OVERVIEW OF THE MAJOR ISSUES REGARDING THE USE OF TAX-EXEMPT BONDS IN CALIFORNIA

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A. INTRODUCTION

There are presently some $30 billion in bonds outstanding that have been issued by California's state and local governments and whose interest income is exempt from both federal and California taxation.

The use of tax-exempt bonds has long been an integral part of financing governmental capital outlays in California; however, in recent years interest in and concern about tax-exempt borrowing has increased significantly, primarily due to such factors as growing backlogs of infrastructure financing needs, tightened budget positions of the government sector generally, certain unfavorable trends in the market for municipal debt, and the expansion of purposes for which tax-exempt bonds are now being issued. Given these factors, it has become increasingly important that the various policy issues associated with use of tax-exempt bonds be understood and addressed.

Today I would like to consider what the major current policy issues are regarding use of tax-exempt bonds, emphasizing one particular perspective--that of the California state government. My remarks assume that the state's goal involves the ability of California governments to:

(1) market enough bonds to meet their basic capital outlay needs,

(2) market bonds in a way that reflects capital outlay priorities, subject to the limited amount of total funding available to finance outlays,

(3) structure debt issues so as to maximize budgeting flexibility, and

(4) service debt at the least possible costs to taxpayers.

B. WHAT ARE THE ISSUES?

From the state government perspective, there appear to exist five general categories of policy issues regarding the use of tax-exempt bonds in California. These are:

(1) For <u>what purposes</u> should governments be permitted to issue tax-exempt bonds?

(2) <u>How much</u> tax-exempt debt should be issued in California and how should it be <u>allocated</u> between alternative uses?

(3) What <u>technical constraints</u> should the state impose on bond issues?

(4) To what extent should there be actual <u>direct state involvement</u> in <u>local</u> borrowing activities?

(5) If California decides that <u>state</u> government subsidies for bond financing are desirable, is the current reliance on the tax-exempt municipal bond subsidy mechanism the <u>best means</u> of providing state subsidies for borrowing?

C. ADDRESSING THE ISSUES

1. For What Purposes Should Tax-Exempt Bonds Be Permitted?

Unless state constitutions provide otherwise, state governments generally enact statutes which provide the legal authority for both themselves and most local governments to issue debt, including bonds whose interest income is exempt from taxes at the federal level and, if a state so chooses, at the state level as well.

Four questions should be considered by state policymakers when determining for what purposes local issuance of tax-exempt bonds should be permitted.

The first question is: Are the projects to be financed with tax-exempt bonds being undertaken for a clearly-perceived public purpose? Satisfying this "public purpose" criterion is important because the "expenditure" of foregone tax revenues implicit in the tax exemption subsidy mechanism should provide specific benefits of some sort to the public. Exactly where the line should be drawn when defining "public purpose", however, is not altogether obvious. Some activities, such as the construction of roads, sewers, and schools, are clearly public purpose and should qualify for tax-exempt financing under this criterion. A second class of activities are those which, like pollution control facilities, are carried out by the private sector and yet still produce certain direct public benefits. A third class of activities are those which, like industrial development and housing construction, are essentially also private sector in nature but directly benefit only certain parties; however, they also bestow indirect benefits to the public generally and are viewed as "good for the state." The case for borrowing subsidies for many activities in these latter two classes is open to considerable debate.

The second question is: Is long-term debt financing itself an appropriate way of funding these projects? In general, debt maturities should correspond to project lifespans. Thus, assuming that a government has already determined it is best to own, versus lease, capital, the answer to this question is "yes" when projects have long lifespans and their costs are to be allocated amongst project beneficiaries, whereas the answer is "no" when operating costs are involved or for short-lifespan capital projects which are better financed using short-term debt or outright up-front cash payments.

The third question is: Is the borrowing subsidy provided by a tax exemption on municipal bonds actually necessary in order for these projects to be undertaken and adequately financed? This question is most relevant for activities normally carried out by the private sector. Determining the actual need for and effectiveness of borrowing subsidies is important if taxpayers' monies are to be used most efficiently, and to avoid granting subsidies for activities which would have been undertaken anyway.

The fourth questions is: Does the federal government grant a tax exemption for bonds used to finance such projects? A federal exemption can benefit bond issuing entities and a state's economy generally, by lowering government capital costs, and by increasing the after-tax incomes of those who invest in such projects.

