TAX REFORM AND TAX PROVISIONS AFFECTING STATE AND LOCAL GOVERNMENTS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

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TAX REFORM AND TAX PROVISIONS AFFECTING STATE AND LOCAL GOVERNMENTS

TUESDAY, MARCH 19, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 10:05 a.m., in Room 1100, Longworth House Office Building, the Honorable Dave Camp [Chairman of the Committee] presiding.

[The advisory of the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225-3625
March 12, 2013
No. FC-03

Camp Announces Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

Congressman Dave Camp (R-MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on Federal tax provisions that affect State and local governments as part of the Committee's continued work on comprehensive tax reform. This tax reform hearing will examine the array of Federal tax provisions that affect State and local government operations and financing. **The hearing will take place on Tuesday, March 19, 2013, in Room 1100 of the Longworth House Office Building, beginning at 10:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

A number of different Federal tax provisions directly affect State and local governments. By far the largest tax expenditure affecting State and local governments is the itemized deduction for State and local taxes. Individual taxpayers who itemize may generally deduct their State and local income and property taxes. For some taxpayers, this deduction is reduced by the recently reinstated "Pease" limitation on itemized deductions and it is disallowed for taxpayers subject to the Alternative Minimum Tax (AMT). In addition, taxpayers may elect to deduct general sales taxes in lieu of income taxes, although this deduction expires at the end of this year, is also subject to the Pease limitation, and is disallowed under the AMT.

State and local governments also benefit from favorable Federal tax treatment of certain types of bonds they issue, including tax-exempt bonds, tax-credit bonds, and "direct-pay" bonds. In addition, numerous other Internal Revenue Code provisions have a significant impact on State and local governments, including pension and retirement provisions and payroll tax provisions, among others.

In announcing this hearing, Chairman Camp said, **"As we continue to work toward comprehensive tax reform that significantly lowers rates and makes the code fairer and simpler so that we can spur a climate for job creation, higher wages and better benefits, we**

must better understand how various aspects of the tax code affect stakeholders. To that end, it is important that the Committee hear directly from those who are familiar with the impact of Federal taxation on State and local governments before considering any proposals as part of comprehensive tax reform."

FOCUS OF THE HEARING:

The hearing will consider Federal tax provisions that affect State and local governments, and how those provisions should be viewed in the context of comprehensive tax reform.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://waysandmeans.house.gov, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Tuesday, April 2, 2013**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at http://www.waysandmeans.house.gov/.

Chairman CAMP. Good morning. The committee will come to order. Good morning, and thank you all for joining us today.

As part of the committee's efforts to strengthen the economy, create more jobs, and increase wages for American families by making the Tax Code simpler and fairer, today's hearing allows stakeholders and members of the public the opportunity to share their perspectives on tax reform and tax provisions affecting State and local governments.

Several items in the Tax Code directly affect State and local governments. The most significant and widely known provisions include the exclusion of State and local government income from Federal income tax; the itemized deduction for State and local income, property, and sales taxes; and various benefits for State and local bonds; and special rules for State and local government employee pensions and benefits. Other provisions indirectly affect State and local governments as well, such as the exclusion for contributions to corporate capital.

Over the last several years, we have heard much about how the Tax Code might be changed in ways that could affect State and local government activity. Some such as President Obama argue that exclusions, such as those for State and local bonds, and deductions, such as those for State and local taxes, inappropriately provide larger subsidies for high-income taxpayers and have advocated limiting the value of deductions and exclusions or replacing them with credits. Other tax reform proposals have also proposed significant reform of Federal tax provisions that affect State and local governments. Generally those proposals reduce the tax expenditures associated with these provisions and use the money to finance either rate reduction or higher spending. Both Democrats and Republicans, including Bowles-Simpson, Domenici-Rivlin, and tax reform panels appointed by President Obama and then-President George W. Bush, have offered these proposals.

Because such a wide range of policymakers have concluded that reform of tax provisions affecting State and local governments should be part of the discussion, it is critical to understand why they have come to such a conclusion, and it is equally critical to make sure the committee hears all sides of the story. Thus, in the interest of fairness, it will be important for the committee to examine how these Federal tax subsidies impact individual States.

For example, with regard to the deduction for State and local taxes, consider the following: In terms of the total value of deductions claimed, taxpayers in just three States—California, New York, and New Jersey—claim over 36 percent, more than one-third in 2010. These same States have some of the highest combined State and local income tax rates. California's State income tax rate is 13.3 percent, New Jersey's is 9 percent, and New York's highest combined income tax rate, which is in New York City, is 12.7 percent. Those findings and many more that have been uncovered over the years raise significant concerns about the current Tax Code is being used to pick winners and losers.

But we are not writing a tax reform bill in some ivory tower. Changes to the Tax Code will have a real impact on State and local economies, and the committee needs to hear directly from these stakeholders before considering any proposals as part of comprehensive tax reform. In addition to this hearing, the committee's 11 separate working groups also serve as a way to gather information from these stakeholders about how current tax laws affect them. These reports will be important to have as we begin to explore what changes, if any, should be considered, and I am hopeful they will take the opportunity to share their thoughts.

I would like to thank all of you for being here today. We have assembled a panel of four witnesses, each of whom has a broad set of experiences in this area, and I am sure they will provide a unique perspective to the discussion, and we look forward to your testimony.

Chairman CAMP. And I will now recognize the ranking member for the purposes of an opening statement.

Mr. LEVIN. Thank you very much, and welcome.

In the 11 tax reform working groups that we set up on a bipartisan basis, based on reports to date and my own participation, we are making progress toward understanding present laws and their pluses and minuses, and their possible implications for the policy challenges we face. In an important sense, the hearing today illustrates that challenge as we address tax reform.

Republicans in the budget to be voted on this week have once again reaffirmed their goal of collapsing the current rate structure to two brackets with a top rate of 25 percent. An analysis by the nonpartisan Tax Policy Center has indicated that the rate reduction and other specific tax policies in that budget would cost \$5.7 trillion over 10 years, yet the budget gives no indication or any illustration as to how to address this huge gap, most of which would involve Ways and Means jurisdiction.

We are familiar with the President's proposal to cap deductions at 28 percent. Various proposals to limit deductions and tax preferences have been put forth in the past. I believe there is value in considering thoughtful proposals as we seek a balanced approach to deficit reduction. However, the differences of opinion in the testimony before us today on one set of tax policies, those relating to State and local government, illustrate the need to distinguish between rhetoric and reality in addressing the important issue of tax reform.

I yield back.

Chairman CAMP. Thank you, Mr. Levin.

Now it is my pleasure to welcome our panel of experts, all of whom bring a wealth of experience from a variety of perspectives.

Their experience and insights will be very helpful as our committee considers the impact of Federal tax reform on State and local governments.

First I would like to welcome Scott Hodge, president of the Tax Foundation here in Washington, D.C. Mr. Hodge has spent over two decades working in tax policy, and his organization has provided this committee with a host of valuable data and insight through the years.

Second we will hear from David Parkhurst, who joined the National Governors Association in 2007 and currently serves as its director of its economic development and commerce committee.

Third we will hear from Christopher Taylor, an independent consultant who spent nearly 30 years as executive director of the Municipal Securities Rulemaking Board and now works in Alexandria, Virginia, as a financial consultant.

And finally we welcome back to the committee and we will hear from John Buckley, the former chief of staff for the Joint Committee on Taxation and the former Democratic chief tax counsel here at the Ways and Means Committee, who is currently a professor of tax law at Georgetown University Law Center. And again, welcome back, Professor Buckley.

Thank you all for being with us today. The committee has received each of your written statements, and they will be made part of the formal record. Each of you will be recognized for 5 minutes for your oral testimony, and, Mr. Hodge, we will begin with you. You are recognized for 5 minutes.

STATEMENT OF SCOTT HODGE, PRESIDENT, THE TAX FOUNDATION, WASHINGTON, DC

Mr. HODGE. Well, thank you, Mr. Chairman, and Ranking Member Levin, Members of the Committee. I appreciate the opportunity to contribute to this really important discussion of fundamental tax reform. And I think, as all of you recognize, one of the obvious goals of tax reform is to eliminate those parts of the Tax Code that have unintended side effects that outweigh whatever sort of policy reasons motivated their original creation. At the top of this list, actually, should be the various tax provisions benefiting State and local governments.

In the same way that a mortgage interest deduction may encourage some families to purchase a more expensive home than they would otherwise afford, the taxes-paid deduction and municipal bond exemptions encourage many States to tax more, spend more, and borrow more than they otherwise would. Academic research indicates that the taxes-paid deduction leads to greater reliance on tax-deductible taxes, such as progressive income taxes and property taxes, and ultimately leads to increases in State and local spending of own-source revenues.

The States with the largest amounts of taxes-paid deductions currently spend $2,800 more per capita on average than States with lower amounts of those deductions. The taxes-paid deduction not only benefits higher-income individuals, but it also tends to benefit the wealthiest States. The wealthiest States, such as New York, New Jersey, Connecticut, Massachusetts, and Virginia, all have among the highest percentages of filers claiming the State tax deduction. Meanwhile the poorest States, such as Arkansas, Mississippi, New Mexico, West Virginia, all have among the lowest and fewest percentage of filers claiming the deduction. Is it fair to have a tax deduction that gives the biggest benefit to the wealthiest States?

As far as individuals, I think we all know that those claiming the taxes-paid deduction, 88 percent of the benefits of that deduction go to taxpayers earning over $100,000 a year. Does that seem fair?

Now let's turn to the debt question. In recent years local governments have taken on an enormous amount of new debt, which now does not seem to be financing a lot of new investment. In fact, since year 2000, State and local debt has increased by 152 percent, increasing from roughly $1.2 trillion to nearly $3 trillion, and meanwhile State and local investment has grown hardly at all after adjusting for inflation.

So we have to ask ourselves, where has all of that borrowed money gone? The municipal bond exemption may not be the sole cause of all that new borrowing, but the availability of this cheap source of financing does create a moral hazard that can only be cured by eliminating the exemption.

Now the question is what would be the economic effects of eliminating the taxes-paid deduction and the municipal bond exemption? We used the Tax Foundation's tax simulation and macroeconomic model to answer this question in two different ways. We ran two scenarios. In the first scenario we eliminated the taxes-paid deduction and used all of the increased revenues for deficit reduction. The model showed that this sort of revenue-raising plan would reduce the long-term level of GDP by 0.23 percent, it would reduce private business stocks by 0.45 percent, and it would reduce wages slightly.

Now, these are not major economic effects, I understand, but this sort of policy would reduce GDP by $1 for every $1 of tax revenues it would raise, and we have to question whether that is worth the trade-off.

Now, in the second scenario we modeled a revenue-neutral plan that eliminated the taxes-paid and the municipal bond exemption going forward, while lowering tax rates across the board, and we found that it had a very positive impact on the economy. It would boost future level of GDP by .26 percent, or about $41 billion, not a huge effect admittedly, but it would boost private business investment and wages as well, and enough to create about 240,000 new jobs.

While, in conclusion, Mr. Chairman, I applaud the committee for taking on this very challenging effort of reforming the Tax Code, I think we all know that the defenders of these kinds of provisions will put enormous pressure on Members of Congress to save them from reform, as was done successfully in 1986. However, the economic evidence is very clear that these provisions produce more harmful effects than benefits. They encourage higher taxes, higher spending, and more debt at the State and local level. And our simulation showed that eliminating these provisions while lowering tax rates across the board would lead to higher GDP, higher private investment, higher wages, and better living standards for all Americans.

I appreciate this opportunity, and I welcome any questions you might have.

Chairman CAMP. Well, thank you very much, Mr. Hodge.

[The prepared statement of Mr. Hodge follows:]

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Since 1937

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Written Testimony of Scott A. Hodge, President, Tax Foundation

Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
Before the U.S. House of Representatives Committee on Ways and Means

March 19, 2013

Mr. Chairman, Mr. Ranking Member, and members of the Committee:

Thank you for the opportunity to speak to you today on the issues related to tax reform and the tax provisions affecting state and local governments.

Founded in 1937, the Tax Foundation is the nation's oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a non-partisan 501(c)(3) organization.

For 75 years, the Tax Foundation's research has been guided by Adam Smith's immutable principles of tax policy which say that taxes should be neutral to economic decision making, they should be simple, transparent, stable, and they should promote economic growth.

In other words, the ideal tax system should do only one thing—raise a sufficient amount of revenues to fund government activities with the least amount of harm to the economy. By all accounts, the U.S. tax code is far from that ideal. Our current tax system is a Byzantine monstrosity that spans 70,000 pages, costs taxpayers more than $160 billion per year to comply with, and is undermining our nation's economic potential.

Contributing to this complexity are the more than 170 different tax expenditure programs in the tax code, which have a total budgetary cost exceeding $1 trillion. These myriad tax provisions were enacted to achieve all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, buy a home, replace the home's windows, adopt children, put them in daycare, then help them go to college, and the list goes on.

Contrary to conventional wisdom, not every tax expenditure is a "loophole." However, there are dozens of tax provisions that produce harmful side effects that outweigh whatever public policy reason motivated their creation. These are the most obvious kind of tax breaks the Committee should target for elimination as you look to simplify the tax code while lowering tax rates.

There is a considerable amount of economic evidence suggesting that the various provisions benefiting state and local governments do have such harmful effects that they should be targeted for elimination within the broader context of fundamental tax reform.

The evidence suggests that these state and local tax provisions:

- Increase state reliance on deductible taxes;
- Lead to higher state and local tax burdens;
- Encourage higher state and local spending;
- Encourage higher state and local debt; and
- They disproportionately benefit high-income states and high-income taxpayers at the expense of low-income states and low-income taxpayers.

Should you choose to eliminate these tax provisions within the broader context of tax reform, it would deliver long-term economic benefits. Using the Tax Foundation's Tax Simulation and Macroeconomic Model, our economists find that a revenue-neutral plan that eliminates the taxes-paid deduction and municipal bond exemption while lowering income tax rates accordingly would boost GDP, wages, private investment, and federal revenue on a dynamic basis.

However, we find that if these provisions were to be eliminated without corresponding cuts in tax rates, such a plan would reduce GDP by $1 for every $1 of new revenues raised, while lowering wages and private investment.

I would like to take a minute to address each of these issues separately.

These Tax Provisions Alter the Behavior of State and Local Governments

While most tax provisions are intended to motivate the behavior of individuals or businesses, we find that the taxes-paid deduction and municipal bond exemption encourages some unwanted behavior from state and local governments.

In the same way that the mortgage interest deduction may encourage some families to purchase a much larger home than they otherwise could afford, the taxes-paid deduction and the municipal bond exemption encourage many states to tax more, spend more, and borrow more than they otherwise would.

For example, academic research indicates that the taxes-paid deduction leads to greater reliance on tax-deductible taxes—such as progressive income taxes and property taxes—and ultimately leads to increases "in state and local spending of own-source revenue."[1]

[1] Gilbert E. Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments*, NATIONAL TAX JOURNAL, June 2011, 64 (2, Pt. 2), 565-590.

The Taxes-Paid Deduction is Linked to Higher State Spending

A simple way of illustrating the effect of the taxes-paid deduction on state and local spending is to compare the spending levels of states that benefit most from the taxes-paid deduction with those that benefit the least.

Chart 1 compares the per capita spending of the states with the largest amount of taxes-paid deductions (as a share of state AGI) with the states with the lowest amount of deductions. Not only do the states with the largest amount of taxes-paid deductions currently spend nearly $2,800 more on average per person than states with lower amounts of deductions, but the gap between their relative spending levels had increased over the past decade.

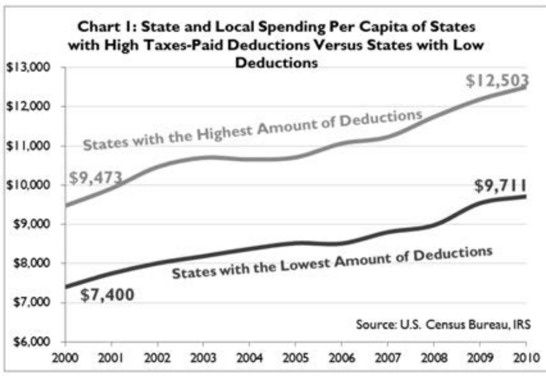


Chart 1: State and Local Spending Per Capita of States with High Taxes-Paid Deductions Versus States with Low Deductions

Furthermore, the taxes-paid deduction not only tends to benefit higher-income taxpayers over lower-income taxpayers, but it also tends to benefit the wealthiest states.

For example, Chart 2 plots the relationship between the percentage of filers in each state who claim the taxes-paid deduction and state incomes per capita. The results show a stark difference between high-income states and low-income states. The highest-income states—such as New York, New Jersey, Connecticut, Massachusetts, and Virginia—all have among highest percentage of filers claiming the deduction of all 50 states.

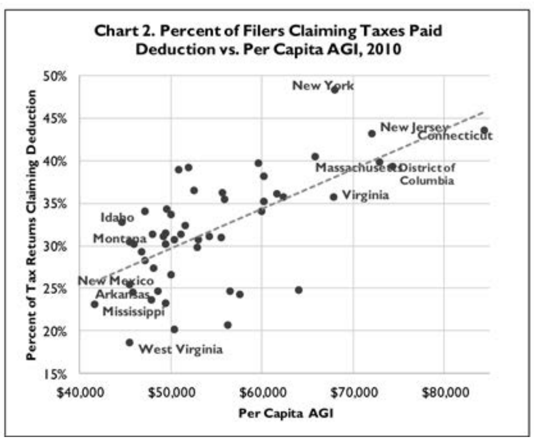


Chart 2. Percent of Filers Claiming Taxes Paid Deduction vs. Per Capita AGI, 2010

By contrast, low-income states, such as Arkansas, Mississippi, New Mexico, and West Virginia, have among the lowest percentage of filers claiming the deduction.

Table 1 shows the distribution of taxpayers claiming the taxes-paid deduction and the value of the deduction for each income group. About 55 percent of the tax benefits accrue to taxpayers with incomes above $200,000 and fully 88 percent of the benefits go to taxpayers earning over $100,000.

Table 1: Distribution of Tax Expenditure for State and Local Income, Sales, and Personal Property Tax Deduction

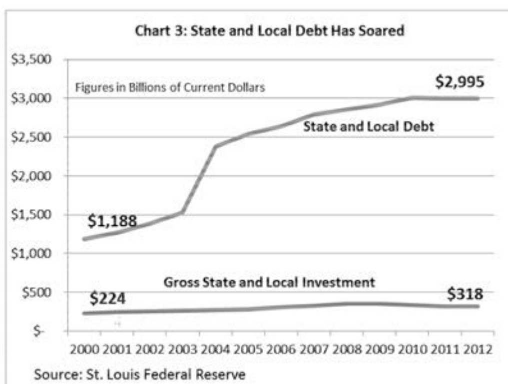
Income Class	Returns (Millions)	Share of Total	Amount ($Thousands)	Share of Total
Below $10,000	6	0.0%	-	
$10,000 to $20,000	163	0.4%	$5	0.0%
$20,000 to $30,000	621	1%	$39	0.1%
$30,000 to $40,000	1,343	3%	$126	0.3%
$40,000 to $50,000	2,304	5%	$303	1%
$50,000 to $75,000	7,781	19%	$1,927	4%
$75,000 to $100,000	7,850	19%	$3,027	7%
$100,000 to $200,000	17,143	41%	$14,262	33%
$200,000 and over	4,805	11%	$24,135	55%
Total...........................	42,016	100%	$43,826	100%

Source: Joint Committee on Taxation

For those members of the Committee who are concerned with the equity of the tax code, eliminating the taxes-paid deduction would seem to be a fair thing to do.

The Tax Exemption for State and Local Bonds

Let's now turn to borrowing and the tax exemption for state and local bonds—so called muni bonds. The ostensible purpose of these bonds is to allow state and local governments to borrow at a much lower interest rate to finance infrastructure projects and other large public investments. However, it turns out that this is a very inefficient way for the federal government



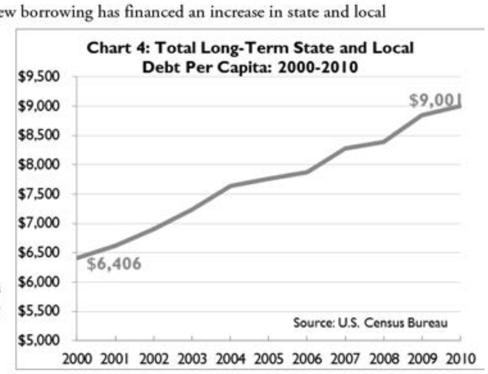
to subsidize such local spending and it has led to an explosion of state and local debt.

While state and local governments are intended to be the primary beneficiaries of the federal tax subsidy, bondholders also benefit. As the Joint Committee on Taxation has illustrated, depending upon the interest rate and the tax bracket of the bondholder, $1 million in tax-exempt bonds can confer $15,000 in interest savings to the local government and $6,000 in tax savings to the bondholder. Thus, in order to generate a "public" benefit of $15,000 the federal government actually forgoes $21,000. This seems like an expensive way to subsidize local investment.

State and Local Debt Explodes

Speaking of state and local investments, in recent years local governments have taken on an enormous amount of new debt, which does not seem to be financing much new investment. Chart 3, above, compares the growth in state and local debt to the amount of annual amount of gross investment at the state and local level. Since 2000, state and local debt has increased by 152 percent, from roughly $1.2 trillion to nearly $3 trillion.

It does not appear, however, that this new borrowing has financed an increase in state and local investment. Over the past twelve years, gross investment has grown by 42 percent, not adjusting for inflation. In other words, investment has been mostly flat for the past twelve years while borrowing has ballooned. We have to ask ourselves: where has all of that borrowed money gone?



What all of this new borrowing has done is place a huge burden on future taxpayers. Chart 4 shows the increase in long-term state and local borrowing per capita between 2000 and 2010. Over that ten year period per capita borrowing increased by 40 percent, from $6,406 per person to over $9,000 per person.

To be sure, the municipal bond exemption not the sole cause of all of this new borrowing. But the availability of this source of cheap financing does create a moral hazard that can only be cured by eliminating the exemption.

While it is certainly true that tax-free municipal bonds provide a steady source of income for many low-to-moderate income retirees, the majority of tax-exempt interest income is earned by upper-income taxpayers. As Table 2 shows, some 52 percent of tax-exempt interest income is earned by taxpayers with incomes over $200,000 and 24 percent is earned by taxpayers with incomes above $1 million. By contrast, about 23 percent of tax-exempt income is earned by taxpayers with incomes below $75,000.

Table 2: Distribution of Taxes-Paid Deduction in 2010

	Returns (Thousands)	Percent Share	Amount ($Thousands)	Percent Share
$0 to $50,000	1,800,138	29%	$11,553,362	15%
$50,000 to $75,000	889,104	15%	$ 5,755,015	8%
$75,000 to $100,000	765,213	13%	$ 5,538,264	7%
$100,000 to $200,000	1,403,272	23%	$13,083,218	17%
$200,000 to $500,000	832,455	14%	$13,692,386	18%
$500,000 to $1 million	240,177	4%	$ 7,600,674	10%
$1 million and above	172,823	3%	$17,940,450	24%
All Returns, Total	6,103,182	100%	$75,163,368	100%

Source: SOI 2010 Tax Year

Again, if equity is a concern of any members of the Committee, this unbalanced distribution of tax-free interest income should prompt a reconsideration of this policy.

Macroeconomic Simulations

To help members of the Committee understand the economic effects of eliminating these state and local tax provisions, Tax Foundation economists performed a series of simulations using our Tax Simulation and Macroeconomic Model. In our first simulation, we eliminated the taxes-paid deduction to see what impact it would have on the economy over the long term. In this simulation, we assumed that all of the new revenue generated by eliminating the deduction would be used for deficit reduction and none would be used to lower individual income tax rates.

SIMULATION #1: ELIMINATE STATE & LOCAL TAX DEDUCTION—NO CHANGE IN RATES

ECONOMIC AND BUDGET CHANGES VERSUS 2013 LAW
(billions of 2012 dollars except as noted)

GDP	-0.23%
Private business GDP	-0.25%
Private business stocks	-0.45%
Wage rate	-0.09%
Private business hours of work	-0.16%
Federal revenue (dynamic)($ billions)	$36.9
Federal spending ($ billions)	-$0.9
Federal surplus (+ = lower deficit) ($ bil.)	$37.8
Static revenue estimate ($ billions)	$44.9
% Revenue reflow vs. static	-17.8%
$GDP ($ billions)	-$35.6
$GDP/$tax increase (dollars)	-$1.1

The model shows that eliminating the taxes-paid deduction would reduce the long-term level of GDP by 0.23 percent, or about $36 billion. The tax change would also reduce private business stocks by 0.45 percent and wages by 0.09 percent. While these are not major economic effects, the policy would effectively reduce GDP by $1 for every $1 of new revenues it raised for deficit reduction. Lawmakers will have to assess whether such a policy is worth the tradeoff.

The table below shows the distributional effects of eliminating the taxes-paid deduction without any corresponding reduction in income tax rates. On a static basis (not accounting for the economic affects), the average tax return would see a -0.48 percent reduction in their after-tax income, or $289. However, the lowest income taxpayers would not be impacted.

By contrast, when we account for the long-term economic effects of eliminating the deduction, we find that taxpayers in every income group would see a decline in their after-tax income and the average reduction would be slightly greater than the static estimate (-$394 versus $289).

DISTRIBUTION EFFECTS OF ELIMINATING THE STATE AND LOCAL TAX DEDUCTION WITH NO OFFSETTING RATE CHANGES

(Billions of 2012 dollars)	Average after-tax income per return			
All Returns AGI Class	Static Change	Static % Change	Dynamic Change	Dynamic % Change
< 0	$0	0.00%	$232	-0.24%
0 - 5,463	$0	0.00%	-$6	-0.21%
5,463 - 10,925	$0	0.00%	-$18	-0.22%
10,925 - 21,850	-$4	-0.03%	-$39	-0.24%
21,850 - 32,775	-$30	-0.11%	-$85	-0.32%
32,775 - 43,700	-$84	-0.22%	-$159	-0.42%
43,700 - 54,625	-$187	-0.38%	-$279	-0.57%
54,625- 81,938	-$378	-0.56%	-$502	-0.75%
81,938 - 109,250	-$680	-0.72%	-$849	-0.90%
109,250 - 163,875	-$1,178	-0.90%	-$1,399	-1.07%
163,875 - 218,500	-$776	-0.42%	-$1,086	-0.58%
218,500 - 273,125	-$858	-0.35%	-$1,227	-0.51%
273,125 - 546,250	-$839	-0.23%	-$1,404	-0.38%
546,250 - 1,092,500	-$3,523	-0.48%	-$4,618	-0.62%
> 1,092,500	-$13,958	-0.39%	-$19,584	-0.54%
TOTAL FOR ALL	-$289	-0.48%	-$394	-0.65%

Simulation #2

In our second simulation, we modeled a revenue-neutral plan that eliminated the taxes-paid deduction and the municipal bond exemption (on a prospective basis) while lowering income tax rates across-the-board. The revenue gains from eliminating these provisions allowed for a corresponding reduction in income tax rates of 5.0 percent.

As the table below shows, this sort of revenue-neutral tax reform could boost the future level of GDP by 0.26 percent, or about $41 billion. Not a huge effect, admittedly, but enough to boost private business investment by 0.29 percent, wages slightly, and hours worked by 0.26 percent—equal to roughly 240,000 private sector jobs. While the plan is revenue neutral on a static basis, the greater economic growth does increase federal revenues slightly on a dynamic basis.

The distributional effects of this revenue-neutral plan are generally positive for all taxpayers. On a static basis, some taxpayers in the upper-middle income groups would see a slight reduction in their after-tax incomes. Obviously, the taxes-paid deduction is most beneficial to taxpayers in these income bands. However, when we take into consideration the positive economic effects of the tax change, we see that most of these taxpayers are made whole and, in many cases, would enjoy higher after-tax incomes.

The results of these simulations make very clear that given the choice between eliminating the state and local tax provisions solely for deficit reduction or doing so within the context of tax reform, the tax reform option produces the biggest bang for the economy, investment, wages, and living standards.

SIMULATION #2: ELIMINATE STATE & LOCAL TAX DEDUCTION AND INTEREST EXEMPTION ON FUTURE MUNI BONDS. REDUCE ALL RATES ON REVENUE NEUTRAL BASIS

ECONOMIC AND BUDGET CHANGES VERSUS 2013 LAW (billions of 2012 dollars except as noted)	
GDP	0.26%
Private business GDP	0.29%
Private business stocks	0.37%
Wage rate	0.03%
Private business hours of work	0.26%
Federal revenue (dynamic)($ billions)	$9.3
Federal spending ($ billions)	$0.8
Federal surplus (+ = lower deficit) ($ bil.)	$8.5
Static revenue estimate ($ billions)	$0.0
% Revenue reflow vs. static	N/A
$GDP ($ billions)	$41.2
$GDP/$tax increase (dollars)	$4.9

DISTRIBUTION EFFECTS OF A REVENUE NEUTRAL RATE CUT AND ELIMINATION OF TAXES-PAID DEDUCTION AND MUNI BOND EXEMPTION

(billions of 2012 dollars)	Average after-tax income per return			
All Returns AGI Class	Static Change	Static % Change	Dynamic Change	Dynamic % Change
< 0	-$8	0.01%	-$287	0.30%
0 - 5,463	$0	0.00%	$7	0.24%
5,463 - 10,925	$1	0.02%	$22	0.27%
10,925 - 21,850	$10	0.06%	$50	0.31%
21,850 - 32,775	$19	0.07%	$83	0.31%
32,775 - 43,700	$23	0.06%	$111	0.29%
43,700 - 54,625	-$18	-0.04%	$89	0.18%
54,625- 81,938	-$84	-0.13%	$61	0.09%
81,938 - 109,250	-$223	-0.24%	-$25	-0.03%
109,250 - 163,875	-$435	-0.33%	-$176	-0.13%
163,875 - 218,500	$256	0.14%	$622	0.33%
218,500 - 273,125	-$13	-0.01%	$418	0.17%
273,125 - 546,250	$80	0.02%	$749	0.20%
546,250 - 1,092,500	$2,108	0.28%	$3,436	0.46%
> 1,092,500	$15,314	0.42%	$22,126	0.61%
TOTAL FOR ALL	$0	0.00%	$124	0.20%

Conclusion

Mr. Chairman, I applaud the Committee for reconsidering the tax preferences that benefit state and local governments within the broader context of fundamental tax reform. I think we all know that the defenders of these provisions will put enormous pressure on Members of Congress to not eliminate them, as was done successfully in 1986.

However, the evidence is very clear that these provisions produce more harmful effects than benefits. They encourage higher taxes, higher spending, and more debt by state and local governments. And our simulations show that eliminating these provisions while lowering tax rates would lead to higher GDP, higher private investment, higher wages, and better living standards for all Americans.

Thank you for the opportunity to testify before you today. I'm happy to answer any questions you may have.

STATEMENT OF DAVID PARKHURST, DIRECTOR OF ECONOMIC DEVELOPMENT AND COMMERCE COMMITTEE, OFFICE OF FEDERAL RELATIONS, NATIONAL GOVERNORS ASSOCIATION, WASHINGTON, DC

Chairman CAMP. Mr. Parkhurst, you are recognized for 5 minutes.

Mr. PARKHURST. Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you for inviting testimony from the National Governors Association, which is the only bipartisan organization of the Nation's Governors. My name is David Parkhurst, and I direct NGA's economic development and commerce committee, led by Pennsylvania Governor Tom Corbett and Kentucky Governor Steve Beshear.

Governors last year appointed a five-member tax reform task force, cochaired by Governors Corbett and Beshear, to explore the possible effects of Federal tax reforms on the States. Other members of the task force included Connecticut Governor Malloy, Michigan Governor Snyder, and U.S. Virgin Islands Governor de Jongh.

Let me begin with a few main points. Number one, Federal and State tax policies are intertwined and linked; two, the preservation of public financing, notably tax-exempt bonds, is necessary because it is the primary method for States and local governments to raise capital for a wide range of infrastructure projects; three, Federal laws and regulations should not increase costs States and local governments incur to issue municipal debt or decrease investor appetite to purchase those products; and number four, no Federal law or regulation should preempt, limit, or interfere with the constitutional or statutory rights of States and local governments to develop and operate their revenue and tax streams.

Tax reform is a complex and multipronged issue. Changes to deductions, credits, exclusions, and exemptions in the Federal code will have corresponding revenue and economic implications for the States because of the variations in each State's linkages to the Federal code.

In anticipation of comprehensive Federal reform, the Nation's Governors recently released guiding principles. They focus on Federal deductibility of State and local taxes and the interest exclusion on municipal bonds, because these topics are top priorities for all States. In addition, the principles address the broader issues of ensuring that Federal reform does not limit or preempt State authority over budget and revenue systems.

I want to highlight one point I think captures an important reminder. Federal tax policies and tax expenditures serve public policy purposes that aren't necessarily captured in revenue and spending numbers. To help avoid unintended consequences from Federal reform, Federal and State partners should work together to determine whether the policy benefits of a particular Federal tax expenditure exceeds its budgetary costs before making final decisions.

For nearly 200 years municipal bonds have assisted States, cities, and counties finance their infrastructure projects. Since its inception at the beginning of the 20th century, the Federal code included the exclusion from income for municipal bond interest. This was intentional and not a special-interest add-on.

Ending or capping this Federal exclusion would increase the cost of financing infrastructure. Investors would demand higher yields as compensation. Higher borrowing costs would chill infrastructure investments, lead to higher taxes on citizens to cover those increased costs, or some combination. Given constraints on direct Federal spending, and with the tremendous overhang of unmet infrastructure needs throughout the country, policymakers should encourage, not limit, State and local financing for those projects that create jobs and boost economic growth.

Finally, every State and local government has some combination of mandatory income, sales or property tax. Each of those combinations benefits directly or indirectly from the Federal deductibility that has long been in place. Ending this Federal tax deduction for State and local income and property taxes changes the rules. It would effectively mean marginal tax rates increase for taxpayers, and, absent an offset for equity purposes, it could create an economic drag and increase uncertainty and risk for bondholders.

The message to Congress from the Nation's Governors is clear: We are all in this together. States and local governments, as the principal owners and operators of our Nation's infrastructure and issuers of municipal bonds, will remain strong advocates for safeguarding municipal markets and supporting investment in infrastructure.

As Congress moves forward on comprehensive tax reform, NGA looks forward to working in partnership with this committee. Thank you.

Chairman CAMP. Thank you very much, Mr. Parkhurst.

[The prepared statement of Mr. Parkhurst follows:]

Statement of

David Parkhurst

Director, Economic Development and Commerce Committee of the National Governors Association

Before the

House Ways and Means Committee

Hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments"

March 19, 2013

Chairman Camp, Ranking Member Levin and members of the House Ways and Means Committee, thank you for inviting testimony from the National Governors Association (NGA) regarding key issues for the states associated with federal tax reform. Founded in 1908, NGA is the only bipartisan organization of the nation's governors.

My name is David Parkhurst, and I am the director of NGA's Economic Development and Commerce Committee led this year by Pennsylvania Governor Tom Corbett and Kentucky Governor Steve Beshear. The Economic Development and Commerce Committee is charged with developing policy positions that reflect the priorities of governors with regard to issues related to the economy, including the implication of federal tax reform.

In preparation of this debate, governors last year appointed a five-member Tax Reform Task Force, co-chaired by Governors Corbett and Governor Beshear, to explore the possible effects of federal tax reform on states. The Task Force includes Connecticut Governor Dan Malloy, Michigan Governor Rick Snyder, and U.S. Virgin Islands Governor John deJongh.

My remarks today will include a short summary of the work of this Task Force.

Let me begin with several main points:

- Public finance – notably tax-exempt bonds -- is the primary method to finance infrastructure projects —including schools, hospitals, roads, and bridges—approved directly by voters or by governing bodies.

- Federal laws and regulations, either directly or indirectly, should not increase the costs states and local governments incur to issue municipal bonds or decrease investor appetite to purchase them.

- No federal law or regulation, including their interpretation and implementation, should preempt, limit or interfere with the constitutional or statutory rights of states to develop and operate their revenue and tax systems.

Federal-State Tax Code Linkages

It has been nearly 30 years since the Tax Reform Act of 1986 became law, which was the last time Congress overhauled the federal tax code ("Code"). Driving factors today include lowering tax rates through closing loopholes and reducing tax expenditures. The variation among states in their linkages to the federal Code is another important factor that will influence tax reform. *See* Attachment 1 for a chart detailing federal-state linkages.

State income taxes, for both individuals and corporations, often rely on the federal Code and to a large degree, conform to its features; definitions; eligible deductions and exclusions; and tax treatment of certain transactions:

- Thirty-six of the 41 states with a broad-based personal income tax base the calculation of state tax on a federal "starting point" such as adjusted gross income (AGI) or taxable income.[1]

[1] According to the Federation of Tax Administrators (FTA), seven states do not impose a state personal income tax: **Alaska, Florida, Nevada, South Dakota, Texas, Washington**, and **Wyoming.** In addition, **Tennessee** and **New Hampshire** impose an income tax on interest and dividends only. FTA (2013)

- In the five states that do not use a federal starting point, the various items of income used to calculate the state base are commonly defined with federal Code definitions.[2]

- Of the 46 states that levy a tax based on corporate income, all of them effectively use "federal taxable income," with certain modifications, as the starting point for state tax computations.[3]

States conform to the federal Code because it promotes taxpayer simplicity and compliance. Many states also rely on federal reporting mechanisms to help administer state tax systems. Changes to deductions, credits, exclusions, and exemptions in the federal Code, moreover, would have corresponding revenue and economic implications for the states depending on the variation in each state's linkages to the federal Code.

Tax Reform Risks for Municipal Bonds and State/Local Tax Deductibility
While changes to the current federal tax treatment of municipal bonds were not part of the latest "fiscal cliff" package in early January, restrictions on the deductibility of state and local income, property and sales taxes were included, and governors are well aware that changes to those tax exclusions and deductions that benefit states may be considered in future negotiations between Congress and the Administration. In this regard, the most important issue for states in federal tax reform is safeguarding public financing— notably tax-exempt bonds — because it is the primary method to finance infrastructure projects.

For nearly 200 years, municipal bonds have assisted states, cities, and counties in financing their infrastructure needs, including roads, bridges, schools, hospitals, transit systems, housing, public power and gas systems and utilities, and other vital projects serving the public good. Since its inception in the early 20th century, the federal Code included the exclusion from income for municipal bond interest. In contrast to the status quo treatment of municipal bond interest are the following policy options that would chill public finance:

Eliminate the Tax Exclusion. The National Commission on Fiscal Responsibility and Reform (i.e. "Simpson-Bowles") in its December 2010 report included an "illustrative proposal" to end the exclusion from taxable income of municipal bond interest. According to federal and private sector estimates, the interest exclusion will reduce federal revenues by $43 billion in fiscal year 2014. The exclusion, however, is an attractive incentive for investors that will help states and local governments issue an estimated $400 billion in new bonds for capital projects in fiscal year 2014. *See* Attachment 2 for a state-by-state summary of long-term tax-exempt bond issuances in the states from 2003-2012.

Ending or capping the federal exclusion from income for municipal bond interest would increase the cost of financing infrastructure because investors would demand higher yields to compensate for the lost exclusion. Higher borrowing costs would chill infrastructure investments, lead to higher taxes on citizens to cover the increase, or some combination. Given constraints on direct federal spending, and with the tremendous overhang of unmet infrastructure needs throughout the country, policymakers should encourage, not limit, state and local financing for those projects that create jobs and boost economic growth.

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[2] According to the FTA, those states are **Alabama, Arkansas, Mississippi, New Jersey**, and **Pennsylvania.**
[3] Four states do not impose a tax at the corporate or business entity level: **Nevada, South Dakota, Washington**, and **Wyoming**. FTA (2013).

Cap Federal Deductions and Exclusions. Both President Obama, most recently in his proposed 2013 budget, and Speaker Boehner during the recent "fiscal cliff" negotiations in late 2012 indicated that capping all tax deductions and exclusions was an option for deficit reduction. While either its form could vary as a percentage cap on high-income taxpayers, or a hard dollar cap applied to all taxpayers who itemize their returns, the effect on municipal bonds would be damaging.

A "hard dollar" cap crowds out lower-valued deductions and exclusions in favor of higher-valued ones like the deduction for mortgage interest effectively making municipal bonds taxable for most taxpayers who itemize. Note, however, that a percentage cap would not necessarily result in investors rebalancing their tax-exempt portfolios fully into taxables. They would instead seek other ways to adjust their portfolios for tax purposes, which would lower federal revenue projections from this option. IRS data for 2010 returns, moreover, offer a snapshot of taxpayers reporting tax-exempt interest: 84 percent earned $250,000 or less (AGI), while five in 10 were taxpayers aged 65 and older; when measured by the total amount of reported tax exempt interest, taxpayers who earned more than $250,000 (AGI) accounted for less than half the total.

Moreover, if a cap applied to both new and outstanding bonds, it changes the contractual terms of those outstanding bonds for investors, creating legal and market disruptions that could put issuers at risk. A cap also creates new technical complexities for both taxpayers and the Treasury because the process for calculating the cap would not be simple.

Other Options. Opponents of the interest exclusion for municipal bonds have suggested alternatives such as tax credit and direct subsidy bonds to replace tax-exempt bonds:

i. Replacing the long-standing tax-exempt market with a tax-credit bond program would harm state and local issuers because investors do not purchase these types of bonds on a wide scale although they are currently available. The outcome goal should be to maximize capital investment through products that attract an optimal basket of retail and institutional investors that will clear the supply of municipal bonds consistently and easily. This is a dynamic process that should involve a mix of tax-exempt and taxable products. Converting to tax credits alone would also increase costs to state and local issuers because investors would demand higher yields, which may also crowd out smaller issuers that do not go to market regularly.

ii. Direct subsidy bonds have complemented the tax-exempt market, most notably during 2009-2010 with Build America Bonds (BABs). BABs were taxable bonds where the federal government provided the state and local issuer a variable subsidy equal to 35 percent of the interest payable over the lifetime of the bonds. However, replacing the tax-exempt market with direct subsidy bonds, most likely at a significantly lower subsidy rate around 25 percent, would limit the scope of financing tools available to state and local issuers, increase costs because of investor demand for higher yields, and inject new uncertainty whether future Congresses would reduce federal subsidy payments. The fact the BAB subsidy is subject to the sequester would only add to the uncertainty—and thus the costs to state and local issuers—of replacing the current exemptions with BABs.

When it comes to ensuring maximum federal flexibility in public finance for state and local governments, the directive should be "all-the-above," not "either/or." The mere discussion about altering the current tax treatment of municipal bonds injects uncertainty into bond markets and raises concern for investors who would demand risk premiums on future bond issues.

State and Local Tax Deductibility
Finally, ending the federal tax deduction for state and local income and property taxes may limit the ability of states to adjust revenue and budget policies in response to uncontrollable economic pressures, which could increase risk concerns for bondholders. It would effectively increase marginal tax rates for taxpayers that, absent an offset for equity purposes, could create an economic drag. Likewise, shifting the federal system of income taxation to something else like a sales or consumption tax could damage administrative viability and limit state control of their tax systems because of federal encroachment into the traditional tax base of states.

Guiding principles on federal tax reform recently affirmed by governors for NGA specifically address state sovereignty. Federal laws and regulations should not preempt or limit state authority to develop and operate their revenue and tax systems.

Conclusion – NGA Guiding Principles on Federal Tax Reform
NGA's Guiding Principles on Federal Tax Reform will help governors evaluate proposals from Congress and the Administration. They offer concrete suggestions that are consistent with the intertwined interests of states and the federal government. In addition to state sovereignty, the Principles address categories including public finance, federal reforms, proportionality, and economic growth and efficiency:

State Sovereignty
- No federal law or regulation, including their interpretation and implementation, should preempt, limit, or interfere with the constitutional or statutory rights of states to develop and operate their revenue and tax systems.

Public Finance
- The preservation of public financing – notably tax-exempt financing – is necessary because it is the primary method for states to raise capital for a wide range of public projects.

- Federal statutory and regulatory policies should neither increase bond issuance costs to states and local governments, directly or indirectly, nor diminish retail and institutional market demand for bonds issued by states and local governments.

Federal Reforms
- Federal tax reforms should deliver simplicity, adopt innovation, promote certainty, and produce savings for both federal and state governments.

- Federal tax policies and expenditures serve public policy purposes not necessarily captured in revenue and spending numbers. To help avoid unintended consequences from federal tax reform, federal and state partners should work together to determine whether the policy benefits of particular federal tax expenditures exceed their budgetary costs before making final decisions.

Proportionality
- Federal tax reforms should not simply shift costs or impose unfunded mandates onto the states.

Economic Growth and Efficiency
- Federal tax reforms should strive to achieve flexibilities for states that help create efficiencies and stimulate economic growth.

The Principles focus on federal deductibility of state and local taxes and the interest exclusion on municipal bonds because these topics are top priorities for all states. In addition, the Principles address the broader issue of ensuring that federal tax reform does not limit or preempt state authority over budget and revenue systems.

As tax reform moves forward in Congress, states will have different priorities and positions on specific proposals involving particular corporate, international, and individual matters because linkages to the federal Code vary among the states. The Principles will guide NGA's collective efforts to oppose federal attempts to preempt or limit state authority because what states are doing on tax policy can and should help drive what happens at the national level.

Moreover, state and local governments, as the principal owners and operators of our nation's infrastructure and issuers of municipal bonds, will remain advocates for safeguarding municipal markets. Thank you for the opportunity to testify. I would be happy to answer questions.

# # #

Attachments

Attachment 1: State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

Attachment 2: Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

AGI = *Adjusted Gross Income*
FTI = *Federal Taxable Income*

State	State has no broad-based personal income tax	State linkage to IRS code	State deduction for federal taxes paid	State has no broad-based sales tax	State issues no General Obligation debt	State accepts Federal deduction/ S-L taxes
Alabama		No link	X			
Alaska	X	No link		X		
Arizona		AGI			X	
Arkansas		No link				Local income tax only
California		AGI				
Colorado		FTI			X	
Connecticut		AGI				X
Delaware		AGI		X		
Florida	X	No link				
Georgia		AGI				
Hawaii		AGI				
Idaho		FTI			X	
Illinois		AGI				
Indiana		AGI			X	
Iowa		AGI	X		X	
Kansas		AGI			X	
Kentucky		AGI			X	Local income tax only
Louisiana		AGI	X			
Maine		AGI				
Maryland		AGI				
Massachusetts		AGI				
Michigan		AGI				
Minnesota		FTI				
Mississippi		No link				
Missouri		AGI	X			
Montana		AGI	X	X		
Nebraska		AGI			X	
Nevada	X	No link				
New Hampshire[1]	X	No link		X		
New Jersey		No link				
New Mexico		AGI				
New York		AGI				
North Carolina		FTI				

[1]New Hampshire taxes unearned income.

State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

State	State has no broad-based personal income tax	State linkage to IRS code	State deduction for federal taxes paid	State has no broad-based sales tax	State issues no General Obligation debt	State accepts Federal deduction/ S-L taxes
North Dakota		FTI			X	X
Ohio		AGI				
Oklahoma		AGI				
Oregon		FTI	X	X		State income tax deduction
Pennsylvania		No link				
Rhode Island		AGI				
South Carolina		FTI				
South Dakota	X	No link			X	
Tennessee[2]	X	No link				
Texas	X	No link				
Utah		AGI				Limited credit/state income tax
Vermont		FTI				
Virginia		AGI				
Washington	X	No link				
West Virginia		AGI				
Wisconsin		AGI				
Wyoming	X	No link			X	
U.S. Territories: *Puerto Rico, American Samoa, Guam, Northern Mariana Islands, U.S. Virgin Islands*	*See Note*[3]	0	USVI (tax credit)	AS, CNMI	AS,USVI	

Source: FFIS, Federation of Tax Administrators (2013)

[2] Tennessee taxes unearned income.

[3] The application of Federal tax rules varies from one territory to another. **Guam**, the **Northern Mariana Islands**, and the **U.S. Virgin Islands** are called "mirror Code territories" because each adopted the Internal Revenue Code of 1986 ("the Code") as the internal tax law of those territories. **American Samoa** and **Puerto Rico** are non-mirror Code possessions and have their own internal tax laws.

State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

Tax Provisions Related to the U.S. Territories[4]

American Samoa
American Samoa is a non-mirror Code possession and imposes its own local tax code. All nationals are subject to tax as U.S. citizens, with an exclusion provided for American Samoa-sourced income. The Code does not provide relief from double filing, so residents potentially have to file with both the United States and the American Samoa governments.

Guam
Guam uses a mirror system of taxation, so taxpayers are required to file a single tax return to either the United States or Guam, depending on whether they are a United States resident or a Guamanian resident. The United States generally pays the Guamanian treasury certain taxes collected on Guamanian-sourced income and on withholding tax on U.S. federal personnel employed or stationed in Guam. Similarly, Guam pays the U.S. Treasury certain taxes collected from individuals on United States- sourced income.

Northern Mariana Islands
The Commonwealth of the Northern Mariana Islands (CNMI) uses a mirror system of taxation; however, the CNMI also has the authority to rebate the tax imposed by its mirror code with respect to CNMI- sourced income.

Puerto Rico
Puerto Rico is a non-mirror Code possession with its own internal tax laws. A person born in Puerto Rico is a U.S. citizen and is subject to U.S income tax. The Code excludes Puerto-Rican derived income from U.S. taxation provided the taxpayer resides in Puerto Rico for a full taxable year. Income excluded from US gross income, however, is generally subject to Puerto Rican taxation.

