis indicating that interest rates on tax-exempt issues would rise as a result of the tax proposal. The elimination of many tax shelters and the narrowed eligibility for tax-exempt status may more than offset the reduction in demand.

-- As indicated in Table 2, of $93.3 billion in total new issues of long term tax-exempt bonds in 1983, only $36.2 billion, or 39% were public purpose. Even with the caps that Congress has placed on IDB's, the public purpose share is projected to stay at that low level through 1986. Of the private purpose bonds, the categories that might involve infrastructure are pollution control IDB's and "other" IDB's (for private businesses that currently qualify for tax-exemption for such purposes as sewage disposal, airports, and docks), which totaled $10.5 billion in 1983. Thus even if the definition of public purpose were expanded to include additional infrastructure uses, fewer than half of the issues currently eligible for tax-exempt status would continue to be eligible.

-- The spread between the tax-exempt and taxable interest rates may increase or not change. There is no convincing evidence at this time that it will decline.

Table 2

TAX EXEMPT FINANCING (in billions of dollars)

	Calendar years										
	Actual [1]								Estimates		
	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Private purpose tax-exempts	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1	67.0	66.5	75.8
Housing bonds	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0	18.5	22.3	24.7
Single-family mortgage subsidy bonds	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0	11.5	14.8	16.6
Multi-family rental housing bonds	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3	5.5	6.0	6.6
Veterans general obligation bonds	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7	1.5	1.5	1.5
Private exempt entity bonds [2]	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7	11.0	12.1	13.2
Student loan bonds	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3	1.5	0.9	0.9
Pollution control industrial development bonds	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5	11.0	9.0	10.4
Small-issue industrial development bonds	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6	15.0	13.0	16.0
Other industrial development bonds [3]	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0	10.0	9.2	10.6
Public purpose tax-exempts	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2	39.6	43.6	48.0
Total new issues, long-term tax exempts	35.0	46.9	49.1	48.4	54.5	55.1	84.9	93.3	106.6	110.1	123.8

[1] Includes some estimates.
[2] Private exempt entity bonds are obligations of Internal Revenue Code Section 501 (c)(3) organizations such as private non-profit hospitals and educational facilities.
[3] Other IDB's include obligations for private businesses that qualify for tax exempt activities, such as sewage disposal, airports and docks.

Source: Office of Tax Analysis, Department of Treasury.