After considering these four questions, states have two separate decisions to make--for what purposes should governments be permitted to issue bonds, and for what types of permissible bonds should a state tax exemption be granted? In actual practice, most states (including California) simply permit bonds to be issued for whatever purposes a federal tax exemption is allowed, including the use of bonds for "quasi-private" purposes like industrial development, pollution facilities, hospitals, and housing. Likewise, most states automatically provide a state tax exemption for all of their own bonds and for locally-issued bonds. In contrast, most states have not specifically defined for themselves exactly what "public purpose" includes, nor have they determined the purposes for which borrowing subsidies are really "needed." As a result, the fundamental policy issue of for what purposes governments should be permitted to issue tax-exempt bonds has not yet been adequately addressed by most states, including California. Given this, we have recommended that:

- The Legislature review existing state policies governing the purposes for which tax exempt bonds may be used.
- The Legislature establish a formal mechanism for overseeing, on an ongoing basis, all bond-related legislation and regulations. One approach would be establishment of special legislative committees or subcommittees. This would enable bond-related matters to be approached in a comprehensive and consistent fashion, as opposed to the fragmented and piecemeal approach which has often characterized the past.

We have also recommended that in cases where tax exempt bonds are permitted, the Legislature consider whether:

- The exemption should be extended to be California franchise tax and
- The exemption should be extended to the anticipated portion of the capital gains income from bonds, not just to coupon interest income.

2. How Much Tax-Exempt Debt Should Be Issued and How Should It Be Allocated Between Alternative Uses?

If "too little" debt is issued, investment in public infrastructure may be inadequate or, because of the need to fund such investment from current revenues, today's taxpayers may be penalized on behalf of those taxpayers who will actually benefit from the public facilities in the future. On the other hand, if "too much" debt is issued, future taxpayers may face unreasonably high debt repayment burdens, interest costs on governmental borrowing by both localities and states may become excessive, and certain government bond issues--including those for essential public services--may become hard to market. At present, the major concern of most states appears to be whether the total level of borrowing has become "too much", and whether the allocation of borrowing is itself improper--specifically, "too much" borrowing for lower priority, nontraditional purposes (like assistance to private industry) and "too little" borrowing, both in relative and absolute terms, for higher-priority, more traditional infrastructure purposes (like roads, sewers, and schools).

Once that state governments have decided upon the general purposes for which governments may issue tax-exempt bonds, they have three basic positions from which to choose regarding the amount and allocation of bond borrowing:

- o First, they can permit the issuance of whatever volume of bonds the state and its localities desire.
- o Second, they can establish general or selective debt ceilings.
- o Third, they can actively control debt issuance, including the approval, priority-ordering, and timing of state and local bond sales.

Which of the above positions is "best" to adopt? This depends partly on the political philosophy in a state regarding the degree of autonomy that local decision-making should have. However, an equally important factor is whether states even have the ability to actually determine what the "right" amount of debt is. In theory, the "right" amount and allocation of debt depends on such factors as the need for public services, the extent to which these services should be provided by governmental-owned facilities as opposed to leased-facilities or contracts with private sector providers, the extent to which public facilities should be debt-financed, the priority-ordering of public services, the fiscal capacity of bond-issuing governments to service debt, and the capability of the financial markets to absorb debt, including the effects on borrowing costs as increasing volumes of debt are issued. In actual practice, providing answers to these questions is extremely difficult, especially given that in many states there are thousands of bond-issuing entities. For most states, even developing a reliable listing of state and local capital outlay needs and their priorities for the vast array of bond-related programs is a next-to-impossible task; the data collection process itself is overwhelming, let alone the difficulties of developing and using consistent measures to define and quantify capital outlay and financing needs. As a result, from an economic perspective, most actual or proposed state-imposed limits on debt issuance are inevitably rather arbitrary. Thus, these general debt limits provide little, if any, assurance that the "right" amount and allocation of debt--which themselves are generally not even known--will exist.

Given the above, it does not appear that the best course of action for · state like California is to attempt to establish comprehensive broad-based debt limits for the state, for individual localities or for localities statewide, or to actively regulate the actual timing and order of local debt sales generally. Rather, it makes more sense to consider the following three-pronged approach.