U.S. Virgin Islands
The U.S. Virgin Islands (USVI) employs a mirror system of taxation. In general, a resident of the USVI is required to file and pay tax only to the Territory. The USVI may also impose certain local income taxes in addition to taxes imposed by the mirror code. USVI taxes its citizens and residents on their worldwide income. USVI taxpayers receive a foreign tax credit for income taxes paid to the United States, and other possessions of the United States.

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[4] Joint Committee on Taxation, "Federal Tax Law and Issues Related to the United States Territories," May 14, 2012. Available at: https://www.jct.gov/publications.html?func=startdown&id=4427

Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

(Dollars in millions)

The following table reports the value of all long-term tax-exempt bonds issued by states and their localities for physical infrastructure purposes for the last decade. A long-term bond is one issued for a period greater than one year. This table does not include refunding transactions for outstanding bonds.

STATE	Housing[1]	Percent[2]	Utilities[3]	Percent	Transportation[4]	Percent	Education[5]	Percent	Environmental[6]	Percent	Public Facilities[7]	Percent	TOTAL	% of Total Issuances
Alabama	$849	0.60%	$6,486	1.96%	$1,463	0.37%	$9,939	1.19%	$1,153	2.00%	$808	0.76%	$20,698	1.11%
Alaska	$1,760	1.25%	$242	0.07%	$2,505	0.64%	$1,852	0.22%	$0	0.00%	$504	0.47%	$6,863	0.37%
Arizona	$1,434	1.02%	$7,098	2.14%	$7,052	1.80%	$16,918	2.03%	$2,169	3.76%	$2,850	2.68%	$37,521	2.01%
Arkansas	$668	0.47%	$1,899	0.57%	$603	0.15%	$9,825	1.18%	$278	0.48%	$473	0.44%	$13,745	0.74%
California	$14,545	10.33%	$54,616	16.49%	$41,112	10.52%	$116,787	13.98%	$5,125	8.89%	$16,374	15.40%	$248,559	13.35%
Colorado	$3,240	2.30%	$6,798	2.05%	$10,124	2.59%	$17,463	2.09%	$211	0.37%	$3,388	3.19%	$41,225	2.21%
Connecticut	$4,617	3.28%	$1,861	0.56%	$4,376	1.12%	$7,776	0.93%	$480	0.83%	$184	0.17%	$19,294	1.04%
Delaware	$969	0.69%	$177	0.05%	$1,701	0.44%	$4,183	0.50%	$386	0.67%	$43	0.04%	$7,458	0.40%
Florida	$4,600	3.27%	$20,370	6.15%	$27,503	7.04%	$38,525	4.61%	$4,880	8.46%	$4,353	4.09%	$100,229	5.38%
Georgia	$1,585	1.13%	$11,506	3.47%	$8,581	2.20%	$15,684	1.88%	$3,262	5.66%	$1,976	1.86%	$42,595	2.29%
Guam	$0	0.00%	$220	0.07%	$212	0.05%	$138	0.02%	$0	0.00%	$0	0.00%	$570	0.03%
Hawaii	$308	0.22%	$2,162	0.65%	$1,863	0.48%	$471	0.06%	$272	0.47%	$41	0.04%	$5,117	0.27%
Idaho	$1,434	1.02%	$217	0.07%	$720	0.18%	$2,493	0.30%	$64	0.11%	$278	0.26%	$5,207	0.28%
Illinois	$3,829	2.72%	$6,602	1.99%	$15,290	3.91%	$31,724	3.80%	$588	1.02%	$7,857	7.39%	$65,889	3.54%
Indiana	$1,659	1.18%	$6,948	2.10%	$3,939	1.01%	$18,814	2.25%	$3,528	6.12%	$4,204	3.95%	$39,092	2.10%
Iowa	$1,379	0.98%	$1,891	0.57%	$322	0.08%	$8,325	1.00%	$333	0.58%	$566	0.53%	$12,816	0.69%
Kansas	$896	0.64%	$2,761	0.83%	$2,582	0.66%	$6,503	0.78%	$835	1.45%	$987	0.93%	$14,564	0.78%

[1] "Housing" category includes single and multi-family housing.
[2] The percentage recorded represents the state's share of bond issuances for the particular category.
[3] "Utilities" category includes combined utilities, water/sewer, gas, flood control, sanitation, and telecommunications facilities.
[4] "Transportation" category includes air, rail, transit, surface transportation, public parking, and other transportation facilities.
[5] "Education" category includes K-12, higher education, other education facilities, and student loans.
[6] "Environmental" category includes pollution control, solid waste, and recycling facilities.
[7] "Public Facilities" category includes correctional, libraries, stadiums, theatres, parks/zoos, police/fire/corrections, and other government buildings.

Source: Thomson Reuters and SIFMA (2012)

Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

(Dollars in millions)

The following table reports the value of all long-term tax-exempt bonds issued by states and their localities for physical infrastructure purposes for the last decade. A long-term bond is one issued for a period greater than one year. This table does not include refunding transactions for outstanding bonds.

STATE	Housing[1]	Percent[2]	Utilities[3]	Percent	Transportation[4]	Percent	Education[5]	Percent	Environmental[6]	Percent	Public Facilities[7]	Percent	TOTAL	% of Total Issuances
Kentucky	$2,121	1.51%	$3,259	0.98%	$3,151	0.81%	$9,139	1.09%	$790	1.37%	$2,952	2.78%	$21,411	1.15%
Louisiana	$2,429	1.72%	$2,727	0.82%	$5,166	1.32%	$5,890	0.71%	$1,713	2.97%	$1,862	1.75%	$19,786	1.06%
Maine	$1,737	1.23%	$133	0.04%	$1,064	0.27%	$1,718	0.21%	$245	0.42%	$276	0.26%	$5,173	0.28%
Maryland	$4,335	3.08%	$4,103	1.24%	$5,547	1.42%	$4,952	0.59%	$573	0.99%	$1,016	0.95%	$20,525	1.10%
Massachusetts	$5,045	3.58%	$9,146	2.76%	$11,528	2.95%	$29,249	3.50%	$1,085	1.88%	$1,215	1.14%	$57,268	3.08%
Michigan	$1,767	1.25%	$9,727	2.94%	$4,962	1.27%	$29,245	3.50%	$1,508	2.61%	$3,575	3.36%	$50,784	2.73%
Minnesota	$4,575	3.25%	$4,074	1.23%	$4,023	1.03%	$13,205	1.58%	$746	1.29%	$2,118	1.99%	$28,741	1.54%
Mississippi	$984	0.70%	$867	0.26%	$920	0.24%	$3,339	0.40%	$216	0.37%	$1,245	1.17%	$7,571	0.41%
Missouri	$1,578	1.12%	$4,064	1.23%	$5,610	1.44%	$15,982	1.91%	$785	1.36%	$3,870	3.64%	$31,889	1.71%
Montana	$658	0.47%	$82	0.02%	$274	0.07%	$1,558	0.19%	$439	0.76%	$94	0.09%	$3,105	0.17%
Nebraska	$1,200	0.85%	$4,114	1.24%	$506	0.13%	$4,605	0.55%	$114	0.20%	$867	0.82%	$11,406	0.61%
Nevada	$666	0.47%	$5,831	1.76%	$9,868	2.52%	$6,930	0.83%	$360	0.62%	$980	0.92%	$24,635	1.32%
New Hampshire	$1,303	0.92%	$117	0.04%	$816	0.21%	$2,636	0.32%	$174	0.30%	$83	0.08%	$5,128	0.28%
New Jersey	$2,358	1.67%	$5,078	1.53%	$25,821	6.61%	$36,432	4.36%	$1,275	2.21%	$2,432	2.29%	$73,396	3.94%
New Mexico	$2,961	2.10%	$1,834	0.55%	$3,109	0.80%	$5,086	0.61%	$725	1.26%	$335	0.32%	$14,050	0.75%
New York	$21,635	15.36%	$29,191	8.81%	$65,369	16.72%	$56,150	6.72%	$2,861	4.96%	$11,097	10.43%	$186,303	10.00%
North Carolina	$1,546	1.10%	$5,053	1.53%	$4,846	1.24%	$11,461	1.37%	$1,134	1.97%	$1,720	1.62%	$25,760	1.38%
North Dakota	$1,222	0.87%	$762	0.23%	$243	0.06%	$764	0.09%	$265	0.46%	$254	0.24%	$3,509	0.19%
Ohio	$2,496	1.77%	$8,462	2.55%	$5,404	1.38%	$31,510	3.77%	$5,437	9.43%	$4,878	4.59%	$58,187	3.12%
Oklahoma	$1,102	0.78%	$2,159	0.65%	$2,735	0.70%	$8,338	1.00%	$138	0.24%	$468	0.44%	$14,939	0.80%
Oregon	$1,978	1.40%	$3,796	1.15%	$4,134	1.06%	$8,251	0.99%	$119	0.21%	$762	0.72%	$19,039	1.02%
Pennsylvania	$3,588	2.55%	$11,250	3.40%	$12,783	3.27%	$56,808	6.80%	$3,553	6.16%	$1,781	1.67%	$89,762	4.82%
Puerto Rico	$1,862	1.32%	$4,932	1.49%	$7,251	1.86%	$773	0.09%	$0	0.00%	$3,156	2.97%	$17,973	0.97%
Rhode Island	$1,904	1.35%	$995	0.30%	$1,051	0.27%	$3,295	0.39%	$75	0.13%	$465	0.44%	$7,784	0.42%

Source: Thomson Reuters and SIFMA (2012)

Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

(Dollars in millions)

The following table reports the value of all long-term tax-exempt bonds issued by states and their localities for physical infrastructure purposes for the last decade. A long-term bond is one issued for a period greater than one year. This table does not include refunding transactions for outstanding bonds.

STATE	Housing[1]	Percent[2]	Utilities[3]	Percent	Transportation[4]	Percent	Education[5]	Percent	Environmental[6]	Percent	Public Facilities[7]	Percent	TOTAL	% of Total Issuances
South Carolina	$580	0.41%	$3,774	1.14%	$4,041	1.03%	$15,428	1.85%	$272	0.47%	$665	0.63%	$24,760	1.33%
South Dakota	$2,004	1.42%	$433	0.13%	$33	0.01%	$1,326	0.16%	$39	0.07%	$356	0.33%	$4,191	0.23%
Tennessee	$3,166	2.25%	$3,408	1.03%	$824	0.21%	$7,687	0.92%	$87	0.15%	$3,063	2.88%	$18,236	0.98%
Texas	$4,208	2.99%	$48,915	14.77%	$44,682	11.43%	$105,260	12.60%	$5,305	9.20%	$4,568	4.29%	$212,938	11.43%
Trust Terr.[8]	$0	0.00%	$0	0.00%	$7	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$7	0.00%
Utah	$2,108	1.50%	$3,142	0.95%	$2,815	0.72%	$6,368	0.76%	$32	0.06%	$655	0.62%	$15,120	0.81%
Virgin Islands	$0	0.00%	$109	0.03%	$64	0.02%	$2,804	0.34%	$0	0.00%	$7	0.01%	$2,984	0.16%
Vermont	$644	0.46%	$0	0.00%	$18	0.00%	$21	0.00%	$74	0.13%	$94	0.09%	$851	0.05%
Virginia	$7,259	5.15%	$5,526	1.67%	$7,189	1.84%	$14,548	1.74%	$464	0.80%	$1,917	1.80%	$36,904	1.98%
Washington	$2,446	1.74%	$7,845	2.37%	$11,502	2.94%	$15,653	1.87%	$537	0.93%	$1,790	1.68%	$39,773	2.14%
West Virginia	$484	0.34%	$715	0.22%	$686	0.18%	$2,565	0.31%	$1,646	2.85%	$549	0.52%	$6,646	0.36%
Wisconsin	$2,031	1.44%	$3,682	1.11%	$2,869	0.73%	$8,011	0.96%	$395	0.68%	$231	0.22%	$17,219	0.92%
Wyoming	$1,102	0.78%	$88	0.03%	$6	0.00%	$775	0.09%	$936	1.62%	$69	0.06%	$2,976	0.16%
TOTAL	$140,852	7.6%	$331,245	17.8%	$390,860	21.0%	$835,181	44.8%	$57,680	3.1%	$106,349	5.7%	$1,862,166	100%

[8] American Samoa & Commonwealth of Northern Mariana Islands

Source: Thomson Reuters and SIFMA (2012)

STATEMENT OF CHRISTOPHER TAYLOR, FORMER EXECUTIVE DIRECTOR, MUNICIPAL SECURITIES RULEMAKING BOARD, WASHINGTON, DC

Chairman CAMP. Mr. Taylor, you are recognized for 5 minutes.

Mr. TAYLOR. Thank you, Mr. Chairman, Ranking Member Levin. I am here to share my observations on the municipal debt market as an economist and as a regulator of the municipal dealer community from 1978 to 2007. In particular I want to focus my remarks both in my statement and in my opening remarks on the Tax Reform Act of 1986, which fundamentally changed the municipal securities market and did so overnight.

That act basically changed the groups that invested in municipal debt, and it did so in a way that destroyed the business models of many of the members of the municipal dealer community. It changed the structure of the market, and it changed the way in which those participants in the market adapted to the new tax law. It moved the dealer community away from a model of risk taking to one that was focused on obtaining fees for services. That led to a series of scandals and problems that the municipal market has wrestled with for nearly 20 years.

Up to date, in the early 1990s, the municipal market paid more than $250 million—the dealer community paid more than $250 million in fines for yield burning that dealt with the reinvestment of bond proceeds for municipal bonds. For Members of the Committee, if you make a bond tax exempt for income tax purposes, the rate at which State and local governments borrow is less than what corporations borrow because of the tax exemption. This gives State and local governments and those that serve them, the dealer community and others, the chance to invest those monies at a higher taxable rate. IRS rules regulate that, and IRS rules were changed as a result and tightened supposedly as a result of the tax reform effort of 1986.

Despite that, and because of the changes in the market, we ended up with two sets of scandals and major rule changes that had to be enacted by the Municipal Securities Rulemaking Board to address problems in the market. The two scandals involved the reinvestment of bond proceeds, yield burning, as I mentioned; fines of about $250 million; and, ongoing today, an SEC, IRS, and Justice Department investigation which has led to the 13 individuals either pleading guilty or being found guilty of violating Federal tax and securities laws. Moreover, in the most recent one to date, the fines have reached the point of $650 billion on the part of the dealer community.

It raises the question about tax law changes; because tax law changes change markets, participants change their behavior. So whatever you do, please keep in mind how it is going to affect the markets and those that are participants in the market, be it State and local governments, the dealer community or investors. Those changes can have a dark side. So I would urge all of you to think very carefully about how you go about doing that so that these markets are not fatally damaged.

We do have one of the greatest sets of infrastructure in this country. In my role as the regulator of the municipal securities market, I had individuals come to my office on a regular basis from foreign countries, and their constant question is, how did you build all these roads, schools, buildings, and everything else? And most of it came out of the municipal securities market. So please look at that market from a point of view of maintaining its integrity and taking steps to maintain its integrity if at all possible.

With that, I will conclude my remarks, Mr. Chairman.

Chairman CAMP. Thank you very much, Mr. Taylor.

[The prepared statement of Mr. Taylor follows:]

Statement of Christopher A. Taylor, Ph.D., CFA

Committee on Ways and Means

House of Representatives

March 19, 2013

One of the great achievements of this country is its extensive infrastructure. For those of us that live here, we take it for granted that we can drive on roads to work, take our children to schools, turn on our faucets and get clean water, and know that there are police and courts to protect us. Yet for visitors, especially those from governmental agencies of developing nations, our infrastructure is a marvel that they wish to emulate.

This infrastructure was put in place over decades largely (1) based on decisions made at the state and local level and (2) financed by the issuance of debt at the same state and local level. Few countries in the world give such freedom to political subdivisions below the national level.

Yet, this achievement has a darker side, an unhealthy aspect of the municipal debt market, which may make it harder for states and localities to address their needs in the future. Future growth may be threatened if issuers of municipal debt do not have the confidence that their financing decisions are being made in the most economical manner and if investors question the integrity of market where they buy and sell that debt.

It is this darker side that I wish to discuss with you today. This aspect of the municipal debt market took shape in the wake of the Tax Reform Act of 1986 coupled with trends developing in the business models of dealers. And it centers on the difference between tax-exempt and taxable rate – arbitrage.

I want to state emphatically at this point that no one should construe my remarks as criticism of that tax reform effort. Rather I want to share my observations of the municipal debt market as an economist and as the regulator of the municipal dealer community from 1978 to 2007. Changes in the tax law invariably change markets; policy makers must decide whether those market changes are worthwhile or need to be addressed further in some way.

Prior to the Tax Reform Act of1986, the investor groups were banks of all sizes, property/casualty insurance companies, and individuals. All of these groups were in the higher, if not the highest tax brackets at the time so the availability of investments producing a return exempt from those taxes was preferable. In fact, banks and property/casualty (p/c) companies were much larger investors than individuals.

The business model of almost all dealers in municipal debt was based on profits from buying and selling debt to the banks and p/c companies. Profits from underwriting new debt (bringing to market new debt issues) and selling securities to individuals were dwarfed by profits from trading.

The Act changed the groups that invested in municipal debt. It changed them overnight – not gradually as would have occurred by normal market forces. Banks were almost eliminated as an investor group. Property/casualty investments in municipal debt were sharply limited. Individuals suddenly became the primary investor group.

The structure of the muni market abruptly went from one dominated by institutions to one that now had to focus on individuals. Coincidently, the Act also eliminated many tax-advantaged investments – tax shelters – that competed for the investment dollar of individuals in upper income tax brackets. This change only heightened the importance of individuals in the muni market.

This change in market structure effectively destroyed the business models of the dealer community. Trading munis was no longer a profit center as individuals are mainly buy-and-hold investors unlike institutions which tend to constantly adjust their investment portfolios. Numbers of dealer firms who specialized in institutional trading went out of business or were forced to merge with firms that had some sort of underwriting capability and/or individual client business.

Dealers had to adapt to survive and, unfortunately, those adaptations led to the dark side of muni finance. The new business model for dealers by necessity placed an emphasis on profitability from underwriting new issues of municipal debt. Underwriting new issues means the dealer or group of dealers buy the whole new debt issue of the state or local government. If a community wants to issue $50 million to build and renovate a number of schools, it typically sells all the debt at one time to a dealer or group of dealers – the underwriter or underwriting group. The underwriter then turns around and sells the debt to investors.

There are two basic forms of underwriting – competitive and negotiated. In a competitive sale, the issuer announces that it will be selling its debt – the $50 million in my example – on a specified day at a specified time. Underwriters then submit bids and the issuer accepts the bid that results in its paying the lowest interest cost. The winning underwriter then bears the risk of any adverse subsequent changes in market interest rates, not the issuer.

A negotiated sale is much different. An issuer requests proposals from underwriters, asking them to submit their qualifications to serve as underwriter and to specify what management fee they will charge. In exchange for the management fee, the underwriter works with the issuer to set the terms of the issue so that investors will find it attractive. The issuer effectively bears the interest rate risk, not the dealer, as the terms of the issue are usually adjusted to the point that almost all the debt is pre-sold.

So the muni dealer community moved from a business model that involved risk-taking in both trading and underwriting to a model essentially based on underwriting fees. The only "competition" occurred in the RFP process where dealers touted their qualifications; it was not a competition for producing the lowest interest cost for the issuer. It is a model with low-risk – most of the bonds are pre-sold, sharply lowering the risks and costs of carrying inventory as well as reducing the capital necessary to be held by the dealer. Moreover, for the underwriter there was now a source of product for the broker distribution system to individuals – another source of profit.

The move to fee-based profits versus risk-taking profits had been occurring in other parts of the financial services industry. It was slowly moving into the muni arena prior to the Tax Reform Act of 1986 but the Act certainly hastened its adoption.

Muni dealers quickly learned, however, that the shift to negotiated underwriting had its downside. Intense competition developed for the awarding of negotiated underwriting. The competition took place throughout the country and, in short order, management fees declined sharply. Dealers began to search for ways to protect their profits and the flow of deals to their respective firms as the deal flow was necessary to justify employee compensation levels.

In a first reaction, dealers engaged in pay-to-play practices whereby campaign contributions were made to public officials in exchange for the dealer being awarded a negotiated underwriting. Pay-to-play had become so pervasive that in 1993 the Municipal Securities Rulemaking Board enacted Rule G-37 banning a firm from any negotiated business with an issuer to whom political contributions. The rule was challenged on Constitutional grounds but upheld by the courts.

A second reaction was the move to seek profits from “the other side” of debt issuance– the reinvestment of bond proceeds. In the example above, after the issuer has sold all the bonds to an underwriter or underwriting group, it has $50 million (less expenses) to invest until the funds are expended for the actual construction and renovation of the schools. Of course, issuers would like to invest all these funds, borrowed at a tax-exempt rate, at a higher taxable rate – arbitraging between the rates.

An issuer’s ability to earn arbitrage was limited by provisions of the Tax Reform Act of 1986 and attendant IRS regulations. Nonetheless, many in the dealer community devised a way to earn outsize profits by selling issuers US Treasury securities at above-market prices thereby lowering their yield supposedly to a level that met IRS restrictions; this practice was called “yield burning.” After SEC and IRS investigations, fines and penalties exceeding $250 million were levied against a substantial number of the dealer community in 1996.

In the following decade leading up to the financial crisis, muni dealers devised several ways to generate fees. Issuers were encouraged to move away from long-term fixed rate financings into short-term “auction-rate” securities, supposedly to capture the benefit of lower short-term rates. From a dealer profit perspective, just doing yet another deal generated underwriting and distribution profits.

Subsequent to the initial issuance of these short-term securities, dealers were paid by the issuer to hold auctions weekly or monthly to reset the rates to reflect current market rates. Unfortunately, the auctions were not really auctions as we know them and dealers often colluded with each other to determine the reset rates. The SEC settled with the large dealer banks for less than $10 million, requiring them only to inform issuers that the resetting process did not involve true auctions.

From an economist’s point of view, even without any collusion, the auction process was not one that would yield a competitive market rate as each dealer individually reoffered the securities to select customers. There was no central marketplace where the rates would be set by the interaction of potential investors with the full field of available securities. In other words, it was a series of temporal monopolies with informational inefficiencies limiting investor choice.

Issuers were sold interest rate swaps for the supposed purpose of protecting them from rising short-term rates. These swaps were quite lucrative for dealers who were able to do them – essentially the largest financial institutions. Municipal issuers were told that such interest rate swaps had been used successfully by corporations for more than a decade. What muni issuers were not told was the length of corporate swaps rarely exceeded five years while the great majority of muni interest rate swaps were more than 20 years in length. By the legal nature of interest rate swaps, muni issuers were “locked” into a long-term relationship with the swap provider and the only way out of that relationship was to “prepay” all the interest payments that were due over the remaining term of the swap. In other words, it would be like having to make all the payments on your current mortgage at once if you wanted to refinance or sell your home.

It should also be noted that muni issuers and many market participants assumed that these interest rate swaps were covered by US securities laws. In fact, they were not; Congress had passed the Commodities Modernization Act of 2000 exempting them from any regulation except private contract law. What looked like a duck, walked like a duck, and squawked like a duck, was declared not to be a duck. Moreover, almost all swaps were based on LIBOR rates which we have come to learn were manipulated through collusive practices.

The risks of using auction rate securities and swaps came home to roost in 2008 as the financial crisis unfolded. These risks and the harm caused to municipal issuers were the subject of hearings held by the House Financial Services Committee at that time.

In the decade following the yield-burning settlements with the IRS and SEC, a number of unregulated entities moved into the muni arena as swap advisors and financial advisors. Like the dealers before them, these parties moved into the “other side” of debt issuance and they, too, sought to evade IRS regulations governing the reinvestment of bond proceeds.

The activities of these unregulated parties and their interaction with the dealer community become the subject of an extensive investigation by the IRS, SEC, and Justice Department. I believe the current totals are 13 persons have either pled guilty or been convicted and fines totaling more than $650 million levied against major investment banks and firms for price-fixing, bid rigging, conspiracy, and the like. The Justice Department has indicated that its probe is continuing.

This statement has focused on some of the reactions of the market to the Tax Reform Act of 1986. It does not address such issues as the greater concentration of underwriting in the largest banks, the lack of national, centralized mechanism for price discovery, or the lack of standards and effective enforcement mechanism for disclosure by issuers. This statement does not discuss the broad policy issue of what projects and activities should be allowed to be financed in the tax-exempt market. Nonetheless, I would be glad to share my views with the Committee on these topics if you choose.

As the Committee considers what, if any, actions it wishes to take with regard to the tax-exemption of municipal securities, it may wish to consider what conditions it wishes to impose on those who are granted the privilege to raise funds at a preferential rate. It is critical for the economic well-being of this country that there is a broad, competitive market with integrity in which municipal entities can raise funds for infrastructure purposes.

STATEMENT OF JOHN BUCKLEY, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW SCHOOL GRADUATE TAX PROGRAM, WASHINGTON, DC

Chairman CAMP. Mr. Buckley, you are recognized for 5 minutes.

Mr. BUCKLEY. Thank you, Mr. Chairman and Ranking Member Levin, for the opportunity to participate in your hearing today.

After completion of your hearings and working group process, this committee faces a fundamental choice as to the structure of the tax reform that it will pursue. Mr. Chairman, you, the work you and your staff have done outlining areas of the code that need structural reform and proposing options for changes in those areas, does offer one way forward. If you put your committee staff and the joint committee staff back to work, you could identify several other similar-type areas. Those areas plus the ones you have already done could be the basis for a fundamental tax reform, a reform that could pass this committee, in my opinion, with bipartisan support, and a reform that would compare favorably to the 1986 tax reform. So that is one way forward.

The other way is to pursue a plan with dramatic rate reductions and equally dramatic repeals or curtailments of existing tax benefits. That will be a very challenging task for this committee for several reasons. First, you, unlike everybody else in this tax reform debate, have to provide the details, something that almost everybody has avoided up to this point.

Second, in 1986, the Congress had the luxury of being able to eliminate rampant, abusive tax sheltering to finance the rate reductions. That does not appear to be present in today's situation. So to finance rate reductions today, you will have to go where the Congress was totally unwilling to go in 1986, and that is repeal or curtailment of long-standing tax benefits that are embedded in our society and in our economy. There are no tax benefits more long-standing than the exemption for interest on State and local bonds and the deduction for State and local taxes.

I think the best way to explain the benefits of State and local bonds is to simply look at how they have been used. Most tax-exempt bonds are borrowing for public infrastructure. Private activity bonds, where there is a private business use, are a relatively small part of the market. In the past decade tax-exempt bonds have financed $1.65 trillion of new infrastructure investment with very small cost to the Federal Government. A third of that infrastructure investment was primary and secondary school construction.

Repealing the exclusion will simply increase the cost of capital for State and local governments, reducing investments in infrastructure. It is that simple. To pretend that there are benefits from reduction in infrastructure spending, I think, is just demonstrably wrong. We have underinvested in our public infrastructure, and there are observable economic costs on account of that underinvestment. Tax reform should not make that problem worse.

You also should recognize the impact of tax reform on State and local governments. Repealing the deduction for State and local taxes will increase the burden of those taxes and make it more difficult for State and local governments to finance basic governmental services.

In the case of the deduction for real property taxes, I think the committee also has to be concerned about the impact of collateral consequences. Most people believe that the value of the mortgage interest deduction and the value of the deduction for State and local real property taxes is embedded in the price of our homes. Repealing those benefits could put further pressure on home values. Studies have indicated it will lead to further real declines in home values, threatening our already too-slow economic recovery.

Mr. Chairman, these issues were debated at great length in the process of formulating the 1986 Tax Reform Act. Substantial changes to these benefits were rejected in 1986, and I believe the reasons for that rejection remain valid today.

Thank you very much.

Chairman CAMP. Thank you very much, Mr. Buckley.

[The prepared statement of Mr. Buckley follows:]

Written Testimony of John Buckley

Committee on Ways and Means
March 19, 2013

I. Introduction

Chairman Camp, Ranking Member Levin, I want to thank you for the opportunity to participate in this hearing. It is a pleasure to be back in a familiar room. I also want to thank a former employee of this Committee, Dallas Woodrum, who now is a student at Georgetown Law School. He provided research assistance for this testimony.

There is little doubt that our tax laws are in need of reform and the Committee did not have to conduct hearings to reach that conclusion. However, this and other hearings on various aspects of tax reform can provide information necessary for this Committee to make the fundamental decisions concerning the structure of the reform.

In my opinion, there are two possible approaches:

- The Committee could attempt to formulate a tax reform plan consistent with the plan contained in the budget proposed last week by Budget Committee Chairman Paul Ryan. Such a plan would have dramatic reductions in tax rates, coupled with equally dramatic repeals or limitations of current tax benefits. Unlike others in the tax reform debate, the Committee cannot avoid the painful details. There would be hard votes, perhaps on party lines, for legislation with highly uncertain prospects of enactment.

- Another approach would be a reform that identifies problematic areas and proposes structural reforms in those areas. The Chairman has already identified three such areas and released options for reform. I may disagree with some of the details, but agree with the choice of the areas where reform is needed and think that the proposed options were thoughtfully developed.

Mr. Chairman, with a little more work by your staff in identifying other areas in need of reform, you would have the framework for significant tax reform, a reform that could be enacted with bipartisan support.

If, as I expect, the majority on this Committee chooses the first approach, you will face a task far more difficult than the task faced by this Committee in developing the Tax Reform Act of 1986. In 1986, the Congress had the luxury of being able to finance much of the cost of rate reductions by eliminating rampant and abusive tax sheltering, a relatively easy target. Undoubtedly, there are abuses today, but I have not seen any as widespread, with revenue consequences as large, as those targeted by the 1986 Tax Reform Act.

As a result, to finance rate reductions today, the Committee would have to go where the Congress refused to go in 1986; namely repeal or substantial curtailment of longstanding tax benefits that are embedded in the structure of our society and economy. The tax benefits that are the primary topic of today's hearing (tax-exempt bonds and the deduction for State and local taxes) are both longstanding and consistent with our federal system of government.

II. Tax- Exempt Bonds.

A. Overview

The Federal income tax exclusion for interest on State and local obligations has been part of the modern Federal income tax since it was first enacted in 1913. That exclusion is mirrored by a similar exclusion in all State and local income tax laws for interest on obligations of the Federal government.

The exclusion in State and local income taxes is not a voluntary, reciprocal, accommodation. It is required by Federal law.[1] This Committee needs to keep that limitation on the taxing powers of State and local governments in mind when it considers changes to the Federal income tax exclusion. It would be difficult to justify substantial limitations on, or repeal of, the Federal exclusion, while retaining the prohibition on State and local taxation of interest on Federal obligations.

The size and complexity of the rules governing tax-exempt bonds has increased dramatically over the last 100 years. However, almost all of that complexity has focused on limiting the use of the exemption for private purposes (private activity bonds) or limiting potential abuses such as arbitrage bonds (borrowing at low tax-exempt rates and investing the proceeds at higher taxable rates) or advance refundings.

When a State or local government borrows money today for traditional governmental purposes (general obligation bonds), the rules are not substantially different than they were many years ago. The main new limitation on the issuance of general obligation bonds is the requirement that they be issued in registered, not bearer, form. Otherwise, all major decisions concerning the structure of the financing and the public purpose being financed are the prerogative of the issuer. I would suggest that this is a fairly conservative method of providing Federal support for State and local investment in public infrastructure, minimizing the role of the Federal government, eliminating the possibility of earmarks, and leaving the decisions on public investments in the hands of issuers which will be responsible for all the principal repayments and the bulk of interest costs.

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[1] See section 3124, title 31, USC.

B. Tax-Exempt Bond Market

The debate over tax reform cannot be merely driven by tax policy concerns. This Committee has to take into account the possible collateral consequences of changes to longstanding tax benefits. Therefore, I want to briefly discuss the size of the tax-exempt bond market and the purposes for which those bonds are being issued.

According to data compiled by the JCT staff, the total issuance of tax exempt obligations averaged $400 billion over the period 2001-2010. Of that amount, $340 billion consisted of long-term bonds typically used for infrastructure financing and $60 billion were short-term obligations. As of the close of 2011, there were $3 trillion in outstanding tax-exempt obligations.

The JCT tax expenditure estimates suggest that the overwhelming portion of tax exempt obligations are general obligation bonds, not private activity bonds. The largest category of private activity bonds consists of bonds issued on behalf of private nonprofit educational institutions, followed by housing-related bonds. The recent press story concerning inappropriate use of private activity bonds may be worthy of Committee attention, but it is important to note that the examples cited in the article are an extremely small part of overall issuances and most were the result of limited relaxations of normal rules to provide disaster relief.

The $340 billion of annual issuances of long-term bonds reflect both new infrastructure spending and refinancing of previously issued bonds. Estimates by organizations representing State and local governments suggest that tax-exempt obligations financed $1.65 trillion in new infrastructure investments over the last 10 years. Primary and secondary school construction accounted for almost a third of those infrastructure investments, $514 billion. The other major categories were $288 in tax-exempt financing for acute care hospitals, $258 for water and sewer improvements, $178 billion for roads and $100 billion for mass transit.

C. Arguments for Change

There are three main policy arguments being presented for repeal or substantial limitation of the exclusion for State and local obligations.

First, there is the argument that the exclusion is inefficient. Inefficiency in this context means that the revenue loss from the exclusion is greater than the cost savings enjoyed by the issuers in the form of lower interest rates. I do not believe that is the real reason why the exclusion is "on the table" in the tax reform debate. In my opinion, the real reason is the potential $124 billion revenue increase over 10 years from repeal that could offset the cost of rate reductions. However, if inefficiency is the main objection, there is a simple answer: restore the Build America Bond direct payment provisions with a dramatically lower payment rate. Such a restoration would create a new market for State and local obligations and increase the efficiency of the exclusion for issuers utilizing tax exemption, with little or no cost to the Federal government.

Second, there is the perception that the exclusion is merely a benefit for upper-income investors. That perception is fostered by distributional methods used by the JCT and Treasury which assume that all of the benefits of the exclusion flow to the investor. Those methods are simply wrong because they ignore the implicit tax borne by the investor in the form of a lower interest rate. Much of the burden from repeal would in fact be borne by State and local governments and their taxpayers.

Finally, there is the argument that the exclusion imposes economic costs by interfering with market allocation of resources. Implicit in this argument is the notion that as a country we have over-invested in public infrastructure on account of tax-exempt bonds. I believe that it would be hard to find an objective observer who does not believe that this country has under-invested in public infrastructure and that there are observable economic costs on account of that under-investment.

Repealing the exclusion will increase the cost of capital for State and local governments resulting in lower governmental investment in infrastructure. Market forces will not compensate for that lower governmental investment because market returns do not reflect the public benefits of infrastructure investments.

D. Caveat Concerning Indirect Limitations

The desire to avoid the political consequences of directly attacking specific tax benefits has led some to propose indirect, overall limitations. One example is the overall cap proposed by Mitt Romney in the recent presidential campaign. Another is a slightly different approach outlined by Martin Feldstein in an op/ed in last week's Washington Post. In both cases, tax-exempt bonds were subject to the overall limitation, but the application to previously issued bonds was not clear.

The Committee should understand that those proposals are equivalent to repeal of the exclusion, unless the overall limit is set so high that it would affect few taxpayers. They are potentially more draconian than total repeal because the case for exempting previously issued bonds is less clear.

Tax-exempt bonds are different from other deductions and exclusions because they come with a cost, an implicit tax in the form of a lower investment return. Another benefit with a similar cost is the charitable deduction. Faced with an overall limitation, taxpayers will fill the limit first with benefits that do not have a cost or are involuntary in nature, such as the exclusion for employer-provided health insurance, the mortgage interest deduction, or the deduction for State and local taxes. Only if the limit is so high as to have no significant impact will there be room for tax-exempt bonds.

The only other form of indirect limit is the Obama Administration proposal to limit the exclusion and other tax benefits to the benefit realized at a 28% marginal rate. The proposal is a direct response to the inefficiency argument discussed above. This is the most difficult proposal to analyze. You could argue that the primary impact of the proposal would be a reduction in the "windfall" enjoyed by upper-income investors with marginal tax rates well in excess of the percentage reduction from taxable rates resulting from the exclusion. Others have argued that the proposal would increase tax-exempt rates and result in a 5% decline in the market value of existing tax-exempt bonds.

I am not in a position to know which argument is correct, but would simply note that the Obama Administration proposal would have a less adverse impact on tax-exempt rates and the market value of existing tax-exempt bonds than a tax reform plan that reduces the top marginal rate to 25%. That is true even if the reform retained the exclusion for tax-exempt bonds.

III. Deduction for State and Local Taxes

The deduction for State and local taxes has been part of the Federal income tax system since its very beginning. The deduction was one of only two deductions specifically provided for in the Income Tax Act of 1861. Every Federal income tax statute enacted since 1861 has continued that deduction, although there have been some restrictions on the types of taxes eligible for the deduction.[2]

A. Policy Rationale for the Deduction

The deduction for State and local taxes has been such a long-standing and accepted part of our Federal income tax that there was no official legislative history justifying its existence until 1964. The legislative history accompanying the Revenue Act of 1964, for the first time, set forth the Congressional rationale for the deduction.

1. Income Taxes

The legislative history of the Revenue Act of 1964 indicates that the policy rationale for the deduction of State and local income taxes is the most

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[2] Harvey E. Brazer, "The Deductibility of State and Local Taxes Under the Individual Income Tax," submitted to the House Committee on Ways and Means, 86th Congress, 1st Session.

compelling: a combination of Federalism and preventing double taxation.

> "In the case of State and local income taxes, continued deductibility represents an important means of accommodation where both the State and local governments on one hand, and the Federal government on the other hand, tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case, could mean that the combined burden of State, local and Federal income taxes might be extremely heavy."[3]

The deduction for State and local income taxes is not the only feature of the Federal income tax designed to coordinate with income taxes imposed by other governmental entities. The Federal income tax system also includes the foreign tax credit which reduces the U.S. tax on foreign source income by the amount of income taxes paid on that income to other countries. The foreign tax credit is a dollar for dollar reduction in U.S. tax, a benefit much greater than a deduction. That credit has never been attacked as a subsidy for foreign governments. It is designed to avoid double taxation. Similarly, the deduction for State and local income taxes is an accommodation for taxes imposed by State and local governments, a far less generous accommodation than is accorded to income taxes imposed by foreign countries.

One of the principal reasons for adopting and maintaining an income tax is the concept that tax liability should be based on the individual's ability to pay. State and local income taxes are involuntary and are the unavoidable cost of earning the income. The case for their deductibility in an income tax is compelling, particularly since the amount of an individual's liability for State and local income taxes bears no direct relationship to the amount of government services received by the individual.

Repeal of the deduction for State and local income taxes would be equivalent to an increase in Federal marginal tax rates. For example, assume an individual resides in a State with a 10% income tax rate and assume for ease of calculation that the top Federal marginal rate is 40%. If the individual is subject to the top rate and earns an additional $100, he or she would pay tax of $10 to the State. With the Federal deduction for the tax, the individual would pay a tax of $36 (40% of the individual's actual economic net income of $90). Without the deduction, the individual would pay $40 in Federal tax (approximately 44.4% of the individual's actual economic net income).

It would be difficult to justify a repeal of the individual deduction for State and local income taxes while retaining the deduction for corporate taxpayers. Concerns for small businesses not organized as a corporation would seem to require an "all or no one" approach.

2. Real Property Taxes

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[3] Report of the Committee on Ways and Means accompanying the bill, H.R. 8363, September 13, 1963.

The Revenue Act of 1964 legislative history justified the continuation of the deduction for real property taxes on the grounds that it is an explicit incentive for home ownership. Denial of the deduction would result in a shift of the Federal tax burden between home owners and non-home owners, a shift that the Congress was unwilling to entertain in 1964.

In this area as in the case of the mortgage interest deduction, the Committee must take into potential collateral consequences. Many believe that the value of the mortgage interest deduction and real property tax deduction is embedded in the price of homes. Withdrawal of those benefits could threaten the slow recovery that we are now experiencing in home values. Indeed, some studies suggest that it would result in a further real decline in home values.

3. Retail Sales Taxes

The legislative history behind the Revenue Act of 1964 states that the deduction for State and local retail sales taxes was continued so as to avoid discrimination among States.

There are three major sources of revenue for State and local governments: income taxes, property taxes, and retail sales taxes. In 1964, Congress chose to continue the deduction for each of those major revenue sources, because "it is important for the Federal government to remain neutral as to the relative use made of these three forms of State or local revenue sources."[4]

In 1986, Congress rejected the rationale for deductibility of retail sales taxes. That rejection was reversed in 2004 when Congress responded to the call for neutrality of the deduction among States using different revenue sources.

B. Why Repeal is "On the Table"

There are two reasons why repeal of the deduction for State and local taxes could be part of a tax reform plan with dramatic rate reductions. The first reason is obvious. The revenue from repeal will be necessary to offset the cost of the rate reductions. Also, some see repeal as consistent with their goal of shrinking government at all levels.

In the early 1980's, the Reagan Administration originally argued for repeal of the deduction on ideological grounds. The 1984 Treasury Tax Reform Report explained "the current deduction for State and local taxes in effect provides a Federal subsidy for public services provided by State and local governments, such as public education, road construction and repair, and sanitary services."[5] One columnist stated the rationale more clearly, "The whole point of eliminating the deduction is to change government behavior by encouraging State tax cuts,

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[4] Report of the Committee on Ways and Means accompanying the bill, H.R. 8363, September 13, 1963.

[5] Tax Reform for Fairness, Simplicity, and Economic Growth, 1984.

contracting out and the privatization of government services, and the shrinkage of the public sector."[6]

Many may disagree with the goal of shrinking government at the State and local level, but it is clear that repeal of the deduction for State and local taxes would further that goal. Repeal effectively would increase the burden of those taxes. It would make it more difficult for States to finance government services, such as education, law enforcement and transportation. It would create pressure to reduce government spending at the State and local level, at the same time as the Federal government is reducing its spending in support of State and local governments.

III. Conclusion.

Quite simply, dramatic reductions in marginal tax rates should not be financed by changes that could reduce needed public infrastructure investments unless the Congress is prepared to finance those investments with appropriated funds.

Also, the reasons the Reagan proposal to repeal the deduction for State and local taxes was rejected in 1986 remain valid today. The Federal deduction for State and local taxes is an important part of our Federal system of government. It is consistent with a tax system based on ability to pay

[6] Bruce Bartlett, "The State and Local Deduction," November 2, 2004, Townhall.com

Chairman CAMP. And now we will go to questions.

Mr. Hodge, you stated that eliminating the Federal tax breaks for State and local taxes and bonds, and using that revenue to reduce rates across the board, would actually create nearly a quarter of a million jobs in America. Given the stubbornly high levels of unemployment that we have seen and we continue to face several years after the financial crisis, could you explain for the committee the economics behind why that trade-off would result in significant job gains?

Mr. HODGE. Sure. Well, what this sort of reform would do—and this is revenue-neutral reform in which the proceeds from eliminating those deductions would go directly toward across-the-board rate reductions, and in our model it would allow all rates to be reduced by about 5 percent—not 5 percent points, but 5 percent. But that is enough to spur a lot of new economic activity either through direct spending on the part of taxpayers or through new investment, and by lowering the cost of capital, we would see a considerable amount of new investment in the economy, which ultimately leads to increased wages and increased jobs. These sorts of effects don't happen overnight, but they do happen over time, and I think that is the critical point is to look at the long-term horizon of what the economy will look like once the reform is fully in place and fully working its way through the economy.

Chairman CAMP. Also, I mentioned in my opening statement that three States are responsible for more than a third, almost 40 percent, of the total Federal deduction for State and local taxes, and they coincidentally happen to be the three States that also have the highest combined State and local income tax rates in the country. Does the State and local tax deduction, as some economists have claimed, does that really encourage bigger government at the State level, in your opinion?

Mr. HODGE. The research is pretty clear that there is a direct linkage between the State and local tax deduction and higher taxes, certain types of taxes at the State level, particularly those that are deductible, those being progressive income taxes and property taxes, and a number of States have, as you indicate, have dramatically increased those particular types of taxes. California has the highest State income tax, personal income tax. New York has some of the highest property taxes in the Nation.

And so those are the kind of taxes that are not only deductible, but then are more easily increased by State and local officials because they know that Washington is going to pick up as much as one-third of the tab through the State and local deduction.

Chairman CAMP. All right. I have a question for everyone on the panel, if you could answer briefly. Do you believe—and I will start with you, Mr. Hodge. Do you believe there is a policy difference between the Federal subsidies for government bonds, which obviously are used for a public purpose, and private activity bonds, which benefit private parties?

Mr. HODGE. I would eliminate both, Mr. Chairman. I don't think it is the proper role of the Federal Government to subsidize either one of those. Essentially what those policies are doing is saying that it is more important to build a sports stadium or some other public infrastructure than to build a private R&D facility, and I think that the Tax Code should be neutral to those kinds of decisions.

Chairman CAMP. All right. Mr. Parkhurst.

Mr. PARKHURST. Mr. Chairman, the vast majority of tax-exempt bonds, whether they are, in this case, private activity bonds where you have a public wrap, or it is a clear tax-exempt bond issued by State and local is usually used for financing traditional purposes, it is helping with government, schools, roads, sewer systems, public power, airports, and other infrastructure.

It is interesting. I would say that some of the examples we have seen recently in the media, were addressing projects financed under special temporary authorities that were granted by Congress following natural disasters and other events like Hurricane Katrina or 9/11, and the authority for those bonds has largely expired. And I think that private activity bonds really do help focus in some areas around low-income housing and do help in certain particular areas.

Chairman CAMP. All right. Mr. Taylor.

Mr. TAYLOR. I believe that——

Chairman CAMP. Your microphone.

Mr. TAYLOR. I certainly believe that if you are going to give a benefit—and that is a decision the committee has to make—if you are going to give a benefit to the State and local government sector, limit it to true public purposes. I do not see a reason to—for the same reasons that I have heard to my right—see any reason to give any kind of public benefit to private corporations or private decisionmakers. I would probably go very strongly in favor of very sharply limiting even the public purposes that are out there.

Mr. Parkhurst mentioned airports and public power. I am not sure, quite frankly, that you could have a good reason for doing either of those as a true public purpose. Limit it to roads, sewers, and those things that local governments and State governments do, not stuff that can be substituted by a private corporation.

Chairman CAMP. All right.

Mr. Buckley.

Mr. BUCKLEY. Well, first of all, I would say that most tax-exempt bonds are general obligation, traditional government financing of infrastructure. The term “private activity bond” picks up a whole wide range of activities, some of which I think have big public benefit: docks, wharves, airports. These are transportation facilities that are necessary for our economy, there are public purposes involved, and therefore I think it is appropriate to have private activity bond financing for that type of thing.

But if this committee is going to look at anything in this area, I would suggest they would look at the private activity bond rules. But let me firmly agree with the prior statement: The abuses that were outlined in that New York Times article are largely because of one-time disaster-related relief, and I would hope the Congress would not repeat that in the future.

Chairman CAMP. Well, the New York Times article talked about the winery in North Carolina, the golf resort in Puerto Rico, the Corvette museum in Kentucky, obviously the Barclay Center in Brooklyn, as well as the Goldman Sachs and Bank of America towers or buildings in New York City. But my question is if those aren't appropriate for federally subsidized borrowing, are there any rules that we might change to help prevent those activities? You sort of touched on that, Mr. Buckley.

Just quickly if you each want to respond if you think there is any—I mean, obviously some have said prevent that activity altogether, and narrowly focus. Any other comments, Mr. Parkhurst or Mr. Taylor?

Mr. PARKHURST. I would associate my remarks with Mr. Buckley. I think that that is an opportunity to obviously correct anomalies, to look very carefully at how private activity bonds are used, and make certain that the private portion is a de minimis amount, and that indeed private activity bonds are used for a public purpose.

I think we have had this discussion over the years around the use of eminent domain, and the Court had been very clear in how that issue was resolved. While State and locals may have won in the court, the court of public opinion, I think, led to some further discussion on the issue. I think we will have a similar discussion going forward with private activity bonds.

Chairman CAMP. Mr. Taylor.

Mr. TAYLOR. Mr. Chairman, if you are going to confer a subsidy or a benefit or something to a State and local government, they should be actively involved and the only ones involved in that activity in terms of either using their taxing power, general obligations, raising sewer fees, whatever it is. But the minute you allow a melding of those things, then I think you open the door to potential abuses both in terms of the amount of issuance that is out there and also about how the funds are subsequently used and invested.

Chairman CAMP. Okay. All right. Thank you.

Mr. Levin is recognized.

Mr. LEVIN. Thank you.

You know, I agree we should look at private activity bonds, remembering they are a small portion of the bonding that is going on, and I would hope, though it isn't clear within the jurisdiction of which of the working groups, Mr. Chairman. I would hope that the working groups——

Chairman CAMP. This working group.

Mr. LEVIN. Well, but also I think we need—I think the testimony today shows the need for much further inquiry into this issue, because, Mr. Hodge, I very much agree at least with what you say at the beginning. I don't agree with other parts of it perhaps. But when you say, contrary to conventional wisdom, not every tax expenditure is a loophole, that is really correct. And I think in this discussion of tax reform we need to press people when they say, let's resolve these huge gaps by looking at loopholes, we need to press them what they mean by that, because I think the issues before us today are not loopholes. There are loopholes, but these are policies that have been embedded in our Tax Code for a long time.

By the way, Mr. Hodge, the Tax Foundation is a nonpartisan entity. How is it financed?

Mr. HODGE. We are entirely privately financed. We are a non-profit. We are a loophole for people who want to avoid taxation by giving us a charitable contribution, and if I——

Mr. LEVIN. But the funders aren't public, right?

Mr. HODGE. I am sorry?

Mr. LEVIN. The funders to your foundation aren't public?

Mr. HODGE. They are private individuals. We accept no government funds.

