

loan substitutes, introduced and encouraged by government policy as a kind of interest rate relief for borrowers. Tax-exempt financing reduces the cost of funds to those classes of borrowers who qualify for this indirect government subsidy. It has significantly reduced the taxable income of banks and thus their effective tax rates have fallen.

The main beneficiaries of this form of financing have not been the banks, but rather those business borrowers who, for one reason or another, could not make full use of the deductibility of interest expenses from their income. Small businesses also have benefitted from this type of financing, since their corporate tax rate is less than that paid by larger companies, including the banks. Under more usual forms of financing, the deductibility of interest expenses is of less benefit to a small business than to a company paying a higher marginal tax rate. Thus, as indicated in the text, this form of financing has had a minimal effect on bank profitability; the borrower receives the benefits of after-tax financing.

The banks' use of "loan substitutes" has had the sanction of government tax law or the explicit approval of government policy. Bank purchases of Small Business Development Bonds and Small Business Bonds have been actively promoted by the Federal Government. Thus the fall in the effective tax rate on banks relates to the extent to which banks act as agents of government policy. In some instances, bank spreads have widened through the use of such financing; however, the value of collateral on these loan substitutes has tended to be less than would normally be the case.

The widespread use of after-tax financing has resulted in some unforeseen tax problems for the banks. Because of the way bank profits are taxed, and because high interest rates and the use of loan substitutes have prompted the banks to defer the use of some tax deductions on domestic expenses, they risk losing some of these in the future. In some instances, banks may even lose some foreign tax credits. If that happens, then it will be bank shareholders, rather than the government, who will subsidize certain classes of borrowers.

The extent to which banks offer loan substitutes is directly related to their taxable income. If bank profitability declines, banks will reduce their offerings of loan substitutes, and the government policy that encouraged these substitutes will be frustrated.

Thus the Committee recommends:

11. The Federal Government should consider the future use of tax-exempt financing through financial institutions very carefully as a means of subsidizing certain classes of borrowers, taking into full account the consequences of this form of financing on bank profit levels, and on effective tax rates on banks, and assessing its net effect on the financial needs of borrowers. If after tax financing continues to be used, then consideration must be given to extending the banks' tax loss carry-forward provisions beyond five years.