First, in the case where bonds are being used to finance traditional public outlays, such as roads, schools, and sanitation facilities, states should permit the issuance of whatever volume of bonds governments desire. The primary state concern here should be whether "too little" bond financing is occurring. Of course, it may be desirable for the state to impose regulations regarding proper debt security. However, rather than having such regulations themselves limit debt volume, states should be sure that localities are provided with sufficient revenue raising options to service whatever level of debt taxpayers should desire to finance needed basic public facilities.

Second, in the case where bonds are issued for nontraditional purposes such as private-purpose bonds issued for housing, pollution control, and industrial development, the state should restrict the amount of bonds issued. However, rather than relying on establishing formal debt limits on the volume of such bonds as the first choice, the state should initially attempt to focus on more tightly defining in statutes the cases in which these bonds should be issued, the interest being to accomplish specified policy goals. This would reduce the need for the state to arbitrarily establish debt limits and to worry about how to ration limited bond authorizations, while at the same time giving the local sector freedom to make its own debt-issuance decisions within the general bounds established by state laws. Another issue to address is whether bonds used for "nontraditional" proposes should be permitted to directly compete for the same sources of debt security as support bonds used for "traditional" purposes.

Third, regarding state certification of local bond issues, this should be confined to cases where a judgment is needed as to whether statutory requirements of bond programs are being met. For example, California permits industrial development revenue bonds to be issued only if such bonds spur economic development and do not subsidize business locations which would occur anyway; and a state review panel exists to judge whether this criterion is met. In contrast, it seems best to avoid broad-based direct state involvement in the approval, timing, and priority-ordering of local bond issues generally.

We have specifically recommended that:

- The Legislature amend existing law to (a) remove open-ended hand authorizations under the state's revenue bond programs and (b) provide that unused bond authorizations lapse automatically after a specified period of time.

- The California Constitution be amended so as to give localities greater access to the general obligation bond market, by permitting localities to temporarily raise property to rates expressly to amortize voter-approved bond-funded facilities.

- General debt ceilings, if implemented, not be viewed as "iron clad." They can be useful as a general "warning sign" of too much debt. However, unless a solid analytical basis can be found for determining what an optimal ceiling is, more tightly defining permissible uses of tax-exempt bonds is probably the most desirable approach to first focus on.

- The state avoid direct involvement in broad-based approval, timing and priority-ordering of local bond sales.

3. What Technical Constraints Should California Impose on Bond Issues?

Technical constraints on the structuring and marketing of bond issues are of interest because these provisions affect both the marketability and debt servicing costs of bonds. Four factors are especially important:

- Selection of the least-cost method of underwriting bond issues--competitive bid versus negotiated sale.

- Adoption of bidding rules to govern the sale of bonds which ensure that interest costs on servicing debt will be minimized.

- Development of optimal policies regarding interest rate ceilings and maximum allowable price discounts on bond issues.

- Creation of new and flexible debt instruments which are especially attractive to today's investors.

a. Competitive Bid Versus Negotiated Sale Underwriting

When governments market their bond issues, they have two basic choices. They can use competitive bidding to select the low bidder or they can attempt to arrange a negotiated sale to a specific underwriter.

The basic argument in favor of competitive underwriting naturally is that the forces of open market competition will tend to (1) minimize the profit spreads which underwriters will accept and (2) induce underwriters to seek out the "best" (that is, lowest-yield-demanding) bond investors. In contrast, the main argument favoring negotiated underwriting is that a bond issue can be designed with the specific interests or preferences of a particular underwriter in mind. In addition, a negotiated underwriting can remove the possibility that a bond issue will not be marketed successfully at a specific point in time, a factor which may be an important policy consideration for some issuers.

Which Marketing Approach is Best?

The answer to the question of which marketing approach--competitive or negotiated--minimizes the present value of interest costs to localities will vary from case to case, depending on the specific characteristics of the bonds involved and the economic climate in which they are sold. There are a number of factors which localities must consider when attempting to select which marketing approach to use, including state statutory requirements, which marketing approach will be most effective in developing investors' interest and knowledge about a bond issue, whether the particular type of financial instrument being marketed is well-accepted in the financial marketplace or requires special explanation, whether the size of the issue is too small to attract competing bidders, and whether the issuer requires flexible arrangements regarding such items as an issue's coupon rates, maturity structure, sales date, and pledged security.