Mr. LEVIN. And it comes from individuals, corporations?

Mr. HODGE. Private foundations.

Mr. LEVIN. Private foundations. Okay.

Mr. Parkhurst, your testimony was approved by the association?

Mr. PARKHURST. Yes, Congressman.

Mr. LEVIN. So you are speaking on behalf of all the Governors, Republicans, Democrats?

Mr. PARKHURST. NGA is a bipartisan organization of the Nation's Governors, correct.

Mr. LEVIN. And when you testify, there is some clearance process, so when you speak on behalf of Governors, it is something that is appropriately said?

Mr. PARKHURST. Yes, there is.

Mr. LEVIN. Because I think that is important. There is a pointing here to three States that receive a substantial portion of the impact of the deduction for State and local taxes. I think when we look at that, we should look at the rest of the States. I think also we should look at what those three States do in terms of the use of their monies, and to simply say they are higher-tax States, I think we also need to look at their educational processes, their role in health care in this country as well as their State.

And, Mr. Buckley, I also think we need to take into account what is outlined in your testimony about the impact of long-term bonds. By the way, we tried to keep the other bonding program alive, and it now isn't in existence. The pages aren't numbered, but you indicate $340 billion of annual issuance. It goes this way according to estimates: $1.65 trillion in new infrastructure investments over the last 10 years in terms of school construction accounted for almost a third of the infrastructure investments. The other major categories were $288 billion in tax-exempt financing for acute care hospitals, $258 billion for water and sewer improvements, and $178 billion for roads, and $100 billion for mass transit.

Mr. BUCKLEY. Yes, Mr. Levin, and let me go back to the discussion of the three big States, because I think the discussion is somewhat unfair to the three big States. They are large States; they are urban States. Urban areas have higher costs than rural areas. So it is unclear in my mind whether they have high tax rates because of the Federal deduction, or because it is much more expensive to have government in the area of an urban area.

They are also high-income States, so clearly the tax rates have—the State and local taxes are being invested for reasons that have created wealth in those States. I think—and they are among the largest populated States.

So there are whole reasons of factors why some States have higher tax burdens that have nothing to do with Federal deductibility. They have to do with some of the choices they have made about their educational system that have proved to be valuable to their citizens and because of the urban nature of the States.

Mr. LEVIN. Thank you.

Chairman CAMP. Thank you.

Mr. Johnson is recognized for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Hodge, last week the Dallas City Council came in to see me, and in that meeting they expressed strong opposition to doing away with the tax exemption for municipal bonds, which you referred to. According to the city's position paper, and I quote, Removing the tax exemption from municipal bonds could raise the city's borrowing costs substantially. The increased borrowing costs would disproportionately impact moderate- and low-income residents since higher borrowing costs for the city would mean either doing less or raising property tax or water and sewer fees to cover higher borrowing costs.

In your testimony you make the case for doing away with the tax exemption, and I am going to ask you about four questions if you would talk to them. In the interest of ensuring a full and fair debate, how would you respond to the council's concerns, one? And, two, is the council crying wolf? Three, would borrowing costs actually increase substantially? And, four, would property taxes have to go up?

Mr. HODGE. Well, and not necessarily in that order, to some degree, yes, they are crying wolf. They are enjoying a benefit, that is absolutely clear.

To the extent of how much interest rates would go up, well, that is up to the marketplace and how creditworthy that particular government is. But I think there should be parity between what that government borrows at and what a private-sector company in the same community would have to borrow at. Whether.

Or not it would lead to a direct increase in property taxes and other taxes to pay for it, it depends. It actually might encourage the city to reduce its overall amount of borrowing and be a little bit more prudent in what it goes about trying to build.

I think, more importantly, if you look at the overall issue, this is a very inefficient way of funding municipal projects because about a third of the benefit will go to bondholders, many of them who are upper income, and then a third of the benefit, yes, does go to the community. But when you are a Federal official looking at this, you are going, wait, we are paying a third extra essentially to finance this particular local project. So it is a very inefficient way to do it.

Actually, I wouldn't recommend this, it would be cheaper in a way to just give the cash to a State community or to a local community to build a project rather than giving a third to the bondholder and a third to the community.

Mr. JOHNSON. In that case New York would probably want more.

Mr. HODGE. It would certainly want more, yes.

Mr. JOHNSON. Thank you so much.

Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Rangel is recognized.

Mr. RANGEL. Thank you so much.

Very interesting, Mr. Hodge, your response to Mr. Levin in terms of your organization receiving tax exemption. I understand that from your testimony you believe that if we eliminate the subsidies given to local and State governments, we can take that money and lower the rates for taxpayers. And I assume that the contributors to your firm are wealthy taxpayers. I mean, it is not poor people that are doing it, right?

Mr. HODGE. I don't know the net wealth of my——

Mr. RANGEL. No, you know your constituency.

Mr. HODGE. We have everything from little old ladies—we have contributors who are little old ladies and wealthy people.

Mr. RANGEL. Well, let me ask you, do you engage in fund-raising?

Mr. HODGE. We do indeed.

Mr. RANGEL. And you have no clue as to who makes the contribution to your——

Mr. HODGE. We do, yes, certainly.

Mr. RANGEL. Are they wealthy people?

Mr. HODGE. There are some, and then there are some who aren't.

Mr. RANGEL. Okay. But the whole idea is that you really want to lower tax rates as opposed to assisting States, especially the three that you mentioned, you think that is a give-away.

I ask you this: Do you have any idea as to the amount of Federal taxes that are paid to the Federal Government from these three States and how it relates to States that are less—have less income? Do you ever take a look at it?

Mr. HODGE. We do. We annually rank the States in terms——

Mr. RANGEL. And it is the highest in the country, isn't it?

Mr. HODGE. It is because of the progressive nature——

Mr. RANGEL. It is the highest amount of revenue in the country.

Mr. HODGE. Right.

Mr. RANGEL. Now, if an argument was made that because God has blessed these States with resources, and that they want to improve their education and their infrastructure and to be a place that is a symbol for American capitalism in this country and the world, just say like New York as an example, if we have to pay heavily for that in order to increase the revenue to turn back over to our Federal Government that makes it possible, don't you really believe that we should get a break for the contribution that we make to society and to your tax-exempt foundation?

Mr. HODGE. I think that people like Donald Trump and others on Wall Street can well afford——

Mr. RANGEL. I wish you wouldn't have mentioned Trump's name. He is not relevant, he really isn't, to this discussion.

Mr. HODGE. He doesn't——

Mr. RANGEL. Please don't do that.

Mr. HODGE. Wealthy people don't need that kind of subsidy.

Mr. RANGEL. Okay. Well, I really would want you to think about whether you would want the lowest States that have the lowest educational areas, the lowest-paid people, the less productive thing, if you are comparing this as an example for fairness, do you think that makes any sense at all that you should compare the lowest States? Now, true, they need revenues, but that you compare them with a higher-paying tax State that has higher expenses than the rest? You don't believe in equality of the 50 States across the board between those that contribute to the Federal Government and those that are the beneficiaries of the Federal Government. Isn't there a difference that has to be considered?

Mr. HODGE. The economic research shows that all of those citizens would be better off with lower rates.

Mr. RANGEL. But isn't it true that we contribute——

Mr. HODGE. Lower tax rates.

Mr. RANGEL. A large amount of States that you mention in your testimony, they are not givers, they are receivers, and a lot of the part of that money comes from California and New York; isn't that true?

Mr. HODGE. There is a considerable amount of redistribution.

Mr. RANGEL. A lot of money comes from the high-tax States, and it goes to the lower-income States, and that is a fact. So when we ask you to consider that, then you should include that in your testimony that we are big givers, and we don't complain about it. They complain to me, but they don't complain to the Federal Government. We are so pleased that our State is able to do it with the support of our partners.

That is what Sandy Hurricane was all about. When one of the States get into trouble, we don't see who is a poor State and who is a rich State, we come in. So for you to single out these three States because we tried to be partners with them in rebuilding, when they rebuild for the city, when they rebuild for the State, I would like to believe that they are rebuilding for our great country as well.

Thank you, I yield back the balance of my time.

Chairman CAMP. Thank you very much.

Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman.

So I want to focus on Washington State now. Mr. Hodge, you talked about a couple of study models that you looked at in your testimony, and that those studies that you did suggested that by eliminating the itemized deductions for State and local taxes, that would result in a lowering of tax rates; is that correct?

Mr. HODGE. That is correct.

Mr. REICHERT. In your study models did you look at those States—and there are just a handful, Texas is one of those from Mr. Johnson's neck of the woods——

Mr. HODGE. Sure.

Mr. REICHERT [continuing]. Did you look at the sales tax States? We don't have an income tax in the State of Washington. We have approximately a 9 percent sales tax. What would happen there?

Mr. HODGE. Well, we didn't look at every State specifically in terms of how it would change the mix of their tax base or their economy overall. We were looking at the national results. But generally speaking, the citizens of Washington State probably have far fewer State and local tax deductions than would be the citizens of other States because of the mix of your taxes. While you do have, certainly by some counts, some higher property taxes, you don't have a personal income tax nor a corporate income tax. You have the B&O tax, and some of that I don't think is deductible.

So to some extent the citizens, the taxpayers in your State would be far better off by giving up the deduction and taking lower Federal income tax rates, and they would be far better off as a result, I think.

Mr. REICHERT. You don't have an opinion as to whether or not the sales tax might be reduced, the State might move that direction or——

Mr. HODGE. Well, since it is not—well, it is deductible to some degree, but not like the personal income tax. I don't think that the State would necessarily reduce it. We would have—I would have to give that some more thought.

Mr. REICHERT. And this is for the panel, last question, Mr. Chairman. Do any of you see a policy reason for doing tax reform and not providing parity for State sales and income taxes, whether it be providing continued permanent deduction for both or eliminating both?

Mr. BUCKLEY. I believe there should be neutrality among the States—regardless of their choice of revenue sources, and that has been the underlying principle of the State and local tax deduction. It was violated somewhat in 1986 when they repealed the deduction for State and local retail sales taxes, but it was replaced, restored, and so I think the principle of neutrality among States is one that should be followed in this area.

Mr. REICHERT. Appreciate that, Mr. Buckley.

Any other response?

Mr. PARKHURST. I would agree with the principle of neutrality, Congressman. Also one of the principles that the Governors have laid out is one of sovereignty. I think the discussion I have heard so far is a question that really rests at State capitols and between the executive and legislative branches of the States to make those decisions on the balance, if you will, of their respective State strategies on taxes, to create a competitive environment.

Mr. REICHERT. Okay, thank you. I yield back.

Chairman CAMP. Thank you.

Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

I think I provide a unique perspective, because I think Mr. Pascrell and I might be the only two on this side who were formerly mayors of major municipalities, and I can tell you that tax-exempt municipal bonds are the most important tool in the United States for financing investments in schools, roads, bridges, water, and sewer systems. The reality is that these initiatives just wouldn't happen without muni bonds.

Bowles-Simpson in its 2010 deficit reduction recommendations proposed full taxation for State and local interests for all newly issued bonds. A recent report shows that if this proposal had been in place during the 2003 to 2012 period, it is estimated that $1.65 trillion of State and local infrastructure would have cost governments an additional $495 billion of interest expense. For Boston, the tax exemption loss over that period would have resulted in a $55 million cost increase. These numbers are staggering, and the reality is that State and local governments can't withstand those additional costs.

John, in our zeal to do tax reform here, which we all agree upon, there apparently are many options that we could consider to raise revenue. You and I have worked over the years on a number of proposals to close tax loopholes, and what do you think of eliminating or capping tax-exempt financing as it relates to good policy?

Mr. BUCKLEY. I think you can pretend that there are economic benefits from capping or repealing the exclusion only if you believe this country will benefit by lower investment in public infrastructure. The exemption goes directly to the cost of funds for State and local governments, which you have experienced.

The answer to Mr. Johnson is governments will pay higher interest rates. I don't think there is anybody in this room will disagree with the proposition that repeal of the exclusion will increase interest rates to State and local issuers, increasing their cost of investment, reducing public infrastructure.

Mr. NEAL. Mr. Parkhurst.

Mr. PARKHURST. Congressman, the question is a very interesting one. I would argue that capping this benefit, to your point, would indeed, I think, raise the cost by simply a percentage. I think we have seen estimates anywhere between 60 to upwards of 200 basis points. But interestingly, if the purpose of cap is to, you know, address revenue issues, it may be a challenge, given that, based on IRS data for 2010, itemizing taxpayers seem to fall primarily, who claim interest on muni bonds, are making less than $250,000, and I think going forward, if the cap is applied in particular to all taxpayers, you going to be effectively taxed twice.

As Professor Buckley says, obviously, going to taxed on the increased cost to infrastructure and we will see the direct tax here that you are referencing.

Mr. NEAL. Let me turn for a moment to Build America Bonds. John Buckley and I, along with Alan Krueger, worked very hard on Build America Bonds. They were part of the 2009 stimulus legislation. BABs are taxable bonds for which the U.S. Treasury Department pays a 35 percent subsidy to the issuer to offset borrowing cost. They were a huge success around the country. Virtually everybody who had an airport expansion, they were done with Build America Bonds during that period of time. And I must tell you that the Accelerated Bridge Program was very successful, and across Massachusetts the Build America Bonds were a smash.

Now, I want to ask you, John, do you think that this would have happened without Build America Bonds?

Mr. BUCKLEY. Build America Bonds were enacted at a time when the municipal bond market was in freefall. There was no market for tax-exempt bonds because of the economic downturn, so clearly it responded to a tremendous need at that time.

I also think it is the response to the argument that the exclusion is inefficient. You can dramatically lower the rate of the subsidy that was provided in Build America Bonds and still dramatically increase the efficiency of the market for tax-exempt bonds. So I think it is something that has to be looked at in the long run because State and local issuers are facing a shrinking market for tax-exempt bonds.

Mr. NEAL. And New Markets Tax Credits were designed to stimulate investment in low-income communities. It has been overlooked by conventional capital markets, and it has generated more than $45 billion in capital for projects in low-income communities. In North Hampton, the Holyoke Public Library, the Colonial Theater in Pittsfield, cities across the country have used New Markets Tax Credits to incent certain behaviors. I have been a real champion from day one of New Markets Tax Credits. Again, very, very successful. And how might cities attract private investment into communities with high employment and deteriorated property without the use of these incentives?

Could we do that quickly, Mr. Chairman?

Chairman CAMP. Very quickly, because time has expired.

Mr. BUCKLEY. I believe that the New Markets Tax Credit and the Low Income Housing Tax Credit are important parts of encouraging redevelopment in low-income areas. The market does not allocate resources to those areas, so if you repeal those, you are relying on market allocations and you will see less development, less low-income housing as a result.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Dr. Price is recognized.

Mr. PRICE. Thank you, Mr. Chairman. And I want to thank the panelists for their presentation.

Mr. Hodge, you make the case that the Federal Government ought to be agnostic as it relates to deduction for State and local taxes, municipal bonds and the like. Can you help me understand why, what the rationale was at the beginning for the providing for tax exemption for State and local taxes?

Mr. HODGE. Sure. Well, according to the principles of sound tax policy, we shouldn't pay taxes on income that has already been taxed by another level of government. The same way we have foreign tax credits where companies don't have to pay tax on—or they get to deduct taxes paid abroad, a similar rationale applies here. And I think that that is true. As a tax purist, I would say we generally shouldn't have to pay taxes on taxes or income that has already been taxed at the local level. However, we ought to look also at the economic effects of that kind of policy, and in this case, the policy, the unintended consequences of this policy are more harmful, I think, in the long run and outweigh whatever benefit comes from that.

Mr. PRICE. Is that because of a difference in rates between States, so different citizens are paying different rates and therefore they are treated differently? Is that part of your rationale?

Mr. HODGE. Well, generally speaking, and this goes back to 1913 when the code was originally written, all State taxes were deductible, and then over time it has been whittled away in various fashion. Today it is further eroded because of the AMT and the Pease provisions, which already reduce the value of these deductions. So the Congress has already made this policy decision to limit these deductions in some fashion. The question is, do we take it to the next level and just eliminate it for all taxpayers? We already do it for high-income taxpayers, and the question is, do we do it for everyone?

Mr. PRICE. Yeah. Mr. Buckley makes the case, I think, that if this exemption were to go away for municipal bonds and the like, that it would drive up costs for infrastructure projects and the bonds that would then be let and that, therefore, I think is the argument, that then taxes would go up for the individuals in that municipality to pay for the increased cost for the project. That makes some sense to me. Tell me why that isn't the case.

Mr. HODGE. Well, no, it probably is the case because, you know, these projects are getting a federal subsidy. So more of the costs would fall on local taxpayers, which means that local officials would have to be entirely up front with local taxpayers about the cost and they couldn't shift part of the cost to the Federal Government.

Mr. PRICE. So the argument is that doing away with the exemption then becomes a much more transparent, much more honest way of governance.

Mr. HODGE. Absolutely, and brings more responsibility to local officials to maintain those costs and reduce those costs and ultimately reduce the long-term borrowing cost to future taxpayers, because you got to remember, this is an obligation on future taxpayers to pay off those bonds. So by essentially subsidizing it at the federal level, you are encouraging more and more of that activity at the local level, putting a greater burden on future taxpayers, and that is what we have seen in the recent data.

Mr. PRICE. Mr. Parkhurst, why doesn't that make any sense?

Mr. PARKHURST. I just want to highlight one key point here, Congressman. When we are talking about investments in infrastructure, we are talking about long-term capital assets that have a long lifecycle, so it makes eminent sense to be issuing long-term debt for infrastructure that is going to benefit——

Mr. PRICE. I think Mr. Hodge's argument was that the process gets more transparent, more accountable, and the elected officials become more then responsive to their constituents. Why isn't that true?

Mr. PARKHURST. I would argue that given that for many States and municipalities that are issuing debt, many are doing it either through a public referendum where they have got to go to the voters to explain why they are going to be issuing bonds. There are caps that are held. Transparency is well addressed, I think, at the municipal level through that at this point right now. I am not certain what the delta would be on additional transparency from Mr. Hodge's point.

Mr. PRICE. Mr. Hodge.

Mr. HODGE. I think that the more we can make this process transparent, the better. And if we look at the increase in debt over the last, say, 12 years relative to the amount of that debt that has gone to new infrastructure, there is a lot of money missing. There has been very little new investment in infrastructure relative to the tremendous amount of new debt that has been taken on.

Mr. PRICE. All right. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Doggett is recognized. After Mr. Doggett concludes, we will go two to one on this side.

Mr. DOGGETT. Thank you, Mr. Chairman.

There is probably no perfect way to ensure public input, public participation for a truly public interest revision of our complex tax laws, but I think what the chairman has done in terms of laying out proposals for public comment, last year on the international tax, recently on derivatives, is a step in the right direction, as is this hearing. I am less confident about how productive in assuring the public interest is represented in this revision, how the working groups are operating. In fact, one of them is meeting as we convene here now with groups that are interested in what is happening in the energy code, and many of these working groups are overlapping. All of them are done in private. And they do provide some insight, but they do not really provide an opportunity for all Members of the Committee to participate in all of these really important groups. And so I think that process is not quite as productive, and the more hearings like this we can have to explore all the implications of Tax Code revision, I think the better product we will get.

You have covered a lot of territory about how we finance infrastructure. I would like to return to a topic that the chairman asked you about, and that is on private activity bonds. While I realize that is a small portion of the overall municipal or bond market, the suggestion in the recent Times critique of the private activity bond market referred to a Bipartisan Policy Center study suggesting that the private activity bond market amounts to a cost to the Treasury of $50 billion over 10 years. Is that a fair analysis of what the cost of that program is?

Mr. BUCKLEY. Let me say that their estimate makes the point that I was trying to make in my testimony, that it is an extremely small piece of the overall cost of tax-exempt bonds.

Mr. DOGGETT. Indeed, and I agree, but $50 billion is $50 billion.

Mr. BUCKLEY. Right. Now, also, the term private activity bond picks up a whole wide range of activities. Bonds issued on behalf of private colleges are private activity bonds. Bonds issued for transportation infrastructure, wharves, docks, airports, where there is a mixed public-private are private activity bonds. So there is a wide range here.

Now, I do believe it is an area where the committee should look at.

Mr. DOGGETT. There were some standards set in the 1986 reform that have gradually been eroded or excepted so that while at that time you couldn't finance golf courses, now some of the subsequent disaster relief proposals have——

Mr. BUCKLEY. What you absolutely should not do is not enact, you know, kind of scattershot disaster relief provisions that just simply waive all the limitations on private activity bonds.

Mr. DOGGETT. In our eagerness to respond to disasters, whether Texas, New York, Louisiana or anywhere else——

Mr. BUCKLEY. The midwest, that is correct.

Mr. DOGGETT [continuing]. Sometimes those standards are forgotten, but isn't that the best way to ensure that doesn't happen to have strong clear, standards in the law about when private activity bonds can be used or to eliminate them entirely?

Mr. BUCKLEY. Well, I think there are standards in the law. I would caution against eliminating them entirely because I think that will affect some types of infrastructure that are valuable and that you will desire. This is an area where I think the committee should look at.

Mr. DOGGETT. Why can't those other forms of infrastructure be, to the extent that they deserve any preference or Federal subsidy, be financed through general obligation bonds?

Mr. BUCKLEY. Just because there is a mixed public-private use is the only reason.

Mr. DOGGETT. The Times article suggested that the largest beneficiary of private activity bonds had been Chevron.

Mr. BUCKLEY. That was a disaster-related provision.

Mr. DOGGETT. And would be the kind of provision that while Chevron might get a benefit, Joe's Chevron station that is a small business in the same area is not accorded any benefit.

Mr. BUCKLEY. They could have probably accessed it as well, but they did not.

Mr. DOGGETT. Mr. Taylor, Mr. Hodge, Mr. Parkhurst, I know you have raised questions pro and con on bonds generally, but specifically on private activity bonds, should they be limited? Are new standards necessary?

Chairman CAMP. Just answer very briefly because time has expired.

Mr. TAYLOR. My answer is, yes, they should be eliminated. If you are going to give a benefit, give it to the State and local government directly. If they don't want to finance it, I don't see a reason that the private sector should benefit in any way.

Mr. PARKHURST. At this point, I think the Governors would want to examine all the options on the table before making any final decisions.

Chairman CAMP. All right. Thank you very much.

Mr. Buchanan is recognized for 5 minutes.

Mr. BUCHANAN. Thank you, Mr. Chairman, for holding this important hearing today, and I would like to thank all our witnesses for taking their time out to be here. As a member from Florida, I am the only member on Ways and Means, but my district, we have 200,000 retirees, and I know that they count on municipal bonds as a stable investment.

Mr. Parkhurst, or any of you, I have got a sense of it myself, you know, as an investor over the years, but how safe are municipal bonds in terms of a sound investment for retirees?

Mr. PARKHURST. Municipal bonds are probably one of the, if not the safest investment that my parents, who are retirees, could invest in. I think, and I will defer to Dr. Buckley on the specific numbers, but I think it is well below 1 percent default rate.

Interesting point on retirees. Again, citing back to the 2010 tax date I referenced earlier, it is in my testimony, of those taxpayers that identify on their tax forms an exclusion for interest for muni bonds, 5 out of 10 of those taxpayers are 65 years or older. So seniors do comprise a large section of investors in muni bonds, either directly or through their mutual funds that invest in these products.

Mr. BUCHANAN. Mr. Buckley, do you have actually a number, a percentage or something? I mean, I assume 1 percent. I just wanted to kind of hear it.

Mr. BUCKLEY. I do not have a specific number. The default rate has been low in this area.

Mr. BUCHANAN. Okay. The other thing was just in terms of this, do you have any sense of what percentage are owned by retirees in terms of these pension funds? Do you have any sense, 65 and older individuals?

Mr. PARKHURST. I don't have a specific answer for you, Congressman, I can look into that. I would say, though, just to give you a little more macro perspective, the market is made up of both retail and institutional investors, and the retail investors are who you are referring to at this point, individuals who are purchasing. They also include the individual investors who have been discussed here as well.

On the institutional side, the primary investors in municipal bonds are P&C, property and casualty insurance companies, as well as banks, not necessarily the large banks, but more regional and community banks that are reinvesting in infrastructure investments within their communities.

Mr. BUCHANAN. Mr. Buckley, the National Federation of Independent Businesses, NFIB, and I have seen that from our local chambers as well, they surveyed their members who make up the small business community across the country, and 85 percent of their members think that Congress should do tax reform, change the Federal Tax Code. However, they favor retaining the deduction for State and local taxes even in exchange for lower tax rates. They want tax reform, but they would like to retain the exemptions for State and Federal Governments. Why do you think that is, or do you have any sense of that?

Mr. BUCKLEY. Well, first of all, as was mentioned previously, repealing the deduction effectively increases their marginal rate. So if you repealed the deduction for State income taxes and replace it with a lower rate, you really haven't done much. You have substituted one form of marginal rate increase for a marginal rate decrease.

Also, my guess is the small business community has to be very concerned about the question of whether corporations would have their deduction for State and local taxes repealed. It is hard, in my mind, to justify taking the deduction away from unincorporated businesses and continuing it for corporate businesses.

Now, in the corporate context, the rationale for the deduction is as strong as it is on the individual side, so my guess is they are worried about discrimination here.

Mr. BUCHANAN. One other thing. Bowles-Simpson and other groups, advisory panel for the President, want to eliminate the deduction, and why is that, do you think? Because at the end of the day you would think it would create more jobs, more opportunities, put more dollars into the Treasury in terms of people being employed, but why did they come up with that analysis?

Mr. BUCKLEY. Revenue. Just revenue to finance rate reductions. That is all.

Mr. BUCHANAN. Thank you, Mr. Chairman. I yield back.

Chairman CAMP. Thank you, Mr. Buckley. I do appreciate your comment that actually reducing the rate would have all taxpayers being treated more similarly as opposed to those taxpayers in those

States that have high incomes and use the deduction more. But if you do eliminate that and lower the rate, there is not a marginal rate increase.

Mr. BUCKLEY. There is a marginal rate increase depending——

Chairman CAMP. Not if you lower the rate. Not if you lower the rate.

Mr. BUCKLEY. Depending on the State in which you reside.

Chairman CAMP. Yes, but you could lower the rate and there may not be a marginal rate increase and then you wouldn't have tax policy favoring certain States and certain constituencies in a way that they don't now.

Mr. BUCKLEY. Mr. Chairman, I disagree with favoring notion here. You know, there are States that are urban in nature and therefore they have higher incomes and higher tax deductions. There are cities, Seattle in the State of Washington, where the tax burdens are higher than they are in the rest of the State. Using averages here, it doesn't really, I don't think, accurately reflects what is going on.

Chairman CAMP. All right. Thank you.

Mr. Smith is recognized for five minutes.

Mr. SMITH. Thank you, Mr. Chairman, and thank you to our witnesses today.

Mr. Buckley, you briefly touched on your assertion that higher taxes in various States are perhaps because of a higher cost of living. Shouldn't higher wages generate higher taxes per capita?

Mr. BUCKLEY. That is correct. I mean, the reason some States have higher taxes than others is a combination both of higher incomes and of higher cost of government, I would argue, largely due to the urban nature of the State.

Now, those States also, as Congressman Rangel pointed out, are typically the donor States. They pay a far greater share of Federal income tax liability than other States for exactly the same reason, they are high-income States.

Mr. SMITH. But that should also reflect on what their tax burden is at the State level and/or local level, correct?

Mr. BUCKLEY. That is correct.

Mr. SMITH. Okay. We have heard briefly about the public power and taxes on public power and perhaps different treatment than private power. Mr. Taylor, coming from a public power State, I am curious because I almost feel like there is more transparency in terms of, okay, there is tax free municipal bond advantages there, but then we know that in other States there are power generators in the private sector that enjoy a number, in fact, perhaps a smorgasbord of tax benefits. Is that accurate?

Mr. TAYLOR. I am not in a position to compare the States and the public power and private power in different States. I think my concern was that the Federal Government is providing a benefit or a subsidy or whatever, tax expenditure, for State and local governments, and I think it then behooves the committee to determine where that benefit is going.

I think Mr. Hodge said earlier, listen, you could essentially eliminate tax exemption on municipal bonds and then decide where you want the money to be spent. It might be a more efficient way to do that. It is not for me to sit here and say, okay, it should always go to A or B. That is really your decision.

That being said, if you are going to talk about State and local governments and those governmental bodies that are making decisions, they should be the ones getting a tax exemption, and it should be very clear.

In the case of Nebraska or other places where public power is a big issue, then you have to sit there and say, to what extent is the State controlling that, is it substituting for private power, at what point should you stop substituting for private power and let the private power companies come in? Those are governmental decisions that should be taken very carefully because you run the risk, with tax exemption, of it substituting for the private sector and it remaining that way even though the economy changes.

Mr. SMITH. Okay. Anyone else wish to comment? No? Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman CAMP. Thank you.

Mr. Blumenauer is recognized.

Mr. BLUMENAUER. Thank you, Mr. Chairman. I appreciate continuing this process of trying to dive into the Tax Code and the implications, and I appreciate the balanced presentation here. It gives us a range of concerns.

I want to go back to the infrastructure piece. I appreciate what my colleague Mr. Neal talked about. Mr. Buckley, you are providing some balance here. I find it——

Mr. BUCKLEY. There are two of us, I think.

Mr. BLUMENAUER. I find it interesting that we are having this hearing today when the American Society for Civil Engineers is putting out its update of its scorecard, which it has been doing over the years. We are still D's, F's, I think a C minus may be in there, and the cumulative deficit, by their estimate, is $3.6 trillion necessary for the standard between now and 2020.

It is interesting to me that the era of highest economic growth and productivity increase, and, by the way, dramatic reduction in Federal debt after World War II, occurred when we made the investments in our returning veterans for their education and enabled them to buy a home. The Interstate Highway System is an obvious example, but we had other infrastructure investments, in higher education, in aviation, in water, in sewer, in areas that now communities are looking at skyrocketing rates—by the way, rates that are not tax deductible at the local level for utilities—at a time when we are scaling back the Federal infrastructure investment.

And looking at the bill that we just passed that expires this Congress for transportation, we are really kind of stuck here. It strikes me that looking at adjusting the interest exemption in these tax deductible bonds is one of the few areas where the Federal Government is actually stepping up and providing support for infrastructure investment.

Do you want to——

Mr. BUCKLEY. I would agree entirely and also state that it is the only stable source of Federal support for local infrastructure spending. It is there. It is not subject to an extension of the highway bill. It is something that State and local governments can plan on. And also it is a form of Federal support that has the least amount of Federal involvement in. All of the decisions about what infrastructure to invest in, how to structure the debt are questions that are left to the prerogatives of State and local government with no Federal interference. It is a fairly conservative way of delivering support here.

Mr. BLUMENAUER. And I know time is short, Mr. Chairman, so I will just prepared to yield back my time, but I think this is a very important concept that the committee should consider as we move forward.

I hope that we are spending a little more time looking at infrastructure, but the consequences of this investment in areas that have tended to be more productive, that have created more wealth, that have challenges and opportunities, that people have the choice, it is the amount of benefit to the communities is commensurate with decisions they have made locally. But I think the multiple effects that the entire country benefits from in terms of increased economic activity, and frankly, reduced pressure for other types of Federal investment bears our being careful with how we move forward with this.

Mr. Taylor.

Mr. TAYLOR. Yes, I would like to comment on that. While I actually agree with both of you on this, in terms of the fact that the decisions are made locally, that the infrastructure is very much needed, the question is, is this the most efficient way and are you getting the bang for your buck? And I think as an economist and someone who has been involved with this area back to 1975, there is no doubt in the economic literature that some program like BABs, maybe not at 33 percent or 20, maybe it is 28, make it is 25, BABs is a much more efficient way to say where the money goes. And I am all for State and local governments defining it, but let's make it efficient.

Mr. BLUMENAUER. And I appreciate the opportunity that we can fine tune the way that some of the programs are administered. We have had this conversation in the past with Mr. Buckley when we were factoring other things. But I just stand by my point that I would be very careful about monkeying with this.

Mr. TIBERI [presiding]. The gentleman's time has expired.

Mr. BLUMENAUER. Thank you.

Mr. TIBERI. The gentleman from Texas is recognized for 5 minutes.

Mr. MARCHANT. Thank you, Mr. Chairman.

I, too, have heard from every one with of my school districts, my cities, counties in my district. I have a very unique district. The center of my district is the Dallas/Fort Worth Airport, and over the last 50 years that airport has spurred growth both in industry as well as population. And I started my political career as a city council member and a mayor, so I am someone that has sat in meetings and looked at water projects, road projects, school projects, projects to bring infrastructure to major industry that wanted to locate in our town, and made those decisions based on the fact that the municipal bond rate was a rate that we could take advantage of and expand our infrastructure.

I don't think there is any mistake that if Congress decides to do away with the exemption for municipal bonds, for school district bonds, for county bonds, that every single taxpayer in my district will have an increase in their taxes. The cities have to provide infrastructure. They have to provide water, sewer. They have to provide that because they are trying to attract the industry, the very industries that are going to bring the jobs to that town.

Now, it might be, for instance, we have in our local town, we have Amazon is bringing a 1 million square foot distribution warehouse because of its proximity to the airport. Could not have done that without a major road project, could not have done that without adequate water, without adequate city sewer, without an adequate workforce who need schools.

Our goal to simplify the Tax Code, I agree with. Our goal to lower taxes across the board, I agree. But for us to think that we are going to be lowering tax rates for our citizens in this case, all we are going to be doing is passing that tax down to a different level. Municipal bonds provided the major catalyst for us making those decisions in school districts, in cities, in counties across the nation. In every council meeting, every school board meeting, every county supervisor meeting, almost every week they are making those decisions to create jobs, create the infrastructure for that.

And so my point today is that maybe we need to look at private activity bonds, maybe we should take a very close look at the entire spectrum, but the core deductibility of municipal bonds, of tax-exempt bonds, all it will do is create a pure tax shift. And I would like to have each of yours opinion on that comment.

Mr. Hodge.

Mr. HODGE. Congressman, I know that property tax issue is a very hot issue in Texas these days, and there has been a lot of attempts to try to control the growth of property taxes. But I would suggest that it is possible that it is the availability of municipal bonds and the ability to borrow that has in some way contributed to those higher property taxes because of the communities and school districts that are over-borrowing and thus taxing their local taxpayers. So it is a circular thing. And so, you know, it is a chicken-and-egg situation.

But I would suggest that the evidence shows that if you were to eliminate these bonds, it would actually end up lowering property taxes overall because communities would not borrow as much and spend as much. And so over time I think that those property taxes and local taxes would come back down. That is what the economic evidence shows.

Mr. MARCHANT. Mr. Parkhurst.

Mr. PARKHURST. Congressman, I think your comments are in accord with the Nation's Governors. I appreciate those thoughts.

I would like to leave you with an interesting data point that I think will help you the next time you have visitors from back home. There are proposed next year of $43 billion in lost revenue to the Federal Government from the interest exclusion. There is also a projected increase, a sale of $400 billion in new issuances of muni bonds, about a 10:1 ratio. That is a pretty good leverage ratio for the dollars.

Chairman CAMP [presiding]. All right. Thank you. The gentleman's time has expired.

Ms. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman.

I think that my colleague from Texas certainly does make a valid argument related to the investment and infrastructure, but as we read in the New York Times, they reported recently that the tax-exempt bonds had been used, as the chairman said, for things like a winery in North Carolina and a golf course in Puerto Rico, a Corvette museum. I probably should temper my comments on that since my husband is a big Corvette person.

But when we look at these, do you think that this is, first of all, an appropriate use for these kinds of projects, as my colleague talked about infrastructure, questioning these as infrastructures, and then in addition to that, what kind of rules could be changed to prevent these types of activities from happening in the future?

So why don't we start with you, Mr. Buckley, and work down the other way?

Mr. BUCKLEY. Well, first of all, I think it is entirely appropriate for this committee to examine the rules for private activity bonds, and they were tightened in 1986. Now, a lot of the examples in the New York Times articles were in response of one-time liberalizations of the rules as part of disaster relief measures, and I would suggest the committee ought not to do that again in the future. I mean, they should tighten the rules.

Now, a lot of what was previously talked about are private activity bonds. When you were talking about the airport development and all of that, those are private activity bonds. And so they do serve, I believe, bona fide public purposes of development, helping, you know, as you say, Amazon would not have come but for the railroad development.

The highways in that circumstance may well be considered private activity bonds because of disproportionate use by one taxpayer. So I believe you should examine those rules. You should tighten them, if necessary. But don't use those, you know, anecdotal stories in the New York Times to justify repeal of a provision that I think has proved to be quite effective.

Mrs. BLACK. Mr. Taylor.

Mr. TAYLOR. In some ways I would agree with Mr. Buckley, but I would also add that any time you give, and I hate to pick on DFW again, if you are going to use the tax exemption there, it benefitted certain airlines over other airlines in terms of allocation of landing slots and the whole kit and caboodle. You had a corporate purpose that was involved in this.

I have absolutely no problem with the Congressman's discussion, the previous Congressman's discussion about water and sewer and schools and things like that. I think it is imperative that the committee decide to what activities does this benefit flow to. Personally, I have a question in my mind of any kind of benefit flowing down to one particular corporation or another without it being available to everyone, and that is what the markets are for.

So if you limit tax exemption to standard governmental purposes that we all could probably agree on here, fine. But once it gets into anything that flows to the private sector, you should be very, very careful.

Mrs. BLACK. Mr. Taylor, I want to just tag onto that for just a second because you mentioned Build America Bonds. And I don't know that much about them. Would they be any different than, in making these kinds of determinations, than——

Mr. TAYLOR. Well, I will go back to a comment that Mr. Hodge made earlier on, that the way the tax exemption is structured right now a certain portion of the dollar that you are providing goes to the investor. And so is that really what you want to do? The answer usually is no, and there isn't an economist, heck, I have read—when I first got involved with munis, the studies were going back to 1963 saying do it, a la BABs, do it that way because it is the most efficient way to give the money, and let the decision making be at the lower level.

I think the real question is, what is that rate? Is it 28, which I have heard bandied about, or 25, that is your decision. But it is a much better way to get the bang for the buck.

Mrs. BLACK. Okay. Mr. Parkhurst.

Mr. TAYLOR. Rather than tax exemption

Mr. PARKHURST. Briefly, I would concur with Mr. Buckley's comments that working to review the rules would make eminent sense to correct anomalies, and I would offer up an opportunity for this committee to reach out to States and local governments that have the direct hands-on experience with many of these private activity bonds—to work in partnership in that.

Mrs. BLACK. Mr. Hodge, I am out of time, so if you have any remarks pertaining to that, if you will submit it, that would be great. Thank you.

Mr. HODGE. I certainly will.

Chairman CAMP. Thank you. Thank you very much.

Mr. Pascrell is recognized.

Mr. PASCRELL. Thank you, Mr. Chairman, to the panelists.

Good to see you back, Mr. Buckley. I don't see you, but I am here. You stated that the debate over tax reform cannot be merely driven by tax policy concerns. This committee has to take into account the possible collateral consequences of changes to long-standing tax benefits. Just give me one sentence of summary in your own mind.

Mr. BUCKLEY. I would use two examples. Home values. I don't think there is any economist in the country that doesn't think the price of our homes have embedded in them the value of the deduction for mortgage interest and real property taxes. I really think the Congress has to be very careful about removing those benefits. I think it would be quite destructive to have further decline in housing prices by reason of what action is taken by Congress.

Employer-provided health care. Almost all of us get our health care through our employer. If you repeal the exclusion for employer-provided health care, you will see a decline in the level of healthcare coverage provided by the employer. I think that is a bad thing.

Mr. PASCRELL. So in solving one, we will create another problem.

Mr. BUCKLEY. You will have to respond with appropriated funds if people lose their health insurance.

Mr. PASCRELL. We discussed it, as you remember, during the debate on Obamacare.

Mr. BUCKLEY. That is correct.

Mr. PASCRELL. Mr. Hodge, if we follow, if we pursue your path, what you are suggesting, we will never ever repair our infrastructure for water and sewers in this country. We lose 25 percent of our water that is already being treated because of the antiquated system that we have and will not repair it, and the municipalities do not have the money, the States do not have the money to do this. So they might as well just wait till they have the money. Well, you know what happens in that circumstance.

That is not acceptable. That is not acceptable. And I agree with the gentleman from Texas that these things will not get done unless these bonds exist, unless these private equity bonds exist. We have had legislation before us for 10 years, passed in this House 3 times, 3 times, and stalled in the Senate. Right, Mr. Camp, Mr. Chairman?

Chairman CAMP. Very familiar with it.

Mr. PASCRELL. We need to keep the collateral consequences that Mr. Buckley refers in mind, as well as the policy goals we wish to accomplish through our Tax Code. One big collateral consequence I am concerned about is in the area, and you have heard about it, the State and local tax provisions, is what would happen to high-cost States like New Jersey if we eliminate the deduction for State and local taxes. According to the National Association of Home Builders, the average New Jersey property owner has $7,398 in real estate deductions. I think Texas is close to $5,500 a year. That is more than double the national average, the New Jersey number. I believe that eliminating this deduction could have a real devastating impact on my State and many other States. We need to think long and hard about the effect it would have. We have a long way to go to get to the $6 trillion the Tax Policy Center says we need to find to finance the Ryan-Camp tax reform proposal, and these are the kinds of issues we need to examine in depth.

Mr. Buckley.

Mr. BUCKLEY. Yes.

Mr. PASCRELL. Can you describe how impact of eliminating the capping of deduction for State and local taxes would be different for high-cost regions of the country? And the second question is, isn't repealing this deduction just a covert marginal rate hike that would double tax individuals' income, and how is this different how we treat foreign source income, Mr. Buckley?

Mr. BUCKLEY. Well, you raise the interesting point. We do provide a foreign tax credit, a dollar-for-dollar reduction in U.S. tax liability for the amount of foreign taxes you pay. Nobody has ever asserted that that is a subsidy for foreign countries. It is an appropriate measure of reducing the potential for double taxation

We provide a far less generous accommodation for the State taxes, an accommodation that I believe is appropriate to prevent double taxation. Now, it will have particular impact on States with high incomes, but those States typically are net donors to the Federal Government.

Mr. PASCRELL. Thank you, Mr. Buckley.

Oh, my time is up. Mr. Chairman, yield back.

Mr. JOHNSON [presiding]. Thank you.

Mr. Young, you are recognized.

Mr. YOUNG. Thank you, Mr. Chairman. I thank all our panelists for a very interesting conversation today and for your appearance here today.

I represent Indiana's 9th Congressional District, and the communities throughout my 13-county district rely heavily in various ways on tax-exempt bonds. But the question, I think, for many of us policymakers here is, of course, the issue of unintended consequences, which has been brought up a number of times, sometimes called collateral consequences. I see that always as a potential consequence of acting in the Federal sphere. You are going to have unintended consequences. What is incumbent upon us is to fully weigh all the evidence before us and try and mitigate those consequences before we act.

We also tend to be risk averse here in Washington. So we will hear a lot of qualifying language from my colleagues, perhaps occasionally from myself about this could happen, we need to weigh things very heavily before acting. But at some point there is a risk to not changing policies towards a more optimal public policy approach of tax-exempt bonds here if one exists

So, you know, I come back to the theme that people really don't fear change so much as they fear loss, and if we can prove that adopting a new mechanism of funding these infrastructure projects and bonding out various projects is better, then it ought to be adopted. I am not persuaded as yet entirely, but there are some things that I want to explore here.

Mr. Hodge, you said for each million dollar in tax-exempt bonds, the Federal Government foregoes $21,000, so that is a potential benefit to the Federal coffers at least, could conceivably have what is called collateral consequences at the local level.

And you, yourself, Mr. Hodge, have conceded that at least initially there might be property tax implications on changing the tax status of these bonds. But you alluded to something very interesting. You said in the longer term, and you said absent this deduction, State and local governments would have lower overall taxes and would have smaller budgets.

I can think of a couple of dynamics that might lead to this. Greater project scrutiny at the local level, conceivably, might be one reason. Another reason would be greater competition for capital between communities and across States. Is that a potential thing that would drive the lower overall taxes and smaller budgets?

Mr. HODGE. Yes.

Mr. YOUNG. Okay. So that is the positive side of the ledger.

The negative side, Mr. Parkhurst, you listed off a number of concerns, and I would like to go through those. An increase in direct taxes on citizens. So this is the burden-shifting concern, right? Do you disagree with the notion, though, that in the longer term you might actually see lower overall taxes and smaller budgets as a result of changing the tax-exempt status, and if so, why do you disagree with that notion?

Mr. PARKHURST. I think given the dynamics of the country's economics, conditions, regions, it is hard to give you a definitive answer on a hypothetical at this point right now. I would argue that what we can see happening or what we could perceive happening is just that point, is that shift in projects that either don't get done because the State and local officials make a rational decision that with limited dollars we can only do X and not Y, or if the decision is made that we must pursue a particular infrastructure project either because it is crisis driven or the public has made a decision, either through referenda or other by electing individuals who are making these decisions, to increase their taxes. I think then that is the response that I am looking at in the short term. But long term, at this point, I don't think I could give you a definitive answer to your question.

Mr. YOUNG. Okay. There are various academic studies supporting this idea that there will be long-term benefits to changing the tax-exempt status. Doug Holtz-Eakin and Larry Lindsey, for example, have studies that the National Governors Association may consult to get further clarity on this.

Mr. Hodge, got about 10 seconds left, I think. You have any thoughts about this?

Mr. HODGE. No, the economic evidence is very clear, that if you were to remove these subsidies, then overall spending at the State and local level would decline and taxes would reduce overall as well.

Mr. YOUNG. Okay. We will continue to explore this. I yield back.

Mr. JOHNSON. Thank you.

Mr. Davis, you are recognized.

Mr. DAVIS. Thank you very much, Mr. Chairman. And I was thinking one of the good things about being near the end is you get a chance to hear all of those things that have been said before you. And when the question arose, came up about Build America Bonds, I just happened to have six pages of projects that were either done or completed or underway in the State of Illinois, most of which, I suspect, would not have been on the table unless these bonds were available.

Also, I thought about the article in the New York Times. I grew up in rural America, and people often used containers to take a bath. They didn't all have indoor plumbing. And when they got ready to throw out the bathwater, there was an old saying that don't throw out the baby with the bathwater. I mean, there are some components of some things that may not be as effective or as good, but that doesn't mean the whole concept is not worthy.

Like my good friend from Texas, Mr. Bishop, I think many of us have had some experiences with local government, and I also think that many of us are firmly convinced that many local infrastructure projects would never get done if the bonds were not available, that they would just simply lay flat, nothing would happen, and the need would continue to exist. So I think that they have been lifesavers for infrastructure development in these communities all over America.

But let me ask, there are some proposals—and, Mr. Buckley, let me ask you—there are proposals to reduce the tax exemption on municipal bond interest, such as one to cap the exemption for certain taxpayers at 28 percent, would have severely detrimental impact on national infrastructure development and the municipal market, raising costs for State and local borrowers and creating uncertainty for investors. These investors' fears translate into investor demands for higher yield from State and local governments issuing the bonds. If these entities are unable to satisfy investor yield demands, then isn't it true that either, one, these much-needed infrastructure projects would not move forward, or the cost of these projects would be passed directly to State and local taxpayers?

Mr. BUCKLEY. You have two problems, I think, when you legislate in this area. First is the uncertainty that you are talking about. Just the fact that this hearing is going on is creating uncertainty in the market about the long-term viability of the tax exemption, thereby demanding higher yields.

The question whether it is going to increase cost and reduce infrastructure that higher yields, I think that is absolutely correct. You can assert that there are economic benefits from repealing the exemption only if you believe that it is in the best interests of this country to have lower investment in public infrastructure.

You know, when Mr. Hodge talks about lower spending at State and local levels, it is all infrastructure. So if you believe we have overinvested in infrastructure, which I don't think anybody does, then you should entertain proposals to repeal this benefit. If you believe that infrastructure is very valuable, then you should not.

The cap has some impact on tax-exempt rates. I have seen a lot of different estimates and I am really not in a position to judge which one is right. I mean, some show it as fairly low. Some show it as fairly high.

Mr. DAVIS. In your written testimony you also indicated a need to maintain a balance between individual exemptions or deductions and corporate deductions. Why do you think that is——

Mr. BUCKLEY. Well, I think it goes back to my answer about small businesses. I don't know how you could deny individuals the deduction for State and local taxes and at the same time permit corporate taxpayers to deduct those items. I just think it is not a politically viable solution.

Mr. DAVIS. Thank you very much. I yield back.

Mr. JOHNSON. The gentleman's time has expired.

Mr. Paulsen, you are recognized.

Mr. PAULSEN. Thank you, Mr. Chairman. This actually is a very, very good hearing, and I heard from a number of folks back home.

I want to follow up on what Mr. Davis was actually asking, because when the President came out with his budget proposal, I think it was last fiscal year's budget proposal, just a year ago, he actually recommended that cap, you know, at the 28 percent level for that exclusion on municipal bond or, you know, State and local bond deductions. And I am curious, what would be the effect—you know, aside from the trade-offs of the policy issue we have been having about whether you allow it or don't allow it—what would be the effect if that was—if that policy went forward as a part of, you know, a budget plan this year or next year in the near term? What is the average length of these bonds that are let out right now; is it 20 years, is it 30 years? What is the effect of these sort of—these existing contracts that are in the market right now? What would be the effect versus, you know, phasing it in or not phasing it in? I am just—in terms of the actual, it is more of a technical question, but what happens specifically to the market, Mr. Parkhurst?

Mr. PARKHURST. Some of the estimates that I have seen, I think they are rather conservative depending upon the percentage cap you are talking about. Anywhere, as I said earlier, from six-tenths of a point to, you know, 1½ points in a bump-up in your yield.

