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IMPACT OF THE FLAT TAX ON TAX EXEMPT BONDS

There has been some concern expressed by traders of tax exempt securities, brokers, and bondholders over the potential impact of major tax restructuring proposals on the tax exempt bond market. In particular, there is concern over the effect of such proposal on the market value of existing tax exempt bonds and on the interest cost facing state and local governments in the future. We conclude that these concerns are unfounded, and that pro-saving tax reform would raise returns to all savers and strengthen state and local government finances.

Most of the major tax restructuring proposals currently being circulated seek to correct the current income tax bias against income used for saving and investment. In the process, some of them would eliminate the difference in tax treatment between currently taxable and currently tax exempt securities.

The "flat tax" (such as the Armey-Shelby proposal) would effectively extend current tax exempt bond treatment to currently taxable bonds, and to other types of saving instruments, in a modified income tax context. Replacement of the income tax with either a national sales tax (such as proposed by Senator Lugar and Representative Archer) or a VAT would also erase the tax distinction between taxable and tax exempt bonds.

By contrast, the saving exempt income tax, as drafted by Senators Domenici and Nunn, would create a deduction for purchases of private sector securities to improve their treatment versus income used for consumption, but would preserve the tax treatment differential between private sector debt and state and local government debt by effectively doubling up on the tax deduction for state and local issues.[1]

Tax exempt bond dealers and financial writers have linked relative price weakness in the tax exempt bond market to prospects of enactment of the flat tax, and suggest that the flat tax would hurt the tax exempt bond market. For example, a recent column in Forbes magazine claims that tax exempt bonds would become less attractive.[2]

Has the prospect of the flat tax (or a national sales tax) depressed prices in the tax exempt bond market? Has this injured holders of existing tax exempt bonds? Would a federal flat tax system injure state, county, and local governments in the future?

There may be other reasons for relative price weakness in the tax exempt bond market.

Prospects for significant tax reform are better now than in many years. However, other tax and budget changes, and changing economic conditions, may also be affecting the tax exempt bond market.

- Taxes. The House passed tax bill provides significant reduction in capital gains taxes and the present value equivalent of first year write-off (expensing) of outlays on plant, equipment, and structures. These reforms may be watered down, but steps in this direction would boost returns on equities and divert saving from bonds to equities. Enhanced depreciation would also improve the ability of businesses to service debt, reducing risk premiums on taxable securities. It is difficult to calculate the net

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1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

effect on debt versus equities, but there would be a relative reduction in risk of taxable versus tax exempt bonds.

- Federal spending. Federal spending cuts would certainly benefit the economy as a whole, and would reduce the threat of tax increases that might add to the tax premium in interest rates and that might impair the ability of the private sector to service its debt. However, the spending cuts may include a reduction in federal transfer payments to the states and the transfer of responsibility for spending programs to state and7 local governments with only limited funding by federal block grants, suggesting that state and local governments might have to borrow more in the future or that they might be facing more budget pressures. It is possible, therefore, that the House and Senate Budget Resolutions could lead to a strengthening of the price of federal or private debt relative to state and local government debt. These concerns might well be over-blown. Reduced federal spending and a stronger private economy would raise the tax base of state and local governments and strengthen their finances.

- Inflation. A few months ago, inflation expectations appeared to be rising. Bond prices may have been depressed by such fears. More recently, there has been less talk of inflation, bond prices have rallied, and long term interest rates have pulled back. Inflation results in an inflation premium in interest rates. That inflation premium is larger for taxable bonds because the premium is taxable. A reduction in inflation expectations would probably result in a larger drop in interest rates and a stronger rally in the taxable bond market than the tax exempt bond market.

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If the demand for state and local government bonds were to fall on the anticipation of tax reform, their yields would have to rise, and existing bonds would fall in price. However, the bonds would pay full face value at maturity. Anyone holding tax exempt bonds to maturity would suffer no losses. In particular, investors who rely for spending money only on the interest from tax exempts, or who are receiving periodic returns of principal from bond funds, or who have a portfolio with staggered maturities such that some bonds are coming due each month or quarter, would not be inconvenienced. Indeed, they would be able to reinvest their principal returns at higher yields, and would have a gain in income, even before passage of the flat tax. (Income gains to savers after passage would be even higher, as noted below.)

The flat tax would not significantly alter the relative treatment of new issues of currently tax exempt and currently taxable types of debt instruments.

The flat tax would not worsen the tax treatment of state and local bonds. Savers currently lend to those governments on an after-tax basis, and there is no tax premium in the interest rate (no federal tax premium, and no state tax premium for own-state holders).

The interest rates on taxable bonds contain tax premiums. Bondholders are subject to federal income tax on interest they receive on their holdings of Federal debt, and to federal and state income

taxes on interest they receive on their holdings of corporate debt. These tax burdens are reflected in higher interest rates on such securities than would occur if the bonds were tax exempt. On an after-tax risk-adjusted basis, their yields are little different from yields on tax exempt securities. If the taxable bonds were to be put on an after-tax basis, their pre-tax yields would fall but their after-tax yields would not change significantly, nor would they suddenly become a threat to state and local debt instruments.

A shift to the flat tax would temporarily raise real after-tax rates of return on investment. Savers and lenders would profit from the change. Workers would benefit from higher investment.