Even when bond issuers have legal authority to choose between the two marketing approaches and have considered all of the above factors, however, making the correct choice can be a complex process and the final decision reached is not always clear-cut. What is important is for governments issuing bonds to realize that there are circumstances where negotiated sales can actually be less costly than competitive sales, and thus issuers should not necessarily assume that competitive-bid marketing will always minimize borrowing costs. This is especially true when there is some question as to the strength of the competitive forces involved in the bidding process itself. Many smaller local governments are especially prone to benefit from using negotiated sales, since their size and often infrequent involvement in selling debt can limit acceptance of their bonds in the competitive marketplace.

Given this, governments should take care to consider the potential benefits of negotiated sales, and existing statutes should be amended to ensure that this marketing option can be utilized. Specifically, we have recommended that:

- The Legislature reconsider the provisions of current state law that require all state general obligation bonds to be sold competitively.

- o The CDAC provide local entities with information and assistance in evaluating the potential benefits to be gained from negotiated sales, and

- o State law be amended to encourage the underwriting of revenue bonds by commercial banks, especially if federal statues are revised along these lines.

b. <u>Bidding Rules that Govern the Sale of Bonds</u>

For bond issues that are marketed competitively, "bidding rules" governing the bidding process must be established. These "bidding rules" can significantly influence the amount of interest that taxpayers must pay during the life of the bonds.

In order to minimize the true interest cost on a bond issue, an issuer must do two things. First, it must recognize that the "real" cost of interest payments on its debt depends on <u>when</u> the interest payments are to be made, because of the "time value of money." When this is not done, bidders tend to "frontload" bids by placing high coupon interest rates on short-maturity bonds, thereby raising "real" interest costs to localities. Second, the issuer must ensure that the coupon interest rates bid on bonds having specific maturities are <u>similar</u> to the interest rates which <u>individual</u> investors, who ultimately will buy the bonds from the underwriters, find attractive. If this is not done, the bonds will have to be resold by underwriters at prices where are either substantially above or below their par values, and this in turn can require bond issuers to pay higher "penalty" yields.

Bond-issuing governments have to choose from one of three basic methods for awarding bond issues to competing bidders. These are (a) the unrestricted net interest cost (NIC) method, (b) the net interest cost with constraints (NIC-C) method, and (c) the true interest cost (TIC) method.

The <u>NIC method</u> evaluates bond bids on the basis of the total coupon interest payments which an issuer would have to make over the life of a bond issue, but takes <u>no</u> special account of the <u>timing</u> of required interest payments, and thus does <u>not</u> recognize the time value of money. Excessive interest cost can thus result under NIC, both because bidders are encouraged to "frontload" their bids and thereby produce inefficient bids with "penalty" yields, and because the bid with the lowest nominal interest cost may not be the bid with the lowest "real" interest cost.

The <u>NIC-C method</u> imposes various constraints on the bidding process in order to overcome the shortcomings of the basic NIC method, with the basic aim being to make a bond issue's time profile of coupon interest rates correspond to the reoffering yield curve for municipal bonds. However, because NIC-C does not recognize the time value of money in evaluating bond bids, it can still result in bond issues being awarded to bidders who do <u>not</u> bid the lowest true interest cost amongst the bids submitted.

In contrast, the <u>TIC method</u> evaluates bond bids by expressing the interest payments required by each bid in terms of their present value or present worth. Thus, unlike the previous two methods, TIC adjusts nominal interest costs to reflect both the time value of money and inflation, by <u>discounting</u> future interest payments into the present.

What Method Should Be Used?

Governments wishing to minimize interest costs should adopt TIC, because TIC eliminates the risk that an economically "wrong" bid will be inadvertently selected, and also reduces the incentives for "frontloading" bids and thus the extent to which penalty yields are demanded by investors. Yet surprisingly, despite its obvious advantages and numerous recommendations from economists that it be adopted, TIC today is often not used for state revenue bond sales and is still used relatively infrequently by localities compared to both NIC and NIC-C. Thus, a clear potential for interest cost savings to many California governments exists. Accordingly, we have recommended that:

- All competitively-sold state general obligation and revenue bond issues be awarded on the basis of TIC, subject to appropriate bidding constraints.

- The same be done in the case of local bond sales.