You are back to the key issue here, which is risk and certainty, and obviously investors are looking for low risk and high certainty. When you are talking about any type—just as Mr. Buckley said, the mere fact that this hearing is being held today is creating uncertainty in the market about what changes may happen, and that is going to have an impact on the market going forward.

Mr. PAULSEN. Mr. Taylor.

Mr. TAYLOR. Yes. Let me kindly point out that this focusing on capping individual interest rates, the deduction for State and local interest is really looking at the problem the wrong way. If your concern, and Mr. Davis' concern, Mr. Marchant's concern is for financing infrastructure, you should be looking at ways in which to expand the market of potential investors, and right now because tax exemption exists for the interest on State and local bonds, you are limiting it to people who are in, by definition, higher-income tax brackets.

I think everyone who has ever been in the market—and one of the reasons BABs were somewhat, from my vantage point, very successful was because it suddenly expanded the number of potential investors. What that does is eventually lower interest rates for people. It means the Federal subsidy is a little lower. That sort of thing is what you should be looking at, from my vantage point as an economist, and looking at markets rather than the reverse.

Mr. Buckley is absolutely right. In 1986, when tax reform was going through, the market froze because of discussions about how you should tax individuals.

Mr. PAULSEN. Mr. Hodge, maybe you can comment. I mean, obviously we have got uncertainty in the marketplace on the healthcare law right now that is not giving predictability to the business community, but, I mean, just give a perspective of what the existing market would be like from a bond transition.

Mr. HODGE. Well, I think we have to be very careful about overdoing the uncertainty element. That would mean that we would never talk about tax reform——

Mr. PAULSEN. Right.

Mr. HODGE [continuing]. Because somebody might be uncertain.

Well, let's look at the certainty here, and that is State and local governments this year are spending $120 billion a year on the interest on their debt, their accumulated debt. That is more than they spend on police protection, twice as much as what they spend on parks and recreation, twice as much as they spend on sewerage, on fire protection, et cetera. They have loaded themselves with debt to the detriment of other elements of their budget. So while they are crying poor and poverty now, that they can't afford to do certain things, a lot of is because they are crowding out their own budgets with the amount of debt they have taken on.

That is not our fault, but it can be attributed to the municipal bond exemption, which affords them the opportunity to overborrow and thus crowd out the things that they think are most important.

Mr. PAULSEN. Okay. Mr. Parkhurst.

Mr. PARKHURST. Just a quick note on that. I can't speak to the interest amount, but I can tell you that the current outstanding bond market is $3.7 trillion. So, again, the leverage ratio is pretty good.

Mr. PAULSEN. Okay, that is good.

Thank you, Mr. Chairman. I yield back.

Mr. JOHNSON. Thank you.

Dr. McDermott, you are recognized.

Mr. MCDERMOTT. Mr. Reed? I believe Mr. Reed is next.

Mr. JOHNSON. I had McDermott, I think.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I am listening to this whole thing, and, Mr. Buckley, you tell me that Seattle has a higher tax rate or pays higher taxes than other places in the State of Washington, and that is true, because we do these bonds for housing and all sorts of things in the city, and we tax ourselves for them, and it seems what—I am having trouble figuring out what the upside of getting rid of municipal bonds is, because all I hear is Mr. Hodge, who says that, well, we will get a smaller government out of this, and people, they will do it with their own money or something.

I am not—I am trying to figure out, does the Federal Government have this pot of money which we dole out, and we bring back earmarks so that we can get certain money, or since we are not using the tax-exempt status and let the local areas do their own thing, then I guess we have got to come here and try to get some earmarks back. Is that—or how are we going to get the infrastructure built is really what I am having a hard time. I hear that BABs are good. All three of you.

Mr. BUCKLEY. Right.

Mr. MCDERMOTT. Mr. Parkhurst, Mr. Taylor, Mr. Buckley, you all say they are good, right?

Mr. TAYLOR. It is a better way to do it than to do it as you currently do it.

Mr. PARKHURST. I want to at least be clear that what the Governors would support is an all-of-the-above strategy, building activity bonds together with existing tax exempts need to be part of the tool kit, not looking to substitute for the existing market.

Mr. BUCKLEY. Let me also agree. I think Build America Bonds are a complement to tax exemption. It gives the issuer a choice, and it does make—even for the issuers that choose to use traditional tax exemption, it means that they will receive much more of the Federal revenue cost because it makes the whole market more efficient.

Mr. MCDERMOTT. So taking—getting rid of the tax-exempt municipal bonds, the only upside is that we would then have some money we could use to make a revenue-neutral reduction in rate on corporations to 25 percent; is that correct?

Mr. BUCKLEY. It is essentially the debate that this committee is having is do you repeal these more targeted tax benefits to finance rate reductions. And this is where I will continue to disagree with Mr. Hodge. The only economic benefits that can come from repealing the exemption are based on the fact that this country will be better off with less public infrastructure. And I would argue our problem is inadequate public infrastructure, and if you don't subsidize infrastructure this way, which has no earmarks, no Federal involvement basically, you will be forced to find another way.

Mr. MCDERMOTT. We will be forced back to our old habits of appropriated earmarks?

Mr. BUCKLEY. Appropriated funds.

Mr. TAYLOR. If I might, you are right in some ways in saying there is no Federal involvement in the initial decision of what infrastructure projects go forward and the like, and while I subscribe and agree with that, the fact of the matter is by issuing tax-exempt bonds, you create the possibility of arbitrage on the part of the issuer, and then I tried to lay out in my prepared statement that has led to a significant amount of abuse. And so if the committee wants to do what you have suggested, Mr. Buckley, which is have both, then I think you have to look at solutions to dealing with the arbitrage, forcing issuers to invest in State and local government securities at the Treasury rather than having it done in the free market, or some other steps to maintain the integrity of that market.

Mr. BUCKLEY. I don't disagree there have been problems in the tax-exempt bonds; that is clear. That means that this committee should take targeted responses, and then perhaps what you just suggested is the right response to those abuses. You should not let the abuses nor the New York Times article to be used as an excuse to eliminate a fairly valuable support for local and State investment in infrastructure.

Mr. MCDERMOTT. That, I think, is sort of like medicine. You can find an individual case one place or another of a problem, but that really doesn't deal with the fact you have to deal with all the people. And when you are looking—you talk about a significant amount of abuse. Could you put a number around that? Are you saying 2 percent, or 25 percent, or 50 percent is abuse?

Mr. BUCKLEY. I will let—I think it is de minimis, but I will let——

Mr. TAYLOR. Well, I think it is all in the eye of the beholder. Personally, where financial firms have paid since 1986 almost a billion dollars in fines and penalties for abusing the arbitrage restrictions, engaging in collusion, pay-to-play schemes and the like in order to take advantage of this, that, to me, is not the right way to promote, you know, national infrastructure programs that will make this a healthy market. That is, in fact, why I was very strong in my remarks about supporting BABs, because it does away with all of those potentialities.

Mr. JOHNSON. The gentleman's time has expired.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Mr. JOHNSON. Mr. Reed, you are recognized.

Mr. REED. Thank you, Mr. Chairman, and thank you, Mr. McDermott, for the attempt at courtesy, but you were here first, so I appreciate that.

You know, I found this conversation very interesting as a former mayor and now a Member of Congress, and I have seen firsthand the benefits of municipal financing and municipal investments through local and State capital bonds.

And, Mr. Hodge, I want to give you an opportunity, because I think you are eager to have that opportunity, in response to Mr. Buckley's conclusion that what this will lead to by removing this exclusion is less of an investment in infrastructure, because I think we have broad support that our infrastructure needs are significant, they need to be made in America, our investments there. And so I want to give you an opportunity to directly respond to Mr. Buckley's conclusion that you are in error.

Mr. HODGE. Sure.

I think we have to be very careful about being sort of one-column accountants here, and what we hear a lot of is just the benefits of these particular programs, and we hear none of the downside. And I think that equalizing the financing of a public infrastructure and a private investment will lead to a better economy in the long run.

I don't think that the person who wants to borrow money in order to invest in a new factory should have to compete with a local community that wants to borrow the same amount of money in order to build a sports stadium. I don't think that that leads to positive outcomes in the economy; I think it leads to a negative. And, as the economic research shows very clearly, it shows it leads to overborrowing, overspending, and ultimately overtaxing at the local level.

And I think to turn that around, we need to equalize the treatment, the borrowing costs, for both private borrowers and the public, and that way you get the best economic efficiencies, and you get an equal rationalization of these kinds of investments, an equal trade-off in—or the balance between public investment and private investment.

Mr. REED. But to follow up on that, though, would that still provide adequate financing for the necessary infrastructure? Because you touched on a thing when you referenced the sports stadium, because one thing I am hearing in this conversation is—and potentially on abuses and in the written material that I read—is there an issue of definition of infrastructure? Because as a mayor, when I was dealing with issues of water system replacements, sewage replacements, there was no way I was going to be able to pay for that based on my tax revenue coming in. I had to have a capital plan 20, 30 years out, and part of that capital plan was not only the year-to-year tax revenue that was coming in, but it was also the leveraging of the dollar that I could get from the municipal financing market to build that capital. And a lot of these projects, as you know, are not 1-year projects. They are 30-, 20-year projects.

So would your proposal still allow for an adequate funding stream for local—I am really talking about local, not so much on the State—local and county level to do the necessary investments that our infrastructure demands outside of sports stadiums and all that? Because I do believe there is a question of what is a definition of a qualifying infrastructure that is worthwhile to take a look at.

But get beyond that, do you still see that you would have the revenue streams coming in?

Mr. HODGE. Well, I am not saying that local governments shouldn't be able to borrow for the long term, absolutely not. They should just pay the same interest rate as a company that wants to build a wafer-fabrication plant, or a pharmaceutical plant, or some other sort of private investment that is also going to have a huge impact on a local community. Those rates should be the same. There shouldn't be a subsidy, an interest rate subsidy, for the public just simply because it is public.

Mr. REED. Mr. Parkhurst, please.

Mr. PARKHURST. Congressman, I am struck by your remarks because I think you are inviting a subsequent discussion about questions around public-private partnerships as an innovative tool to finance.

I think that your conversation lends to a great discussion, because there is a great model here of outcome-based-value-for-money analysis where the public sector is looking to get something built, but they don't have the front-end capital to do it. The private sector is looking for a stable revenue stream in the long term, and the way, for instance in the U.K., how this has been perceived—and let me be clear, in the U.K. when you are looking at public-private partnerships, or as they are calling it Private Finance 2, going forward here, that is only 10 percent of their finance. And so it is back to the argument that I have made about everything needs to be in the tool kit that is available here.

But you are looking at a situation where the public-private partnership provides for front-end capital for the construction costs that the private entity is contributing; the public sector, in your case, your home community, doesn't pay a dime until that infrastructure is online, and it meets all of the obligations and outcomes that you as one of the parties negotiating this deal expect. Then going forward you have a long-term relationship with the operator, where the local government or community or State is paying regular operational costs going forward.

So it is an interesting option that I think would really benefit discussion going forward.

Mr. REED. I appreciate that.

My time has expired. I yield back.

Mr. JOHNSON. That was a great closing comment. Thank you all. I know you recognize the problems down at the local level, and I hope we do, too. This is a difficult program that we are embarking on, and I thank you for your help. Each and every one of you made good comments. Thank you for being here.

The committee stands adjourned.

[Whereupon, at 12:14 p.m., the committee was adjourned.]

Public Submissions for the Record

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Statement for the Record

of the

American Hospital Association

before the

House Committee on Ways and Means

Tax Reform and Tax Provisions Affecting State and Local Governments
March 19, 2013

On behalf of our nearly 5,000 member hospitals, health systems and other health care organizations, and our 42,000 individual members, the American Hospital Association (AHA) appreciates this opportunity to provide input on the importance of the tax-exempt bond financing for America's 2,903 non-profit hospitals.

As the Committee reviews various tax reform proposals, we ask you to consider that current tax code incentives for the provision of health care have worked to provide access to hospital services in communities large and small across the country. The ability to obtain tax-exempt financing and to accept tax-deductible charitable contributions are two key benefits of hospital tax-exemption that work to make access to hospital services available where needed.

Hospitals do more to assist the poor, sick, elderly and infirm than any other entity in health care. Since 2000, hospitals of all types have provided more than $367 billion in uncompensated care to their patients. In 2011 alone, hospitals delivered more than $41.4 billion (in costs) in uncompensated care to patients, and uncounted billions more in value to their communities through services, programs and other activities designed to promote and protect their health and well-being. This broad array of benefits includes basic research, medical education, labor and delivery services, and emergency stand-by services such as disaster response readiness, burn units and high-level trauma care.

America's communities receive a positive return on their investment from the tax-exemption of non-profit hospitals. Federal revenue forgone because of non-profit hospital tax-exemption represents an estimated 2.3 percent of hospital expenses; in contrast, non-profit hospitals spend 9.3 percent of expenses on benefits to their communities. These communities are the ultimate beneficiaries of the health care infrastructure and capital improvements made possible by tax-exempt hospital bond financing.

HOSPITAL FINANCIAL CONDITION

Moody's Investors Service is maintaining its negative outlook for the U.S. not-for-profit health care sector for 2013. The negative outlook reflects Moody's view that revenue growth will remain positive, but will continue to decelerate as a result of federal cuts to health care spending, limited reimbursement increases from commercial health insurers, and a tepid economy that dampens demand for health care services. Moody's outlook has been negative since 2008, as the recession has left a lasting impact on patient volumes, and hospitals confront significant challenges stemming from changes in how they are paid. The sector faces heightened pressure from all levels of government, as well as businesses, to lower the cost of health care services.

Since 2010, hospitals have faced $250 billion in cuts to federal health programs, including more than $14 billion in reductions included in the recent *American Taxpayer Relief Act*. These cuts are increasing losses on services to Medicare patients and threatening the overall financial health of hospitals. In its March 2013 Report to Congress, the Medicare Payment Advisory Commission (MedPAC) indicated that hospital Medicare margins fell to negative 4.0 percent for inpatient services, negative 11.0 percent for outpatient services, and negative 5.8 percent for overall Medicare services in 2011.

Even under this financial pressure, hospitals continue to be an economic mainstay for their communities. Hospitals directly employed nearly 5.5 million people in 2011 and are the second-largest source of private-sector jobs. The $702 billion in goods and services hospitals purchased in 2011 from other businesses created additional economic value for their communities.

A hospital's ability to finance projects through tax-exempt bonds depends primarily on its credit rating, which is shorthand for its ability to access capital and the price at which it can borrow money. A higher bond rating indicates a lower investment risk, which allows hospitals to pay a lower interest rate on the bonds. Even the slightest drop in bond rating – resulting in a slightly higher interest rate – may cost a hospital significantly more over the lifetime of a bond issue.

The health care sector is becoming increasingly bifurcated into "haves" and "have nots." In 2009, 88 percent of hospitals reported that it was "more difficult or impossible to access capital from tax-exempt bonds" since the 2008 recession. Without capital expenditures, hospitals are unable to invest in new technology and equipment that benefits patients. They also may find it more difficult to recruit top physicians and other staff.

HEALTHCARE DELIVERY AND DEMOGRAPHICS

Aging baby boomers and an increasingly diverse population create demand for new and different services. *The Patient Protection and Affordable Care Act's* promise of expanded health insurance coverage will add to demand. Clinical procedures continue to evolve, as do diagnostic techniques and communication technologies.

Americans rely heavily on hospitals to provide 24/7 access to care for all types of patients, to serve as a safety-net provider for vulnerable populations and to have the resources and skills needed to respond to disasters. Emergency department visit volume has increased by nearly 26 percent since 2000, and will continue to grow.

Over the past 15 years, market, economic and regulatory forces have led hospitals and physicians to explore new ways to better align their interests and achieve greater integration in order to both reduce costs and improve the quality of care. With an eye on the future, hospitals across the country are in constant state of renovation and improvement in order to provide the latest treatments and services to meet the increasing and changing needs of their communities.

Yet even with these increasing demands, the growth in spending on hospital care is at historic lows. This leveling of growth is evident across Medicare, Medicaid and private payers. The Congressional Budget Office recently revised its future projection of Medicare spending downward by $169 billion for the next decade. Growth in premium levels for employee health benefits are half of what they were in 2011, as new benefit care models begin to take hold.

TAX-EXEMPT FINANCING INSURES ACCESS TO HEALTH SERVICES

Meeting the health care demands of the future will require significant capital investment. Raising capital at a reasonable cost is more difficult than ever for the majority of America's hospitals. Capital markets for non-profit hospitals still have not fully recovered from the 2008 financial meltdown. Three temporary federal financing options that helped ease the credit crunch expired in 2010.

For many communities, tax-exempt financing has been the key to keeping vital hospital services. Governments would otherwise be called upon to provide these necessary services. If that were the only alternative, the resulting increased borrowing cost to state and local governments would be borne by taxpayers and ratepayers in every local jurisdiction through the imposition of increased taxes and fees (e.g., *ad valorem* property taxes, special assessments, sales taxes, toll charges and utility rates) or through service cuts. These taxes or fees, including especially sales taxes, tolls or user fees, would fall disproportionately on lower- and middle-income households, as would service cuts.

If hospital access to tax-exempt financing is limited or eliminated entirely, the result could be devastating for both patients and their communities. The financial unraveling of a hospital has the potential to impact a community more profoundly than the unplanned closure of nearly any other institution. Patients will suffer as hospitals struggle to survive and slowly deteriorate. Prices will rise, equipment will wear down without being replaced, and physicians will leave for greener pastures. Ultimately, the health of the community will suffer. Furthermore, closure may result in reduced specialty services and overcrowding in other hospital emergency departments, while patients may delay treatment if services aren't readily available.

TAX-EXEMPTION REDUCES BORROWING COSTS

Tax-exempt bonds reduce hospitals' borrowing costs because they normally can be sold at a lower rate of interest than can taxable debt of comparable risk and maturity. Non-profit hospital borrowers save, on average, an estimated two percentage points on their borrowing compared to taxable bonds or bank financing. Lower borrowing costs translate into lower health care costs for patients.

The lower cost of tax-exempt financing also makes possible necessary upgrades and modernizations that would not be possible for hospitals with weaker balance sheets. More costly alternatives, such as taxable bonds and bank loans are out of reach for many community hospitals.

CONCLUSION

At a time when hospital revenues are already strained, hospitals must respond to rapidly changing market and government forces, including: (1) reimbursement reductions and changes, (2) an increasing necessity to provide access to a broad range of health services to a growing population, and (3) limited access to capital. These market forces are driving an urgent need for hospitals to make significant capital investments while reducing costs, both of which require continued access to low-cost capital through tax-exempt financing.

As Congress works toward tax code reform, the AHA strongly recommends retention of the current law exemption from income for tax-exempt bond interest.

Statement

Of the

AMERICAN PUBLIC POWER ASSOCIATION,

LARGE PUBLIC POWER COUNCIL, and

TRANSMISSION ACCESS POLICY STUDY GROUP

Submitted to the

HOUSE WAYS AND MEANS COMMITEE

For the March 19, 2013, hearing on

"Tax Reform and Tax Provisions Affecting State and Local Governments"

(Submitted April 2, 2013)

The American Public Power Association (APPA)[1], Large Public Power Council (LPPC)[2], and Transmission Access Policy Study Group (TAPS)[3] appreciate the opportunity to submit this statement in relation to the House Ways and Means Committee's March 19, 2013, hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments." Collectively, public power utilities deliver electricity to one of every seven U.S. electricity consumers (approximately 47 million people). Our members serve some of the nation's smallest towns—roughly four out of five public power utilities serve 10,000 or fewer customers—and largest cities, including Los Angeles and Orlando.

Fundamental income tax reform could have a direct effect on a number of issues of concern to our members, including the treatment of health care expenses and of pension and retirement contributions and accruals. However, given the potential damage that could be done to our members' ability to continue their mission—to provide affordable and reliable electricity to their customers—this statement will focus primarily on the effect of tax reform on financing of capital expenditures.

As Congress debates tax reform, it should consider carefully the effect on state and local governmental entities', including public power utilities', ability to finance the critical infrastructure investments needed to provide for economic growth and our citizens' well-being. Changes to the current law treatment of tax-exempt bonds will increase the price that public power customers pay for electricity, especially affecting small businesses and low- and fixed-income households, and reduce the ability to fund necessary public power infrastructure improvements.

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[1] APPA is the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities ("public power utilities") throughout the United States (all but Hawaii). LPPC and TAPS members are all members of APPA.

[2] LPPC is the national service organization comprised of 26 of the nation's largest public power utilities. LPPC member utilities own and operate more than 86,000 megawatts of generation capacity and over 35,000 circuit miles of high voltage transmission lines. Together, LPPC members control 90% of the public-agency-owned, but non-federal, transmission investment in the nation.

[3] TAPS is an association of 45 transmission-dependent public power utilities located in more than 35 states advocating for a robust transmission grid and competitive wholesale electric markets.

Municipal Bonds

Municipal bonds have been used for centuries by state and local governments to finance a wide range of public infrastructure. They allow issuers to build projects with capital provided upfront by bond investors, repaid over the projects' useful life by the citizens and customers benefitting from the project.

Municipal bonds are the largest source of financing for core infrastructure in the U.S.,[4] and are the single most important financing tool for public power, given the capital-intensive and long-lived nature of assets needed by the electric industry. Each year, on average, public power utilities make $15 billion in new investments financed with municipal bonds. Over the last 10 years, power-related projects have totaled $147 billion, roughly 9% of all municipal issuances.[5]

Public power utilities use municipal bonds to finance investments in power generation (including through renewable and alternative fuels), transmission, distribution, reliability, demand control, efficiency, and emissions controls. While the typical power-related bond issue is relatively small, electric generation or transmission projects often cost hundreds of millions or even billions of dollars and can have as long as a 50-year operational life.

Because interest on municipal bonds is exempt from federal income tax, investors generally accept a lower rate of return than they would otherwise demand from issuers of taxable debt. Investors are also attracted to municipal bonds because of the stability of the municipal bond market and the extremely low rate of default for municipal bonds. Historically, interest rates demanded by investors for tax-exempt municipal bonds have been an estimated average 200 basis points lower than comparable taxable corporate bonds. Savings to the issuer from this reduced cost in borrowing allow further investments or are passed through to taxpayers in the form of lower taxes or, in the case of public power customers, reduced utility rates.[6]

An added advantage of municipal bonds as a source of state and local financing is that the need for, and terms of, financing are determined by state and local citizens, either directly or through their representatives. Additionally, significant flexibility is afforded to state and local government issuers compared to issuers of taxable debt, including the term of the issue, the debt structure, and the ability to optionally call fixed rate debt after 10 years.

Current Financing Alternatives

Several alternative debt instruments exist that supplement municipal bonds as a means of financing state and local infrastructure investments. However, as explained below, each has its own inefficiencies and none, alone, would be a viable replacement for municipal bonds.

Taxable Bonds

On occasion, state and local governments issue taxable debt to finance infrastructure investments, generally as a supplement to financing provided by tax-exempt debt. Taxable bonds appeal to a different type of investor, typically those less concerned with tax considerations (such as pension funds and foreign

[4] Cong. Budget Office, J. Comm. on Taxation "Subsidizing Infrastructure Investment with Tax-Preferred Bonds" (Oct. 2009)(showing that for education, water, and sewer, nearly all capital investments are made by state and local governments and that for transportation most investments are made by state and local governments).
[5] The Bond Buyer & Thomson Reuters "2012 Yearbook" (2012); The Bond Buyer & Thomson Reuters "2006 Yearbook" (2006).
[6] American Public Power Association "2012-2013 Public Power Annual Directory and Statistical Report" 51 (2012).

investors) and so can expand the potential pool of investors for a larger project. Because investors generally demand a higher rate of return on taxable bonds than on tax-exempt municipal bonds, there use is limited and could not replace tax-exempt municipal bonds as a means of financing.

Other considerations also limit the use of taxable bonds by municipal issuers. Issuers are subject to more restrictions on the terms of debt issued in the taxable market. For example, while the right to optionally call a bond early at par is included in most municipal bonds, such provisions are rare in taxable bonds. As a result, state and local government issuers are generally effectively precluded from refinancing taxable debt to take advantage of an interest rate decrease.

Direct Payment Bonds

Direct payment bonds are government purpose bonds the interest on which is taxable to the bond holder, but for which state and local government issuers receive a direct federal payment generally set at a percentage of the interest rate paid to bond holders. Build America Bonds (BABs) were able to be issued as direct payment bonds from February 17, 2009, through December 31, 2010. The reimbursement rate for these bonds was set at 35 percent. Of the $843 billion in municipal bonds issued in 2009 and 2010, roughly $181 billion were direct payments BABs. This unprecedented willingness of municipal issuers to issue taxable debt stemmed in large part because of the reimbursement rate though also in part because of the unusual difficulties being experienced in the municipal market which the expanded pool of investors provided by issuing taxable debt helped overcome.

The Clean Renewable Energy Bond (CREB) program was intended to provide for not-for-profit issuers the same incentives to invest in renewable projects as was provided by the production tax credit. The original program was a tax credit bond program, but after very limited success, in a new version of the CREB program, New CREBs, was created in 2008 and modified in 2010 to allow issuers the option of receiving a direct payment from Treasury in lieu of providing bond holders a tax credit.

Although direct pay bonds appear to be an efficient means of providing a federal subsidy to issuers of state and local bonds, these bonds have their own inefficiencies. First, concerns about offsetting payments by amounts potentially owed to the federal government under other programs have concerned many issuers. Second, sequestration of direct payment bond payments[7] has confirmed concerns that the federal government could change the amount of the subsidy after issuers borrowed in reliance on the expectation of direct subsidy payments.

Tax Credit Bonds

Tax credit bonds are taxable obligations in which the investor receives a tax credit in lieu of tax- exempt interest. BABs, Clean Renewable Energy Bonds (CREBs), and Qualified Energy Conservation Bonds can be issued as tax credit bonds. They are sophisticated debt instruments that have traditionally been purchased by investment banks for their own account.

The tax credit rate is set daily by the Treasury Department based on the average “AA” corporate rated debt. This “one-size-fits-all” coupon approach has led to either discounting of the bond upon issuance or a requirement that issuers pay a “supplemental coupon” to increase the yield on the bonds in order to attract investors.

[7] Office of Mgmt. & Budget, Exec. Office of the President, OMB Report to the Congress on the Joint Committee Sequestration for Fiscal Year 2013 48 (Mar. 1, 2013).

In 2008, tax credit bonds were modified to allow investors to separate (or "strip") the tax credits from the bond and sell them separately. However, because the logistics of stripping is complex, investors discount the value of both the credits and the remaining bond. Investors further discount the value of tax credit bonds to reflect additional costs and risks, including the risk that the investor may not have a federal tax liability in later years against which to use the credits.

Because of these difficulties, the demand for tax credit bonds has been limited and issuers have been reluctant to rely on them.[8]

Private Activity Bonds

Private activity bonds issued by state and local governments for certain permitted facilities are exempt from regular federal income tax, but subject to the alternative minimum tax. Such facilities include airports, docks and wharfs, multi-family housing and solid waste disposal facilities, and facilities for the furnishing of local power.

Unlike governmental bonds, these qualified private activity bonds are subject to a wide range of restrictions and limitations including limits on the amount of bond proceeds which may be applied to finance costs of issuance, limits on state bond volume, rules regarding public notice of the bond issue and the purpose to be financed, and limits on the maturity of the bonds.

Additional restrictions mean private activity bonds are seldom issued by government-owned utilities to finance energy infrastructure improvements such as generation, transmission and distribution assets. Options to remove or alleviate these restrictions to make private activity bonds a better tool for financing power-related infrastructure are discussed below.

Municipal Bond Market

While the use of municipal bonds in America predates the birth of our nation, the first recorded general obligation municipal bond was not issued until 1812. Since then, the municipal bond market has been a steady source of financing for state and local governments. Today, there are nearly $3.7 trillion municipal bonds outstanding, with approximately $400 billion in issuances every year.

The policy of "reciprocal immunity"—that the federal government does not tax interest on state and local borrowing and state and local governments do not tax federal borrowing—and the longevity of this exemption have given municipal bond investors and issuers great confidence in its permanency and allowed the market to function efficiently.[9] While subsequent changes to the tax code have placed additional requirements and restrictions on the issuance of municipal bonds, interest on government-purpose bonds has always been exempt from federal tax.

This stability has allowed the market to accommodate a vast number of issuers. Over 47,000 state and local governments issue debt in this market. By comparison, roughly 5,000 corporations issue debt in the taxable market. The market also accommodates issues that vary significantly in size and rating. From 2002 to 2011, the median municipal issuance was $7 million.

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[8] Of 29,315 municipal bonds reported to the IRS in 2010, just 199 were tax credit bonds (http://www.irs.gov/file_source/pub/irs-soi/10bd11arra.xls)(last visited Mar. 29, 2013).
[9] Conversely, the threat that Congress might alter this tax treatment, has caused demonstrable harm to the municipal bond market, both in terms of higher rates for new borrowings and in the loss of value of tax-exempt holdings in the secondary market (*see*, Janney Capital Markets, "Municipal Bond Market Note: The Threat to Tax Exemption" 3 (Oct. 19, 2012)).

Investors purchase municipal bonds in part because of tax considerations, accepting a lower rate of return because the interest is exempt from federal income tax. But municipal bonds are also valued for their stability, the low rate of risk of default, and their ability to generate a steady stream of revenue for fixed-income households. In 2010, nearly 60 percent of bond interest paid to individuals was reported on returns for households aged 65 and older.

Also, while municipal bonds are perceived by some as an investment of the rich, 52 percent of all bond interest paid to individuals went to households with income of less than $250,000;[10] roughly 75 percent went to households with income of less than $1 million.[11] IRS data also show that for those who own municipal bonds, the amount of interest earned actually declines as a percentage of overall income as income increases. In other words, for households holding municipal bonds, the interest paid is more important as a source of income as household income decreases.

Market and Regulatory Safeguards

There is a longstanding and comprehensive federal legislative and regulatory system in place to regulate the tax-exempt bond market. Both the IRS and SEC have active enforcement programs for state and local bonds to help ensure that the applicable rules are satisfied. Federal tax laws significantly limit: the entities that can issue tax-exempt bonds; the purposes for which the bonds may be issued; and the investment of bond proceeds. These rules are particularly restrictive for public power utilities. For example, in the case of public power bond issuances, regardless of the size of the borrowing, no more than $15 million (or 10% of the total, if less than $15 million) of the proceeds can go to the benefit of private use. Furthermore, the IRS "private use rules" effectively prevent issuers from using tax-exempt bonds to build larger facilities than are required to meet the needs of their communities or to issue bonds with longer terms than needed.

The SEC and Municipal Securities Rulemaking Board regulate the manner in which state and local governments may sell their bonds and provide rules on the types of disclosure required in connection with the sale of municipal bonds, as well as ongoing annual and material event disclosure.

Significant market-based safeguards also prevent state and local issuers from irresponsibly issuing bonds or using bond financing for ill-advised projects.

Alternatives to the Current-Law Exclusion for Municipal Bond Interest

As Congress considers proposals to reform the federal income tax, it should bear in mind the unique origin of the exclusion for municipal bond interest and the substantial damage that would be done by any of the alternatives currently being advanced. Such proposals would not only affect current bondholders, but would force tax and rate increases on state and local residents to accommodate higher borrowing costs and reduce the amount spent on needed infrastructure by state and local governments.[12]

Some critics say the exclusion for municipal bond interest is inefficient. These arguments come from several sources, including the Joint Committee on Taxation (JCT). However, research over the last decade

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[10] Internal Revenue Service, "Statistics of Income—2010: Individual Income Tax Returns" (2012).
[11] *Ibid.*
[12] Testimony at this hearing indicated that there is consensus among economists that repealing the exclusion would reduce borrowing costs, but cited a single study on the effect of the exclusion for state and local sales taxes and not the exclusion for municipal bond interest (Scott Hodge, Tax Foundation "Testimony on Tax Reform and Tax Provisions Affecting State and Local Governments before the House Committee on Ways and Means" n.1 (Mar. 19, 2013)).

has called into questioned JCT's conclusions[13] and its methodologies.[14] On the whole, these analyses indicate that inefficiency and revenue lost from the exclusion is dramatically overstated. Even critics of the exclusions agree that at least 80% of the benefit of the exclusion goes to reduce state and local borrowing costs and not as a windfall to investors.[15]

More importantly, there is virtually no disagreement as to who will pay the price if Congress were to upend the 100-year precedent of exclusion to tax municipal bond interest with, for example, a surtax on municipal bond interest.[16] It will not be borne by the investor, who will be compensated with higher rates for any taxes they pay, but rather by state and local residents forced to pay billions more every year in additional financing costs.

As noted above, throwing roughly 50,000 state and local issuers into the taxable bond market would be incredibly disruptive. Each of the proposed alternatives to tax-exempt bonds comes with its own inefficiencies from the perspective of issuers of these bonds. In contrast, the current municipal bond market provides issuers ready access to capital with maximum flexibility. This market charges a premium to issuers who have undertaken unwise projects or borrowed beyond their constituents' willingness (or ability) to repay these bonds. As a result, it should come as no surprise that municipal bonds are second only to Treasury bonds in their stability.[17]

<u>Repeal</u>

An outright repeal of the exclusion for municipal bond interest would both undermine a century of tax-policy precedent and devastate the ability of state and local governments of all sizes to seek financing in an effective, well-regulated, well-understood, and stable market.[18] Estimates of the increased cost to issue taxable debt vary and generally are based on the historic spread between corporate taxable debt and municipal tax-exempt debt that, on average, has been nearly 200 basis points. Recent analysis of the cost of issuing taxable debt in the current market showed a nearly 150 basis point increase for a larger municipal issuer and a 166 basis point increase for a smaller issuer.[19] At the historic spreads, if proposals to eliminate tax-exempt financing had been in place over the last 10 years, it would have cost state and local governments $495 billion in additional interest expense.

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[13] Francis Longstaff , "Municipal Debt and Marginal Tax Rates: Is There a Premium in Asset Prices?" *NBER Working Paper 14687* 21-22 (Jan. 2009); Andrew Ang, Vineer Bhansali, & Yuhang Xing, "Taxes on Tax-Exempt Bonds" *Journal of Finance*, pp 565-601 (Nov. 11, 2008).
[14] James M. Poterba & Arturo Ramirez Verdugo, "Portfolio Substitution and the Revenue Cost of Exempting State and Local Government Interest Payments from Federal Income Tax" *NBER Working Paper 14439* (Oct. 2008); George Friedlander, Citi, "The Tax Exemption of Municipal Bonds: A Much More Efficient Financing Mechanism Than Government Analyses Suggest" (Jan. 17, 2013).
[15] Frank Sammartino, Congressional Budget Office, Testimony before the U.S. Senate Finance Committee Hearing on "Federal Support for State and Local Governments through the Tax Code" (Apr. 25, 2012).
[16] George Friedlander, Citi "Muni Issuers and the Current Market Environment: Threats, Challenges and Opportunities" 10 (Mar. 30, 2012)(estimating a yield increase of as much as 75 basis points); John Hallacy & Tian Xia, Bank of America Merrill Lynch, "Munis & Derivatives Data" 1 (Feb. 13, 2012)(estimating a 40 basis point increase on issuer costs); BLX at 6 (estimating a 77 basis point increase in all-inclusive borrowing costs for large issuers and a 92 basis point increase in all-inclusive borrowing cost for smaller issuers).
[17] See, for example, Moody's "U.S. Municipal Bond Defaults and Recoveries: 1970-2011" (Mar. 7, 2011)(showing that of a sample of 17,700 rated issuers, just 71 had defaulted over the 42-year period and, of those, just two were public power issuers).
[18] This statement is primarily concerned with the tax policy considerations of tax reform, but a number of academics have questioned whether federal tax on state and local financing would violate constitutional intent and whether the courts would uphold such a tax.
[19] BLX Group LLC, "Tax Reform Proposal Analysis: Impact on Tax-Exempt Bond Financing," prepared for American Public Power Association 6 (Jan. 28, 2013).

The actual costs would likely be far greater, as roughly 50,000 state and local issuers with median financing needs of $7 million would be forced into a taxable market where the median issue for roughly 5,000 corporate issuers is closer to $200 million. Likewise, flexibility unique to municipal bonds—such as the ability to ladder bond maturities to match revenues and project life and to call bonds prior to maturity to take advantage of changes in interest rates—would be lost or would come at a premium in the taxable market.

28% "Cap"

A "cap" on the tax value of the exemption for municipal bond interest is, in principle and in construction, a surtax on municipal bond interest. For example, to "cap" the tax value of municipal bond interest at 28%, a surtax of up to 11.6% is imposed. While theoretically targeted at upper-income investors, the reality is that such a tax would hurt the issuers of new tax-exempt bonds and the secondary market value of holdings for all outstanding bond-holders.[20]

As a result, all potential investors would demand a premium on new issuances either as compensation for the loss of net earnings or to reflect the downward pressure on secondary market value caused by the new tax. An additional risk premium would be demanded to compensate for possible future tax rate increases. Recent analysis shows that a 28% "cap" would increase financing costs for a larger issuer by 77 basis points, while a smaller issuer's costs would increase by 92 basis points.

In addition to increasing the cost of borrowing for state and local government issuers, the notion that the bonds are a "hybrid investment" - that is, depending on the tax status of the purchaser either all or some of the interest will be excluded from federal gross income - adds complexity to all debt issuances, requires more lengthy and comprehensive disclosure and increases borrowing and transaction costs.

Flat-Dollar Cap

A flat dollar cap on the amount of deductions and exclusions a taxpayer could claim would essentially amount to a repeal of the current exclusion for municipal bond interest. Under this proposal, taxpayers would be given the option to exclude from income some or all of such interest if other deductions and exclusions are not used to "fill" the cap. It is generally assumed that taxpayers would first fill the cap with non-optional expenses – such as employer-provided health care, retirement investments, education, child and dependent care, and home mortgage interest. As a result, at the dollar levels being discussed, a flat dollar cap would result in the full taxation of municipal bond interest for most if not all municipal bond holders. The cost in the secondary market to bond holders and to issuers for new issuances would likely be on par with that of a full repeal.

Replacing Municipal Bonds with Tax Credit Bonds

Generally, the tax credit bond market is an illiquid, small market that and could not replace the current municipal bond market. The tax credit bond market cannot absorb the average annual debt issuance of tax-exempt bonds, which over the last 10 years has averaged approximately $380 billion per year.

Purchasers of taxable bonds include entities that pay no federal income tax, such as public pension funds, private pension funds and foreign investors. To attract such investors, the tax credits would need to be

[20] ETF Trends "Muni Bond ETFs Tumble on Tax-Break Speculation" (Dec. 14, 2013) (http://finance.yahoo.com/news/muni-bond-etfs-tumble-tax-181300222.html)(last visited Mar. 28, 2013).

stripped and sold to entities that pay federal income taxes. In addition to discounting the amounts paid for credits due to the complexity of stripping and selling a stream of tax credits, purchasers will discount the credits to offset the following: (i) transaction costs; (ii) tax risk associated with concerns that the credits might stop in the event the bonds do not meet the federal bond tax rules; (iii) risk that the investor may not have a federal tax liability in later years to fully utilize the credits; and (iv) default risk and related factors.

Replacing Municipal Bonds with Taxable Direct Payment Bonds

All the concerns regarding cost, access to capital, and flexibility for issuers caused by an outright repeal of the exclusion for municipal bond interest would apply to a replacement of the exclusion with a taxable direct payment bond. Further, the small issuers that dominate the tax-exempt bond market would be disproportionately affected by having to borrow in the taxable market. Recent analyses show that replacing municipal bonds with a 25 percent direct payment bond would still result in a net cost increase to a large issuer of 51 basis points and to a smaller issuer of 58 basis points.[21] Further, there is a legitimate question among our members as to whether these direct payment bonds have been forever tarnished by the impact of sequestration. This sequestration cut was not envisioned by the drafters of BABs; it therefore calls into question whether or not more cuts would be forthcoming at some point in the future.

Improvements to Municipal Bonds

While much of Congress's recent discussion of municipal bonds has focused on how much revenue could be raised by taxing them, this Committee has begun discussing how to improve the rules surrounding municipal bonds. A thoughtful discussion of ways to modernize the tax code would be welcome.

For example, state and local governments may issue qualified private activity bonds, the interest on which is exempt from federal gross income tax. As mentioned above, qualified private activity bonds may be issued to finance a range of capital improvements to be used by private sector entities. Such improvements include airports, docks and wharfs, multi-family housing and solid waste disposal facilities, and the local furnishing of power, among others.

Unlike governmental bonds, qualified private activity bonds are subject to a wide range of restrictions and limitations, many of which apply specifically to power-related bond issuances:

- Qualified furnishing of power may only be to a city and one contiguous county or two contiguous counties;[22]
- Only up to 10 percent of the output of an electric facility may be used for private use;[23] and
- Only up to $15 million per project of private use for power-related projects.[24]

Private activity bond rules are also used to severely limit the ability of municipal utilities to acquire existing privately-owned, power-related assets with government-purpose bonds.[25]

[21] BLX Group LLC, "Tax Reform Proposal Analysis: Impact on Tax-Exempt Bond Financing," prepared for American Public Power Association 6 (Jan. 28, 2013).
[22] 26 USC 142(f).
[23] 26 USC 141(b)(2).
[24] 26 USC 141(b)(4).

A related issue is the taxation of capital contributions by public power utilities to investor-owned utilities (IOUs) to build facilities (e.g., interconnections and associated facilities, transformers, circuits, etc.) to serve the public power utility's retail demand ("load") are treated as taxable "contributions-in-aid of construction" to the IOU.[26] Because the IOU traditionally requires the municipal utility to "gross up" its contribution, the cost of the investment is effectively increased by as much as 35 percent.

These limitations severely limit the ability of municipal utilities to work cooperatively with investor-owned utilities to finance energy infrastructure improvements such as generation, transmission and distribution assets. Re-examining these restrictions could increase public-private partnerships in critical infrastructure investments.

Likewise, we endorse the National Governors Association's all-of-the above approach to municipal finance. For example, while direct payments bonds could not replace municipal bonds, in the case of New Clean Renewable Energy Bonds (New CREBs) and Build America Bonds, they have served as a helpful supplement to traditional municipal bond financing.

Problems with New CREBs have been the limited amount of bond volume available; the laborious process for seeking approval to issue these bonds; and the "locking out" of projects by projects for which allocations have been approved, but which have not begun. Congress has also failed to continue its investment in the policy—extending the production tax credit while failing to increase the allocation for New CREBs.

Taxable direct-payment Build America Bonds (BABs) also provided a welcome expansion of potential investors in 2009 and 2010—a time when the appetite for municipal bonds was limited. The recent experience with the cutting of payments to BABs issuers under sequestration has substantially dampened enthusiasm for BABs in the issuer community. As a result, the cost of issuing such bonds going forward would likely be higher as provisions to recall bonds in the wake of similar budget cuts would be included.

However, a taxable direct payment BAB could still make a welcome supplement to traditional municipal bonds. Reimbursement rates for proposal reinstating BABs are much lower than the 35% provided under the original BABs program. Still, if Congress were demonstrate its commitment to the program going forward, a taxable direct payment bond could be a useful supplement to traditional municipal bonds, and could reduce state and local borrowing costs overall.

[25] 26 USC 141(d).
[26] 26 USC 118(b).

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United States House of Representatives
Committee on Ways and Means

Hearing on

"Tax Reform and Tax Provisions
Affecting State and Local Governments"

March 19, 2013

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Bond Dealers of America (BDA) is pleased to submit this statement to the United States House of Representatives Committee on Ways and Means as a part of the written record of the March 19, 2013 hearing to examine "Tax Reform and Tax Provisions Affecting State and Local Governments".

BDA strongly supports the continued exemption from federal taxation for interest earned on municipal bonds. Our comments will focus on the potential impact on the municipal market, investors, and issuers if the tax exemption for municipal bonds is altered, replaced or eliminated.

The BDA, with fifty-six members headquartered coast to coast, is the Washington, DC, based organization that represents securities dealers and banks focused on the U.S. fixed income markets. The BDA is the only organization representing the unique interests of national, middle-market, sell-side, fixed-income dealers. In addition to federal advocacy, the BDA hosts a series of meetings and conferences specific to domestic fixed income, and spearheads industry cooperation on economic surveys and on market practice documents. Additional information about the Bond Dealers of America can be found at www.bdamerica.org. BDA is also a member of the Municipal Bonds for America (MBFA), a non-partisan coalition of municipal bond issuers and state and local government officials combined with municipal market professionals working together to explain benefits of the municipal bonds market and the importance of the tax-exempt bond model.

Bond dealers are a bridge between the bonds issued to finance infrastructure that serves the public day in and day out, and investors who seek financial security in purchasing the bonds that make public works possible. From assisting school districts in structuring bond issuances that minimize interest costs, to financing new transit systems and critical sewer system improvements, bond dealers and the state and local governments they serve touch nearly every aspect of public life. If the bonds are issued with the prudent advice on the structuring, marketing and liquidity that BDA's members provide, governments and their citizens can make the most desirable economic choices at a local level while enjoying the benefits of public infrastructure.

The Municipal Market and Municipal Bonds have Served Issuers and Investors Well

2013 is the 100th anniversary of the Revenue Act of 1913 that created the first federal tax code in which federal tax-exempt status was granted to interest earned on municipal bonds. This anniversary was recently commemorated in bipartisan House Joint Resolution 112 by Reps. Lee Terry (R-NE) and Richard Neal (D-MA). BDA commends these members for its introduction and encourages Members of Congress to cosponsor this resolution.

The municipal bond interest exemption was granted in recognition of the federal and state separation of powers and buttressed by the 1895 U.S. Supreme Court decision in *Pollock v.*

Farmers' Loan & Trust Co.,[1] which held that federal taxation of interest earned on certain state bonds violated the doctrine of intergovernmental tax immunity. Although in 1988 the Supreme Court concluded in *South Carolina v. Baker* that the Constitution does not explicitly protect municipal bonds from imposition of federal tax.[2] Congress has repeatedly preserved the tax-exempt status and, in doing so, has enabled critical infrastructure to be financed in a cost-effective manner. Intergovernmental tax immunity remains an important principle so that state and local governments may continue to raise capital and make local infrastructure decisions without interference from the federal government.

BDA believes past Congresses made the correct decision to preserve the tax-exempt status for interest earned on municipal bonds and the present Congress and Administration should not use the politically-charged atmosphere of federal tax reform—and the desire to generate significant federal revenues to offset tax cuts or spending increases—to limit or eliminate this valuable exemption.

Municipal bonds are the key mechanism used by state and local governments to finance the nation's infrastructure needs. Three-quarters of the total United States investment in infrastructure is accomplished with tax-exempt bonds, which are issued by over 50,000 state and local governments and authorities. Nearly four million miles of roadways, 500,000 bridges, 1,000 mass transit systems, 16,000 airports, 25,000 miles of intercoastal waterways, 70,000 dams, 900,000 miles of pipe in water systems, and 15,000 wastewater treatment plants have been financed through tax-exempt municipal bonds.[3] Nearly all long-term tax-exempt bonds are issued to finance capital expenditures.

The historical stability of the municipal market and municipal bonds as an investment vehicle for millions of taxpayers is also a key consideration supporting retention of the tax-exemption. Currently, there is $3.7 trillion worth of capital in the municipal market, with roughly 70% of outstanding bonds held by individuals either through direct investment or indirectly through mutual funds. 2010 IRS data regarding individual income tax returns reveals that 60% of interest income on tax-exempt bonds is reported by taxpayers over the age of 65, and the majority of tax-exempt interest is earned by taxpayers with gross incomes under $250,000. Municipal bonds are the cornerstone of retirement portfolios for many Americans seeking a safe and consistent return on their investments.

[1] *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, 15 S. Ct. 673, 39 L. Ed. 759 (1895)
[2] *South Carolina v. Baker*, 485 U.S. 505, 108 S. Ct. 1355, 99 L. Ed. 2d 592 (1988). We note that some scholars consider the Constutional issue still unresolved.
[3] Council of Development Finance Agencies, "Built by Bonds," 2011.

<u>The Potential Impact of Proposed Changes in the Tax Laws Governing Municipal Bonds</u>

Recently proposed changes to the tax-exempt status of municipal bonds will have immediate and long-term impacts on issuers, investors and financing costs absorbed by state and local governments and their citizens. This testimony discusses the impact of two of these proposals – (1) proposals to cap or limit the value of the municipal tax exemption, such as the President's 28% limit on the value of exemptions and deductions, and (2) proposals to expand the utilization of direct-pay or tax credit bonds as a replacement for tax-exempt bonds. As illustrated by the examples below, Congress must be mindful that policies affecting municipal bonds should not be created in a vacuum that denies the current existence of an efficient marketplace that provides the ready source of capital and liquidity needed by state and local governments to find investors for their bonds.

Tax laws and regulations governing municipal bonds have remained largely consistent over the past few decades since the Tax Reform Act of 1986 made sweeping changes to that market, both in terms of the restrictions imposed on issuers of tax-exempt bonds and on investors in those bonds. At the same time, dramatically increased regulation since 1986 on broker-dealers and the municipal securities market, most recently under Dodd-Frank, has lent stability and transparency to the marketplace. In the name of increased market transparency that benefits issuers, investors and taxpayers, broker dealers, fully regulated by the SEC, FINRA and MSRB, must comply with rules governing such issues as comprehensive disclosures to investors, pay-to-play restrictions, licensing requirements, record retention, requirements for fair dealing and many more.

The municipal market has relied on solid regulations and consistent tax law treatment to build a vibrant trading platform that provides effective financing for issuers and stable returns for investors. However, economic and political crises trigger volatility in the markets that harm all market participants. The onset of the 2008 fiscal crisis provides an example of the type of turmoil that can occur. In late 2008, economic uncertainty sparked a demand for higher yields on municipal bonds as investors began to incorporate a risk factor into their investment considerations. Volatility and uncertainty cause needlessly higher bower costs for state and local governments, and policies that invite these elements to the marketplace should be avoided, as explained below.