- Assume for a moment that all borrowers and lenders are in the 35% federal tax bracket (and ignore state taxes). A state bond with a 6.5% coupon would be equivalent, after taxes, to a corporate bond with a 10% yield (ignoring risk differentials between government and private bonds). Both the buyer and the issuer of a corporate bond realize a 6.5% after-tax interest rate. The buyer of a corporate bond nets 6.5% after paying tax on the interest. The borrower gets to deduct interest paid, and only pays 6.5% after taxes. The gain from the tax exempt status of the state bond accrues to the state, not to the bondholder. In a competitive market, the bondholder would get the same after-tax yield from either type of bond, and the borrowers would face the same cost of borrowing.

- Under the flat tax, the corporate bond interest would be neither taxable to the lender nor tax deductible to the borrower. The tax premium would be removed from the interest rate, which would drop to 6.5%, leaving everyone in the same after-tax position as before. The state bond need not experience a change in interest rates to remain competitive.

- Interest rates on federal debt also include a tax premium. Removal of the tax on federal debt interest would result in a drop in interest rates on federal debt.

- Not everyone is in the same tax bracket, of course, so high bracket lenders tend to buy tax exempt securities while lower bracket lenders tend more toward the taxable bonds. However, the differences in after-tax yields are not great. (Again, most of the tax advantage is captured by the issuers, not the lenders.) In the event that the tax premiums were eliminated, the segmentation of the market would vanish and all lenders would consider buying all bonds. Current buyers of state and local bonds would put some corporate bonds in their portfolios; some buyers of corporate bonds would include state and municipal obligations in their portfolios. The net-of-tax interest rate changes needed to equalize the attractiveness of the various bonds would not be large.

- State and local debt would continue to enjoy the advantage of a tax exemption for own-state income taxes.

If the flat tax were to pass, its primary effect would be to alter the relative treatment of equities vs. debt, not taxable debt vs. non-taxable debt.

The Forbes magazine column claims that, relative to equities, the flat tax would make most bonds (the currently taxable types) more attractive (while municipal bonds, it claims, would become less attractive). The article asks, "If you can get 7.5% on Treasurys, free from all income tax, who needs the risks of the stock market? If relatively high quality junk bonds yield 10%, who needs to speculate in new issues?"[3]

The article has it exactly backwards. First of all, Treasurys and junk bonds would no longer yield

7.5% and 10%, respectively, but more like their current after-tax rates of (about) 4.9% and 6.5%, respectively (assuming a 35% tax rate).

Second, the current tax code double-taxes saving in interest bearing instruments, but triple-taxes (or worse) saving in equities. Income is taxed when it is first earned. If used for consumption, there is no further federal tax (a few excises aside). If, however, the income is saved, as in a bank account or by buying a bond, the saver also pays tax on the interest he or she receives. If the saving is invested in stock, there is the corporate tax on the earnings. In addition, however, if the after-tax corporate income is paid out, there is another tax on the dividends, and if the after-tax earnings are retained and reinvested, raising the stock price, there is a capital gains tax if the stock is sold. The flat tax puts debt and equity on an equal plane; it removes the single excess layer of tax on debt instruments, and the two excess layers of tax on equities. Tax neutrality would provide more relief, relative to current law, to equities than to debt, and would boost the stock market more than the bond market.

State and local governments would see an improvement in their fiscal condition brought about by the expanding economy and the resulting higher tax base.

If a more nearly neutral tax system were implemented, the economy would strengthen and state and local government revenues would increase. Those governments would be better off, not worse off.

State and local governments would have less need to borrow as the flat tax increased economic activity, incomes, property values, and state and local tax revenues. State and local governments would be better able to service debt, and have better credit ratings.

A shift to the flat tax would temporarily raise real after-tax rates of return on investment. Savers and lenders would profit from the change. Workers would benefit from higher investment.

The flat tax and the saving-exempt income tax would permit expensing (first year write-off) of investment in plant, equipment, and structures. A national sales tax, if confined to the retail level, would not tax purchases of plant and equipment. If these tax systems replace the current income tax, they would, initially, raise the real return on physical capital. The higher real returns on investment would be shared with lenders in the form of higher real after-tax interest rates.

The economy would adjust to lower taxes and higher rates of return by adding additional plant, equipment, and structures in the private sector over several years. As the desired augmentation of the physical capital stock was gradually achieved, and rates of return on capital declined to normal, real after-tax interest rates would return to normal levels as well. (Witness the pattern in the early 1980s as reduced taxes on saving and investment led to faster growth, which later tapered off.)

During the expansion, savers would have higher income per dollar of assets, and on a permanent basis, would have more assets on which to earn income. Additional capital accumulation would raise productivity, wages, and employment permanently. State and local governments would see an improvement in their fiscal condition brought about by the expanding economy and the resulting higher tax base.

Stephen Entin
Resident Scholar

Endnotes

1. In the Domenici-Nunn proposal, income saved, including income used to purchase bonds, would be deducted from taxable income, and returns on saving, including bond interest, would generally be included in taxable income (unless reinvested). Exempting the amount saved while taxing the return is equivalent, over the life of the bond, to simply excluding the interest from tax, as with current tax exempt bonds. If only private sector bonds were allowed this deduction of principal, and state and local bond interest were not taxed, the two types of bonds would enjoy equivalent tax status. However, Domenici-Nunn would allow individual income taxpayers to deduct purchases of state and local government securities as well, while continuing to exempt the interest on such bonds from tax, effectively doubling up on the current tax exclusion for state and local bonds and retaining their current tax advantage vis-a-vis private sector issues. For financial intermediaries, however, the state and local bond interest would be included in the taxable income.

2. "Flat tax winners and losers," by Richard Lehmann, *Forbes*, May 22, 1995, p. 280.

3. *Ibid*.

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.