- In addition to using TIC to award competitively-sold bonds, the state and its localities should also use the TIC method to assess interest costs when negotiated bond sales are being arranged.

- In the absence of TIC, California governments should use the "second best" approach of adopting whatever NIC bidding constraints will assure that the lowest NIC bid results in a TIC which is close to that which TIC bidding itself would produce.

c. Interest Rate Ceilings and Price Discounts

Interest Rate Ceilings. California imposes statutory limitations on the maximum interest rates that can be paid on both certain state and local government bonds. There have been a number of reasons offered in favor of interest rate ceilings, including placing an upper bound on debt servicing costs, discouraging the sale of government bonds when interest costs are temporarily inflated, and protecting the public from paying excessive interest costs when there is imperfect competition amongst underwriters or when bond sales are being negotiated with large and powerful underwriting syndicates.

What is often not considered, however, is that interest rate ceilings can produce costs as well as benefits, and that there are times when these costs can actually exceed the benefits. For example, interest rate ceilings can at times inadvertently prevent bond issues form being sold. Under such circumstances, rate ceilings may actually increase the cost of capital projects by forcing the postponement of contract awards, thereby allowing project costs to be driven up by inflationary forces. And even when bond-issuing governments faced with interest rate ceilings are successful in marketing debt during periods of high interest rates, they often do so only by adopting other bond features which make the issues more attractive to investors and thereby counteract the effect of the coupon interest rate limit on investors' willingness to purchase the bonds. Such actions--which can include shortening maturity structures and eliminating call provisions--tend themselves to raise the issuers' debt servicing costs and restrict their budgetary flexibility, and in some cases, may result in consequences even more undesirable than had interest rates exceeded the ceilings.

Given this, we have recommended that the Legislature should consider either:

(1) Removing statutory interest rate ceilings altogether and giving borrowing officials discretionary responsibility to establish ceilings on an issue-by-issue basis, so as to reflect actual credit market conditions at the time individual bond issues are marketed, or

(2) Indexing statutory interest rate ceilings to some barometer of financial market conditions, such as one of the widely-quoted Bond Buyer municipal bond interest rate indexes.

Price Discounts. When an underwriter purchases a local bond issue, the price it pays may be greater than, less than, or equal to the aggregate face value of the individual bonds comprising the issue. The issue is said to be purchased at a premium when the underwriter's payment is greater than the aggregate face value, at par when the purchase price equals the issue's face value, and at a discount when the price is less than face value.

In California, the state and some local governments prohibit the sale of certain local bond issues at a discount. This is most commonly done in the case of general obligation bonds requiring voter approval, since when a bond issue is sold at discount, a given limited bond authorization will raise less capital than otherwise. Nevertheless, there is a general consensus that governments can usually sell their bond issues at lowest interest cost if at least a small price discount to underwriters is permitted. This enables underwriters both to realize an underwriting profit and at the same time market the majority of individual bonds in an issue to investors at or near par value, which is a condition past studies have shown most individual investors prefer.

Accordingly, we have recommended that California governments permit a limited discount approximately equivalent to normal underwriting spreads--usually 1½ percent to 2 percent of the face value for most bond issues.

d. New and Modified Borrowing Instruments

A fourth consideration is that of better tailoring debt instruments to reflect investors' preferences.

In recent years, an unpredictable economy and turmoil in the financial markets have greatly increased the uncertainties facing both investors and bond issuers. Because of these conditions, reliance on the traditional long-term governmental debt instrument--the fixed-income, fixed-maturity, tax-exempt bond--is no longer necessarily the least cost means of financing state and local government capital expenditures. Instead, use of new or modified types of "creative capital financing" debt instruments can sometimes be mutually preferable to investors and bond issuers, and result in reduced borrowing costs. These alternative instruments include, among others, zero coupon bonds, compound interest bonds, stripped coupon bonds, stepped coupon bonds, tender option (or "put") bonds, super sinker bonds, floating rate and flexible interest bonds, detachable warrant bonds, tax-exempt leveraged lease financing, tax-exempt certificates of participation, and convertible bonds.

In many instances, conventional bond financing of capital expenditures will undoubtedly continue to be preferred by investors and issuers. At the same time, however, there certainly are cases where new financing tools will in fact reduce state and local borrowing costs, and governments can thus benefit from becoming more familiar with the new tools and exploring how to best utilize them. Existing statutes should be revised to permit the use of these tools.