<u>Proposals to Limit the Value of the Municipal Exemption Damage the Market</u>

Political debate also has tremendous power to stir market turmoil. Recent proposals to limit the value of the municipal exemption to the 28% tax rate have served to inject an element of uncertainty that resulted in a "domino effect" of increased yield demands by investors, increased financing costs to issuers, and reduced valuations of existing bonds. For a period in December 2012, when investors first perceived that the cap could be enacted, municipal bond funds experienced net cash outflows and increases in tax-exempt interest rates. The increase in tax-exempt yields for municipal bonds was 14-40 basis points greater than the increase in Treasury yields at that time.

The impacts would be more severe if a cap were to actually be enacted. Analysts predict that the imposition of a retroactive, 28% cap could cause an increase in borrowing costs of approximately 70 basis points. Part of that increase is attributable to a new world in which investors are uncertain what the future tax rate could be of a municipal bond that was once wholly tax-exempt. In other words, if Congress can act once to tax municipal bonds, couldn't it act again in the near-term with an even higher tax, as revenue pressures dictate? And it is state and local government borrowers -- not the wealthy-- who will pay the high price for this uncertainty, with borrowing costs increasing by 15 percent.[4] Those costs could climb even higher depending upon the market's perception of the future tax risk. In essence, investors will demand higher yields to compensate for the cap and to address the uncertainty – and the costs will be borne by the issuers. These higher costs to issuers will result in increased taxes, utility rates, user fees – and conversely, if these increases are untenable to voters, the higher costs will result in the deterioration of the nation's infrastructure.

Direct-Pay and Tax Credit Bonds are Not Acceptable Substitutes

Direct-pay bonds (such as, Build America Bonds), and tax credit bonds, provide considerably less certainty and flexibility than tax-exempt bonds, and should only be viewed as an alternative or complement to tax-exempt bonds – not a substitute. An overview of direct-pay and tax-credit bond programs, and concerns with those programs, is provided in Appendix A.

By way of background, direct-pay bonds appear to bondholders similar to corporate, taxable bonds. Bondholders receive principal and interest payments from the issuer, and the interest payments are taxable. These interest payments are higher than what the issuer would need to pay to the bondholder if the interest had been tax exempt. Since the interest payments are higher, the Federal government provides the state and local government issuer a subsidy to reimburse them for all or part of the interest payments. Depending on the portion of the interest paid by the federal government, direct-pay bonds can provide an overall borrowing cost to issuers that is greater than, less than or equal to the borrowing cost obtained through tax-exempt bonds.

From the outset, state and local governments and the market as a whole had concerns with direct-pay bonds. For example, many issuers were concerned that the direct-pay subsidy could be reduced due to federal "offsets" for amounts that the federal government, rightly or wrongly, believed that an issuer of direct-pay bonds owed under other programs. The deeper concern was that the federal government could change the direct pay rate on outstanding bonds. Such

[4]National Association of Counties, National League of Cities, United States Conference of Mayors, "Protecting Bonds to Save Infrastructure and Jobs 2013," 2013

potential risks were a part of the disclosures to investors and part of the analysis by issuers, but investor and issuer concerns were just that – concerns, with no precedent.

Investor and issuer fears have now been borne out. The market's perception of direct-pay bonds has been dealt a significant blow under sequestration, because the federal government has reneged on its promised subsidy by reducing reimbursement payments by 8.7 percent. (The same negative perception will affect tax credit bonds wherein the bondholder essentially receives a tax credit from the federal government in lieu of interest from the issuer). Sequestration's impacts will have a lasting effect on the desirability and marketability of direct-pay bonds, tax credit bonds or any other bonds requiring a federal payment as a component, as issuers and investors will take into account the fact that the federal government has acted in the past to reduce the subsidy. In the future, this very real risk will have to be borne by the issuer or the investor, creating inefficiencies in BABs that are not present in tax-exempt bonds.

Compounding this issue is the fact that some direct-pay bonds were issued with provisions that make the bonds callable in the face of federal actions that alter the subsidy. The trading of such direct-pay bonds, under threat of being called, encountered significant headwinds in the marketplace under both the threat and reality of sequestration. This can been seen quite graphically in the example in Appendix B with respect to Columbus, Ohio general obligation Build America Bonds. Investors demanded a huge premium with the specter that the bonds could be called by issuers at par, and uncertainty around the future of the federal subsidy. Spreads between the BABs and relatively stable taxable municipal bonds widened nearly 200 basis points, with the investors demanding a significant premium to buy the bonds – essentially freezing the market for such bonds, and cutting off the flow of capital.

Beyond sequestration, direct-pay bonds and tax credit bonds create a slippery slope for issuers (who are concerned about receiving the subsidy payments) and investors (who may demand a premium for the associated credit and redemption risks). Congress could intervene to lower the reimbursement subsidy in tax bills any time federal budgetary pressures dictate. A basic measure of local control and decision-making about financing local needs would now be shared with the federal government, creating a back-door opportunity to tax state and local governments. State and local governments generally swallowed these concerns in the context of Build America Bonds with their 35% subsidy rate – but at a "revenue neutral" subsidy rate, direct pay bonds are not a better tool for issuers when compared to tax-exempt bonds.

An additional concern about replacing tax-exempt bonds with direct-pay bonds is that direct-pay bonds are sold as taxable bonds in the global financial markets that are dominated by the largest and most highly rated and well-known issuers. Small issuers and lower-rated issuers would not be able to access the marketplace on a cost effective basis as they can with tax-exempt bonds. Simply put, direct pay bonds would cost all issuers more than tax-exempt bonds, and smaller and lower-rated issuers would be cut out of the market unless they dramatically increase interest rates paid to investors.

Tax-credit bonds fare even worse than direct-pay bonds when considered as a replacement for tax-exempt bonds. Among investor concerns are the fact that Treasury sets the tax credit rate (rather than the marketplace); the bond maturity is set by statutory formula; and there is a far more narrow market of investors who have a tax appetite and who want to purchase a novel type of bond.

BDA believes that tax-exempt municipal bonds must remain the cornerstone of the municipal market and that drawbacks associated with other bond products and proposals make them unacceptable if they are proposed substitutes for tax-exempt bonds. Direct-pay and tax credit bond programs should be considered only as additional options. While some policymakers argue that alternative programs are more efficient mechanisms for the federal government subsidy, BDA believes that the market-driven nature of tax exempt bonds without federal interference will be in the big picture, the most efficient model.

A Federal Infrastructure Bank is Not an Acceptable Substitute

Beyond alternative bond programs, a variety of bills and budgets have featured federal infrastructure banks as the solution to infrastructure finance. These entities must be kept in perspective as they cannot meet the significant and growing infrastructure needs nationwide. Federal infrastructure banks strip state and local governments of local control and decision-making authorities – holding local infrastructure needs hostage to federal political whims and federal agency bureaucracy. It is simply inconceivable that a new federal entity will be able to deal effectively with the many thousands of governmental infrastructure projects that are financed each year. In just one example - the federal Transportation Infrastructure Finance and Innovation Act program provides federal credit assistance to finance surface transportation projects. It is perhaps the most successful federal infrastructure program, and yet it finances only a few transportation projects each year.

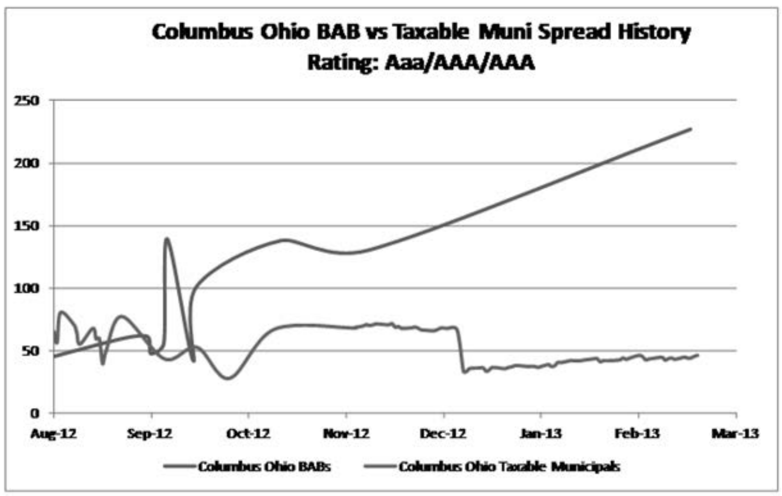
Summary

The municipal market and tax-exempt municipal bonds are the backbone of state and local government finance and a key component in a vibrant federal economy. Congress and the Administration must continue to recognize the vital role that tax exempt municipal bonds play in providing state and local governments with cost-effective financing for capital projects, including roads, bridges, schools, community health and higher education facilities. Ensuring that issuers can continue to fund capital projects by effective means reduces the burden on every taxpayer and all levels of government. Bond Dealers of America urges Congress to reaffirm nearly 100 years of federal tax law by retaining the current tax law treatment of municipal bonds.

APPENDIX A – Marketplace Reacts to Direct-Pay Bond Sequestration

This chart depicts trades on Columbus, Ohio General Obligation Bonds that were issued as direct-pay, Build America bonds and contained par-call provisions. The red line depicts pricing on the several BAB trades related to those bonds; the blue line depicts pricing on Ohio taxable municipal bond trades, which would be unaffected by sequestration.

As investors worried that sequestration would cause the bonds to become callable (red line), the market priced the direct-pay Build America Bonds far higher, when compared to the relatively stable marketplace for taxable municipal (blue line). Spreads widened nearly 200 basis points, with the investors demanding a significant premium to buy the bonds – essentially freezing the market for such bonds, and cutting off the flow of capital.[5]



[5] Source: MSRB Trade Data, Bloomberg BVAL Valuations, Piper Jaffray

APPENDIX B – Tax Credit Bonds and Tax-Exempt Bonds Compared

Type of Bond	Description	Example	Comments
Tax Credit Bond	Taxable bond issued with maturity set by IRS and reduced (or no interest). Investor receives a federal tax credit.	Qualified zone academy bonds	Limited market for tax credits creates real world inefficiencies for this method of borrowing.
Tax Credit Bond-Direct pay (maturity established by Treasury)	Taxable bond issued with maturity established by statutory formula and tax credit rate set under Treasury index. Issuer has a choice of selling it as a tax credit bond with reduced interest (as described above) or selling it as interest bearing but with the IRS paying an interest subsidy directly to the issuer.	New clean renewable energy bonds	The "one size fits all" approach of the Treasury tax credit rate setting process creates inefficiencies and higher borrowing costs. Limited market for tax credits creates real world inefficiencies for this method of borrowing.
Tax Credit Bond--Direct pay (terms set by issuer)	Taxable bond issued at market rates and maturity chosen by the issuer but the issuer has a choice of selling it as a tax credit bond with reduced interest (as described above) or selling it as interest bearing but with the IRS paying an interest subsidy directly to the issuer.	Build America Bonds	Risk of reduced payments due to sequestration or other change in law. Risk of reduced payments due to "offsets" for amounts that the federal government believes are owed by the issuer, even if in dispute. Smaller issuers and lower rated issuers generally incur higher borrowing costs using taxable direct pay bonds.
Tax Credit Bond-Refundable Credit	Taxable tax credit bond issued with reduced (or no interest). Investor receives a refundable tax credit.	Qualified Transportation Infrastructure Bonds	Tax committees are concerned about the precedent of a refundable credit delivered to tax-exempt organizations
Tax-Exempt Bonds	Interest on bonds is exempt to holder	Tax-exempt bonds	The tax exemption mechanism assures that the market, and not the federal government, dictates borrowing costs

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Submission to House Ways and Means Committee hearing:

Tax Reform and Tax Provisions Affecting State and Local Governments

Tax reform should seek to maximize the effectiveness and efficiency of any federal subsidy, including the subsidy to municipalities through the exemption of municipal bond interest. The Federal Government forgoes tax revenue on municipal bond interest in order to reduce municipalities' cost of capital for financing important public infrastructure projects. The subsidy is effective as long as the supply of tax-exempt bonds is met with sufficient demand. When demand is insufficient, municipal bond yields rise and the benefit of the subsidy shifts to the bondholder/investor in the form of higher taxable equivalent yields.

In recent years, the supply of tax-exempt bonds has often exceeded demand, shifting much of the benefit of tax-exemption to investors rather than municipalities. Perhaps as a result, there has been a proposal to limit the benefit to investors by limiting the exemption to 28%. This proposal would do far more harm than good. A much better way to limit tax-exempt interest would be to reduce the size of the tax-exempt market. Doing so would allow policymakers to preserve the tax-exemption for those municipalities that truly need it: smaller issuers.

The proposal to limit the exemption to 28% would raise some additional revenues, but an even greater cost would be borne by state and local governments. The rise in municipal borrowing costs would almost certainly exceed the tax that high-income investors would pay on their bonds. Investors have little appetite for the complexities of partially taxable bonds. The sloppy trading history and poor liquidity of municipal Market Discount Bonds* provide ample evidence of that fact.

In fact, it's likely that limiting the tax-exemption for municipal interest would produce an even greater yield penalty than that for Market Discount Bonds. Investors will certainly be wary of future limits to the tax-exemption, and thus, a yield premium for heightened "tax risk" would result. Simply put, when the federal government's credibility with tax-exemption falls, the borrowing costs for state and local governments go up.

A much more straightforward approach that retains the credibility of the federal government and actually benefits the municipal market would be to limit the volume of new tax-exempt issuance to favor small issuers. Capping tax-exempt issuance by issuer at $100 million annually would cut annual tax-exempt issuance roughly in half. The vast majority of municipal issuers - probably well over 90% - would fall within the cap and continue issuing tax-free bonds. The tighter supply would immediately cause a significant drop in tax-free bond yields. Borrowing costs would fall, and state and local governments would then reap a far greater share of the benefit from the tax-exemption.

This solution would preserve tax-exemption for the small issuers who borrow too infrequently and in sums too small to entice institutional investors. These communities depend on retail demand, so tax-exempt financing is critical for their efficient access to capital. It enables them to prioritize local infrastructure spending from the bottom-up. This is important. It's why the Bank Qualified Program has been supported for over thirty years; to ensure small issuers have access to affordable capital. Top-down, central planning has its place, but our Country has always favored some local control.

Placing a per-issuer limit on annual tax-exempt issuance would redirect the largest municipal issuers to the taxable market. While their borrowing costs would rise, the increase would be relatively small. Over the last several years, high-grade corporate bond yields have been only slightly higher than yields on comparable tax-free municipal bonds. The taxable fixed income market would certainly welcome the added high-grade bond supply. Institutional investors have a strong appetite for the long duration bonds that finance the infrastructure projects that state and local governments routinely build. This demand would only grow stronger if a large and steady supply of taxable municipal issuance were made permanent.

Redirecting large issuers to the taxable market would raise federal revenue regardless of whether the new institutional buyers were untaxed pension or endowment funds. Every dollar of municipal debt that is redirected to the taxable market is one less dollar of tax-exempt issuance. There is not an infinite supply of tax-preferred investments, so somewhere down the line more federal tax will be paid. The Joint Committee on Taxation estimates that complete elimination of the tax exemption would generate $40 billion. While cutting new tax-exempt issuance in half would generate something less, it would also reduce tax-exempt yields, and in so doing, lower financing costs for important municipal infrastructure.

We all understand that getting serious about deficit reduction will require making some sacrifices. We also recognize the need for meaningful tax reform. To succeed on both fronts will require smarter tax policy - and tax-exempt policy, where the goal isn't just the amount of added federal tax revenue. Financial markets - and Americans - expect policymakers to strive for greater simplicity, more credibility and far less waste and inefficiency. By all three measures, a plan that limits tax-exemption to smaller issuers is vastly superior to what's currently being discussed in Washington.

**The Market Discount Tax requires Investors to pay ordinary income taxes on the accretion of tax-exempt municipal bonds purchased in the secondary market at a significant discount.*

Comments for the Record

U.S. House of Representatives

Committee on Ways and Means

Hearing on Tax Reform and Tax Provisions

Affecting State and Local Governments

Tuesday, March 19, 2013, 10:00 AM

By Michael G. Bindner
Center for Fiscal Equity

Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit these comments for the record to the Committee on Ways and Means. They are substantially similar to our comments in April of last year to the Senate Finance Committee. Feel free to contact us for a more in depth briefing on our testimony for either members or staff. As always, our comments are in the context of our four part tax reform plan:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

Our proposals have several impacts on state and local tax and fiscal policy. Those states with fixed conformity provisions regarding income taxation in law or their constitutions will be greatly affected by enactment of a simplified income tax which treats distributions from inheritance as normal income. Indeed, if they do not enact similar reform, which includes a much higher income floor for filing, many more heirs will be touched by this provision than in federal law. As most state income tax rate structures are much less progressive than the federal system, many states will be able to abandon income taxation altogether, possibly increasing use of Land Value Taxes if some form of redistributive tax is still desired.

If the basic structure of reform is adopted in the states, the biggest change will be the need for a common base between federal and state consumption taxes. Shifting from retail sales taxes and gross receipts taxes to value added taxes and VAT-like net business receipts taxes will change the nature of most state taxation, while enabling ease of collection of taxes on online sales, since taxes would be levied at every stage of the production process.

If a common base agreement can be negotiated for these taxes, state treasurers can collect both their own taxes and the federal taxes, as well as analytical information on tax credit usage, which can then be shared with the U.S. Internal Revenue Service in order to track income accruing to payers of the federal high income surtax, as well as to recipients of the federal child tax credit, which would be paid to employees with wages under the NBRT and then verified by a mailing from both the employer and the Internal Revenue Service, with employees verifying that their employees paid every dollar to them reported as a credit.

Our hope is that states would match the Child Tax Credit at a level consistent with their cost of living. Some states might even include higher credits for certain high-cost counties, for instance, Northern Virginia.

The NBRT at both the state and federal levels should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

States may also include several of the educational and social service credits recommended under our proposal. The NBRT could be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. This is a feature that is impossible with the FairTax or a VAT alone.

To extract health care cost savings under the NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit, provided that services are at least as generous as the current programs. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed. Increasing Part B and Part D premiums also makes it more likely that an employer-based system will be supported by retirees.

Enacting the NBRT is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

There will be no impact on the states of FICA reforms, except to the extent that our suggested reforms yield a higher base benefit for seniors, which will decrease their need for state social service benefits.

Income tax simplification will eliminate the deduction for state income and property taxes. The extent to which state income taxes are eliminated will also eliminate the demand for these, although if states adopt higher land value taxes for redistributive purposes, some residual deduction for this tax may need to be included in the federal tax code, although doing so will simply require higher federal rates to make up the difference. Additionally, abandonment of the state income tax deduction has been seen as a reason to entirely federalize Medicaid as an offset. Doing so may be appropriate, however if participants in subsidized and paid adult education are covered by the provider's insurance as if employees and retirees long term care needs are increasingly covered by the firms they retired from as an offset to Net Business Receipts Taxes, the question of funding Medicaid may be a minor footnote.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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Committee on Ways and Means

Hearing on Tax Reform and Tax Provisions

Affecting State and Local Governments

Tuesday, March 19, 2013, 10:00 AM

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.

City of
Boerne

March 18, 2013

Ways and Means Committee Office
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Camp:

The City of Boerne is opposed to any efforts to impose a tax on municipal bonds, including any partial tax or cap. We are also opposed to any replacement of the current municipal bond structure with direct payment bonds or any other taxable form of bonds. The City of Boerne, which also owns and operates its own utilities, relies on the ability to fund critical infrastructure using tax exempt municipal bonds. We need to retain the current federal tax exclusion for interest on these bonds.

I had the opportunity earlier this month to visit with our legislative representatives, while attending the American Public Power Association 2013 Legislative Rally, to express our concerns about the proposal to tax municipal bonds. If this proposal goes forward, it will dramatically impact our city's ability to make needed infrastructure investments in our community at a reasonable cost.

Thank you for the opportunity to submit comments for consideration by the Committee on Ways and Means.

Sincerely,

MDS/pb

Michael D. Schultz,
Mayor

cc: Boerne City Council members
Ronald C. Bowman, City Manager
Jeff Thompson, Deputy City Manager
Sandy Mattick, Finance Director

COCONUT CREEK
BUTTERFLY CAPITAL OF THE WORLD®

OFFICE OF CITY COMMISSION
4800 WEST COPANS ROAD
COCONUT CREEK, FLORIDA 33063

BECKY TOOLEY
MAYOR

March 28, 2013

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member, Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Re: Tax Exempt Municipal Bonds

Dear Mr. Chairman and Ranking Member:

On behalf of the residents of the City of Coconut Creek, Florida, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." The City of Coconut Creek is very concerned about proposals to cap or eliminate the tax exempt status of municipal bonds.

We utilize tax-exempt municipal bonds to finance public infrastructure that generates jobs and promotes economic growth in our community. Recent examples include a City Series 2009 Tax Exempt Revenue Note issued to finance hurricane preparedness and safety capital projects including undergrounding electric utility lines and the construction of our Public Works/Emergency Communications and Operations building.

Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for schools, hospitals, transit and infrastructure for water, roads, and public power. Proposals to limit or eliminate tax deduction for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (.7 percent), requiring issuers to pay more in interest in order to attract the same investors.

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bond financing.

Tax exempt municipal bonds are an effective means of attracting private investment to public projects. We strongly oppose any changes made to the tax exempt status of municipal bonds and would encourage you reject any such proposals in a future tax package the committee may consider. Thank you for your attention to this important issue.

Sincerely,

Becky Tooley
BECKY TOOLEY
Mayor

cc: The Honorable Ted Deutch, U.S. House of Representatives, District 21
Coconut Creek City Commission
David J. Rivera, City Manager

City of Dallas, Texas
Written Testimony for the Record

Committee on Ways & Means
United States House of Representative

Tax Provisions Affecting State & Local Governments
March 19, 2013

The City of Dallas appreciates the opportunity to submit testimony for the record in response to the Committee's hearing: Tax Provisions Affecting State & Local Governments. The City especially appreciates the opportunity to address comments that Scott Hodge, President of the Tax Foundation, made about the City of Dallas during his appearance before the Committee. (If the Committee is looking for tax expenditures to eliminate, the City respectfully suggests that the Committee need look no further than the tax exempt status enjoyed by the Tax Foundation. Indeed, we would be eager to put the value of what our tax exemption produces up against the value of what the Tax Foundation's tax exemption produces.)

With all due respect to Mr. Hodge, the elected officials of the City of Dallas are never "crying wolf" when we bring issues to the attention of our congressional delegation and congressional committees. The City Council debates and adopts a detailed Federal Legislative Program at the beginning of each Congress. City staff and the City Council take this process very seriously and devote considerable time and attention to crafting a document that reflects real concerns about federal legislation, policies and proposals that would have serious impacts on the City and its citizens.

In the case of proposal to eliminate or cap the tax exemption for municipal bonds, we cannot exaggerate the seriousness or reality of our concerns. According to every analysis we have seen, capping or eliminating the tax exemption for municipal bonds would significantly increase the City's borrowing costs. A Government Finance Officers Association study found that in 2012 alone, a 28 percent cap would have raised our borrowing costs by 14.7 percent or $27 million; the absence of the tax exemption would have raised our 2012 borrowing costs by 42 percent or $78 million. Simply put, without the tax exemption, we would be faced with the choice of delaying much-needed core infrastructure improvements or passing on the costs to our taxpayers and ratepayers. (*In the case of water and wastewater improvements designed to meet increasingly stringent federal mandates, we would have no choice but to pass higher costs on to our ratepayers.*)

The City takes strong exception to Mr. Hodge's allegation the municipal bond tax exemption has encouraged the City of Dallas to spend beyond its means or to finance frivolous or questionable projects. The City of Dallas uses municipal bonds to finance the core municipal infrastructure that is the foundation of a modern economy and is vital to public health and safety: water, sewer, streets, flood control, storm sewer, fire stations, police stations and parks. Despite Mr. Hodge's belief that our nation suffers from a surfeit of infrastructure investment, local elected officials operating at the ground level in the real world know the opposite is true. Our nation has significant infrastructure needs and they are largely being met by state and local governments using municipal bonds.

Dallas voters have approved four major bond programs since the late 1990s to improve the City's infrastructure and boost economic growth. Most recently, Dallas voters in November overwhelmingly approved (80 percent!) a $642 million "Back to Basics" bond package that will make critical investments in storm drains and storm pumps; streets and sidewalks, and in south Dallas economic development. Despite Mr. Hodge's misgivings, Dallas citizens clearly have strong trust in the City of Dallas' ability to make prudent and responsible investments in core public infrastructure. We do not take this responsibility lightly. Dallas voters are not alone in this trust. The City of Dallas is proud of its strong bond rating: Aa1 from Moody's and AA+ from Standard and Poor's. These ratings reflect our sound management and our ability to consistently balance our budget while maintaining basic services and a strong foundation for economic growth.

The City of Dallas operates in the real world where changes to the tax code would have a real impact on real people. Intellectual discussions about the inefficiencies of tax exempt bonds may have some appeal in Washington think tanks, but so far none of the proponents of eliminating or capping the exemption offer a realistic replacement to pay for basic infrastructure investments in a manner that does not burden local taxpayers and utility ratepayers with tax and rate increases.

Tax credit bonds and direct subsidy bonds are a good complement to traditional tax exempt municipal bonds, but they would be a poor replacement for many reasons:

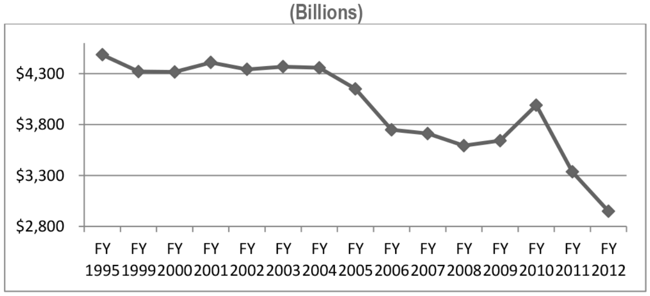
- They have a narrower market than traditional municipal bonds;
- Programs to date have been far too small to meet infrastructure needs;

- Their underwriting costs are more expensive than traditional municipal bonds, making them a poor choice for small issuers; and
- In the case of direct subsidy bonds, sequestration has eaten into the subsidy, creating mid-year budget difficulties for many issuers, including the City of Dallas (sequestration has shown that the federal subsidy provided by these bonds cannot be relied upon, injecting uncertainty into the marketplace).

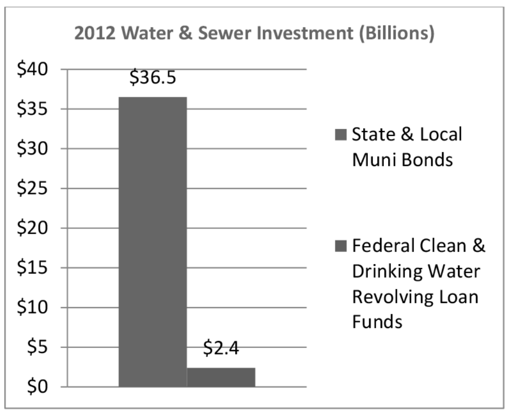
While the City appreciates the federal grants we receive, they cannot serve as a substitute for tax-exempt municipal bonds and fall far short of meeting core local infrastructure needs. The City is especially troubled that proposals to eliminate or cap the tax exemption for municipal bonds are gaining steam at the same time that federal assistance to local governments for infrastructure has been drastically cut. Given the downward funding trend and outright elimination of many core state and local government grant programs over the past decade, *capping or eliminating the tax exemption for municipal bonds would effectively signal federal divestment in our nation's infrastructure.*

One need look no further than the Community Development Block Grant, which states and cities use to upgrade infrastructure in low- and moderate-income neighborhoods, for evidence of how federal grants for infrastructure have dried up. Congress and successive Administrations have cut funding for this vital block grant by 34 percent since FY 1995. These cuts are even more severe when measured for inflation and population increase: *Congress would have to increase funding by 270 percent to bring funding back to where it was in 1978!*

CDBG Funding FY 1995-FY 2012 (Billions)



Similarly, federal funding for water and wastewater infrastructure has fallen from over 70 percent of such investments in the 1970's to a negligible share today. The federal funding that remains available for water and wastewater infrastructure investments comes mostly in the form of loans and is accompanied by so much paperwork and red tape that most utilities prefer to go to the bond market to finance improvements. This decline has been accompanied by increasingly stringent clean water mandates, placing the burden of achieving our nation's clean water goals almost entirely on cities and their utility ratepayers.



Tax exempt municipal bonds are a time-tested and effective financing tool that local governments rely on to make investments in public infrastructure. In an era of ever-increasing federal mandates on local governments and increasingly scarce federal grants, capping or removing the tax exemption for municipal bonds would make little sense.

The City of Dallas urges the Committee to oppose any proposal to do so.

CITY OF LINCOLN NEBRASKA   Lincoln Public Schools   LES Lincoln Electric System

April 2, 2013

The Honorable Dave Camp
U.S. House of Representatives
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

RE: Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

Dear Representative Camp and Members of the Committee on Ways and Means:

We appreciate the opportunity to submit a statement for the record of the March 19, 2013 Committee "Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments." The City of Lincoln, Lincoln Public Schools and the Lincoln Electric System respectfully request that this joint statement be included in the hearing record.

Municipal bonds are the most important tool local governments, schools and public power utilities use to finance new infrastructure and to maintain and upgrade existing infrastructure. Nearly three-quarters of core infrastructure investments, representing trillions of dollars, are financed with tax-exempt municipal bonds. Stability of the municipal bond market provides issuers of all sizes ready and timely access to capital while the exclusion of bond interest from federal income tax reduces state and local borrowing costs overall. The beneficiaries are tax payers who ultimately pay less to fund these necessary infrastructure projects. Without the tax exemption on municipal bonds, it is estimated that the average cost of borrowing could be increased from 70 to 200 basis points (0.7% - 2.0%).

Over the last ten years, more than $1.65 trillion of infrastructure projects nationwide have been financed with tax-exempt bonds. In Nebraska alone, there have been $16.5 billion in infrastructure projects financed with tax-exempt bonds. These projects have helped Nebraska's economy remain strong through the recession by investing in necessary new infrastructure, replacing/repairing aging infrastructure, providing jobs, and keeping our unemployment rate near the lowest in the country. Currently, the new Pinnacle Bank Arena and associated infrastructure is being financed with $300 million of tax-exempt bonds. This project is creating hundreds of jobs that are helping to grow both Lincoln's and Nebraska's economies. Lincoln provides an excellent illustration of how investment in infrastructure can vitalize a local economy.

Representative Camp and
Members of the Committee on Ways and Means
April 2, 2013
Page 2

There have been suggestions that propose a partial tax or "cap" on tax exempt interest from these bonds or a replacement of tax-exempt bonds with "direct payment" bonds. A cap that would limit tax-exempt interest deduction to the 28% tax bracket would have the effect of imposing a surtax on bond interest. Recent analysis shows that such a proposal would increase borrowing costs by 32 percent to 35 percent. Of additional concern is discussion that the proposal should be applied retroactively to $3.7 trillion of existing bonds. Not only would this be unfair to the existing bond holders, but we believe it would cause instability in the municipal bond market. We believe these ideas represent short-term budget-focused thinking that ignores the long-term consequences of increasing costs to build infrastructure. Taxing municipal bonds upends a more than 100-year U.S. Supreme Court established-precedent of the reciprocal immunity principle whereby local and state governments do not tax federal bonds, bills and notes and, in return, there is a federal tax exemption for interest on municipal bonds.

We appreciate the opportunity to provide the Committee on Ways and Means with our thoughts on the importance of tax-exempt financing and we urge the Committee to resist any attempts to reduce or eliminate the federal tax exemption for interest payments on municipal bonds. It is imperative that we preserve this important economic tool for state and local governments.

Sincerely,

By: *S/Chris Beutler*
Chris Beutler
Mayor
City of Lincoln

By: *S/Kevin G. Wailes*
Kevin G. Wailes
Administrator & CEO
Lincoln Electric System

By: *S/Dr. Steve Joel*
Dr. Steve Joel
Superintendent
Lincoln Public Schools

March 28, 2013

The Honorable Dave Camp Chairman, Committee on Ways and Means U.S. House of Representatives 1102 Longworth House Office Building Washington, DC 20515	The Honorable Sander Levin Ranking Member, Committee on Ways U.S. House of Representatives 1106 Longworth House Office Building Washington, DC 20515

Re: Tax Exempt Municipal Bonds

Dear Mr. Chairman and Ranking Member:

On behalf of the residents of the City of Manteca, California, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." The City of Manteca is very concerned about proposals to cap or eliminate the tax-exempt status of municipal bonds.

The City of Manteca utilizes tax-exempt municipal bonds to finance public infrastructure that generates jobs and promotes economic growth in our community. Recent examples include a 2000 tax-exempt bond series for our surface water project, and again in 2003 for the expansion of our wastewater quality control facility. Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for schools, hospitals, transit and infrastructure for water, roads, and public power.

Proposals to limit or eliminate tax deductions for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (.7 percent), requiring issuers to pay more in interest in order to attract the same investors.

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bonds.

Tax-exempt municipal bonds are an effective means of attracting private investment to public projects. We strongly oppose any changes made to the tax-exempt status of municipal bonds, and would encourage you reject any such proposals in a future tax package the committee may consider. Thank you for your attention to this important issue.

Sincerely,

WILLIE W. WEATHERFORD
Mayor

c: Rep. Jeff Denham

Mayor L. Dennis Michael • *Mayor Pro Tem* Sam Spagnolo
Council Members William J. Alexander, Marc Steinorth, Diane Williams
City Manager John R. Gillison

THE CITY OF RANCHO CUCAMONGA

March 28, 2013

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member, Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Re: Tax Exempt Municipal Bonds

Dear Mr. Chairman and Ranking Member:

On behalf of the residents of the City of Rancho Cucamonga, California, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." The City of Rancho Cucamonga is very concerned about proposals to cap or eliminate the tax exempt status of municipal bonds.

The City of Rancho Cucamonga utilizes tax-exempt municipal bonds to finance public infrastructure that generates jobs and promotes economic growth in our community. For example, the upcoming I-15/Base Line Road Interchange Project is financed with tax-exempt municipal bonds and is estimated to create 776 jobs. Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for schools, hospitals, transit and infrastructure for water, roads, and public power.

Proposals to limit or eliminate tax deduction for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (.7 percent), requiring issuers to pay more in interest in order to attract the same investors.

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bonds.

Tax exempt municipal bonds are an effective means of attracting private investment to public projects. We strongly oppose any changes made to the tax exempt status of municipal bonds and would encourage you to reject any such proposals in a future tax package the committee may consider. Thank you for your attention to this important issue.

Sincerely,

L. Dennis Michael
Mayor

cc: Rep. Gary Miller
Nancy Cisneros, League of California Cities

10500 Civic Center Dr. • P.O. Box 807 • Rancho Cucamonga, CA 91729-0807 • Tel (909) 477-2700 • Fax (909) 477-2849 • www.CityofRC.us

Statement for the Record
Submitted on behalf of the City of Seattle, Seattle City Light,
and Seattle Public Utilities
Marco Lowe, Director of Intergovernmental Relations, City of Seattle
Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
House Ways and Means Committee
April 2, 2013

Thank you for the opportunity to provide a statement for the record related to your March 19 hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments." This statement is written on behalf of the City of Seattle and its enterprise utilities, Seattle City Light and Seattle Public Utilities, which includes our water, drainage and wastewater, and solid waste utilities. While there are many ways in which the federal tax system impacts local government financing, we would like to focus on the current tax treatment of municipal bonds and possible changes to that tax treatment. We would first like to provide some context on the City's use of bonding authority.

City of Seattle's Use of Debt Service[1]
The City uses bonds and property tax levies to fund a variety of special capital improvement projects. The City's budget includes funds to pay interest due on outstanding bonds and to pay the principal amount of bonds at maturity. The City has issued three types of debt to finance its capital improvement programs:

Unlimited Tax General Obligation Bonds
By state law, the City may issue Unlimited Tax General Obligation (UTGO) Bonds for capital purposes if a proposition authorizing their issuance is approved by 60% of the voters in an election in which the number of voters exceeds 40% of the voters in the most recent general election. Payment of principal and interest is backed by the "full faith and credit" of the City. This means that the City commits itself to include in its property tax levy an amount that is sufficient to pay principal and interest on the bonds. Property taxes levied to pay debt service on UTGO bonds are not subject to the statutory limits in state law on the taxing authority of local governments, which is why UTGO bonds are "unlimited". However, state law does limit the amount of UTGO bonds that can be outstanding at any time to 7.5% of assessed valuation of property in the city: 2.5% for open space and park facilities, 2.5% for utility purposes, and 2.5% for general purposes. As of December 31, 2012, there were approximately $90 million in UTGO bonds outstanding.

Limited Tax General Obligation Bonds
The City Council may authorize the issuance of Limited Tax General Obligation (LTGO) Bonds, also known as Councilmanic bonds, in an amount up to 1.5% of assessed valuation, without a vote of the people. The City pledges its full faith and credit to the payment of

[1] The following discussion on City of Seattle Debt Service is taken from the 2013 Adopted and 2014 Endorsed Budget of the City of Seattle, pp. 698-700. The debt numbers were updated to reflect 2012 numbers.

principal and interest on LTGO bonds, but this pledge must be fulfilled within the City's statutory property tax limitations. Thus, these are "limited" general obligation bonds. The combination of UTGO bonds issued for general purposes and LTGO bonds cannot exceed 2.5% of assessed property valuation. If LTGO bonds are issued up to the 1.5% ceiling, then UTGO bonds for general purposes are limited to 1% of assessed value. As of December 31, 2012, there were approximately $890 million obligations counting in this LTGO debt limit.

Revenue Bonds
Revenue bonds are used to provide financing for the capital programs of Seattle City Light and the three other utilities – Water, Drainage and Wastewater, and Solid Waste – which are grouped together in Seattle Public Utilities. The City does not pledge its full faith and credit to the payment of debt service on revenue bonds. Payment of principal and interest on the bonds issued by each utility is derived solely from the revenues generated by the issuing utility. No tax revenues are used to pay debt service.

When revenue bonds are sold, the City commits itself to set fees and charges for the issuing utility that will be sufficient to pay all costs of operations and maintenance, and all payments of principal and interest on the bonds. While the amount of revenue bonds is not subject to statutory limits, the utility's ability to repay debt with interest is a practical constraint.

City Debt Management Policies and Bond Ratings
The use of debt financing by the City is subject not only to state law, but also to the debt management policies adopted by the Mayor and City Council. According to these policies, a capital project should be financed with bond proceeds only under certain circumstances including the following:

- In emergencies;
- When the project being financed will produce revenues that can be used to pay debt service on the bonds; or
- When the use of debt will result in a more equitable sharing of the costs of the project between current and future beneficiaries of the project.

Paying for long-lived assets, such as libraries or parks, from current tax revenues would place a large burden on current taxpayers, while allowing future beneficiaries to escape the burden of payment. The use of debt effectively spreads the cost of acquiring or constructing capital assets over the life of the bonds. The City's debt management policies require that 12% of the City's LTGO total issuance capacity be reserved for emergencies. They also state that net debt service on LTGO bonds (defined as total debt service, minus dedicated project revenues) should not exceed 9% of the General Fund budget, and should remain below 7% over the long term (currently about 6%).

The City has earned very high ratings on its bonds as a result of a strong economy and prudent financial practices.

The City's UTGO debt is rated Aaa by Moody's Investors Service, AAA by Fitch IBCA, and AAA by Standard & Poor's (S&P), which are the highest possible ratings. The City's LTGO debt is rated Aa1 by Moody's, AA+ by Fitch, and AAA by S&P. In addition, the City's utilities have very high ratings for revenue debt, reflecting sound finances and good management.

Proposed Changes to the Municipal Bond Tax Exemption and Impacts on the City of Seattle

Municipal bonds are the engine driving our infrastructure development and our economic growth. Not only do the projects financed by municipal bonds provide construction jobs in the short term, in the long term, the infrastructure built by bonds provides the backbone of economic growth in city. Municipal bonds are financing projects all over the city, including the replacement of the Elliott Bay Seawall and the construction of a new substation in the burgeoning South Lake Union neighborhood. These projects are essential to the long term economic health of our city.

The current discussion around changing the municipal bond tax exemption revolves around two proposals. The first proposal would eliminate the municipal bond tax exemption altogether. The second would include the tax exemption on municipal bonds as part of any cap on deductions. The level of the cap being discussed is 28 percent. Both of these proposals would result in an increase in borrowing costs for the city of Seattle. These costs would be borne by our taxpayers, slowing our long-term economic growth and development and requiring the city to forgo or delay projects in order to pay the increased borrowing costs.

In the normal course of our capital program, we project that the city (including our publicly-owned utilities, Seattle City Light and Seattle Public Utilities) will issue at least $2 billion of new debt over the next 5 years. Based on this current level of debt maintenance and using a conservative estimate of what the change in the interest rate would be, if the municipal bond tax exemption were eliminated, it would result into increased interest expense for all of our projects of about $20 million annually, or about half a billion dollars over the next 30 years. Under a scenario where there is a 28 percent cap on the tax exemption, the annual impact would be just under $4 million or about $100 million over the next 30 years. And this is when interest rates are at an all-time low. These costs will only go up as interest rates do. Below are examples of specific projects that would affected by a change in the tax-exempt status of municipal bonds.

Examples of Projects Funded by Municipal Bonds

The Elliott Bay Seawall Project
The Elliott Bay Seawall Project is a critical public safety project. Failure of the seawall would have significant impacts to the public, the City of Seattle, the Puget Sound region, Washington State, and the nation. Protection from coastal storm damage and shoreline erosion is vital to preserving Seattle's downtown, the economy, and the region's quality of life and economic competitiveness. The Elliott Bay Seawall:

- Protects Seattle's downtown waterfront from wind-driven storm waves and the erosive tidal forces of Puget Sound and Elliott Bay.
- Supports and protects major public and private utilities, including power for downtown Seattle and the western seaboard, natural gas, and telecommunications.
- Supports State Route 99, the ferry terminal, and rail lines, all of which transport local commuters and visitors as well as local, regional, and international freight.

This past November, Seattle voters, with **77 percent of the voters voting in favor**, passed a $290 million bond to replace the existing southern half of the Elliott Bay Seawall along Seattle's waterfront with a structure that meets current safety and design standards.

The loss of the tax exemption on municipal bonds would have an immediate impact on Seattle taxpayers. Based on conservative estimates, the complete loss of the tax exemption would increase annual costs on the seawall to taxpayers by about $2.5 million or over $75 million over 30 years. A 28 percent cap on tax exemption would potentially increase annual costs on the seawall project by almost $500,000 or $14 million over 30 years.

Denny Substation Project
The City's municipal electric utility, Seattle City Light, is building a new north downtown substation to create a stronger and better-integrated distribution system through the city. In addition, the substation, when complete provides highly reliable power to serve the city's growing biotechnology research and information technology sectors.

As a part of Seattle City Light's capital program, Seattle City Light is using some of its bonding capacity on this substation. The remaining substation project costs are around $152 million. Based on conservative estimates, the complete loss of the tax exemption would increase annual costs on to ratepayers by about $1.3 million or about $40 million over 30 years. Assuming a 28 percent cap on tax exemption, the impact on financing would be a total of $7.6 million higher for Seattle City Light ratepayers. This averages out to around a $253,000 increase per year over the repayment period.

We appreciate that the federal government is facing fiscal challenges, but we believe one of the ways to meet those challenges is to support programs and policies that encourage economic growth. Municipal bonds have a proven track record of helping to create jobs and providing the infrastructure that underlies a strong economy. Now is not the time to change this policy.

About the City of Seattle, Seattle City Light and Seattle Public Utilities
With a population of over 615,000, **Seattle** is the largest city in Washington State and the 23rd largest city in the country. Seattle has a budget of $4.1 billion, with Seattle City Light and Seattle Public Utilities accounting for about one-half of the budget.

Seattle City Light is the 10th largest public electric utility in the United States. It has some of the lowest cost customer rates of any urban utility, providing reliable, renewable and environmentally responsible power to nearly 1 million Seattle area residents. City Light has been greenhouse gas neutral since 2005, the first electric utility in the nation to achieve that distinction.

Seattle Public Utilities (SPU) is comprised of three separate utilities- Water, Drainage and Wastewater, and Solid Waste. SPU delivers an average of 120-130 million gallons of drinking water per day to more than 1.3 million people and businesses in Seattle and 22 surrounding cities and water districts, collects and disposes of the solid waste generated within the City of Seattle and maintains the drainage and wastewater system in Seattle.

st.petersburg
www.stpete.org

CITY OF ST. PETERSBURG
Office of the Mayor

Bill Foster, Mayor

March 14, 2013

The Honorable Congressman Dave Camp
United States House of Representatives
Ways and Means Committee Office
1102 Longworth house office Building
Washington, D.C. 20515

Dear Representative Camp:

Recent proposals to eliminate or curtail the tax exemption of municipal bonds threaten local communities like ours. We urge your support and commitment to tax-exempt bond financing in recognition of the critical role it plays in the ability of state and local governments to fund national priorities, particularly infrastructure.

Maintaining the tax-exempt status of municipal bonds is essential to help our national economy grow, create jobs, and best serve the constituencies of every community. Repeal of the deduction for state and local taxes will increase the effective rate of state and local taxes with all of the resulting revenue going to the federal government. While federal officials may view this tax exemption as a benefit to those who can afford to invest in tax exempt bonds, we in local government view it as a mechanism to help us hold down the cost of vital services to our citizens, such as clean affordable drinking water, the efficient processing of wastewater, and the safety of critical infrastructure like roads and bridges.

Three-quarters of the total United States investment and infrastructure is provided by state and local governments, and tax-exempt bonds are the primary financing tool used by over 50,000 state and local governments to accomplish these infrastructure goals. If municipal bonds are taxed, the cost of infrastructure financing will skyrocket at a time when communities like ours are in dire need of upgrades to roads, bridges, schools and sewer systems.

Next week the City will be marketing approximately $45 million in bonds to refinance a portion of the City's current Utility Debt to save approximately $2.5 million and a similar amount to finance new projects that will save our utility rate payers over $30 million during the next twenty years. Given the historical interest rate variance between tax-exempt and taxable bonds, losing tax exempt status would cost the City's rate payers $13.88 million more over the life of these new bonds alone. Issuing bonds at a taxable rate would have prevented the City from doing many of the projects we were otherwise able to do.

Eliminating or curtailing the tax exemption would be extremely detrimental to the City of St. Petersburg, Pinellas County, the State of Florida, and the entire nation. We appreciate your support.

Sincerely,

Bill Foster

Bill Foster, Mayor

City of St. Petersburg, P.O. Box 2842, St. Petersburg, Florida 33731 • Telephone (727) 893-7201

Clean Water Services
Our commitment is clear.

March 25, 2013

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member, Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Re: Tax Exempt Municipal Bonds

Dear Mr. Chairman and Ranking Member:

On behalf of Clean Water Services (CWS), located in Washington County, Oregon, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." CWS is very concerned about proposals to cap or eliminate the tax exempt status of municipal bonds.

As the water resource management utility serving more than 530,000 residents of urban Washington County, Oregon, Clean Water Services utilizes tax-exempt municipal bonds to finance improvements to our wastewater infrastructure. Since 2002, CWS has invested in excess of $405 million in system improvements to support the mission of clean water stewardship within the Tualatin River Basin. This investment was made possible through the issuance of over $263 million in tax-exempt municipal bonds. Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for schools, hospitals, transit and infrastructure for water, roads, and public power.

Proposals to limit or eliminate tax deduction for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (.7 percent), requiring issuers to pay more in interest in order to attract the same investors.

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bonds.

Tax exempt municipal bonds are an effective means of attracting private investment to public projects. We strongly oppose any changes made to the tax exempt status of municipal bonds and would encourage you to reject any such proposals in a future tax package the committee may consider. Thank you for your attention to this important issue.

Sincerely,

Bill Gaffi

Bill Gaffi
General Manager

Cc: Rep. Suzanne Bonamici

2550 SW Hillsboro Highway Hillsboro, Oregon 97123
Phone: (503) 681-3600 Fax: (503) 681-3603 www.CleanWaterServices.org

STATE OF MICHIGAN
COUNTY OF NEWAYGO
BOARD OF COMMISSIONERS

At a regular session of the said Board, held in the City of White Cloud, in said County, on the 27th day of March 2013, the following Resolution was adopted:

RESOLUTION #03-006-13
RESOLUTION OPPOSING CHANGES TO FEDERAL TAX PROVISIONS AFFECTING STATE AND LOCAL GOVERNMENTS

WHEREAS, President Obama has made proposals to reduce or eliminate tax exempt municipal bonds and to eliminate the deduction of state and local property taxes on federal income tax returns, with the intent to raise taxes/revenue; and

WHEREAS, tax exempt municipal bonds are used to finance three-quarters of all infrastructure investments made in the United States; and

WHEREAS, the tax exempt status of municipal bonds was established one hundred years ago, codified by the Federal Revenue Act of 1913; and

WHEREAS, this tax exemption is part of a more than century-long system of reciprocal immunity under which owners of federal bonds are, in turn, not required to pay state and local income tax on the interest they receive from federal bonds; and

WHEREAS, tax exempt financing allows state and local governments to reduce borrowing costs because investors are willing to accept a lower interest rate on tax exempt bond issues, reflecting the reduced tax burden; and

WHEREAS, the tax exemption represents a fair allocation of the cost of projects between federal and state/local levels of government, with the federal cost leveraging an almost 9 to 1 return that is difficult to replicate through other federal programs; and

WHEREAS, Newaygo County residents have realized the benefits of tax exempt municipal bonds that have financed projects including expansions to the Medical Care Facility, the Health Services Building, the Sheriff's Office and Jail, as well as the construction of numerous waste water treatment systems throughout the county; and

WHEREAS, the President has proposed legislation to cap or repeal the tax exemption on municipal bonds; and

WHEREAS, eliminating or capping the tax exemption would increase the cost of borrowing for infrastructure improvements, increasing the cost to the public and reducing available funding for other local government services at a time when America's infrastructure is aging and Michigan's roads are deteriorating; and

WHEREAS, federal tax law currently allows homeowners that itemize deductions to deduct local property taxes, which has provided broad-based relief to taxpayers; and

WHEREAS, The President and Congress are considering the elimination of the itemized deduction for state and local taxes for individual taxpayers.