4. To What Extent Should There Be Direct State Involvement in Local Borrowing Activities?

There are three areas in which some direct state involvement in local debt activities appears potentially desirable. These areas are (a) data collection, (b) technical assistance, and (c) "pooled" marketing and insuring of bonds issued by differing localities.

a. Data Collection

States are the governmental entities in the best position to collect, standardize, and make available financial information on local governments, including the outstanding volume of their bonded debt, the amount of new bond sales, the purposes for which debt has been issued, and debt servicing costs. Such data can help states to monitor the general fiscal position of their localities, and can serve as the foundation for assessing the ability of localities to finance capital needs. Local bond-related information can be maintained on detailed computerized data bases, cross-classified according to such dimensions as purpose, type of issuing locality, and type of debt, and disseminated either in routine reports or on a special request basis. There is, however, one thing which states should recognize--namely, that the collection of data, especially in large volume such as is involved in the case of local debt, imposes costs on both states and their bond-issuing localities. Thus, although most states need to improve their local debt-related data, states should carefully define the purposes for which such data is to be used so as to avoid imposing unnecessary costs on taxpayers.

b. Technical Assistance

States are also in a position to provide technical assistance to individual localities in the areas of structuring, marketing, and administering debt. This type of state technical assistance can be especially beneficial to small local entities with only limited or infrequent experience in bond financing. In developing its assistance programs, we believe that California should apply the following three general guidelines:

- First, state technical assistance in bond structuring, administration, and marketing should be limited to those activities which local governments cannot carry out effectively and efficiently themselves, or with advice from other localities, and should avoid duplicating functions which are already provided at reasonable cost by the private sector.

- Second, participation by local governments in technical assistance programs should be strictly voluntary.

- Third, except in special cases, technical assistance provided by the state should be funded on a full-cost basis by the local governments who benefit.

c. "Pooled" Marketing and Insuring of Local Bonds

One means by which localities can reduce their borrowing costs is to share the benefits of scale economies in bond marketing. One way of doing this is to "pool" together the debt issues of various localities for bidding and marketing purposes, so that average overhead underwriting and advertising costs per bond dollar can be reduced. A second method is to establish umbrella bond insurance programs for pools of bonds issued by different localities. This can reduce the riskiness of and broaden the geographic marketing areas for such bonds, thereby again lowering borrowing costs. The potential benefits of such programs are especially great for smaller and infrequent debt issuers without strong credit ratings, whose bonds normally sell only in a very narrow geographic market and who are frequently rejected for insurance coverage by private bond insurance companies or, if accepted, pay very high insurance premiums.

There are several ways in which local government bond marketing and insurance pools can be organized and administered. One is by groups of localities themselves. A second and better means, however, is by state governments. This latter option offers a number of advantages, since state governments are organizationally well-situated to coordinate pooled marketing activities of localities and are generally more experienced in matters related to debt issuance. Under this approach, state government administrative costs can be reimbursed by the local governments which benefit from the pooling activities, while the underlying autonomy of localities themselves can be protected by making participation voluntary.

Probably the best single approach for state like California is to consider establishing state bond banks for the pooled marketing, administering, and insuring of qualified local bonds. Empirical studies have shown that under such programs, many localities can in fact realize borrowing cost savings, especially when their bond issues are small and low-rated. In order to successfully establish and operate state bond bank programs, however, we believe that California must be sure to address the following three key issues:

- State Financial Liability. Unless an explicit state subsidy to local issuers is desired, a state bond bank program should operate at no direct cost to the state government. The focus of the state's effort, thus, should not be in any way to subsidize localities but rather to help make available to them the benefits of scale economies in bond marketing, administration, and insurance.

- Participation. Participation by localities in any future California bond bank program should be strictly voluntary. However, states should structure the programs to encourage participation by small and infrequent local bond issuers, for whom the potential cost savings from the programs are greatest.

- Criteria for Acceptance. Pooled local bond issues marketed by state bond banks should be packaged so as to be broadly accepted by investors in the prime national financial marketplace. To do so, pooled issues must have good credit standing. Thus, California would have must devise a means of identifying and rejecting applicants whose ability to service their debt is poor or who have ill-conceived projects. In addition, pooled issues should be constructed to include as homogeneous a group of local bond issues as possible, since the credit rating and general acceptability of pooled issues tend to decline the more heterogeneous their component bonds.

5. Is the Tax-Exempt Subsidy Mechanism the Best Means of Providing State Subsidies for State and Local Borrowing in California?

When states exempt from taxation the interest earned on bonds issued by themselves and their localities--as most states do--the borrowing costs paid by issuers are generally reduced. The tax exemption has a number of advantages as a mechanism to lower and subsidize borrowing costs. For example, it is well established in the financial marketplace and imposes no administrative costs on states. In addition, because the tax exemption generates an implicit subsidy to localities which automatically accrues to them whenever their bonds are outstanding, localities never have to be concerned about interruptions in receiving their subsidy benefits from states.

At the same time, however, many economists have also noted that the tax exemption on municipal bond interest income is not the most efficient means by which to subsidize governmental borrowing. This is because, of the intended subsidy amount--that is, the amount of foregone tax revenues due to the exemption--only a portion actually accrues to the governmental bond issuer. The remainder is retained by bond investors, and is referred to as the efficiency loss due to the tax exemption. This efficiency loss equals the amount of interest paid to investors which is in excess of the amount actually needed in order for them to be willing to purchase bonds. It arises because all investors who purchase a defined type of tax-exempt security at a specific point in time receive the same interest yield--namely, the yield needed to "clear the market"--even though some investors actually are willing to accept lower interest yields than others, because they are in higher tax brackets and thus the "value" of the tax exemption is greater to them. This "windfall" which certain investors reap represents the efficiency loss.

One obvious consideration for California is to reduce or eliminate altogether the efficiency loss inherent in its state tax exemption subsidy mechanism. This would enable the implicit state borrowing subsidy on bonds to be increased at no additional cost to the state government. Of course, the greatest potential for savings lies with eliminating the efficiency loss associated with the federal tax exemption for state and local government municipal bond interest income, given the high level and wide spectrum of federal marginal tax rates. However, there are also potential benefits to be gained from reducing the efficiency loss associated with state tax exemptions for state and local municipal bond interest income, given California's strongly progressive personal income tax bracket structure.

In the case of state-issued bonds, we have recommended that the Legislature consider to eliminating altogether the state tax-exemption on interest, since the revenues lost by the state in trying to "subsidize itself" probably exceed the savings from borrowing in the tax exempt market. In the case of locally-issued bonds, California has several means of addressing the efficiency loss inherent when using the tax exemption as a local bond subsidy mechanism:

- First, it can give localities the option of issuing state-taxable as well as state-tax-exempt bonds, or the state tax exemption itself can be entirely removed. Then, whenever state-taxable bonds are issued, localities can receive a direct subsidy payment from the state, to compensate in whole or in part for the increased borrowing costs incurred in selling state-taxable instead of state-tax-exempt bonds. These subsidy payments can be financed, at least in part, by state tax collections on the taxable local bonds.

- Second, subsidized loans can be provided to local bond issuers. Under this option, the state can directly loan monies to local governments at reduced interest rates. This subsidy approach offers the added benefits of taking advantage of the increased scale economies in marketing and administering debt available to the state government relative to localities. Of course, to the extent that the state finances these loans (or finances direct subsidy payments on taxable local bonds for that matter) by selling its own federally tax-exempt bonds, an efficiency loss will remain at the federal (although not at the state) level.

- Third, California can provide indirect subsidies such as state-financed insurance programs for local bond issuers. These programs reduce costs paid by localities, because of the reduced risk of default faced by investors and elimination of the need for localities to purchase their own insurance.

Under all of these alternatives, it may be possible for California localities to receive greater state subsidy benefits than under the current tax exemption mechanism, thereby reducing their borrowing costs, even though the state's cost of providing the subsidy need not increase. Another important advantage of these alternatives is that they would give the state greater ability to target subsidies and to discriminate in terms of the amount of subsidies granted to different types of bonds, different categories of bond-issuing entities, and different purposes for which bond financing is to be used. This is important because, from the perspective of state policymakers, some bond issues deserve greater state subsidies than others. Thus, the state and its local governments may both be able to benefit from replacing the state tax exemption on local bonds with alternative subsidy mechanisms.