Resolution #03-006-13
Page 2

NOW, THEREFORE, BE IT RESOLVED that the Newaygo County Board of Commissioners opposes any efforts by the White House to reduce or repeal the federal tax exemption on interest earned from municipal bonds; and

BE IT FURTHER RESOLVED that the Newaygo County Board of Commissioners opposes any action that would reduce or repeal the exemption on tax exempt bond interest, and affirm that there should be no legislative action to apply any changes retroactively to current outstanding bonds; and

BE IT FURTHER RESOLVED that the Newaygo County Board of Commissioners opposes any changes to the local property tax deduction in any broad federal tax reform legislation; and

BE IT FURTHER RESOLVED that a copy of this resolution shall be sent to our Congressional Representatives and to the United States House of Representatives Committee on Ways and Means.

Motion by: Maike Seconded by: Lethorn, to adopt the foregoing Resolution.
The Ayes being: Gardner, Lethorn, Maike, Nieboer, Ortwein, Trapp
Nays: 0 Absent: Deur

The Resolution was adopted
on March 27, 2013

Patrick Gardner, Chairman
Newaygo County Board of Commissioners

STATE OF MICHIGAN)
)ss
COUNTY OF NEWAYGO)

I, Laurel J. Breuker, County Clerk, do hereby certify that the foregoing is a true copy of Resolution #03-006-13 adopted by the Newaygo County Board of Commissioners at a regular session held on the 27th day of March, 2013.

Laurel J. Breuker

Laurel J. Breuker
Newaygo County Clerk

Please attribute written comments to:

Commissioner Patrick Gardner
Commissioner Philip Deur
Commissioner Larry Lethorn
Commissioner James Maike, Jr.
Commissioner Stanley Nieboer
Commissioner Christian Ortwein
Commissioner Charles Trapp

Organization: Newaygo County Board of Commissioners

Contact Name: Marcy Dix

Organization Address: 1087 Newell, PO Box 885, White Cloud, MI 49349

Contact Phone Number: (231) 689-7223

Contact Email Address: grantsmgr@co.newaygo.mi.us

CTIA
The Wireless Association®

Expanding the Wireless Frontier

March 19, 2013

The Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives
1106 Longworth
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1106 Longworth
Washington, D.C. 20515

Dear Chairman Camp and Ranking Member Levin:

I commend you for holding your March 19 hearing, "Tax Reform and Tax Provisions Affecting State and Local Governments." This hearing is of great interest to the wireless industry, as nearly thirteen years after the National Governors Association and the National Conference of State Legislatures urged states to reform and modernize their telecommunications tax systems, discriminatory impositions by state and local governments continue to drive up the cost of wireless broadband and other mobile services. On average, wireless customers now pay 17.2% in state, local and federal taxes and fees, a 5.5 percent increase in just two years.

Congress, the Administration, and the Federal Communications Commission have made expanding wireless broadband a national priority to spur innovation and expand economic growth. The continued regressive taxation of wireless services works against this objective, harming lower-income Americans who tend to rely more exclusively on wireless devices for communication services and access to the Internet.

Last Congress, Rep. Zoe Lofgren (D-CA) and Rep. Trent Franks (R-AZ) introduced H.R. 1002, the Wireless Tax Fairness Act, to curb the rapidly increasing rate of discriminatory taxes imposed only on wireless services by state and local governments. The legislation would halt this trend by providing a temporary, five-year freeze on new taxes that are levied solely on wireless. Importantly, the bill did not take away any existing revenue from states or localities. CBO scored H.R. 1002 and determined that it would impose no cost on state, local or tribal governments.

H.R. 1002 was genuinely bipartisan legislation, enjoying the support of 236 cosponsors. On November 1, 2011 the House passed the bill by voice vote. Regrettably, the Senate failed to take up the bill before the 112th Congress adjourned.

In the coming weeks, Reps. Lofgren and Franks will reintroduce the Wireless Tax Fairness Act. I realize that this legislation falls within the jurisdiction of the House Judiciary Committee; however, the Finance Committee does retain jurisdiction on the Senate companion bill. As the Committee on Ways and Means continues its efforts on comprehensive tax reform, I strongly encourage you keep the merits and successful legislative track record of the Wireless Tax Fairness Act in mind as the Committee moves forward.

Sincerely,

Steve Largent

Steve Largent
President and CEO

1400 16th Street, NW Suite 600 Washington, DC 20036 Main 202.785.0081 Fax 202.785.0721 www.ctia.org

EASTERN MUNICIPAL WATER DISTRICT
SINCE 1950

March 26, 2013

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member, Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairman Camp and Ranking Member Levin:

Re: Maintaining Tax Exempt Municipal Bonds

On behalf of Eastern Municipal Water District (EMWD), located in Riverside County, California, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." EMWD is very concerned about proposals to cap or eliminate the tax exempt status of municipal bonds.

EMWD utilizes tax-exempt municipal bonds to finance improvements to our water and wastewater infrastructure. Over the last few years alone, the District issued approximately $140 million in tax-exempt Certificates of Participation to finance a needed expansion to our primary wastewater recycling plant, as well as a separate tax-exempt general obligation bond financing for approximately $32 million to fund various water and sewer infrastructure replacement and system betterment projects. Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for water, wastewater, transit, and public power infrastructure, as well as schools and hospitals.

Proposals to limit or eliminate tax deductions for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (0.7 percent), requiring issuers to pay more in interest in order to attract the same investors. Our District estimates that proposal would cost our ratepayers at least $7,000,000 per year in additional interest costs – more than $50 per year for each customer account.

Mailing Address: Post Office Box 8300 Perris, CA 92572-8300 Telephone: (951) 928-3777 Fax: (951) 928-6177
Location: 2270 Trumble Road Perris, CA 92570 Internet: www.emwd.org

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many critical infrastructure projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bonds.

Tax exempt municipal bonds are an effective means of attracting private investment to public projects. We strongly oppose any changes made to the tax exempt status of municipal bonds and would encourage you reject any such proposals in a future tax package the committee may consider. Thank you for your attention to this important issue.

If you would like additional information regarding EMWD's use of tax-exempt bonds, please contact Debby Cherny, EMWD's Assistant General Manager of Finance and Administration at 951-928-3777 ext. 6154, or by email at cherneyd@emwd.org.

Sincerely,

Paul D. Jones II

Paul D. Jones II, P.E.
General Manager

cc: Representative Raul Ruiz
Representative Duncan Hunter
Representative Ken Calvert
Representative Mark Takano

EDUCATION FINANCE COUNCIL

Hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments"

Statement for the Record by the Education Finance Council

House Committee on Ways and Means

March 19, 2013

The Education Finance Council (EFC) is the national trade association representing nonprofit and state agency student loan organizations. EFC commends the Ways and Means Committee for examining Federal tax provisions that affect State and local governments as it continues its work on comprehensive tax reform. Many EFC members function as entities of their state—these entities and the students they serve are uniquely affected by the following Federal tax provisions.

Tax-Exemption of Municipal Bonds

Many EFC members are issuers of tax-exempt bonds which are used for funding student loans. Tax-exempt bonds lower issuers' financing costs, which they pass along to student loan borrowers in the form of lower interest rates. Tax-exempt bonds have been a source of affordable financing for decades and have provided millions of students the ability to affordably access higher education. In order to maintain the stability of the tax-exempt bond market, EFC opposes efforts to limit or cap the deductions or exemptions a taxpayer may claim because this effectively places a tax on these bonds. EFC also opposes replacing tax-exempt bonds with tax credit or direct pay bonds because of their limited market acceptance.

AMT Holiday for Private Activity Bonds

In 2009, legislation was passed that granted an exemption for private-activity bonds (PAB) and municipal bonds – like those issued by state agency student loan providers - from the individual Alternative Minimum Tax (AMT). This "AMT holiday" reduced the cost significantly of financing; creating savings that were passed on to borrowers and investors. The AMT holiday expired in December of 2010. EFC urges Congress to renew the AMT holiday for PABs this year, potentially in conjunction with comprehensive tax reform.

Allowing 150(d) Nonprofits to Originate Alternative Loans

For many years, certain nonprofit student loan providers were allowed to utilize tax-exempt financing to originate and purchase student loans under the Federal Family Education Loan Program (FFELP). Because lending under the FFELP was eliminated in 2010, EFC supports changing section 150(d) of the tax code to allow nonprofit lenders to access tax-exempt funding to provide college students with low-interest loans to fill the gap between Direct Federal loans, Pell grants, and other financial aid and the cost of education.

EFC strongly encourages the Committee to take into consideration the impact tax reform will have on all forms of state governments, including nonprofit student loan issuers. Changes to Federal tax provisions to expand the use of tax-exempt bonds will have a meaningful effect in helping students and parents finance access to higher education.

February 2013

NACo National Association of Counties

NATIONAL LEAGUE of CITIES

THE UNITED STATES CONFERENCE OF MAYORS

Protecting Bonds to *Save Infrastructure and Jobs* 2013

REPORT BY:
The National Association of Counties
The National League of Cities
The United States Conference of Mayors

WITH ASSISTANCE FROM:
The Government Finance Officers Association

National Association of Counties

Chris Rodgers
President
Commissioner of Douglas County, NE

Matthew D. Chase
Executive Director

NATIONAL LEAGUE of CITIES

Marie Lopez Rogers
President
Mayor of Avondale, AZ

Clarence E. Anthony
Executive Director

THE UNITED STATES CONFERENCE OF MAYORS

Michael Nutter
President
Mayor of Philadelphia

Tom Cochran
CEO and Executive Director

Assumptions and methodology

The issuance data contained in this report represent long-term, tax-exempt issuance by state and local governments and state and local agencies and authorities over the period 2003–2012 for the listed use of proceeds. The source is the Thomson Reuters SDC Platinum database. Taxable bonds and bonds subject to the individual alternative minimum tax are excluded.

Several assumptions were made in calculating the attached estimates. First, the average maturity of bonds is assumed to be 15 years. Bonds are assumed to have been issued at the rate of the median value of the Bond Buyer 20-Bond Index for the year of issuance. It is assumed that the proposal to cap the tax benefit of the tax exemption at 28 percent would have increased borrowing costs by 70 basis points and that the proposal to fully repeal the tax exemption would have increased borrowing costs by 200 basis points, based on various industry reports, including Municipal Market Advisors and Citigroup, and produced by the Government Finance Officers Association. For the estimates of increases in 2012 interest costs by city and county, the 2012 interest payment cost was provided by each government and then the assumptions were completed using with an average maturity of 15 years at the median value of the Bond Buyer 20-Bond Index over the 15-year period 1998–2012. Please note that individual results may vary by jurisdiction.

CHARTS

Introduction

Tax-exempt municipal bonds are the most important tool in the U.S. for financing investment in schools, roads, water and sewer systems, airports, bridges and other vital infrastructure. State and local governments financed more than $1.65 trillion of infrastructure investment over the last decade (2003–2012) through the tax-exempt bond market (**Chart E**).

During that decade, $514 billion of primary and secondary schools were built with financing from tax exempt bonds; nearly $288 billion of financing went to general acute care hospitals; nearly $258 billion to water and sewer facilities; nearly $178 billion to roads, highways, and streets; nearly $147 billion to public power projects; and $105.6 billion to mass transit (**Chart A**). These categories represent 90 percent of the total amount of municipal bonds used to finance infrastructure between 2003 and 2012.

In 2012 alone, more than 6,600 tax-exempt municipal bonds financed over $179 billion worth of infrastructure projects.

CHART A

The Impact of Proposals to Limit/Eliminate Tax-Exempt Financing

Under the federal tax code, investors are not required to pay federal income tax on interest earned from most bonds issued by state and local governments. The tax exemption for municipal bond interest has been in law since the federal income tax was promulgated 100 years ago, and tax-exempt bonds have financed trillions of dollars of infrastructure investment over that time. The effect of this tax exemption is that state and local governments receive a lower interest rate on their borrowing than they would if their interest was taxable to investors. In typical market conditions, the tax exemption can save states and localities up to two percentage points on their borrowing rates.

Several legislative proposals have been offered to curtail or eliminate the federal tax exemption for municipal bond interest. One proposal would impose a tax-benefit cap of 28 percent for certain taxpayers on many itemized deductions and exclusions, including tax-exempt interest. The effect would be a partial tax on interest that would otherwise be exempt from income tax. In effect, the tax-exempt bond market would no longer be entirely tax-exempt.

If the proposal to impose a 28-percent benefit cap on tax-exempt interest had been in effect during the last decade, it is estimated that this would have cost states and localities an additional $173 billion in interest expense for infrastructure projects financed over the past ten-year period (**Chart B**).

For an investor in the 39.6-percent federal tax bracket, the tax benefit cap proposal would equate to an 11.6-percent tax on municipal bond interest income, the difference between the 39.6-percent tax rate and the 28-percent benefit cap. While it may appear that this tax would fall on high-bracket taxpayers, in effect, it would be borne almost exclusively by state and local governments in the form of higher interest rates

If a 28-percent benefit cap on tax-exempt interest had been in effect during the last decade, it is estimated that this would have cost states and localities an additional **$173 billion** in interest expense for infrastructure projects financed over the past ten-year period.

on their borrowing. Market analysts have estimated that this proposed tax on municipal bond interest would raise state and local borrowing costs by up to 70 basis points (0.70 percentage point) or more. Because the tax would apply not only to new state and local borrowing but also to all outstanding bonds, investors would be taxed on investment which they reasonably expected would be tax-exempt as long as they are outstanding, an unprecedented form of retroactive taxation. As a result, investors would face the new risk that Congress could tax interest on outstanding bonds even more in the future, a risk that would raise state and local borrowing costs even more and create unprecedented uncertainty for investors in the municipal securities market.

Some have proposed an even more onerous full federal income tax on municipal bond interest. For example, the National Commission on Fiscal Responsibility and Reform (the "Simpson-Bowles Commission") in its 2010 deficit-reduction recommendations proposed full taxation for state and local interest for all newly-issued bonds. **If this proposal had been in place during the 2003–2012 period, it is estimated that the $1.65 trillion of state and local infrastructure investment would have cost governments an additional $495 billion of interest expense (Chart B).**

CHART B

Interest costs with and without tax exemption

$ MIL

	current law	with 28-percent cap		with full repeal	
	ESTIMATED INTEREST COST WITH TAX EXEMPTION AS IS	ESTIMATED TOTAL INTEREST COST	COST INCREASE	ESTIMATED TOTAL INTEREST COST	COST INCREASE
2003	114,128.55	130,876.97	16,748.42	161,981.19	47,852.64
2004	96,239.27	110,820.97	14,581.71	137,901.29	41,662.02
2005	121,966.14	141,458.44	19,492.31	177,658.44	55,692.30
2006	118,248.09	137,017.62	18,769.54	171,875.34	53,627.25
2007	125,282.78	145,214.14	19,931.35	182,229.50	56,946.72
2008	140,294.09	161,012.63	20,718.54	199,489.91	59,195.82
2009	110,288.35	126,890.90	16,602.55	157,724.20	47,435.85
2010	91,207.92	105,952.85	14,744.93	133,336.29	42,128.37
2011	83,022.35	95,965.70	12,943.35	120,003.35	36,981.00
2012	100,111.45	118,949.63	18,838.18	153,934.81	53,823.36
TOTAL			**173,370.87**		**495,345.33**

SOURCE: SIFMA ESTIMATES BASED ON THOMSON REUTERS DATA USING THE REPORT'S ASSUMPTIONS

Increased Costs to Select Jurisdictions

Partially or fully taxing the interest on municipal borrowing would have a direct effect on state and local budgets in the form of increased interest expense. Looking at interest expense incurred by some sample local governments in fiscal year 2012 (**Chart C**), it is estimated that individual cities and counties would have faced an increase of approximately 15 percent in interest costs in fiscal year 2012 if the 28-percent cap proposal had been in effect during the 15-year period 1998–2012. This additional financial burden reflects the direct pass-through effect of the additional federal tax if it had been in place when the bonds were issued. Taxing the interest on municipal borrowing for investors would have the same effect as taxing state and local governments directly.

The information in Chart C was determined by taking the amount of interest paid by each jurisdiction in the last fiscal year, with a median interest average of 4.69 over the past 15 years (Thomson Reuters), and applying a 70 BPS increase for what the interest costs would have been if the bonds were issued with a cap in place, and applying a 200 BPS increase for what the interest costs would have been if the bonds were issued without the exemption in place. The estimates have been rounded to the 000.

CHART C

Municipal tax exemption loss and deduction cap impact

2012

	current law	with 28-percent cap		with full repeal	
	ACTUAL 2012 INTEREST PAYMENT COST WITH TAX EXEMPTION AS IS	ESTIMATED TOTAL INTEREST COST	COST INCREASE	ESTIMATED TOTAL INTEREST COST	COST INCREASE
Akron, OH	$37,327,482	$42,898,000	$5,570,518	$53,245,000	$15,917,518
Athens County, OH	$44,993	$51,708	$6,715	$64,179	$19,186
Avondale, AZ	$4,975,700	$5,718,000	$742,300	$7,097,000	$2,121,300
Baltimore, MD	$83,361,980	$95,804,000	$12,442,020	$118,910,000	$35,548,020
Boston, MA	$131,000,000	$150,552,000	$19,552,000	186,863,000	$55,863,000
Burnsville, MN	$2,100,000	$2,413,000	$313,000	$2,995,000	$895,000
Charlotte, NC	$34,750,000	$39,936,000	$5,186,000	$49,568,000	$14,818,000
Chattanooga, TN	$32,080,143	$36,868,000	$4,787,857	$45,760,000	$13,679,857
Chicago, IL	$800,000,000	$919,403,000	$119,403,000	$1,141,000,000	$341,000,000
Cleveland, OH	$103,624,286	$119,090,000	$15,465,714	$147,813,000	$44,188,714
Columbia, SC	$14,689,802	$16,882,000	$2,192,198	$20,954,000	$6,264,198
Dallas, TX	$183,165,993	$210,504,000	$27,338,007	$261,275,000	$78,109,007
Douglas County, NE	$2,730,088	$3,137,000	$406,912	$3,894,000	$1,163,912
Fairfax County, VA	$98,105,012	$112,747,000	$14,641,988	$139,941,000	$41,835,988
Grand Traverse County, MI	$821,279	$943,857	$122,578	$1,171,000	$349,721
Houston, TX	$159,025,000	$182,760,000	$23,735,000	$226,839,000	$67,814,000
Linn County, IA	$628,226	$721,991	$93,765	$896,126	$267,900
Louisville, KY	$592,370	$680,783	$88,413	$844,979	$252,609
Mecklenburg County, NC	$91,136,163	$104,738,000	$13,601,837	$130,000,000	$38,863,837
Mesa, AZ	$52,115,271	$59,893,000	$7,777,729	$74,339,000	$22,223,729
Montgomery County, MD	$94,200,000	$108,259,000	$14,059,000	$134,370,000	$40,170,000
New Haven, CT	$24,500,000	$28,156,000	$3,656,000	$34,947,000	$10,447,000
Oklahoma City, OK	$60,051,714	$69,014,000	$8,962,286	$85,660,000	$25,608,286
Philadelphia, PA	$356,404,987	$409,599,000	$53,194,013	$508,390,000	$151,985,013
Prince Georges County, MD	$53,800,000	$61,829,000	$8,029,000	$76,742,000	$22,942,000
Racine, WI	$4,045,739	$4,649,000	$603,261	$5,771,000	$1,725,261
Sacramento, CA	$54,544,102	$62,685,000	$8,140,898	$77,803,000	$23,258,898
Salt Lake City, UT	$13,826,914	$15,890,000	$2,063,086	$19,723,000	$5,896,086
Seattle, WA	$192,000,000	$220,656,000	$28,656,000	$273,876,000	$81,876,000
Taney County, MO	$902,030	$1,036,000	$133,970	$1,286,000	$383,970
Wake County, NC	$86,324,566	$99,208,000	$12,883,434	$123,136,000	$36,811,434
Wichita, KS	$41,214,518	$47,365,000	$6,150,482	$58,790,000	$17,575,482

SOURCE: AS PRODUCED BY GOVERNMENT FINANCE OFFICERS ASSOCIATION

The Broad Use of Tax-exempt Financing

Tax-exempt financing is used widely across the country by communities large and small. The $1.65 trillion of infrastructure financed by state and local governments in 2003–2012 was spread across nearly 58,000 individual transactions, with an average transaction size of $29 million (**Chart D**). Bonds financed everything from large, multibillion transportation projects to school expansions of several hundred thousand dollars and are used by governments ranging from the largest states to the smallest towns and school districts. Because the interest on municipal bonds is usually exempt from state income taxation for residents of the states in which they are issued, investors tend to buy bonds issued within their states. In that manner, local investment is often financed to a significant degree by local capital.

In the last decade (2003–2012) state and local governments financed more than **$1.65 trillion** of infrastructure projects through tax-exempt bonds.

CHART D

Infrastructure borrowing by state

LONG-TERM, TAX-EXEMPT
2003–2012

STATE	$ mil	# of issues	avg size ($ mil)
Alabama	16,984.5	724	23.5
Alaska	4,529.2	69	65.6
Arizona	36,128.0	808	44.7
Arkansas	10,089.9	1,421	7.1
California	232,831.4	4,600	50.6
Colorado	33,869.9	951	35.6
Connecticut	11,659.6	256	45.5
District of Columbia	5,846.7	64	91.4
Delaware	2,897.7	50	58.0
Florida	103,081.0	1,250	82.5
Georgia	40,975.6	676	60.6
Guam	909.8	8	113.7
Hawaii	4,675.0	48	97.4
Idaho	3,625.8	214	16.9
Illinois	59,454.8	2,927	20.3
Indiana	35,905.1	1,594	22.5
Iowa	9,280.2	1,471	6.3
Kansas	14,103.7	899	15.7
Kentucky	18,882.9	1,420	13.3
Louisiana	16,091.7	659	24.4
Maine	2,974.6	89	33.4
Maryland	19,221.8	268	71.7
Massachusetts	37,931.1	592	64.1
Michigan	46,304.3	2,130	21.7
Minnesota	27,593.8	2,309	12.0
Mississippi	5,604.1	383	14.6
Missouri	27,056.6	2,353	11.5
Montana	1,717.2	202	8.5
Nebraska	16,483.5	2,216	7.4
Nevada	19,750.7	253	78.1
New Hampshire	2,900.4	94	30.9
New Jersey	62,502.0	1,559	40.1
New Mexico	9,432.0	441	21.4
New York	149,790.1	3,581	41.8
North Carolina	28,390.8	449	63.2
North Dakota	1,992.6	392	5.1
Ohio	49,473.5	1,855	26.7
Oklahoma	12,851.5	2,209	5.8
Oregon	17,044.2	545	31.3
Pennsylvania	76,471.1	3,579	21.4
Puerto Rico	20,847.6	38	548.6
Rhode Island	3,535.3	101	35.0
South Carolina	28,590.3	681	42.0
South Dakota	2,518.9	357	7.1
Tennessee	18,892.7	574	32.9
Texas	193,415.7	6,524	29.6
Utah	14,070.1	401	35.1
Vermont	864.2	31	27.9
Virgin Islands	232.2	5	46.4
Virginia	25,828.5	359	71.9
Washington	49,529.8	1,264	39.2
West Virginia	4,442.5	132	33.7
Wisconsin	20,545.7	1,631	12.6
Wyoming	1,223.1	48	25.5
TOTAL	**1,661,845.0**	**57,754**	**28.8**

SOURCE: THOMSON REUTERS DATA, FEBRUARY 2013

Conclusion

Tax-exempt municipal bonds are the country's most important source of financing for infrastructure investment. Municipal bonds represent a partnership among the federal government, state and local governments, and private investors in contributing to public infrastructure which creates jobs and improves economic efficiency. The proposals to limit or eliminate the federal tax exemption for municipal bond interest would substantially impair the federalist system of government that currently exists and shift unnecessary cost burdens to local taxpayers. Tax-exempt bonds maintain decision making and project selection at the state and local level, where citizens and elected officials can best determine where needs are greatest and where investments will generate the maximum return. Finally, tax-exempt bonds force market tests of investment projects, since investors will not commit capital until they are convinced the credit behind the borrowing is financially sound. The default rate on borrowing by states and localities is near zero.

Congress should preserve the tax exemption for interest on municipal bonds. The tax exemption has successfully provided trillions in low-cost financing for infrastructure investment. Curtailing or eliminating the tax exemption would raise costs for financially-strapped state and local governments and would result in less investment in infrastructure at a time when jobs are scarce and the physical state of our public works is deteriorating.

CHART E

Infrastructure issuance volume by use

LONG-TERM, TAX-EXEMPT, $ MIL

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	totals
Airports	3,366.2	2,950.7	5,446.5	2,191.0	4,029.8	3,393.3	6,581.9	13,844.1	3,051.1	4,471.0	49,325.6
Bridges	2,721.7	1,213.4	706.9	3,228.2	1,957.7	2,471.0	1,698.1	1,362.0	1,424.2	3,380.3	20,163.5
Combined utilities	1,746.8	2,894.4	1,526.6	1,071.5	1,094.3	1,079.8	1,420.4	647.3	787.4	1,947.4	14,215.9
Fire stations & equipment	230.0	215.4	296.3	357.4	312.2	230.8	319.6	193.6	276.5	212.6	2,644.4
Flood control	6.2	0.0	0.0	0.0	1.0	0.0	1.6	4.4	5.4	0.0	18.6
Gas	0.7	352.6	397.7	515.2	2,957.2	3,477.3	2,210.6	1,322.5	186.8	2,176.6	13,597.2
General acute care hospitals	19,295.3	17,303.2	28,642.1	29,182.3	36,241.6	53,343.2	37,021.3	23,652.3	19,025.6	24,198.8	287,905.7
General purpose/public improvement	71.3	101.9	235.8	58.6	87.1	170.1	215.3	211.0	75.3	0.0	1,226.4
Government buildings	8.0	0.0	25.3	0.0	2.0	0.0	22.2	0.1	186.8	0.0	244.4
Mass transportation	9,011.7	9,922.6	11,627.9	13,775.1	8,405.5	12,635.7	8,348.2	5,607.3	9,143.2	17,146.0	105,623.2
Multifamily housing	7,055.1	3,585.1	2,923.6	1,826.1	952.3	2,357.5	3,216.7	3,141.3	2,539.0	3,439.7	31,036.4
Police stations & equipment	170.0	255.7	51.6	538.8	151.4	119.1	381.3	33.5	74.5	143.2	1,919.1
Primary & secondary education	51,432.5	54,059.4	72,570.7	59,218.1	62,631.5	47,084.3	40,915.7	34,221.0	37,375.3	54,548.3	514,056.8
Public power	15,834.3	6,524.2	12,983.8	21,190.4	19,717.1	19,762.0	11,743.8	17,137.1	9,905.7	12,194.2	146,992.6
Recycling	112.7	258.4	3.8	0.0	10.0	21.7	0.0	0.0	0.0	2.5	409.1
Sanitation	1,084.2	552.8	465.4	731.8	1,205.1	465.5	731.9	219.8	564.6	275.4	6,296.5
Seaports/marine terminals	1,062.8	276.4	328.6	790.0	1,889.4	1,211.4	719.7	1,821.7	943.6	100.1	9,143.7
Solid waste	1,091.2	815.8	522.7	755.5	819.2	1,724.1	703.4	1,602.2	846.2	387.6	9,267.9
Toll roads, highways, & streets	29,946.9	26,903.1	17,478.1	13,963.1	17,717.8	17,141.5	13,743.7	13,668.5	9,413.9	18,000.3	177,976.9
Tunnels	0.0	0.0	800.0	0.0	0.0	99.6	0.0	0.0	0.0	240.3	1,139.9
Water & sewer facilities	15,261.2	10,688.3	28,607.6	29,364.4	29,640.2	30,531.5	28,124.1	21,738.2	27,444.9	36,546.9	257,947.3
TOTALS	159,508.8	138,873.4	185,641.0	178,757.5	189,822.4	197,319.4	158,119.5	140,427.9	123,270.0	179,411.2	**1,651,151.1**

SOURCE: THOMSON REUTERS DATA, FEBRUARY 2013

NACO National Association of Counties

National Association of Counties
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Tel: 202.393.6226
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NATIONAL LEAGUE of CITIES

National League of Cities
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Washington DC 20004
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The United States Conference of Mayors
1620 Eye Street, NW
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Fax: 202.293.2352
usmayors.org

Written Statement for the Record of the Honorable Stephen K. Benjamin
Mayor of Columbia, South Carolina

<u>On behalf of the Municipal Bonds for America Coalition</u>

United States House of Representatives
Committee on Ways & Means
Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
March 19, 2013

The Honorable Steve Benjamin
1201 Main Street
Suite 1450
Columbia, SC 29201
803-253-6846

Contact:
Ralph Garboushian
1212 New York Avenue NW #250
Washington DC 20005
202-842-5430

Thank you for the opportunity to submit testimony in support of maintaining the tax exemption for municipal bonds.

Municipal Bonds for America (http://www.munibondsforamerica.org/) is a non-partisan coalition of municipal bond issuers, state and local government officials and other municipal market professionals working together to explain the benefits of the tax-exempt municipal bond market, which provides the financing needed to build vital infrastructure throughout the United States.

I serve as Mayor of the City of Columbia, the capital of South Carolina and home of the University of South Carolina and Fort Jackson, the army's premier training base. Like many cities, Columbia faces the dual challenges of maintaining aging infrastructure that is vital to health, safety and our local economy, and building new infrastructure to accommodate population and economic growth. Federal mandates and dwindling federal assistance add to these challenges. I also sit on the Executive Committee of Municipal Bonds for America.

Off the top, Municipal Bonds for America is pleased that Representatives Lee Terry and Richard Neal have introduced a resolution (H Res 112) celebrating the 200th anniversary of the first municipal bond and the 100th anniversary of the tax exemption for municipal bonds. The tax exemption for municipal bonds is not a special interest loophole or giveaway to the wealthy. It is a century-old compact between the federal government, state and local government, the public and investors that has built much of our nation's core infrastructure. I deeply appreciate Representative Terry's and Representative Neal's introduction of this resolution and urge the House to pass it.

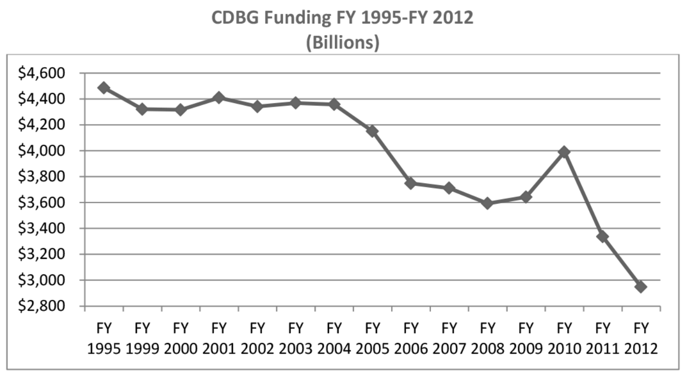
The era of fiscal cliffs, debt ceiling showdowns and budget stalemates in Washington has many Americans wondering whether our government institutions are equipped to tackle the major issues of our day. However, at the state and local level, government continues to accomplish the routine tasks we often take for granted: sanitation, patrolling city streets, responding to fires and other emergencies, inspecting buildings and educating our children. While Washington holds hearings, fights ideological battles about infrastructure funding sources and otherwise wrings its hands about our nation's aging infrastructure, state and local governments are busy creating jobs and building, renovating and maintaining the core infrastructure that serve as the backbone of civilized society and are essential to our economy, public safety and, most importantly, public health: schools, education, affordable housing, hospitals, airports, roads, reliable electric generation and distribution, bridges, highways, transit and water and wastewater systems.

I and most of my fellow state and local leaders are therefore increasingly concerned, if not alarmed, about proposals that would cap or even eliminate the primary tool that state and local governments use to finance these basic infrastructure investments: tax-exempt municipal bonds.

Tax-exempt municipal bonds are a stable, flexible and successful financing tool that are among the safest securities in the world; the default rate on investment grade municipal bonds is less than 0.1 percent. (The rare municipal default garners such broad and intense media coverage *because* of the rarity of such defaults.) The tax exemption for municipal bonds dates to the creation of the income tax. Its elimination would break a century-old commitment to local governments, the public and investors. It makes little sense to break this commitment in an era of ever-increasing federal mandates on local governments and increasingly scarce federal grants.

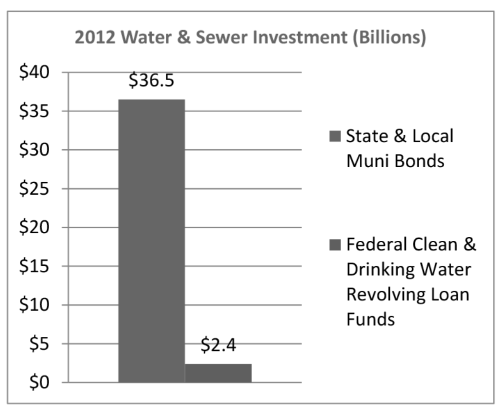
Indeed, given the downward funding trend and outright elimination of many core state and local government grant programs over the past decade, capping or eliminating the tax exemption for municipal bonds would effectively signal federal divestment in our nation's infrastructure.

One need look no further than the Community Development Block Grant program for evidence of how federal grants for infrastructure have dried up. Congress and successive Administrations have cut funding for this program by 34 percent since FY 1995. When measured for inflation and population increase: *Congress would have to increase funding by 270 percent to bring funding back to where it was in 1978!*



Similarly, federal funding for water and wastewater infrastructure has fallen from over 70 percent of such investments in the 1970's to a negligible share today. The federal funding that remains available for water and wastewater infrastructure investments comes mostly in the form of loans and is accompanied by so much paperwork and red tape that most utilities prefer to go to the bond market to finance improvements.

The majority of taxpayers who invest in tax-exempt bonds have annual incomes of less than $250,000. In addition, everyone in the community benefits from the infrastructure investments made with municipal bonds. And, the tax exemption lowers local government borrowing costs; its elimination would lead to rate and tax increases that would disproportionately impact low- and moderate-income households and rob us of tens of thousands of solid middle class jobs.



In more typical interest rate environments, the yield investors receive from municipal bonds is up to 200 basis points lower than what they would receive on a taxable bond. But, because of the tax benefit, municipal bonds become a comparable investment, allowing state and local governments to borrow at a lower rate, saving billions of taxpayer dollars. In addition, the cost to the federal government for not taxing these investments is insignificant compared to the jobs they create and sustain and the overall benefit that tax-exempt bonds provide for citizens in every community.

In the next decade, our capital improvement plan will require the City of Columbia to issue well in excess of $500 million in bonds. Removing or capping the tax exemption for municipal bonds would increase our borrowing costs significantly, an increase that would impact our taxpayers and utility ratepayers directly. According to a study by the Government Finance Officers Association (GFOA), in 2012, capping the tax exemption for municipal bonds at the 28 percent tax bracket as the Administration has proposed would have increased our borrowing costs by $2.1 million or 15 percent. The absence of the tax exemption would have increased our borrowing costs that year by $6.2 million or 42 percent. Either way, that is a big hit on a city with an annual budget of approximately $100 million! Simply put, if either proposal were enacted, we would have to choose between delaying needed investments or pushing these higher costs on to our taxpayers and ratepayers. (On water and sewer, where we must meet federal mandates, we would have no choice: we would have to pass those higher costs on to ratepayers.)

The arguments against the tax exemption suffer from significant flaws. In arguing that the tax exemption only benefits high-income taxpayers, critics fail to recognize that the tax exemption broadly benefits every American in the form of basic infrastructure, lower state and local taxes and lower utility rates. Other critics fail to appreciate the centrality to our economy and to public health and safety of state and local investments in water, wastewater, transportation and other core infrastructure. Implicit in these investments are jobs that are critical to the nation's economic recovery.

Most importantly, none of the proponents of eliminating or capping the exemption offer a realistic replacement to pay for basic infrastructure investments in a manner that does not burden state and local taxpayers and utility ratepayers with crippling tax and rate increases. As illustrated above, we are in an era of federal budget austerity. While grants may be an efficient means of assisting state and local infrastructure investment, state and local governments clearly cannot count on them. Similarly, while Build America Bonds and other direct subsidy and tax-credit bonds are a good *complement* to traditional tax exempt municipal bonds, they would be a poor replacement for numerous reasons:

- They have a narrower market than traditional municipal bonds,
- Programs to date have been too small to meet our nation's infrastructure needs,
- Their underwriting costs are more expensive than traditional municipal bonds, making them a poor choice for small issuers and
- In the case of direct subsidy bonds, sequestration has eaten into the subsidy, creating mid-year budget difficulties for many issuers,
- Sequestration has shown that the federal subsidy provided by these bonds can not be relied upon, injecting uncertainty into the marketplace.

Tax exempt municipal bonds provide our nation with the certainty of a stable, flexible and successful tool for financing infrastructure. I urge the Committee to refrain from limiting or eliminating this time-tested and valuable tool.

Municipal Bonds for America

MUNICIPAL BONDS FOR AMERICA is a non-partisan coalition of municipal bond issuers and State and local government officials along with other municipal market professionals working together to explain the benefits of the tax-exempt municipal bond market which provides the financing needed to build vital infrastructure throughout the United States.

As we work to renew economic growth in America, it is critical that cities and states have access to the capital they need to make our nation competitive.

Harry Black, Director of Finance at the City of Baltimore

SUPPORTING ORGANIZATIONS

Airports Council International – North America
American Public Gas Association
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Investment Company Institute
Kentucky School Boards Association
National Association of Local Housing Finance Authorities
National League of Cities
National School Boards Association
South Carolina Jobs Economic Development Authority (SCJEDA)

Texas Association of Local Housing Finance Agencies
The Associated General Contractors of America
The League of Minnesota Cities

INSTITUTE ON TAXATION AND ECONOMIC POLICY

Official Testimony

Informing the debate over tax policy nationwide

Federal Tax Reform: Effects on State and Local Governments

Matthew Gardner, Executive Director of the Institute on Taxation and Economic Policy

Testimony before the Senate Committee on Finance, United States Senate for Hearing:
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

March 19, 2013

Thank you for the opportunity to submit this written testimony. My name is Matt Gardner and I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP), a Washington-DC-based nonprofit research group. ITEP's research focuses on federal and state tax policy issues with an emphasis on the goals of sustainability, transparency and fairness in the tax laws.

Federal tax reform can affect state and local taxes in several ways. The federal government can create, repeal or change tax expenditures in a way that is passed on to the states because virtually every state has tax rules linked to the federal rules. The federal government can subsidize state and local governments' ability to raise taxes and can subsidize their ability to borrow funds to finance capital investments. Finally, the federal government can regulate state and local governments' ability to raise taxes in a way that coordinates and harmonizes their tax rules or in a way restricts their taxing power and makes their tax systems more complex.

My testimony makes four points.

> **1. Federal tax reform can provide state governments an opportunity to improve their finances by repealing or reducing tax expenditures.**
>
> **2. The federal income tax deduction for state and local taxes is indeed a tax expenditure that reduces the amount of revenue collected by the federal personal income tax, but in many ways is more justified than many other tax expenditures.**
>
> **3. The federal government's practice of not taxing the interest income on state and local bonds is an inefficient way to subsidize state and local governments, and the President's proposal to extend Build America Bonds would mitigate this problem.**
>
> **4. When lawmakers consider legislation intended to coordinate tax rules among the states, they must distinguish proposals that will truly achieve this result (like the Marketplace Fairness Act) from those that simply restrict states' taxing powers at the behest of corporate interests (like the Business Activity Tax Simplification Act).**

Federal Tax Reform Can Provide State Governments an Opportunity to Improve Their Finances

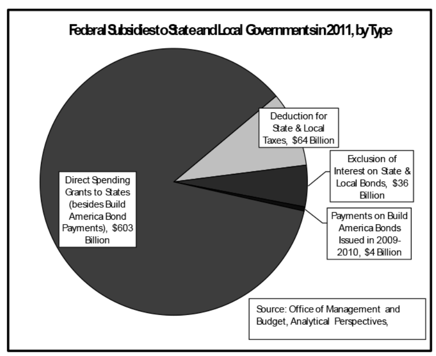
Federal tax reform can have a major impact on state and local taxes and revenues most obviously because virtually every state has tax rules that are linked to the federal rules. For example, many states have personal income taxes and corporate income taxes that have the same "base" as the federal personal income tax and corporate income tax, which is another way of saying they follow the federal rules to define what income is taxable. This is true even though these states have their own rate structures, which are not linked to federal income tax rates in any way.

A federal tax reform that eliminates or reduces many of the deductions and exclusions used in calculating federal income taxes would automatically do the same for most state governments, but state income tax rates would be left unchanged because they are not linked to the federal rules. This would, of course, increase state revenues unless states subsequently act to reduce their tax rates or make some other changes.

Indeed, this is what occurred following the Tax Reform Act of 1986. Provisions of the 1986 act that closed federal income tax loopholes expanded the income tax base for states. Some states responded by cutting their tax rates while others used the increased revenues to finance public investments.

This could be particularly important today, as state governments have just experienced the greatest drop in revenue on record. State revenues have improved since the recession but remain 6 percent below where they were five years ago.[1] Meanwhile, the end of federal aid from the economic recovery act enacted in winter of 2009 combined with sequestration , and the resulting drop-off in spending at the state and local level, serves as an anti-stimulus to the economy, potentially slowing down the recovery. The state governments' experience during the recession also begs the question of whether or not their existing tax systems — most of which are linked to federal rules — are sufficient to weather the next economic downturn.

The Federal Income Tax Deduction for State and Local Taxes Has Significant Justifications



When taxpayers calculate their federal personal income taxes, they are allowed to itemize deductions (that is, deduct certain expenses from their income to calculate taxable income) or take the standard deduction if that is greater than the sum of their itemized deductions. One of the itemized deductions that reduces federal taxable income the most is the deduction for state and local taxes.

Like many deductions, exclusions, credits and preferential tax rates, the deduction for state and local taxes is listed as a "tax expenditure" in reports compiled annually by the Congressional Joint Committee on Taxation and the Treasury Department. That means that the deduction is defined by analysts as a subsidy that is paid through the tax code rather than as a direct payment from the government.

[1] Nicholas Johnson and Michael Leachman, "Four Big Threats to State Finances Could Undermine Future U.S. Prosperity," Center on Budget and Policy Priorities, February 14, 2013.
http://www.cbpp.org/cms/index.cfm?fa=view&id=3903

The deduction for state and local taxes paid is often seen as a subsidy for state and local governments because it effectively transfers the cost of some state and local taxes away from the residents who directly pay them to the federal government. For example, if a state imposes a higher income tax rate on residents who are in the 39.6 percent federal income tax bracket, that means that each dollar of additional state income taxes can reduce federal income taxes on these high-income residents by almost 40 cents.[2] The state government may thus be more willing to enact the tax increase because its high-income residents will really only pay 60.4 percent of the tax increase, while the federal government will effectively pay the remaining 39.6 percent.

1. Tax Expenditure or a Way to Define Taxable Income?

Viewed a different way, the deduction for state and local taxes is not a tax expenditure at all, but instead is a way to define the amount of income a taxpayer has available to pay federal income taxes. State and local taxes are an expense that reduces one's ability to pay federal income taxes in a way that is generally out of the control of the taxpayer. A taxpayer in a high-tax state has less income to pay federal income taxes than a taxpayer with the same pre-tax income but residing in a low-tax state.

Most other itemized deductions are for expenses that the taxpayer has more control over, like home mortgage interest or charitable giving.

2. Addressing Spillover Effects of State and Local Public Investments

Another argument in favor of the itemized deduction for state and local taxes paid is that the public investments funded by state and local taxes produce benefits for the entire nation. This can be seen as a justification for the deduction for state and local taxes paid because it encourages state and local governments to raise the tax revenue to fund these public investments that the jurisdictions might otherwise not make.

For example, state and local governments provide roads that, in addition to serving local residents, facilitate interstate commerce. State and local governments also provide education to those who may leave the jurisdiction and boost the skill level of the nation as a whole, boosting the productivity of the national economy. State and local governments may have an incentive to provide less of these public investments than is optimal for the nation because the benefits partly go to those outside the jurisdiction.

It is probably impossible to quantify exactly what fraction of the benefits of public investments accrue to those outside the jurisdiction instead of those residing in the jurisdiction, but it seems unreasonable to deny the existence of these "spillover" effects.

The federal government also directly subsidizes (with direct cash payments) state and local governments to encourage them to make these public investments. Indeed, 85 percent of the federal subsidies to state and local jurisdictions in 2011 took the form of direct spending rather than tax subsidies.[3]

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[2] The Alternative Minimum Tax (AMT) and the "Pease" limitation on itemized deductions can, in some cases, limit the savings a high-income individual would otherwise derive from the itemized deduction for state and local taxes paid.

[3] Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013, pages 252-253, 302. http://www.whitehouse.gov/omb/budget/Analytical_Perspectives/

3. Prioritize Repeal of Most Regressive Tax Expenditures First

One approach for lawmakers contemplating tax reform is to prioritize repeal of tax expenditures based on how regressive they are. This would be in keeping with special attention Congress and the public have lately paid to income inequality and tax fairness. Under this approach, it is not obvious that lawmakers would prioritize repeal of the deduction for state and local taxes, for two reasons.

First, as already explained, it might make sense to view the deduction for state and local taxes paid not as a tax expenditure, but as a way to help define income. Second, even if one does view the deduction as a tax expenditure, repeal of another category of tax expenditures (the tax preferences for investment income) would take a far higher priority.

Share of Tax Increase from Repealing Federal Tax Expenditures in 2013

Income Group	Deduction for State and Local Taxes Paid	Preferential Income Tax Rate for Capital Gains & Dividends
Lowest 20%	0%	0%
Second 20%	0%	0%
Middle 20%	3%	1%
Fourth 20%	12%	4%
Next 15%	34%	11%
Next 4%	18%	15%
Top 1%	32%	69%
ALL	100%	100%

Source: Institute on Taxation and Economic Policy (ITEP) microsimulation tax model, March 2013

For example, 32 percent of the benefits of the deduction for state and local taxes will go to the richest one percent of taxpayers this year. This means the deduction certainly benefits the rich disproportionately. However, the special, low income tax rate for capital gains and stock dividends is much more skewed toward the rich, with 69 percent of the benefits going to the richest one percent of taxpayers. The fact that this income tax preference for capital gains and stock dividends has a very weak policy rationale, combined with its extremely regressive impact, should prompt lawmakers to prioritize its repeal as part of tax reform.[4]

Unfortunately, many proposals offered as “tax reform” would repeal or limit the deduction for state and local taxes paid (and other itemized deductions) but leave in place or even expand the income tax preferences for investment income.[5] This is exactly backwards.

Federal Subsidies for State and Local Debt Would Be More Efficient Under the President’s Build America Bonds Proposal

In general, the federal personal income tax does not tax interest payments made by state and local governments to their bondholders. State and local governments are therefore able to pay a lower interest rate to bondholders, who will accept a lower interest payment because it will not be taxed.

Unfortunately, the amount of money that state and local governments save by paying lower interest rates is less than the amount of revenue that the federal government loses. In other words, the personal income tax exclusion for tax-exempt bond interest is an inefficient way to subsidize state and local governments because the subsidy to the state and local governments is less that the amount of revenue that the federal government loses. The difference is a windfall to bondholders.

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[4] For more details, see Citizens for Tax Justice, “Policy Options to Raise Revenue,” March 8, 2012. http://ctj.org/pdf/revenueraisers2012.pdf

[5] For example, the budget plans devised by Republican House Budget Committee Chairman Paul Ryan would reduce or eliminate unspecified deductions and tax credits but leave in place the tax preference for capital gains and stock dividends. See Citizens for Tax Justice, “Ryan Budget Plan Would Cut Income Taxes for Millionaires by at Least $187,000 Annually and Facilitate Corporate Tax Avoidance,” March 22, 2012. http://www.ctj.org/pdf/ryanplan.pdf Other proposals go further. For example, during his 2012 presidential campaign, former Republican House Speaker Newt Gingrich proposed a “flat tax” that would actually have two rates, zero percent for capital gains, stock dividends and interest and 15 percent for other income, and would not allow a deduction for state and local taxes paid.

This occurs because most of the bondholders are high-income individuals who have a marginal income tax rate of 35 percent or 39.6 percent and corporations that pay the 35 percent corporate income tax rate, and these taxpayers could be motivated to buy the bonds if the interest paid on them was enough to at least equal the interest income they would receive from ordinary bonds after paying income taxes on that income. But state and local governments often find that they need to make the bonds attractive to individuals with lower marginal tax rates, and thus pay interest at rates that are higher than needed to attract the majority of their bond holders (those with a marginal tax rate 39.6 percent or 35 percent). The majority of the bondholders are thus getting a benefit in excess of what would be necessary to motivate them to buy the bonds.

In his written testimony for a Senate Finance Committee hearing on this topic last year, Frank Sammartino of the Congressional Budget Office explained,

> "In 2009, the average yield on (taxable) high-grade corporate bonds was 5.3 percent, and the average yield on tax-exempt municipal bonds of similar creditworthiness was 4.6 percent—a difference of 0.7 percentage points, or approximately 13 percent of the taxable return. That 13 percent also represents the marginal tax rate at which an investor would be indifferent between purchasing a taxable bond yielding 5.3 percent and a tax-exempt bond yielding 4.6 percent."

Sammartino went on to cite studies showing that most of the bondholders are taxpayers with a marginal tax rate that is much higher than that and, as a result, about 20 percent of the revenues foregone by the federal government are a subsidy to these bondholders rather than to the state and local governments issuing the bonds.[6]

This problem would be remedied under the President's proposal to revive and reform Build America Bonds, a special type of bond that state and local governments were allowed to issue in 2009 and 2010 under the economic recovery act enacted in the winter of 2009. The interest paid on these bonds is not excluded from the income of the bondholders. Instead, the federal government simply makes a payment of a certain percentage of the interest payments to the state and local governments. The government issuing the bonds can afford to pay interest at market rates, and the subsidy takes the form of a direct payment that goes entirely to the state or local government. The bonds are also attractive to some tax exempt entities (like pension funds) that have no incentive to buy the state and local bonds that pay interest at lower rates but are tax-free.

The direct payments made from the federal government to the state and local issuers of the bonds issued in 2009 and 2010 equal 35 percent of the interest paid, which was particularly generous and was intended to help state and local governments weather the recession. The proposal included in the President's most recent budget plan would make Build America Bonds permanently available and would provide state and local bond issuers direct payments equal to 28 percent of the interest paid to bondholders. The Obama administration estimates that this is the rate at which encouraging a switch from traditional tax-exempt bonds to Build America Bonds would be roughly revenue-neutral for the federal government.[7]

A key point about this proposal is that it is roughly revenue-neutral precisely because it would replace a wasteful tax subsidy with a better targeted subsidy that is provided through direct spending by the federal government.

Technically, federal tax revenue will rise (because there will be fewer taxpayers benefiting from the income tax exclusion for interest on state and local debt) and federal outlays will rise (because payments will be made

[6] Frank Sammartino, "Federal Support for State and Local Governments Through the Tax Code," Testimony Before the Committee on Finance, April 25, 2012. http://finance.senate.gov/imo/media/doc/Testimony%20of%20Sammartino.pdf
[7] U.S. Treasury Department, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, February 2012, page 11. http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

directly from the federal government to the state and local governments). But from a budgetary and economic perspective, nothing will have changed except that the subsidy will be more efficiently targeted at the state and local governments it is intended to help.

This point has not been fully understood. For example, during last year's Senate Finance Committee hearing on this topic, the ranking Republican, Senator Orrin Hatch of Utah, said that the President's Build America Bonds proposal would result in "an increase in taxes of $63 billion" over ten years and that "this would naturally increase the size of the federal government by $63 billion" over ten years.

This view fails to recognize that the federal government can provide the exact same type of subsidy through the tax code or through direct payments. Changing a tax subsidy into a direct payment is simply paying the subsidy in a different, potentially more efficient way. In the case of state and local bonds, the current subsidy provided through the tax code is less efficiently targeted to the intended recipients (state and local governments) than would be the case if the subsidy were provided as direct payments (payments made from the federal government to state and local jurisdictions to offset part of their interest expense).

Lawmakers Must Distinguish Proposals to Coordinate and Streamline State and Local Taxes from those Intended Only to Restrict Them

Congress frequently considers proposals for regulating state and local tax administration. These proposals can either facilitate state and local governments' exercising their taxing authority in a fair, efficient way, or limit their taxing authority and complicate taxes in response to heavy lobbying from multistate corporations and other special interests. While some proposals to coordinate tax rules between state and local governments would ease efficient collection of taxes, many of these proposals are simply ways to restrict state and local taxes at the behest of corporations and other powerful interests. Lawmakers need to distinguish between the two.

1. Taxing the Income of Corporations and Other Businesses

When determining the extent to which a state can tax the income of a particular business under current law, the first question is whether or not the business has sufficient contacts with the state to be taxed at all (whether the business has sufficient "nexus" with the state to be taxed by it). The second question is how states allocate among themselves the income of those businesses that do have sufficient nexus to be taxed.

In the 1950s and 1960s, Congress hindered states from answering the first question in a sensible way, but nonetheless helped states answer the second question in a sensible way.

Under Public Law 86-272, enacted in 1959, Congress declared that a business selling physical goods in a state would not have sufficient "nexus" with the state to justify being taxed unless the business had a "physical presence" (generally meaning property or employees) in the state. This meant that a state could not tax a company's income if that company did not have stores or physical operations in a state but solicited orders for sales of goods to be shipped from outside the state.

This physical presence standard has done more harm than good. The so-called "Business Activity Tax Simplification Act (BATSA)" would extend the same standard to businesses with income from other types of sales (sales of services or intangible products) into a given state, and would wreak havoc on state tax collections for reasons that will be explained below.

While the 1959 act unnecessarily and restrictively defined the "nexus" a company must have in order for a state to tax its income, it left open the question of how exactly states should tax the income of those businesses that do have sufficient nexus. To explore this question, the act established a special subcommittee known as the Willis Committee that actually did help states coordinate their tax collection efforts in an efficient way.

The Willis Committee Report is an example of Congress facilitating coordinated and efficient tax collection among the states without actually enacting any federal legislation. Rather, the Willis Committee's very suggestion that Congress should enact legislation to fairly apportion business income to states based on certain factors prompted most of the states with a corporate income tax to adopt a similar proposal known as the Uniform Division of Income for Tax Purposes Act (UDITPA).[8]

The basic idea behind UDITPA is that a business with sufficient nexus with a given state will have a portion of its income taxed by that state based on the percentage of property, payroll and sales in the state. While there might be many ways, in theory, to define the proportion of income a multistate business earned in a particular state, this method is the most straightforward and fairest way. If each state adopted UDITPA and continued to follow it, then each portion of a multistate business's income would be taxed once, and only once.

In recent years, states have strayed from the basic principles behind UDITPA by altering their apportionment formula (by, for example, double-weighting the sales factor) or by replacing it entirely with a single-factor formula relying on sales alone. Many states have been convinced that companies will be more willing to locate headquarters or operations within their borders if having payroll and property in the state does not increase the percentage of the company's income subject to state taxes.[9]

This has made state tax collection more complicated, less efficient, and less fair. A company in State A might be subject to State A's corporate income tax under an apportionment formula that considers three factors (the percentage of property, payroll and sales in the state) but if State A adopts a single-factor formula based on sales, some of the company's income could escape taxation entirely.

This can happen because the company sells many of its goods to a state that does not have a corporate income tax or a state where the company does not have any physical presence, meaning it lacks the sufficient "nexus" to be taxed by that state. The possibility of such "nowhere" income (income that is not taxable in any state) is obviously very attractive to multistate corporations, which lobby states to enact single-factor formulas based on sales.[10]

States have strayed from the three-factor formula mainly at the behest of corporations that understood this would enable their tax avoidance.[11] Congress should be very careful that any proposal to coordinate state taxes on business income move us back to the simple, straight-forward three-factor apportionment formula rather than away from that formula.

Unfortunately, the most prominent legislation in this area would move the country in the wrong direction by further restricting the level of "nexus" of business must have with a state in order for its income to be taxed by that state.

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[8] Joe Huddleston and Shirley Sicilian, "The Project to Revise UDITPA," from the Proceedings of the New York University Institute on State and Local Taxation, 2009. http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf

[9] Institute on Taxation and Economic Policy, "Corporate Income Tax Apportionment and the 'Single Sales Factor,'" August 2011. http://www.itepnet.org/pdf/pb11ssf.pdf

[10] Institute on Taxation and Economic Policy, "'Nowhere Income' and the Throwback Rule," August 2011. http://www.itepnet.org/pdf/pb39throw.pdf

[11] The result, as highlighted in a December 2011 report by my organization, is that an astonishing number of Fortune 500 corporations are finding ways to avoid paying any state corporate income taxes despite being hugely profitable. See Institute on Taxation and Economic Policy and Citizens for Tax Justice, "Corporate Tax Dodging in the Fifty States, 2008-2010," December 7, 2011. www.ctj.org/corporatetaxdodgers50states

This legislation is the so-called Business Activity Tax Simplification Act (BATSA), H.R. 1439, which was most recently introduced during the last Congress. This legislation would make state and local taxes on businesses dramatically more complex, increase litigation related to business taxes, increase government interference in the market and reduce revenue to state and local governments by billions of dollars each year.[12]

Even if the "physical presence" standard made any sense, it would not matter under H.R. 1439 because it is not the standard set out in the bill. The bill has many "safe harbors" which are essentially loopholes allowing large corporations with lobbying clout to avoid state and local taxes even though they have what any rational person would call a "physical presence" in the jurisdiction.

For example, under BATSA, a company that sends a full-time worker into another state each day to install equipment could be subject to that state's taxes. However, if the company created two subsidiaries which each provided half of the equipment and which each hired the worker to perform the installations, the state would not be able to tax the business under BATSA.

The state would also be unable to tax a business if the employee was only sent into the state 14 days each year, or if the company created several subsidiaries that each hired the employee and sent him or her into the state for just 14 days each year.

If the company warehoused items in the state before shipping them to customers, one would think this constitutes "physical presence," but under BATSA it might not. Items could be warehoused in the state by a second company that ships them to customers and this second company could also be exempt from the state's business activity taxes under the exception for third-party "fulfillment" activities.

Perhaps the most outrageous abuses would occur when a company is actually based in the state in question. Such a company might create subsidiaries in other states (states without business activity taxes) and transfer trademarks and logos to them. The company would then pay royalties to those subsidiaries for the use of the trademarks and logos, and these payments would reduce or even wipe out the income reported to the state where the company is based. Most states currently have laws that allow them to tax the out-of-state subsidiaries receiving royalties in this scenario, but BATSA would nullify those laws so that this type of tax avoidance would increase dramatically.

The various intricacies of BATSA that would encourage more aggressive tax planning would naturally lead to increased litigation. Besides that, some of the safe harbors in BATSA are not defined at all, which will certainly leave state and local governments no choice but to call upon the courts to interpret the provisions of the law when companies manipulate them.

For example, even a company that has physical property and employees in a state will not have a "physical presence" there under BATSA if the property and employees are only used to carry out "limited and transient business activity," which is left undefined. It's difficult to imagine how this ambiguity would *not* lead to increased litigation.

Perhaps some lawmakers may comfort themselves with the notion that despite all of these problems, in the end BATSA will mean the government has a lighter hand in the economy because businesses will be taxed by fewer state and local governments.

To the contrary, BATSA is the ultimate example of government picking "winners and losers" among businesses competing against each other. BATSA would create artificial advantages for very large, multi-state companies

[12] For more details on the problems with the Business Activity Tax Simplification Act, see Michael Mazerov, "Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits And Harm the Economy," Center on Budget and Policy Priorities, updated April 13, 2011. http://www.cbpp.org/cms/index.cfm?fa=view&id=424

that conduct most of their business online or over the phone and which have the resources to engage in the type of tax avoidance schemes already described.

2. Requiring Businesses to Collect Sales Taxes on Interstate Sales

Whereas the previous section of this testimony addressed the extent to which a state can tax a multistate business's income, another question is the extent to which a state can require a multistate business to collect sales taxes. This question has nothing to do with taxes on the business's income, but merely asks whether or not the business must take the administrative step of collecting sales taxes that its customers are required to pay.

In a jurisdiction that imposes a sales tax, a business that sells a product from a physical store is required to collect the sales tax from the buyer. The sales tax is not paid by the seller but by the buyer, whose total purchase price includes the sales tax as well as the underlying retail price of the product. The business that sells the product is merely required to collect the tax and pass it on to the state or local government.

However, when a person in the state buys a product online, the state is often unable to require the business selling the product to collect the sales tax because the business does not have a physical presence in the state. This level of "nexus" (the connection that a business must have with a state before the state can require it to collect sales taxes) was imposed not by Congress but by the U.S. Supreme Court's interpretation of the Commerce Clause in a 1992 decision.[13]

Under the Supreme Court's decision, Congress can decide to grant the states the authority to require out-of-state businesses to collect sales taxes on sales into their jurisdictions. This would make it far easier for state and local governments to adapt to the internet age.

The question is not whether or not sales taxes should be imposed, but who has responsibility for collecting them and delivering them to the state or local government. In states with sales taxes, internet purchases (and other purchases from out-of-state businesses) are subject to the sales tax, but the buyers themselves are required to calculate the sales tax and send it to the state or local government. (In these cases the tax is technically called a "use tax.") But these rules are unenforceable. Needless to say, almost no one who buys a product from Amazon thinks to calculate their sales taxes and send a payment to their state or local government.

A bill before Congress would allow states to require internet sellers and other out-of-state sellers to collect sales taxes in return for states simplifying their sales taxes. The legislation, the Marketplace Fairness Act (MFA), S. 336, is an example of a federal proposal that really would help states coordinate their tax rules and collect revenue in a more efficient way.

The MFA would allow states to compel remote retailers to collect sales taxes from customers. This power would be available for states that adopt a minimal set of common rules (which mostly involve harmonizing sales tax rules for taxing jurisdictions within the state's borders). Twenty-four states have already joined what is called the Streamlined Sales and Use Tax Agreement (SSUTA), which includes a common set of sales tax rules, and would be authorized to require sales tax collection immediately under the MFA. Other states would be authorized if they meet the minimal standards set out in the bill.

SSUTA does not restrict member states' power to set their own sales tax rates or even their power to determine the base of their sales tax (which sales are subject to the sales tax) but requires them to use uniform definitions to define the sales tax base. This addresses the complexity that motivated the Supreme Court's

[13] *Quill Corporation v. North Dakota* (U.S. 1992).

1992 decision — the complexity that would otherwise be faced by multistate business with sales in several jurisdictions with different sales tax rules.[14]

New technology, combined with the harmonized sales tax rules under SSUTA, would make it relatively easy for internet retailers to determine what sale taxes apply in a customer's jurisdiction. We know this because major retailers that have a "physical presence" in numerous states, like Best Buy and Barnes and Noble, already collect sales taxes on sales made over the internet, in addition to those made inside their physical stores. Similarly, Amazon collects sales tax on behalf of a number of merchants located all around the country that sell via its website, though it mostly refuses to do so on items it sells directly. Netflix's CEO summed up the reality of the tax complexity problem when he said, "We collect and provide to each of the states the correct sales tax. There are vendors that specialize in this... It's not very hard."[15]

Opponents of the Marketplace Fairness Act have incorrectly labeled it a tax hike. The bill doesn't actually create a new tax, nor does it raise an existing one. Rather, it merely creates a mechanism to collect taxes that have always been owed.

Failing to collect these taxes creates two major problems. First, states are losing out on badly needed revenue. Second, traditional brick and mortar stores are at a competitive disadvantage when their customers have to pay a tax that online shoppers are able to evade. There is no reason for large online retailers like Amazon to have this sort of competitive advantage — which exists only because of tax law — over businesses that operate in traditional, physical stores.

As an extreme example of this second problem, in many instances customers will go so far as to examine and "try out" merchandise at stores, only to return home and purchase the same product online in order to evade their sales tax responsibility. It's no surprise then that numerous organizations representing retail owners, such as the Retail Industry Leaders Association (RILA), support the bill.[16]

[14] Institute on Taxation and Economic Policy, "How Can States Collect Taxes Owed on Internet Sales?" July 2011. http://www.itepnet.org/pdf/pb2quill.pdf
[15] Id.
[16] Joint Statement of Senators Michael B. Enzi, Richard J. Durbin, Lamar Alexander, Tim Johnson, John Boozman, Jack Reed, Roy Blunt, Sheldon Whitehouse, Bob Corker, Mark Pryor for Hearing: Tax Reform: What It Means for State and Local Tax and Fiscal Policy, April 25, 2012.

City of NORWALK

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March 25, 2013

The Honorable Dave Camp
Chairman, Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member, Committee on Ways & Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Re: Tax Exempt Municipal Bonds

Dear Mr. Chairman and Ranking Member:

On behalf of the City of Norwalk, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." The City of Norwalk is very concerned about proposals to cap or eliminate the tax exempt status of municipal bonds.

The City of Norwalk utilizes tax-exempt municipal bonds to finance public infrastructure projects that generate jobs and promote economic growth in our community. Tax-exempt municipal bonds have allowed the City of Norwalk to complete recent water-related infrastructure improvements including the construction of a high-capacity water well; past projects include the Norwalk Arts & Sports Complex, Aquatic Pavilion, City Transit and Public Services facility and a City parking structure.

Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for schools, hospitals, transit and infrastructure for water, roads, and public power.

Proposals to limit or eliminate tax deduction for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (.7 percent), requiring issuers to pay more in interest in order to attract the same investors.

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bonds.

Tax exempt municipal bonds are an effective means of attracting private investment to public projects. We strongly oppose any changes made to the tax exempt status of municipal bonds and would encourage you reject any such proposals in a future tax package the committee may consider.

Thank you for your attention to this important issue.

Sincerely,

Luigi Vernola
Mayor

Cc: Linda Sanchez, Congresswoman (FAX: 202-226-1012)
Ron Calderon, Senator (FAX: 916-327-8755)
Ian Calderon, Assemblymember (FAX: 916-319-2157)
Cristina Garcia, Assemblymember (FAX: 916-319-2158)
Kristine Guerrero, League of California Cities (Email: kguerrero@cacities.org)

Congress of the United States
Washington, DC 20515

March 28, 2013

The Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives
1106 Longworth
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1106 Longworth
Washington, D.C. 20515

Dear Chairman Camp and Ranking Member Levin:

As members of the House Judiciary Committee, we are well-acquainted with issues pertaining to state taxation and their impact on interstate commerce. One such issue is the manner and rate in which states and localities are discriminatorily taxing wireless services. Currently, wireless consumers pay an average of 17.2% in taxes and fees, more than twice the rate of 7.4% on other goods and services.

Last Congress, we introduced H.R. 1002, the "Wireless Tax Fairness Act" to halt this trend by imposing a temporary, five-year freeze on new discriminatory taxes that are imposed only on wireless services. As a former San Jose County Supervisor and Arizona State Representative respectively, we are both sensitive to the taxing prerogatives of state and local governments; however, as the Federal Communications Commission (FCC) explained in the National Broadband Plan, "wireless broadband is poised to become a key platform for the innovation in the United States over the next decade." Clearly, wireless services are an important component of our domestic and global digital economy, and have become a major driver of economic growth and opportunity. This is especially true for minority and low-income Americans, who typically use wireless devices to access the Internet even more than other Americans.

H.R. 1002 was truly a model for bipartisan legislation. It enjoyed the support of 236 of our colleagues, many of whom are Ways and Means Committee members, and passed the House on the Suspension Calendar by voice vote on November 1, 2011. Despite the overwhelming support in the House, the Senate failed to take it up before it adjourned the 112th Congress.

In the coming weeks, we plan on reintroducing the "Wireless Tax Fairness Act" and are hopeful that Chairman Goodlatte and the Judiciary Committee will take it up expeditiously and move it to the Floor for consideration. As you know, the Senate Finance Committee will hold jurisdiction over the Senate companion bill. As your Committee continues its work on comprehensive tax reform, we respectfully ask that you keep this pro-consumer, pro-broadband legislation in mind as the Committee moves forward in its consideration with your counterpart, the Senate Finance Committee.

Sincerely,

Zoe Lofgren
Member of Congress

Trent Franks
Member of Congress

My name is Louis Jambois, and I am the President of the Saint Paul Port Authority. For purposes of your submission requirements, the following information is pertinent:

Name:	Louis Jambois
Organization:	Saint Paul Port Authority
Address:	380 St. Peter Street Suite 850 St. Paul, MN 55102
Phone:	651-224-5686
Contact email:	lfj@sppa.com

Title of Hearing:	Tax Reform and Tax Provisions Affecting State and Local Governments (March 19, 2013)

I would like to speak in opposition to any further limitations on tax-exempt bonds.

The Saint Paul Port Authority uses tax-exempt bonds to promote economic development that is significant to the City of Saint Paul and the State of Minnesota. The tax exempt bonds that we issue are typically qualified for tax-exempt treatment as a result of being:

- Governmental bonds to finance environmental remediation and infrastructure;
- Qualified 501(c)(3) bonds used to support the work being done in Saint Paul by a very strong non-profit community, including schools, hospitals and social service agencies;
- Qualified exempt facility bonds used to provide and expand Saint Paul's noteworthy district heating and cooling system and provide other needed facilities, such as solid waste disposal; and
- Small issue bonds for manufacturing projects that provide much-needed job creation and tax revenue.

Over the last ten years, the Saint Paul Port Authority has issued approximately $332,500,000 of tax-exempt bonds in these four categories.

The work of the Saint Paul Port Authority includes:

- Contamination remediation of more than 1,200 acres of brownfield property—property that could not be re-purposed without remediation.
- The development of 21 business centers on former brownfield sites.

- Those business centers are home to businesses that have created more than 21,000 living wage jobs (not including construction jobs); and

- Have resulted in facilities that now contribute more than $32 million of property tax revenue to the City; and/or

The availability of tax-exempt financing is a significant and valuable tool to the Saint Paul Port Authority. Without it, we would not be able to provide comprehensive economic development support to the City in general, or to the nonprofit community that plays such a critical role in the life of Saint Paul and the greater Metro East community.

It is essential for local governmental units, such as the Saint Paul Port Authority, to have the power and flexibility to provide financing that results in job creation, tax revenue and the building and repair of infrastructure. Please do not take that away from us by further restricting our power to issue tax exempt bonds.

Statement for the Record
Submitted on behalf of the City of Seattle, Seattle City Light,
and Seattle Public Utilities
Marco Lowe, Director of Intergovernmental Relations, City of Seattle
Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
House Ways and Means Committee
April 2, 2013

Thank you for the opportunity to provide a statement for the record related to your March 19 hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments." This statement is written on behalf of the City of Seattle and its enterprise utilities, Seattle City Light and Seattle Public Utilities, which includes our water, drainage and wastewater, and solid waste utilities. While there are many ways in which the federal tax system impacts local government financing, we would like to focus on the current tax treatment of municipal bonds and possible changes to that tax treatment. We would first like to provide some context on the City's use of bonding authority.

City of Seattle's Use of Debt Service[1]
The City uses bonds and property tax levies to fund a variety of special capital improvement projects. The City's budget includes funds to pay interest due on outstanding bonds and to pay the principal amount of bonds at maturity. The City has issued three types of debt to finance its capital improvement programs:

Unlimited Tax General Obligation Bonds
By state law, the City may issue Unlimited Tax General Obligation (UTGO) Bonds for capital purposes if a proposition authorizing their issuance is approved by 60% of the voters in an election in which the number of voters exceeds 40% of the voters in the most recent general election. Payment of principal and interest is backed by the "full faith and credit" of the City. This means that the City commits itself to include in its property tax levy an amount that is sufficient to pay principal and interest on the bonds. Property taxes levied to pay debt service on UTGO bonds are not subject to the statutory limits in state law on the taxing authority of local governments, which is why UTGO bonds are "unlimited". However, state law does limit the amount of UTGO bonds that can be outstanding at any time to 7.5% of assessed valuation of property in the city: 2.5% for open space and park facilities, 2.5% for utility purposes, and 2.5% for general purposes. As of December 31, 2012, there were approximately $90 million in UTGO bonds outstanding.

Limited Tax General Obligation Bonds
The City Council may authorize the issuance of Limited Tax General Obligation (LTGO) Bonds, also known as Councilmanic bonds, in an amount up to 1.5% of assessed valuation, without a vote of the people. The City pledges its full faith and credit to the payment of

[1] The following discussion on City of Seattle Debt Service is taken from the 2013 Adopted and 2014 Endorsed Budget of the City of Seattle, pp. 698-700. The debt numbers were updated to reflect 2012 numbers.

principal and interest on LTGO bonds, but this pledge must be fulfilled within the City's statutory property tax limitations. Thus, these are "limited" general obligation bonds. The combination of UTGO bonds issued for general purposes and LTGO bonds cannot exceed 2.5% of assessed property valuation. If LTGO bonds are issued up to the 1.5% ceiling, then UTGO bonds for general purposes are limited to 1% of assessed value. As of December 31, 2012, there were approximately $890 million obligations counting in this LTGO debt limit.

Revenue Bonds
Revenue bonds are used to provide financing for the capital programs of Seattle City Light and the three other utilities – Water, Drainage and Wastewater, and Solid Waste – which are grouped together in Seattle Public Utilities. The City does not pledge its full faith and credit to the payment of debt service on revenue bonds. Payment of principal and interest on the bonds issued by each utility is derived solely from the revenues generated by the issuing utility. No tax revenues are used to pay debt service.

When revenue bonds are sold, the City commits itself to set fees and charges for the issuing utility that will be sufficient to pay all costs of operations and maintenance, and all payments of principal and interest on the bonds. While the amount of revenue bonds is not subject to statutory limits, the utility's ability to repay debt with interest is a practical constraint.

City Debt Management Policies and Bond Ratings
The use of debt financing by the City is subject not only to state law, but also to the debt management policies adopted by the Mayor and City Council. According to these policies, a capital project should be financed with bond proceeds only under certain circumstances including the following:

- In emergencies;
- When the project being financed will produce revenues that can be used to pay debt service on the bonds; or
- When the use of debt will result in a more equitable sharing of the costs of the project between current and future beneficiaries of the project.

Paying for long-lived assets, such as libraries or parks, from current tax revenues would place a large burden on current taxpayers, while allowing future beneficiaries to escape the burden of payment. The use of debt effectively spreads the cost of acquiring or constructing capital assets over the life of the bonds. The City's debt management policies require that 12% of the City's LTGO total issuance capacity be reserved for emergencies. They also state that net debt service on LTGO bonds (defined as total debt service, minus dedicated project revenues) should not exceed 9% of the General Fund budget, and should remain below 7% over the long term (currently about 6%).

The City has earned very high ratings on its bonds as a result of a strong economy and prudent financial practices.

The City's UTGO debt is rated Aaa by Moody's Investors Service, AAA by Fitch IBCA, and AAA by Standard & Poor's (S&P), which are the highest possible ratings. The City's LTGO debt is rated Aa1 by Moody's, AA+ by Fitch, and AAA by S&P. In addition, the City's utilities have very high ratings for revenue debt, reflecting sound finances and good management.

Proposed Changes to the Municipal Bond Tax Exemption and Impacts on the City of Seattle

Municipal bonds are the engine driving our infrastructure development and our economic growth. Not only do the projects financed by municipal bonds provide construction jobs in the short term, in the long term, the infrastructure built by bonds provides the backbone of economic growth in city. Municipal bonds are financing projects all over the city, including the replacement of the Elliott Bay Seawall and the construction of a new substation in the burgeoning South Lake Union neighborhood. These projects are essential to the long term economic health of our city.

The current discussion around changing the municipal bond tax exemption revolves around two proposals. The first proposal would eliminate the municipal bond tax exemption altogether. The second would include the tax exemption on municipal bonds as part of any cap on deductions. The level of the cap being discussed is 28 percent. Both of these proposals would result in an increase in borrowing costs for the city of Seattle. These costs would be borne by our taxpayers, slowing our long-term economic growth and development and requiring the city to forgo or delay projects in order to pay the increased borrowing costs.

In the normal course of our capital program, we project that the city (including our publicly-owned utilities, Seattle City Light and Seattle Public Utilities) will issue at least $2 billion of new debt over the next 5 years. Based on this current level of debt maintenance and using a conservative estimate of what the change in the interest rate would be, if the municipal bond tax exemption were eliminated, it would result into increased interest expense for all of our projects of about $20 million annually, or about half a billion dollars over the next 30 years. Under a scenario where there is a 28 percent cap on the tax exemption, the annual impact would be just under $4 million or about $100 million over the next 30 years. And this is when interest rates are at an all-time low. These costs will only go up as interest rates do. Below are examples of specific projects that would affected by a change in the tax-exempt status of municipal bonds.

Examples of Projects Funded by Municipal Bonds

The Elliott Bay Seawall Project
The Elliott Bay Seawall Project is a critical public safety project. Failure of the seawall would have significant impacts to the public, the City of Seattle, the Puget Sound region, Washington State, and the nation. Protection from coastal storm damage and shoreline erosion is vital to preserving Seattle's downtown, the economy, and the region's quality of life and economic competitiveness. The Elliott Bay Seawall:

- Protects Seattle's downtown waterfront from wind-driven storm waves and the erosive tidal forces of Puget Sound and Elliott Bay.
- Supports and protects major public and private utilities, including power for downtown Seattle and the western seaboard, natural gas, and telecommunications.
- Supports State Route 99, the ferry terminal, and rail lines, all of which transport local commuters and visitors as well as local, regional, and international freight.

This past November, Seattle voters, with **77 percent of the voters voting in favor**, passed a $290 million bond to replace the existing southern half of the Elliott Bay Seawall along Seattle's waterfront with a structure that meets current safety and design standards.

The loss of the tax exemption on municipal bonds would have an immediate impact on Seattle taxpayers. Based on conservative estimates, the complete loss of the tax exemption would increase annual costs on the seawall to taxpayers by about $2.5 million or over $75 million over 30 years. A 28 percent cap on tax exemption would potentially increase annual costs on the seawall project by almost $500,000 or $14 million over 30 years.

Denny Substation Project
The City's municipal electric utility, Seattle City Light, is building a new north downtown substation to create a stronger and better-integrated distribution system through the city. In addition, the substation, when complete provides highly reliable power to serve the city's growing biotechnology research and information technology sectors.

As a part of Seattle City Light's capital program, Seattle City Light is using some of its bonding capacity on this substation. The remaining substation project costs are around $152 million. Based on conservative estimates, the complete loss of the tax exemption would increase annual costs on to ratepayers by about $1.3 million or about $40 million over 30 years. Assuming a 28 percent cap on tax exemption, the impact on financing would be a total of $7.6 million higher for Seattle City Light ratepayers. This averages out to around a $253,000 increase per year over the repayment period.

We appreciate that the federal government is facing fiscal challenges, but we believe one of the ways to meet those challenges is to support programs and policies that encourage economic growth. Municipal bonds have a proven track record of helping to create jobs and providing the infrastructure that underlies a strong economy. Now is not the time to change this policy.

About the City of Seattle, Seattle City Light and Seattle Public Utilities
With a population of over 615,000, **Seattle** is the largest city in Washington State and the 23rd largest city in the country. Seattle has a budget of $4.1 billion, with Seattle City Light and Seattle Public Utilities accounting for about one-half of the budget.

Seattle City Light is the 10th largest public electric utility in the United States. It has some of the lowest cost customer rates of any urban utility, providing reliable, renewable and environmentally responsible power to nearly 1 million Seattle area residents. City Light has been greenhouse gas neutral since 2005, the first electric utility in the nation to achieve that distinction.

Seattle Public Utilities (SPU) is comprised of three separate utilities- Water, Drainage and Wastewater, and Solid Waste. SPU delivers an average of 120-130 million gallons of drinking water per day to more than 1.3 million people and businesses in Seattle and 22 surrounding cities and water districts, collects and disposes of the solid waste generated within the City of Seattle and maintains the drainage and wastewater system in Seattle.

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Statement of

Missouri River Energy Services

House Ways and Means Committee

Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

March 19, 2013

The generation, transmission, and distribution of electricity are highly capital-intensive undertakings. Tax-exempt bonds remain the most important tool available to Missouri River Energy Services (MRES) and its member communities to finance necessary electricity infrastructure projects.

As units of state and local government, MRES and its members have historically relied on tax-exempt bonds as the primary means of financing new generation and transmission.

This critical tool has come under fire as part of the larger effort to reform the tax code and reduce the federal budget deficit. In 2010, the Simpson-Bowles Report suggested eliminating it altogether, and Republicans and Democrats on both sides of Capitol Hill have offered proposals to curb the deductibility of municipal bond interest. Adoption of any of these proposals would place even greater strain on municipalities.

The broad goal of tax simplification and reform is laudable. However, as the Committee contemplates tax reform legislation, we would urge careful consideration of the following points with respect to tax-exempt financing:

- **Tax-exempt bonds are the primary mechanism for financing local public infrastructure.** These projects not only include electric utility facilities, but also schools, roads, bridges, hospitals, and water and wastewater infrastructures. Eliminating tax-exempt bonds or reducing their attractiveness as investment vehicles will raise borrowing costs for all levels of government from townships to states. Today, the vast majority of our nation's infrastructure is financed by states and localities. Tax-exempt bonds are the primary vehicle for these investments. Given the current condition of most state and local budgets, increased financing costs resulting from the taxation of municipal bond interest would delay, scale back, or even shelve many critical projects. The impact on economic recovery and growth could be devastating.

- **Taxing the interest on municipal bonds is no way to fix the federal budget deficit**. States and localities are already engaged in aggressive measures to trim their budgets. Restricting a key financial tool would make their fiscal situation more challenging. Removing the tax exemption for municipal bonds would simply push the nation's fiscal problems onto state and local governments.

- **Reduced benefits for tax-exempt financing would shift greater tax burden to lower and middle income families**. New restrictions on tax-exempt financing would also place a greater burden on lower and middle income families as state and local governments raise taxes to pay for increased costs of infrastructure, construction, and upgrades.

- **Restricting tax-exempt bonds would threaten economic growth**. Tax-exempt bonds finance countless projects that produce quality jobs and put in place infrastructure necessary for sustained economic recovery and growth. Restrictions on tax-exempt financing might temporarily improve the federal balance sheet, but they would harm the economy and damage deficit-reduction efforts in the long term.

The on-going debate over reducing the benefits of tax-exempt financing and the possibility of such actions affecting existing bonds retroactively threatens to shake the confidence of the market in tax-exempt financing opportunities even if Congress ultimately chooses to leave this financing mechanism untouched.

MRES urges the Committee to recognize the value and importance of tax-exempt bonds and retain the existing federal tax exempting for municipal bonds.

NMHC National Multi Housing Council®
Apartments: Smart Communities, Smarter Living

NAA National Apartment Association

STATEMENT BY
THOMAS F. MORAN
CHAIRMAN AND MANAGING PARTNER
MORAN & COMPANY
ON BEHALF OF THE
NATIONAL MULTI HOUSING COUNCIL
AND THE
NATIONAL APARTMENT ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
FOR THE HEARING ON
"TAX REFORM AND RESIDENTIAL REAL ESTATE"

APRIL 25, 2013

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Chairman Camp and Ranking Member Levin, the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) would like to thank you for this opportunity to testify on the multifamily industry's priorities for tax reform. We applaud your efforts to examine the nation's tax code with an eye toward enacting tax reform that simplifies the nation's tax laws while promoting economic growth and job creation.

NMHC/NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships engage in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. NAA is a federation of 170 state and local apartment associations comprised of approximately 60,000 multifamily housing companies representing more than 6.6 million apartment homes throughout the United States and Canada.

Background on the Multifamily Housing Sector

Prior to addressing the multifamily housing industry's recommendations for tax reform, it is worthwhile to take a moment and note the fundamental role multifamily housing plays in providing safe and decent shelter to millions of Americans, as well as the sector's considerable impact on our nation's economy.

In communities across the country, apartments work – helping people live in a home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice to meet their specific housing needs.

Apartment homes and our 35 million residents contribute $1.1 trillion annually to the economy. That is nearly 26 million jobs in construction, operations, leasing, management and skilled trades, as well as all the local businesses supported by apartments and the millions who live there. This tremendous economic impact is comprised of the following:

- New apartment construction produced $14.8 billion in spending, supported 323,781 jobs, and had a total economic contribution of $42.5 billion.

- The operation of the nation's existing apartments accounted for $67.9 billion in outlays, 2.3 million jobs, and a total economic contribution of $182.6 billion.

- Apartment resident spending totaled $421.5 billion, supporting 22.8 million jobs and a total economic contribution of $885.2 billion.

Demand for apartments continues to grow. With 77 million Baby Boomers who may consider downsizing and nearly 80 million Echo Boomers beginning to enter the housing market, it is no surprise that Harvard University research suggests that up to seven million new renter households will form this decade.

Unfortunately, supply is already falling short of meeting this demand. An estimated 300,000 to 400,000 units a year must be built to meet expected demand; yet just 158,000 apartments were delivered in 2012 – not enough to even replace the units lost every year to demolition and obsolescence. Furthermore, while the market continues to work through an oversupply of single-family housing, the nation could actually see a shortage of multifamily housing. The shortage is particularly acute for low- and moderate-income households. The Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of three million units.

Key Priorities for Tax Reform

Like many other small businesses, the apartment industry has a considerable stake in tax reform. In addition, we provide homes for millions of Americans covering the entire socioeconomic spectrum. We pay taxes when properties are built, operated, sold, or transferred to heirs. As the Committee drafts legislation, we ask that tax reform takes special care not to harm the thousands of businesses in the industry or the 35 million residents who call an apartment home.

Priority 1: Tax Reform Must Not Harm Pass-Through Entities

The multifamily industry is dominated by "pass-through" entities (e.g., LLCs, partnerships and S Corporations) instead of publicly held corporations. Indeed, over three-quarters of properties are owned by pass-through entities. This means that a company's earnings are passed through to the partners, who pay taxes on their share of the earnings on their individual tax returns. This treatment contrasts with the taxation of large publicly held corporations or C corporations that often face two levels of tax. Those entities remit tax at the corporate level under the corporate tax system. Shareholders are then taxed upon the distribution of dividend income.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities. For example, given that Congress recently raised marginal tax rates on ordinary income to as high as 39.6 percent as part of the *American Taxpayer Relief Act of 2012*, rates should certainly not be increased once again. Additionally, while many are calling for a reduction in the nation's 35 percent corporate tax rate, flow-through entities should not be called upon to make up the lost revenue from this change. Nor should flow-through entities be subjected to a corporate-level tax as President Obama proposed be examined in the White House's February 2012 report, *The President's Framework for Business Tax Reform*. Finally, a corporate rate cut should not be financed by denying flow-through taxpayers credits and deductions.

Priority 2: Maintain the Current Law Tax Treatment of Carried Interest

NMHC and NAA would also like to use this opportunity to underscore our strong opposition to proposals to change the current law governing the tax treatment of carried interest. If enacted, this proposal would significantly reduce the ability to develop or rehab apartments across the nation.

A "carried interest," also called a "promote," has been a fundamental part of real estate partnerships for decades. Carried interest was designed to offset the considerable financial risks our firms take – including recourse debt on construction and rehabilitation loans, litigation, refinancing risk, cost overruns, and environmental remediation. In fact, one in ten multifamily projects never break ground. These risks have major financial consequences that carried interest helps offset, justifying capital gains treatment.

Current tax law, which treats carried interest as a capital gain, is the proper categorization of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue is inappropriate. Notably, any fees that a general partner receives that represent payment for operations and management activities are today properly taxed as ordinary income.

Taxing carried interest at ordinary income rates will adversely affect real estate partnerships. At a time when the nation already faces a three million unit shortage of affordable rental housing, increasing the tax rate on long-term capital gains will discourage real estate partnerships from investing in new construction. Furthermore, such a reduction will translate into fewer construction, maintenance, on-site employee, and service provider jobs during a period in which the unemployment rate remains abnormally high.

For these reasons, in 2010, both the U.S. Conference of Mayors and the National Association of Counties passed resolutions opposing this proposal as it relates to real estate partnerships and urged Congress to maintain the current law-capital gains treatment of “carried interest,” noting that any change would bring extremely negative consequences to “main streets” throughout the country.

Additionally, it should be noted that proposals that have been made to tax carried interest at ordinary income rates as opposed to capital gains tax rates would retroactively recharacterize income from capital gain to ordinary. It is extremely unfair to change not just the tax rate, but also the characterization of income in such a retroactive manner, which, in many cases, could be well over a decade after the underlying partnership was formed. Moreover, modifying the tax treatment of carried interest would force the general partner to face ordinary income tax rates while the limited investment partners would see capital gains rates. There is little justification for such a disparity that would certainly disrupt the decision making of real estate partnerships that never anticipated that the character of income would be changed. Thus, if Congress were interested in modifying the tax treatment of carried interest, it should do so only with respect to real estate that comes into existence after the effective date of the proposal.

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. Enacting a bad tax law, such as changing the taxation of carried interest, merely to gain revenue to make other tax changes, is a distorted view of tax policy, which demands that each tax proposal be judged on its individual merits.

Priority 3: Retain the Full Deductibility of Business Interest

Under current law, business interest is fully deductible. However, efforts to prevent companies from overleveraging are leading to an examination of whether the current 100 percent deduction for business interest expenses should be curtailed. Unfortunately, reducing this deductibility would greatly increase the cost of debt financing necessary for multifamily projects, curbing development activity at a time when supply is falling well short of demand.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities. Because such entities often look to debt markets to garner capital, the full deductibility of interest expenses is critical to promoting investment. Indeed, according to the Federal Reserve, as of September 30, 2012, total multifamily debt outstanding was $846.6 billion. Reducing the full deductibility of interest would undoubtedly increase costs for owners and developers of multifamily housing and negatively impact aggregate construction.

In addition to harming the multifamily industry, it is also instructive to note that modifying the full deductibility of business interest would be precedent setting. In fact, Drs. Robert Carroll and Thomas Neubig of Ernst & Young LLP concluded in their analysis, *Business Tax Reform and the Tax Treatment of Debt*:

> The current income tax generally applies broad income tax principles to the taxation of interest. Interest expenses paid by borrowers are generally deductible as a business expense, while interest income received by lenders is generally includible in income and subject to tax at applicable recipient tax rates. With this treatment, interest income is generally subject to one level of tax under the graduated individual income tax rates. This is the same manner in which most other business expenses, such as wages payments to employees, are taxed, and also follows the practice in other developed nations.

Priority 4: Protect the Low-Income Housing Tax Credit and Make Permanent the Flat 9 Percent Credit

The Low-Income Housing Tax Credit (LIHTC) has a long history of successfully generating the capital needed to produce low-income housing while also enjoying broad bipartisan support in Congress. According to the National Council of State Housing Agencies, the program has led to the construction of more than 2.4 million units since its inception in 1986. Maintaining this supply of affordable housing is critical given that the market is short at least three million affordable rental units, according to Harvard University estimates. The program has also been an important source of economic development for many communities, helping to revitalize struggling neighborhoods. At its peak, the LIHTC program created approximately 140,000 jobs and $1.5 billion in state and local tax revenues annually.

The LIHTC has two components. The so-called 4 percent tax credit can be used to subsidize 30 percent of the unit costs in an acquisition of a project and can be paired with additional federal subsidies. In contrast, the 9 percent tax credit supports new construction by subsidizing 70 percent of the costs.

Developers receive an allocation of LIHTCs from state agencies through a competitive application process. They generally sell these credits to investors, who receive a dollar-for-dollar reduction in their federal tax liability paid in annual allotments, generally over 10 years. The equity raised by selling the credits reduces the cost of apartment construction, which allows the property to operate at below-market rents for qualifying families; LIHTC-financed properties must be kept affordable for at least 30 years. Property compliance is monitored by state allocating agencies, the Internal Revenue Service, investors, equity syndicators and the developers.

First and foremost, Congress should retain the LIHTC as part of any effort to overhaul the nation's tax code. It should also improve the LIHTC by making the flat 9 percent and 4 percent tax credit rates permanent. Because these rates float and are not fixed, their value can be reduced by as much as 50 basis points, which, in turn, reduces the amount of resources available to finance affordable housing.

Notably, in January 2013, Congress enacted the *American Taxpayer Relief Act of 2012* that extends the temporary fixed rate on the 9 percent tax credit for projects that received a LIHTC allocation prior to January 1, 2014. Given the current low interest rate environment, the actual value of the credit is likely to fall below the 9 percent mark for projects receiving an allocation following the deadline, reducing investors' activity in the affordable housing sector. For this reason NMHC and NAA propose to make the fixed 9 percent credit permanent and to extend the fixed rate policy to the 4 percent tax credit, keeping financing flowing for acquisitions.

Priority 5: Preserve Current Law Estate Tax

As part of the *American Taxpayer Relief Act of 2012*, Congress has enacted permanent estate tax relief legislation. The Act sensibly establishes an exemption level of $5.25 million (indexed for inflation) and a top tax rate of 40 percent. It also retains the stepped-up basis rules applicable to inherited assets. NMHC and NAA believe that the current structure of the estate tax effectively enables owners, operators and developers of multifamily housing to transfer assets to future generations. The law should not be further modified as part of tax reform.

There are three key elements to the estate tax: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements are important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- *Exemption Levels:* The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. In 2013, there is a $5.25 million exemption.
- *Tax Rates*: The estate tax rate applies to the value of an estate that exceeds the exemption level. The maximum rate is 40 percent.
- *Basis Rules:* The basis rules determine the tax basis of inherited property. There are generally two different types of basis rules—stepped-up basis and rollover basis. The estate tax today features stepped-up basis rules, and under this regime, the tax basis of inherited property is reset to reflect the fair market value of the property at the time of the inheritance. By contrast, under rollover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor. This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Retaining a stepped-up basis rule is critical for estates that contain significant amounts of depreciated real property as it helps heirs reduce capital gains taxes and maximize depreciation deductions.

Priority 6: Provide Incentives for Improving Energy Efficiency in Commercial Buildings and Large Multifamily Properties

As the Committee considers how the tax code could be used to facilitate national priorities in the energy sector, we wish to call your attention to the Energy Efficient Commercial Buildings Tax Deduction (Sec. 179D of the Internal Revenue Code of 1986) and the importance of this incentive in achieving improved environmental quality, reinforcing our national security, creating jobs in the construction and manufacturing sector and increasing housing affordability by decreasing utility expenses for millions of Americans who live in apartment homes.

S. 3591, the *Commercial Building Modernization Act*, which was introduced in the 112th Congress, provides a responsible plan for enhancing the current Sec. 179D to assist property owners to make meaningful improvements in the energy performance of their properties. Many older properties have been unable to fully utilize the current-law incentive because they have had difficulty in achieving the requisite 50 percent improvement in building energy performance over the level specified in the 2001 version of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) 90.1 code. While S. 3591 includes updated energy code references against which whole building performance will be measured for many properties, it also includes a pathway for older properties to qualify for incentives that will assist property owners in making building system upgrades that will yield significant energy savings.

Older building structures face technical limitations in achieving the energy performance metrics specified by the current code, let alone reaching the incremental "above-code" performance characteristics required to claim the current deduction under Sec. 179D. S. 3591 establishes a sliding scale of energy improvements, using the property's current energy performance as the baseline. This pathway of significant improvement in energy performance relative to the property's own baseline performance will provide a much-needed financial tool for property owners who want to make these types of investments but have not been able to do so.

Advances in residential construction methods have improved the energy use profile of new buildings; however the majority of the nation's building stock predates the use of highly energy efficient products and techniques. The U.S. Department of Energy (DOE) reports that housing built after 2000 used 14 percent less energy per square foot than housing built in the 1980s and 40 percent less than housing built before 1950.[1] As such, there is considerable room for improvement in energy performance even among well designed, constructed and maintained properties. A recent study conducted by CNT Energy and the American Council for an Energy-Efficient Economy finds that "[b]uilding owners often need financial incentives to adopt new technologies or equipment with higher up-front costs. Despite this, studies have documented

[1] U.S. Department of Energy, 2011 Buildings Energy Data Book. March 2012. Chapter 2.

that affordable housing, often multifamily, receives a disproportionately small share of available energy efficiency funding."[2]

According to the American Housing Survey (2009), almost 81 percent of the nation's stock of apartment properties (with 5 or more units) was constructed prior to 1990, which marks the decade in which the first building energy codes were implemented. This older stock of housing, which is an important source of affordable housing, represents a significant opportunity for achieving energy savings while at the same time adding to the available spending capacity of individuals who live in these apartment homes. This is a significant consideration given that in 2010 approximately 70 percent of renter households had incomes below the *national median* and more than 40 percent had incomes in the bottom quartile.[3] Furthermore, "energy costs as a share of gross rents rose from 10.8 percent to 15.0 percent between 2001 and 2009. Lowest income renters saw the largest increase in their utility share, a jump from 12.7 percent to 17.4 percent."

There is a direct relationship between the age of a residential building and energy expenditures. The per-square-foot energy costs of housing constructed between 1980 and 1989 is 16 percent higher than that of a building constructed after 2000. Those expenditures soar to a 28 percent increase in residential buildings built between 1970 and 1979 over post-2000 properties.[4] Energy efficiency in multifamily properties could be economically improved by 30 percent with a savings of $9 billion in averted energy costs not to mention the substantial savings in greenhouse gas emissions.[5]

NMHC/NAA believe that a sound national tax policy can be used to catalyze a market transformation marked by significant improvements in building energy performance. A meaningful and predictable tax incentive would leverage private investment in qualified building retrofits and would have a positive effect on the economy as it would result in increased demand for construction services, materials and equipment.

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[2] CNT Energy and American Council for an Energy-Efficient Economy, Engaging as Partners in Energy Efficiency: Multifamily Housing and Utilities. January 2012. http://www.cntenergy.org/media/Engaging-as-Partners-in-Energy-Efficiency-MF-Housing-and-Utilities-Final-012512.pdf. p.4.

[3] Joint Center for Housing Studies of Harvard University. America's Rental Housing-Meeting Challenges, Building on Opportunities. 2011. p. 17 http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/americasrentalhousing-2011.pdf; U.S. median household income fell from $51,144 in 2010 to $50,502 in 2011 according to the *United States Census, American Community Survey Briefs*, September 2012, Appendix Table 1, page 5.

[4] U.S. Department of Energy, *supra* note 1, at p. 2-20 derived from Table 2.3.12.

[5] Joint Center for Housing Studies of Harvard University, *supra* note 2, at p.33.

Conclusion

In closing, NMHC/NAA look forward to working with the House Ways and Means Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. On behalf of the apartment industry and our 35 million residents, we stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide.

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National Association of Bond Lawyers

Statement for the Record
Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
March 19, 2013

Dear Chairman Camp and Ranking Member Levin:

I want to commend you for holding the hearing on Tax Reform and Tax Provisions Affecting State and Local Governments. There are many aspects of tax reform that can affect state and local governments but none is more important than the treatment of state and local debt. Municipal bonds are a $3.7 trillion market. Those bonds are used to finance investments in roads, schools, clean water, sewers, hospitals, colleges, airports and seaports. Those investments provide the infrastructure that supports business and educates the workforce.

While the overwhelming portion of state and local bonds are used for governmental purposes, a significant portion is used for private activity bonds. These exempt private activity bonds are generally available to finance only specifically enumerated types of projects, including financing hospitals, colleges and universities, airports, seaports and low-income housing. Recent press reports have focused on the use of tax-exempt financing by some large corporations, but those instances were the result of *exceptions* to the general tax-exempt bond rules enacted by Congress in response to disasters. They are not the rule.

I have attached a paper and summary prepared by the National Association of Bond Lawyers that discusses the importance of tax-exempt bonds to the national economy and why proposals to eliminate or restrict the exemption – including the Administration's proposal to limit the benefit to the 28 percent bracket – would be detrimental.

The main points are:

- The exemption of state and local government bond interest helps lower the cost of capital funding for state and local governments.
- State and local government bonds provide funding for critical infrastructure.
- Changes to the exemption of state and local government bonds will increase state and local borrowing costs, which will be passed on to the public.
- Principles of federalism support maintaining the current exclusion of state and local government bond interest.
- State and local government bonds encourage local control over the development of infrastructure.
- Infrastructure is important to our economy.
- Limiting or eliminating the exemption will mean less infrastructure investment.

Thank you for the opportunity to submit this statement for the record.

Sincerely,

Scott Lilienthal

The National Association of Bond Lawyers (NABL) was incorporated as an Illinois non-profit corporation on February 5, 1979, for the purposes of educating its members and others in the law relating to state and municipal bonds and other obligations, providing a forum for the exchange of ideas as to law and practice, improving the state of the art in the field, providing advice and comment at the federal, state and local levels with respect to legislation, regulations, rulings and other action, or proposals therefore, affecting state and municipal obligations, and providing advice and comment with regard to state and municipal obligations in proceedings before courts and administrative bodies through briefs and memoranda as a friend of the court or agency. More information about NABL is available on its website, www.nabl.org.

National Association
of Bond Lawyers

Tax-Exempt Bonds: Their Importance to the National Economy and to State and Local Governments

The tax exemption of the interest on State and local government bonds is a proven, effective way to provide needed funding for public infrastructure and the related benefits to the economy from job creation and business development.

- **The exemption of state and local government bond interest helps lower the cost of capital funding for state and local governments.** Any repeal of or change to the exemption of state and local bond interest, including making state and local government bond interest subject to tax for higher-income taxpayers, will increase borrowing costs for state and local governments. The burden of such changes will fall primarily on state and local governments and through them on their taxpayers and ratepayers, not on high-income federal taxpayers.

- **State and local government bonds provide funding for critical infrastructure.** With limited exceptions, state and local government bonds fund capital projects. Unlike Treasury bonds, state and local government bonds are generally not used to fund deficits. State and local government bonds finance schools, roads and highways, bridges, hospitals, universities, airports, water and sewer facilities, and other infrastructure that powers our economy.

- **Changes to the exemption of state and local government bonds will increase state and local borrowing costs, which will be passed on to the public.** These increased borrowing costs will be passed through to taxpayers, ratepayers (e.g., of a municipal water system or utility), or other users (e.g., hospital patients, students or residents in low income housing). Since the facilities benefitted by state and local government bonds are limited to specified public purposes by the Internal Revenue Code, the burden of these increases will be borne regressively by lower and middle income individuals.

- **Principles of federalism support maintaining the current exclusion of state and local government bond interest.** States cannot tax interest on Treasury bonds. Similar treatment of state and local government bonds is consistent with the reciprocal principles of federalism and has a long-standing historical basis.

- **State and local government bonds encourage local control over the development of infrastructure.** State and local governments set the priorities for infrastructure and economic development and shoulder the burden of these investments. If the current system were replaced with one in which the federal government provided grants or loans instead of the assistance now provided by the exclusion of interest on state and local debt, the federal government would inevitably appropriate control over infrastructure and economic development decisions that are now made, effectively, at the state and local level.

- **Infrastructure is important to our economy.** The development of infrastructure provides construction jobs with related multiplier affects to local economies. Public infrastructure is also important to economic activity (i.e., airports, highways, and electric, water and sewer utilities are important to existing businesses and the creation of new businesses).

- **Limiting or eliminating the exemption will mean less infrastructure investment.** Unless substantial amounts of other federal funds are made available state and local governments will be discouraged from infrastructure investments. A lack of investment in infrastructure will hurt long-term economic growth and, in the short term, result in loss of construction-related jobs.

Tax-Exempt Bonds:

Their Importance to the National Economy and to State and Local Governments

The United States today is facing unprecedented challenges in job creation, infrastructure development and deficit reduction. These challenges are interrelated, and one of the key elements to addressing them is tax reform. Tax reform can induce more efficient allocation of capital, thereby stimulating economic growth and job creation. It can generate increased revenue to reduce the deficit. Tax reform can also encourage the investment in infrastructure that is necessary to support economic growth and jobs.

There is general agreement that tax reform should "close loopholes" and "eliminate tax preferences" in the current tax code in order to make the system fairer and more efficient. However, some provisions in the current tax code advance the goals of infrastructure investment and job creation and with them the economic growth that will help reduce the deficit. This paper looks at one provision – the provision in the tax code that helps state and local governments invest in the infrastructure that forms the basis for economic growth. This provision—the exclusion from gross income of the interest on state and local bonds—supports investment in roads, bridges, schools and ports, among many other examples. This paper summarizes the current use of tax-exempt bonds and considers the impact the elimination, or limitation, of the bond tax exemption would have on state and local governments, their taxpayers and ratepayers, on other qualified tax-exempt bond borrowers and on bond investors.

I. Overview

The United States is simultaneously facing several critical challenges. Congress and elected leaders at all levels feel the need to enact legislation that encourages job creation. Dramatic events, such as bridge collapses on interstate highways, and more every day events, such as water main ruptures, highlight the desperate need for improvements to and repairs of our crumbling infrastructure. Infrastructure spending helps the overall economy by providing construction-related employment, stimulating demand for manufactured construction materials, and providing the roads, bridges and other support necessary for sustained economic growth.

At the same time, however, the President and Congress are under pressure to reduce the federal deficit and reform the federal income tax system, which requires changes to the Internal Revenue Code (Code). President Obama, Congress and various commissions and commentators recently have been considering proposals to address these interrelated issues.

Some proposals would eliminate or limit the exclusion of interest on state and local government bonds. For instance, the report of the National Commission on Fiscal Responsibility and Reform (also known as the Simpson-Bowles Commission) included, as an illustrative example for tax reform, the repeal of the exclusion for interest on newly-issued state and local bonds. Separately, the Obama Administration has proposed limiting the value of the exclusion, not only with respect to newly-issued bonds but also bonds that are currently outstanding and in the hands of investors.

There are several rationales for these proposals and others like them. One is that eliminating or limiting the exclusion will enhance "tax equity" by increasing the amount of taxes paid by high-income taxpayers. According to this view, the exclusion disproportionately benefits high-income taxpayers. Another rationale is that including state and local bond interest in gross income would increase federal tax revenues, helping to reduce the federal deficit. Third, some proponents of these proposals believe that the inclusion of state and local bond interest in gross income would broaden the tax base, thereby permitting a reduction in marginal income tax rates that is considered by many to be the key element in tax reform. These rationales are closely related, and all of them appear to be premised on the notion that the exclusion of state and local bond interest benefits high-income taxpayers and that eliminating or limiting the exclusion of such interest will generate significant new revenues to reduce the federal deficit.

There are serious flaws in these rationales. Moreover, the reduction in infrastructure investment that is likely to occur if the exclusion were eliminated or limited would likely impede economic growth, job creation and deficit reduction.

For one, the economic burden of the elimination or limitation of the exclusion of interest on state and local government bonds would not be borne exclusively by high-income taxpayers. Instead, much of the burden would be borne by state and local governments, their taxpayers and ratepayers, and by other qualified borrowers in the form of higher borrowing costs. By virtue of the subsidy provided by the exclusion of state and local bond interest under current law, investors today are content to require lower interest rates from bond borrowers, because investors do not have to pay tax on the interest they receive. If the exclusion from income tax were to be eliminated or reduced, investors would require bond borrowers to pay higher interest rates.

As a result, the burden of the elimination or limitation of the exclusion will largely fall not on high-income taxpayers because those taxpayers, as bond investors, can "pass-through" their increased federal taxes to the state and local governments. These governments, in turn, pay the interest on their bonds from sales taxes, property taxes, fees, tolls and to a lesser extent, income taxes.[1] As a result, the burden of the elimination or limitation will fall largely on lower and middle-income state and local taxpayers and ratepayers in the form of higher fees for such items as water and sewer, higher tolls on roads and bridges, and increased sales and property taxes. These governments could also reduce services, but those cuts would also fall disproportionately on lower and middle-income households.

Apart from these considerations, the most likely result of the elimination or limitation of the subsidy for state and local bonds would be decreased investment in our nation's infrastructure, with a resulting loss in infrastructure-related employment and the support that infrastructure provides to economic growth.

While the tax equity argument has serious problems, there remain the arguments that the elimination of or limitations on the exclusion would raise significant revenue for deficit reduction, lower marginal tax rates or both. However, the extent to which any change to the treatment of tax-exempt interest would result in additional taxes being paid by high-income taxpayers is not certain, since those investors would have an incentive to move their funds to other tax-favored transactions or investments.[2]

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[1] On the whole, these state and local tax systems, which would be drawn on to service increased debt service on taxable bonds, are regressive and take a greater share of the income of lower and middle-income families than of upper-income families. See Davis, et al., *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 3rd Ed.*, Institute on Taxation and Economic Policy, Nov. 2009, at 1.

[2] See *Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds*, James M. Poterba and Arturo Ramírez Verdugo, National Tax Journal, June 2011. The authors of this paper conclude that "the revenue gain from repealing interest tax exemption [is likely to be overstated], since at least some current holders of tax-exempt bonds would probably reposition their portfolios to hold other lightly-taxed assets, rather than heavily-taxed bonds, after interest payments on state and local government bonds became fully taxable." Id. at 2. See also Joint Committee on Taxation, *The Federal Revenue Effects of Tax-Exempt and Direct Pay Tax Credit Bond Provisions* (JCX-60-12), July 16, 2012, at 10-16 (noting that "[w]hile investigations into the revenue consequences of more realistic investor portfolio reallocations are important, determining whether the taxable bond substitution assumption either underestimates or overestimates the estimated revenue cost to these alternative assumptions is exceedingly difficult.").

In order to maximize the amount of tax revenues resulting from a change to the exclusion of interest on municipal bonds, some of the proposals would apply the repeal or limitation to all outstanding bonds (i.e., retroactively apply the repeal or limitation to existing bonds that were bought by investors on the basis that the interest on such bonds would continue to be fully exempt from federal income tax). *A retroactive change in the taxation of outstanding state and local government bonds would result in an immediate decrease in the market value of much of such outstanding debt, a loss that will be felt by current holders of such bonds, more than three-fourths of whom are retail investors,[3] many of whom are middle income and at least some of whom are older Americans.* Over 5.3 million households with annual adjusted gross income under $250,000 reported tax-exempt income in 2009.[4] Those households reported over 55 percent of all the tax-exempt income reported that year.[5] In addition to the effect on the savings of those investors, if the investors sold those bonds at a loss, federal tax receipts could be lower in the near term.

Because the revenue that might be gained by the elimination or reduction of the exclusion may not be as significant as some think, the opportunity for deficit reduction and base-broadening also would not be as significant.

While the tax equity argument for and revenue benefits to be derived from eliminating or limiting the exclusion of state and local bond interest can easily be overstated, there are important policy reasons to maintain the current Code exclusion, including principles of federalism, encouraging local control over capital projects, and promoting infrastructure development by state and local governments.

II. Background

The municipal bond market has been a key, low-cost source of infrastructure financing in the United States since the mid-1800s. The municipal bond market is large and very diverse, with many different types and sizes of issuers of municipal bonds. As of the end of 2011, there were approximately $2.9 trillion of long-term tax-exempt state and local government securities outstanding, including securities issued to provide "new money" for infrastructure and refundings.[6] These securities were issued by approximately 51,000 state and local government issuers, ranging from villages, towns, townships, cities, counties and states, as well as special districts and authorities, such as school districts and water and sewer authorities.[7] The overwhelming majority of state and local bonds issued by these governmental issuers are issued to finance or refinance capital projects and infrastructure.[8] This is in contrast to the federal government's issuance of debt, which is used to fund current operating deficits.

Municipal bonds are used to finance a broad spectrum of public infrastructure, such as roads, bridges, airports, utility systems, schools, hospitals, courthouses, jails, administrative offices, and other public facilities. Some municipal bonds are issued for the benefit of private entities, often nonprofit 501(c)(3) organizations, who use the proceeds to finance educational facilities, health care

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[3] At the end of 2011 there were approximately $3.7 trillion municipal securities outstanding. Households held approximately $1.9 trillion directly, and approximately $930 billion were held in mutual, money market, closed-end and exchange-traded funds. Federal Reserve Board, *Flow of Funds Accounts of the United States*, March 8, 2012, Table L.211.

[4] Internal Revenue Service, Statistics of Income, *Individual Income Tax Table 1.4 All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2009.*

[5] Id.

[6] In addition, at the end of 2011 there was outstanding $52.3 billion in short-term state and local debt, $254.4 billion in tax-exempt debt of non-profit organizations and $497.4 billion in debt of other tax-exempt borrowers. Federal Reserve Board, *Flow of Funds Accounts of the United States*, March 8, 2012, Table L.211.

[7] *SEC Release 34-62184A (May 28, 2010)* at 8 & n. 22.

[8] A small portion of municipal bond issues finance cash flow or working capital needs of state and local governments. As a result of federal tax law limitations, these bonds are almost always issued as short term obligations.

facilities, senior living facilities, multifamily housing for low or moderate income persons, solid waste disposal facilities and manufacturing facilities. The amount of tax-exempt debt issued to finance new infrastructure projects undertaken by the public and private sectors totaled $1.7 trillion from 1991 to 2007.[9] About three-quarters of those bonds were used for capital spending on infrastructure by states and localities, and the remainder was to fund private capital investment for projects that serve a public purpose, such as non-profit schools and hospitals.[10] In 2009 alone, approximately $365 billion in bonds were issued to finance long-term projects.[11]

The Code has provided an exclusion from gross income for interest on municipal bonds since the modern income tax system was enacted in 1913. Until late in the 20th century, the tax-exempt status of interest on state and local government bonds also was believed to be constitutionally protected under the doctrine of intergovernmental immunities, based on the Supreme Court decision in *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429, *modified*, 158 U.S. 601 (1895) (holding earlier income tax unconstitutional for various reasons, including the taxation of state and local government bond interest). In *South Carolina v. Baker*, 485 U.S. 505 (1988), however, the Supreme Court concluded that the tax exemption of the interest on state and local government bonds is not constitutionally protected.

Although, under the holding in *South Carolina v. Baker*, Congress now has the constitutional power to eliminate or limit the federal tax exemption of interest on state and local government bonds, there are sound policy reasons for Congress not to do so.

The first is based on the fundamental principle that American government is organized as a federal system with co-existing layers of sovereign governments. The federal government was intended to be a limited government, with the powers not expressly delegated to it reserved to the states or to the people. For example, the states are not permitted to tax interest on U.S. Treasury obligations.[12] The exclusion from taxation under the Code of state and local bond interest can, and should, be viewed in this context as a reciprocal expression of federalist principles, recognizing the sovereign primacy of the states, and not as just another "tax expenditure."

Second, the ability of state and local governments to access readily available low-cost financing encourages infrastructure development throughout the United States. To the extent that the cost of borrowing to state and local governments increases, unless substantial amounts of other federal funds, including grants, are made available to compensate them for the higher costs of taxable debt, state and local governments will be discouraged from such infrastructure investments. Public infrastructure is critical to a healthy economy. Businesses depend on airports, highways, and electric, water and sewer utilities and upon quality education systems to provide an educated workforce. A lack of investment in infrastructure will hurt long-term economic growth and, in the short term, result in loss of construction-related jobs.

Moreover, the ability of state and local governments to issue bonds on a tax-exempt basis encourages local control over local capital projects. State and local governments set their priorities for infrastructure and economic development and shoulder the burden of these investments through the issuance of their own tax-exempt debt. They pay all of the principal of and interest on the debt, with the federal government contributing a relatively small portion through foregone tax revenue. If the current system were replaced with one in which the federal government provided grants or loans

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9 Congressional Budget Office and Joint Committee on Taxation, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds* (October 2009) at 9. Note that this figure also includes other types of tax-preferred debt such as tax credit bonds (e.g., QZABs).
10 Id.
11 Aaron Barnes, *Municipal Bonds 2009,* Internal Revenue Service, Statistics of Income, Fall 2011.
12 31 U.S.C. § 3124

to replace the assistance now provided by the exclusion of interest on state and local bonds, the federal government would inevitably appropriate control over infrastructure and economic development decisions that are now made, effectively, at the state and local level.

Of course, an alternative to a reduction in infrastructure spending by state and local governments or to a new federal grant or loan program would be for state and local governments to keep the same level of infrastructure investment and fund it entirely on their own. The increased borrowing cost to state and local governments would be borne by taxpayers and ratepayers in every local jurisdiction through the imposition of increased taxes and fees (e.g., ad valorem property taxes, special assessments, sales taxes, toll charges and utility rates) or through service cuts. As pointed out above, these taxes or fees, including especially sales taxes, tolls or user fees, would fall disproportionately on lower and middle-income households, as would service cuts. This would be an ironic result for a change which may have been intended by some proponents to increase the amount of taxes paid by higher income taxpayers.

The same result would also occur with respect to state and local bonds issued for the benefit of nonprofit healthcare or educational institutions to finance hospitals, schools, senior facilities and the like, and for the benefit of certain specified for-profit borrowers, such as small manufacturers and low-income housing. In most if not all of these cases, increased borrowing costs will be passed on to end users, many of whom may be lower- and middle-income households, through higher tuition, bed rates, insurance premiums, rents, and similar charges.

III. Quantifying the Effects of Elimination of or Limitation on Exclusion of Interest on State and Local Government Bonds

Effects on Bond Borrowers

Quantifying the effect on the interest rates that state and local borrowers would pay in the event of the elimination of or limitation on tax-exempt interest is complicated, especially because there would likely be other changes to the Code occurring at the same time. However, investors would demand an increase in the interest rate paid to them so that their after-tax return remained approximately the same. The amount of that increase would depend in large part on how the elimination or limitation of the exclusion were written and on other changes that might be made in the Code as part of tax reform. In addition to the increased rate of return that investors would require to maintain the same after-tax return on their investment, it is also likely that they would demand a "risk premium" to account for the fact that the federal government would have demonstrated that it is willing to change the rules regarding state and local bonds and that, therefore, the federal government might well change the rules in the future. But regardless of the exact magnitude, the direction of the change is clear. State and local borrowers would pay higher interest rates.

State and local borrowers would pay these higher interest rates in two circumstances. First, they would pay a higher rate on newly issued bonds. Second, if the elimination or limitation on state and local bond interest were to apply retroactively to bonds that had already been issued, as proposed for instance by the Obama Administration, state and local governments would pay a higher rate on some of those already-issued bonds if those bonds are "variable rate" bonds. With variable rate bonds, the interest rate is reset periodically (e.g., daily, weekly, monthly, yearly) to whatever the then-current market rate is. For most variable rate bonds, the interest rate would increase shortly after the change in tax law to compensate the investor for the loss of tax exemption. As with newly issued bonds, these increased interest rates would be passed through immediately to the issuer and ultimately to taxpayers, users or ratepayers.

In sum, if there are changes to the interest exclusion for state and local government bonds, it is likely that interest rates will increase and the cost will be borne by the issuing state and local governments. These governments would have three basic choices to get the money to pay for those increased interest rates - increases in taxes or fees, decreases in spending or a combination of increased taxes and fees and decreased spending. However, because the political pressures on state and local governments may limit their ability to implement spending cuts and revenue increases, it is likely that there would be a net reduction in their issuance of bonds and their spending on infrastructure projects. That reduction in infrastructure investment will harm the long-term economic growth of the country and result in a loss in construction-related employment.

Effects on Bond Investors

Investors in state and local bonds would be adversely affected if the elimination or limitation on tax-exempt interest applied to existing bonds, as has been proposed by President Obama. With respect to fixed rate bonds (and those variable rate bonds where the interest rate cannot be adjusted immediately to reflect a change in tax status) the holders of these bonds, whether individuals or financial institutions such as banks or insurance companies, would experience a loss in the market value of their bonds due to the change in tax treatment of the existing bonds..

For example, suppose an investor owns a tax-exempt bond maturing in 10 years with a 5 percent fixed interest rate that was purchased at par for $1000. Under current law, the investor receives the full 5 percent as the after-tax return on the investment. If the exclusion of tax-exempt interest were eliminated or limited for existing bonds, that investor would discover that prospective purchasers would not be willing to pay $1000 for the bond because a holder of the bond would not receive the full 5 percent as an after-tax return. The loss in value could be substantial. If the exclusion for state and local bonds were completely eliminated for existing bonds a purchaser would only be willing to pay about $815 for the bond that originally was worth $1000.[13]

The effect of President Obama's proposal to limit the value of the exemption to 28 percent would similarly reduce the value of a $1000 bond maturing in 10 years by more than 5 percent to less than $950.[14] As noted above, there are trillions of dollars of tax-exempt bonds outstanding and about three-fourths of those bonds are held, directly or indirectly, by individuals.[15] Over 5.3 million households with incomes under $250,000 a year reported tax-exempt income in 2009.[16] Retroactive application of changes to tax-exempt status could have dramatic effects on the savings of millions of Americans who are by no means rich.

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[13] Certain fixed rate bonds, typically sold in private placements, have been issued with a mechanism whereby the interest rate on the bond would be modified if there are changes in the marginal rate under the Code. It is unclear whether those provisions would be triggered by any particular change to the municipal interest exclusion since some of the proposals would not actually affect the marginal rates but would affect the exclusion itself.

[14] These calculations reflect the lower price that would be necessary to maintain the equivalent post-tax yield. The effect may in fact be larger than these calculations indicate, however, if investors demand a risk premium to account for the fact that the federal government would have demonstrated that it is willing to change the tax rules retroactively.

[15] See footnote 3 above.

[16] See footnote 4 above.

Conclusion

The extent of the effect of eliminating or limiting the exclusion of interest on state and local bonds would depend in part on whether any change is applied retroactively to all outstanding tax-exempt bonds or only prospectively. If a particular proposal applies retroactively to all outstanding tax-exempt bonds, the loss in value in existing bonds and the increase in the interest rates on many floating rate bonds would be almost immediate. In contrast, applying a change in the Code prospectively to newly issued debt would at least protect investors with respect to their current portfolios but would have an adverse effect on municipal issuers going forward with respect to all newly-issued bonds.

Regardless of whether the change is prospective only or retroactive, the effect on state and local borrowers will be some combination of lower infrastructure spending, higher tax and rate paying burdens on the public, and lower spending in other areas. These burdens would fall mainly on lower and middle-income households.

Finally, high-income taxpayers have historically been quite resourceful with respect to tax planning. While their current tax planning may include the ownership of tax-exempt bonds, if there are material changes to the Code provisions with respect to tax-exempt bonds, high-income taxpayers may adjust their holdings, either at once or over time, to other tax-advantaged investments and strategies to reduce the taxes they pay. To the extent that taxpayers reallocate their portfolios in that manner, the expected revenues from the elimination or limitation of the tax-exemption may well not be realized.

NAHEFFA

National Association of Health and Educational Facilities Finance Authorities

April 2, 2013

Joint Testimony of the National Association of Health and Educational Facilities Finance Authorities Regarding the March 19, 2013 Hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments."

The National Association of Health and Educational Facilities Finance Authorities (NAHEFFA), respectfully submit this testimony relating to the Committee's hearing on municipal finance and tax reform. We represent the major issuers of nonprofit, 501(c)(3) tax-exempt bonds. Our purpose is to describe the vital role this financing plays in providing critical public services and enhancing and maintaining the economic strength of countless communities across the United States.

NAHEFFA (www.naheffa.com) represents 43 issuers of nonprofit tax and bonds in 35 states. Most of its members are statewide issuers with decades of experience and expertise in assisting large and small nonprofit institutions accessing the capital markets. While some authorities issue only for health or education institutions, a number of authorities issue for multiple purposes and also include youth activities, the arts, and museums. These financings support hospitals, health clinics, drug and alcohol treatment centers, boys and girls clubs, small and large colleges and universities, and other purposes and compose the majority of so-called "private activity bonds."

Tax exempt financing was authorized for federally recognized 501(c)(3) organizations in the Revenue and Expenditure Control Act of 1968. The authorization was consistent with the principles that have governed federal tax since the early 19th century by recognizing the legal appropriateness of government support for charitable organizations.

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Although technically these financings are classified private activity bonds because the use and repayment of the bonds is by “nongovernmental” persons, nonprofits which benefit from tax-exempt financing are entities recognized for their public purpose under state and federal laws. Further, tax exempt bond financings may only occur through authorities and other issuers specifically created or authorized under state laws which impose additional criteria and procedures to ensure the public purpose and benefits of these financings.

Many of the institutions benefiting from tax exempt bond financings are an integral part of the social "safety net” created and supported by governments. In fact, many of the non-profits benefitting from tax exempt bonds provide a safety net for those who fall between the cracks of state and local government services. Thousands of hospitals and other healthcare providers, colleges and universities and other nonprofit educational organizations serve as a tangible part of the very fabric of their local communities through their services and their economic stability, employment and stimulus of other goods and services.

Any analysis that concludes that a disproportionate percentage of the benefits of tax exempt financing is enjoyed only by wealthy individuals is mistaken, as other commenters have noted in submitted testimony. These analyses, frequently totally neglect the real world advantages and efficiencies of this decentralized system of decision-making and allocation of capital. Through their statutory authorization, boards, state and local oversight and the transparency required by public disclosure laws, these financings reflect the best federalist policies of local control and decision making by those in the best position to make educational and health care facility decisions in an environment of scarce financial resources. The system effectively sorts projects through determinations not only by the issuing authorities, but by the borrowers who must show to investors feasibility of repayment. To paraphrase Professor John Buckley’s testimony, this is a conservative method of providing federal support for state and local investment in public purpose, non-profit facilities, minimizing the role of federal government, limiting the possibility of earmarks, and placing the decisions for public purpose investments in the hands of issuers and borrowers who have every incentive to be financially responsible.

In contrast, direct federal financial support working independently of the capital markets tends to be an ineffective substitute. Approval and implementation of projects tends to be slow, poorly targeted and highly subject to political pressures. By contrast, the capital markets – albeit with the federal subsidy – have important advantages as providers of timely, low – cost capital for projects selected by borrowers and approved by issuers. These parties have strong incentives to use proceeds efficiently to minimize annual debt service and maintain credit ratings. This approach often leverages direct federal support for health and higher education by recognizing, particularly in the aftermath of the recession and serial federal budget crises, that there is not, nor likely to be, sufficient federal capacity to pay for the needed improvements and infrastructure of the nonprofit and governmental sectors. The genius of the current federal –state/local-non- profit partnerships which constitutes tax-exempt financing for 501(c)(3) institutions is that it recognizes the limits of direct federal funding and provides for a viable alternative.

It is also critical to appreciate that these financings, and the borrowing institutions, are heavily regulated under state and federal law. For example, the Internal Revenue Code imposes strict arbitrage, advanced refunding, cost of issuance and other requirements. Further, these institutions are increasing called upon by the marketplace and by federal and state regulations to provide large amounts of information informing investors and the public about their operations, including the use of the bond proceeds. That 501(c)(3) financings are not subject to the state-by-state private activity bonds reflects, as JCT indicated, the well-founded belief that tax-exempt bonds for nonprofit have a larger component of benefit to the general public than do many other private activities eligible for the tax exemption.

Beyond the well-recognized and critical public services that education and healthcare offer in every community across the United States, these institutions, large and small, often are among the most significant employers in their communities whether urban, suburban or rural. Their well-being and the financing of improvements and new infrastructure in buildings and equipment provide major employment multiplier effects directly and indirectly.

A variety of proposals have been made to restrict or dilute the benefits of tax exempt financing in general and for nonprofit bonds in particular. While well-intentioned, these proposals are problematic and damaging to the public interest. The most extreme proposal would simply be to eliminate the tax exemption for 501(c)(3) financing and require thousands of health and education institutions across the country to access capital only through the taxable market. No one denies that this would have a significant and negative impact on borrowing costs, particularly for the thousands of small health care and education institutions with low or no credit rating. Borrowing costs could increase by as much as two percent and in many cases projects would be delayed, postponed, canceled or never developed. This approach not only would undermine the critical missions of the schools and hospitals but increase education and healthcare costs.

More empathetic proposals are aimed at developing or expanding types of direct pay bonds. First, there has been a continuing attempt to impose on the marketplace tax credit bonds. This is an alternative that simply won't work well and has not where it is available due to the lack of "stripability" of the tax credits. It is not an attractive investment, particularly for those not seeking such credits.

Somewhat more useful but still seriously flawed options as total substitutes for tax exempt bonds are direct pay bonds similar to the popular Build America Bonds and the infrastructure bonds President Obama has proposed. BAB's were not available to nonprofits, and if they are revived in some form there are highly credit worthy nonprofits that would benefit from the opportunity to use them. Direct pay bonds also have the secondary benefit of improving the overall tax exempt bond market because of the impact on supply. But, if, as is likely, any renewed BAB program will set subsidies at significantly lower interest rates than the previous program it is unlikely these bonds would be viable.

In addition, the credibility of the federal government as a partner in this type of program is under serious question. Not only were the initial BAB's allowed to lapse but all proposals to renew them have been at significantly different terms. There is no reason to think that this approach would not continue in the future, meaning that nonprofits, just like state local governments, cannot rely on them for their future basic financing needs. In addition, through the application of offsets and now reductions in payments due to sequestration the viability of this approach is suspect. There is simply no assurance for nonprofits that the level of subsidy and continuity of payments are reliable. Finally, there is great reason to doubt that many of the purchasers of these types of bonds, such as non-US tax payers, would have much interest in the thousands of small colleges and clinics that presently benefit from tax-exempt financing. The cost of marketing and placing BAB's around the world would be infeasible for the vast majority of 501(c)(3) borrowers.

There also have been proposals to limit the benefits of tax-exempt interest to high income individuals. Unfortunately, the main impact of these proposals, particularly as they are applied retroactively, is to greatly devalue tax-exempt debt, thereby imposing severe penalties on health and education institutions across the United States.

The proposed 28% cap on deductions and exemptions would effectively impose a tax on otherwise tax exempt interest. The practical and direct consequence of this action would be not only to disincentivize potential investors but also to require them to seek a higher return for tax exempt bonds. An additional grave concern about this proposal is that it would apply to interest in existing bonds, representing a violation of the basic assumption that Congress will not change the terms governing the taxability of interest for bonds already outstanding. In the nearly hundred year history of the tax exemption, Congress has never applied a retroactive tax to bonds already held by investors. It is estimated that borrowing rates could increase between 60 to 75 basis points if this proposal is enacted.

Alternatively there is a proposal for a dollar threshold cap on deductions and exemptions (e.g., $50,000). This proposal would limit the total amount that taxpayers from all income brackets may use for federal income tax purposes. Its consequence could well be that there would be no benefit for many investors to purchase municipal securities since they will apply to the cap and prioritize the use of essentially "nonvoluntary" deductions such as the home mortgage and state local tax deduction. Because this proposal would affect all taxpayers, it is estimated that nonprofit and state and local borrowing costs could rise between 120 – 250 basis points.

We urge the Committee in its deliberations of Tax Reform to maintain the current law exemption from income of tax-exempt bonds. We urge the Committee not to eviscerate an imperfect but critical method for thousands of charities and health and education nonprofits across the country to access vitally needed capital. We also urge the Committee not to make decisions that paint with broad strokes what constitutes private activity bonds but to consider carefully the public purpose services critical to our communities provided by nonprofit health and education institutions that are supported by the tax exemption for 501(c)(3) nonprofit bonds. It is critical to maintain the access to affordable capital that results from the current partnership between issuing authorities and hospital and education borrowers.

Respectfully submitted,

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NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

STATEMENT OF RECORD

SENATOR ELLEN ROBERTS, COLORADO

CO-CHAIRS, BUDGETS AND REVENUE COMMITTEE

ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

REGARDING

"Tax Reform and Tax Provisions Affecting State and Local Governments"

TO THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 2, 2013

Dear Chairman Camp and Ranking Member Levin:

We appreciate the opportunity to submit the following statement on state and local taxation on the behalf of the National Conference of State Legislatures (NCSL) and respectfully request that you enter it into the official record. NCSL is a bipartisan organization that serves the legislators and staffs of the nation's 50 states, its commonwealths and territories. We are pleased you held a hearing looking into the interrelated nature of federal and state taxes, as so often this relationship is overlooked and undervalued. As you work toward comprehensive tax reform, NCSL would like to remind the committee that federal and state tax systems are inextricably linked, and any federal tax reform efforts will likely have serious fiscal and administrative ramifications on states. We recommend you carefully consider the effect any changes you propose would have on state revenue authority and the states' abilities to fund a wide array of public works' activities.

NCSL urges the committee to adhere to the following principles as you consider reforming the federal tax code:

- Maintain the tax-exempt status of state and local government bonds for infrastructure and capital projects;
- Preserve the fiscal viability and sovereignty of state governments;
- Preserve states' abilities and discretion to tax certain revenue sources;
- Protect the state and local income tax, sales tax and property tax deductions for federal income tax purposes; and
- All federal tax law changes should be prospective so that states do not suffer unexpected revenue losses that would emanate from a retroactive application.

The first principle is the most beneficial and productive instrument for governmental infrastructure and capital needs purposes. Since the inception of the federal income tax, municipal bonds have received an interest exclusion due to the reciprocal immunity principle between the federal and state and local governments. Municipal bonds are also exceptional economic development and job creating/maintaining tools. Any restriction would likely lead to increased costs or less investment activity, and in comparison to other bond subsidies this tax treatment is the most effective tool for infrastructure development. We ask you to keep in mind the positive factors of this public financing instrument in your future deliberations.

In 2010 NCSL established a task force whose goal was to ensure any federal deficit reduction plan does not result in exporting the deficit to state governments. Several principles became readily apparent. These include no new unfunded mandates on state governments, the support of infrastructure programs and programs serving low-income populations, the enactment of the Marketplace Fairness Act, and the preservation of tax-exempt financing for municipal bonds.

NCSL understands the desire for the committee to simplify the federal tax code, and ultimately the objective for Congress to address the nation's fiscal challenges. While we recognize state and local governments will see funding reductions due to federal deficit savings, states and localities will struggle if we are disproportionately impacted or an unreasonably fiscal burden is shifted on us. NCSL strongly opposes any effort by Congress or the administration that singularly targets state and local revenue bases or infrastructure financing mechanisms.

We are pleased you have conducted this hearing and welcome the opportunity to work collaboratively with the committee in your effort to reform the federal tax code. For additional information, please contact Michael Bird (202-624-8686; michael.bird@ncsl.org) or Jeff Hurley (202-624-7753; jeff.hurley@ncsl.org).

NATIONAL GOVERNORS ASSOCIATION

Statement of

David Parkhurst

Director, Economic Development and Commerce Committee of the National Governors Association

Before the

House Ways and Means Committee

Hearing on "Tax Reform and Tax Provisions Affecting State and Local Governments"

March 19, 2013

Chairman Camp, Ranking Member Levin and members of the House Ways and Means Committee, thank you for inviting testimony from the National Governors Association (NGA) regarding key issues for the states associated with federal tax reform. Founded in 1908, NGA is the only bipartisan organization of the nation's governors.

My name is David Parkhurst, and I am the director of NGA's Economic Development and Commerce Committee led this year by Pennsylvania Governor Tom Corbett and Kentucky Governor Steve Beshear. The Economic Development and Commerce Committee is charged with developing policy positions that reflect the priorities of governors with regard to issues related to the economy, including the implication of federal tax reform.

In preparation of this debate, governors last year appointed a five-member Tax Reform Task Force, co-chaired by Governors Corbett and Governor Beshear, to explore the possible effects of federal tax reform on states. The Task Force includes Connecticut Governor Dan Malloy, Michigan Governor Rick Snyder, and U.S. Virgin Islands Governor John deJongh.

My remarks today will include a short summary of the work of this Task Force.

Let me begin with several main points:

- Public finance – notably tax-exempt bonds -- is the primary method to finance infrastructure projects —including schools, hospitals, roads, and bridges—approved directly by voters or by governing bodies.

- Federal laws and regulations, either directly or indirectly, should not increase the costs states and local governments incur to issue municipal bonds or decrease investor appetite to purchase them.

- No federal law or regulation, including their interpretation and implementation, should preempt, limit or interfere with the constitutional or statutory rights of states to develop and operate their revenue and tax systems.

Federal-State Tax Code Linkages

It has been nearly 30 years since the Tax Reform Act of 1986 became law, which was the last time Congress overhauled the federal tax code ("Code"). Driving factors today include lowering tax rates through closing loopholes and reducing tax expenditures. The variation among states in their linkages to the federal Code is another important factor that will influence tax reform. *See* Attachment 1 for a chart detailing federal-state linkages.

State income taxes, for both individuals and corporations, often rely on the federal Code and to a large degree, conform to its features; definitions; eligible deductions and exclusions; and tax treatment of certain transactions:

- Thirty-six of the 41 states with a broad-based personal income tax base the calculation of state tax on a federal "starting point" such as adjusted gross income (AGI) or taxable income.[1]

[1] According to the Federation of Tax Administrators (FTA), seven states do not impose a state personal income tax: **Alaska, Florida, Nevada, South Dakota, Texas, Washington**, and **Wyoming.** In addition, **Tennessee** and **New Hampshire** impose an income tax on interest and dividends only. FTA (2013)

- In the five states that do not use a federal starting point, the various items of income used to calculate the state base are commonly defined with federal Code definitions.[2]

- Of the 46 states that levy a tax based on corporate income, all of them effectively use "federal taxable income," with certain modifications, as the starting point for state tax computations.[3]

States conform to the federal Code because it promotes taxpayer simplicity and compliance. Many states also rely on federal reporting mechanisms to help administer state tax systems. Changes to deductions, credits, exclusions, and exemptions in the federal Code, moreover, would have corresponding revenue and economic implications for the states depending on the variation in each state's linkages to the federal Code.

Tax Reform Risks for Municipal Bonds and State/Local Tax Deductibility
While changes to the current federal tax treatment of municipal bonds were not part of the latest "fiscal cliff" package in early January, restrictions on the deductibility of state and local income, property and sales taxes were included, and governors are well aware that changes to those tax exclusions and deductions that benefit states may be considered in future negotiations between Congress and the Administration. In this regard, the most important issue for states in federal tax reform is safeguarding public financing— notably tax-exempt bonds — because it is the primary method to finance infrastructure projects.

For nearly 200 years, municipal bonds have assisted states, cities, and counties in financing their infrastructure needs, including roads, bridges, schools, hospitals, transit systems, housing, public power and gas systems and utilities, and other vital projects serving the public good. Since its inception in the early 20th century, the federal Code included the exclusion from income for municipal bond interest. In contrast to the status quo treatment of municipal bond interest are the following policy options that would chill public finance:

Eliminate the Tax Exclusion. The National Commission on Fiscal Responsibility and Reform (i.e. "Simpson-Bowles") in its December 2010 report included an "illustrative proposal" to end the exclusion from taxable income of municipal bond interest. According to federal and private sector estimates, the interest exclusion will reduce federal revenues by $43 billion in fiscal year 2014. The exclusion, however, is an attractive incentive for investors that will help states and local governments issue an estimated $400 billion in new bonds for capital projects in fiscal year 2014. *See* Attachment 2 for a state-by-state summary of long-term tax-exempt bond issuances in the states from 2003-2012.

Ending or capping the federal exclusion from income for municipal bond interest would increase the cost of financing infrastructure because investors would demand higher yields to compensate for the lost exclusion. Higher borrowing costs would chill infrastructure investments, lead to higher taxes on citizens to cover the increase, or some combination. Given constraints on direct federal spending, and with the tremendous overhang of unmet infrastructure needs throughout the country, policymakers should encourage, not limit, state and local financing for those projects that create jobs and boost economic growth.

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[2] According to the FTA, those states are **Alabama, Arkansas, Mississippi, New Jersey**, and **Pennsylvania.**
[3] Four states do not impose a tax at the corporate or business entity level: **Nevada, South Dakota, Washington**, and **Wyoming**. FTA (2013).

Cap Federal Deductions and Exclusions. Both President Obama, most recently in his proposed 2013 budget, and Speaker Boehner during the recent "fiscal cliff" negotiations in late 2012 indicated that capping all tax deductions and exclusions was an option for deficit reduction. While either its form could vary as a percentage cap on high-income taxpayers, or a hard dollar cap applied to all taxpayers who itemize their returns, the effect on municipal bonds would be damaging.

A "hard dollar" cap crowds out lower-valued deductions and exclusions in favor of higher-valued ones like the deduction for mortgage interest effectively making municipal bonds taxable for most taxpayers who itemize. Note, however, that a percentage cap would not necessarily result in investors rebalancing their tax-exempt portfolios fully into taxables. They would instead seek other ways to adjust their portfolios for tax purposes, which would lower federal revenue projections from this option. IRS data for 2010 returns, moreover, offer a snapshot of taxpayers reporting tax-exempt interest: 84 percent earned $250,000 or less (AGI), while five in 10 were taxpayers aged 65 and older; when measured by the total amount of reported tax exempt interest, taxpayers who earned more than $250,000 (AGI) accounted for less than half the total.

Moreover, if a cap applied to both new and outstanding bonds, it changes the contractual terms of those outstanding bonds for investors, creating legal and market disruptions that could put issuers at risk. A cap also creates new technical complexities for both taxpayers and the Treasury because the process for calculating the cap would not be simple.

Other Options. Opponents of the interest exclusion for municipal bonds have suggested alternatives such as tax credit and direct subsidy bonds to replace tax-exempt bonds:

i. Replacing the long-standing tax-exempt market with a tax-credit bond program would harm state and local issuers because investors do not purchase these types of bonds on a wide scale although they are currently available. The outcome goal should be to maximize capital investment through products that attract an optimal basket of retail and institutional investors that will clear the supply of municipal bonds consistently and easily. This is a dynamic process that should involve a mix of tax-exempt and taxable products. Converting to tax credits alone would also increase costs to state and local issuers because investors would demand higher yields, which may also crowd out smaller issuers that do not go to market regularly.

ii. Direct subsidy bonds have complemented the tax-exempt market, most notably during 2009-2010 with Build America Bonds (BABs). BABs were taxable bonds where the federal government provided the state and local issuer a variable subsidy equal to 35 percent of the interest payable over the lifetime of the bonds. However, replacing the tax-exempt market with direct subsidy bonds, most likely at a significantly lower subsidy rate around 25 percent, would limit the scope of financing tools available to state and local issuers, increase costs because of investor demand for higher yields, and inject new uncertainty whether future Congresses would reduce federal subsidy payments. The fact the BAB subsidy is subject to the sequester would only add to the uncertainty—and thus the costs to state and local issuers—of replacing the current exemptions with BABs.

When it comes to ensuring maximum federal flexibility in public finance for state and local governments, the directive should be "all-the-above," not "either/or." The mere discussion about altering the current tax treatment of municipal bonds injects uncertainty into bond markets and raises concern for investors who would demand risk premiums on future bond issues.

State and Local Tax Deductibility
Finally, ending the federal tax deduction for state and local income and property taxes may limit the ability of states to adjust revenue and budget policies in response to uncontrollable economic pressures, which could increase risk concerns for bondholders. It would effectively increase marginal tax rates for taxpayers that, absent an offset for equity purposes, could create an economic drag. Likewise, shifting the federal system of income taxation to something else like a sales or consumption tax could damage administrative viability and limit state control of their tax systems because of federal encroachment into the traditional tax base of states.

Guiding principles on federal tax reform recently affirmed by governors for NGA specifically address state sovereignty. Federal laws and regulations should not preempt or limit state authority to develop and operate their revenue and tax systems.

Conclusion – NGA Guiding Principles on Federal Tax Reform

NGA's Guiding Principles on Federal Tax Reform will help governors evaluate proposals from Congress and the Administration. They offer concrete suggestions that are consistent with the intertwined interests of states and the federal government. In addition to state sovereignty, the Principles address categories including public finance, federal reforms, proportionality, and economic growth and efficiency:

State Sovereignty

- No federal law or regulation, including their interpretation and implementation, should preempt, limit, or interfere with the constitutional or statutory rights of states to develop and operate their revenue and tax systems.

Public Finance

- The preservation of public financing – notably tax-exempt financing – is necessary because it is the primary method for states to raise capital for a wide range of public projects.

- Federal statutory and regulatory policies should neither increase bond issuance costs to states and local governments, directly or indirectly, nor diminish retail and institutional market demand for bonds issued by states and local governments.

Federal Reforms

- Federal tax reforms should deliver simplicity, adopt innovation, promote certainty, and produce savings for both federal and state governments.

- Federal tax policies and expenditures serve public policy purposes not necessarily captured in revenue and spending numbers. To help avoid unintended consequences from federal tax reform, federal and state partners should work together to determine whether the policy benefits of particular federal tax expenditures exceed their budgetary costs before making final decisions.

Proportionality

- Federal tax reforms should not simply shift costs or impose unfunded mandates onto the states.

Economic Growth and Efficiency

- Federal tax reforms should strive to achieve flexibilities for states that help create efficiencies and stimulate economic growth.

The Principles focus on federal deductibility of state and local taxes and the interest exclusion on municipal bonds because these topics are top priorities for all states. In addition, the Principles address the broader issue of ensuring that federal tax reform does not limit or preempt state authority over budget and revenue systems.

As tax reform moves forward in Congress, states will have different priorities and positions on specific proposals involving particular corporate, international, and individual matters because linkages to the federal Code vary among the states. The Principles will guide NGA's collective efforts to oppose federal attempts to preempt or limit state authority because what states are doing on tax policy can and should help drive what happens at the national level.

Moreover, state and local governments, as the principal owners and operators of our nation's infrastructure and issuers of municipal bonds, will remain advocates for safeguarding municipal markets. Thank you for the opportunity to testify. I would be happy to answer questions.

# # #

Attachments

Attachment 1: State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

Attachment 2: Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

AGI = *Adjusted Gross Income*
FTI = *Federal Taxable Income*

State	State has no broad-based personal income tax	State linkage to IRS code	State deduction for federal taxes paid	State has no broad-based sales tax	State issues no General Obligation debt	State accepts Federal deduction/ S-L taxes
Alabama		No link	X			
Alaska	X	No link		X		
Arizona		AGI			X	
Arkansas		No link				Local income tax only
California		AGI				
Colorado		FTI			X	
Connecticut		AGI				X
Delaware		AGI		X		
Florida	X	No link				
Georgia		AGI				
Hawaii		AGI				
Idaho		FTI			X	
Illinois		AGI				
Indiana		AGI			X	
Iowa		AGI	X		X	
Kansas		AGI			X	
Kentucky		AGI			X	Local income tax only
Louisiana		AGI	X			
Maine		AGI				
Maryland		AGI				
Massachusetts		AGI				
Michigan		AGI				
Minnesota		FTI				
Mississippi		No link				
Missouri		AGI	X			
Montana		AGI	X	X		
Nebraska		AGI			X	
Nevada	X	No link				
New Hampshire[1]	X	No link		X		
New Jersey		No link				
New Mexico		AGI				
New York		AGI				
North Carolina		FTI				

[1] New Hampshire taxes unearned income.

State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

State	State has no broad-based personal income tax	State linkage to IRS code	State deduction for federal taxes paid	State has no broad-based sales tax	State issues no General Obligation debt	State accepts Federal deduction/ S-L taxes
North Dakota		FTI			X	X
Ohio		AGI				
Oklahoma		AGI				
Oregon		FTI	X	X		State income tax deduction
Pennsylvania		No link				
Rhode Island		AGI				
South Carolina		FTI				
South Dakota	X	No link			X	
Tennessee[2]	X	No link				
Texas	X	No link				
Utah		AGI				Limited credit/state income tax
Vermont		FTI				
Virginia		AGI				
Washington	X	No link				
West Virginia		AGI				
Wisconsin		AGI				
Wyoming	X	No link			X	
U.S. Territories: *Puerto Rico, American Samoa, Guam, Northern Mariana Islands, U.S. Virgin Islands*	*See Note*[3]	0	USVI (tax credit)	AS, CNMI	AS,USVI	

Source: FFIS, Federation of Tax Administrators (2013)

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[2] Tennessee taxes unearned income.

[3] The application of Federal tax rules varies from one territory to another. **Guam**, the **Northern Mariana Islands**, and the **U.S. Virgin Islands** are called "mirror Code territories" because each adopted the Internal Revenue Code of 1986 ("the Code") as the internal tax law of those territories. **American Samoa** and **Puerto Rico** are non-mirror Code possessions and have their own internal tax laws.

State Sensitivities to Various Federal Tax Policies: Personal Income Taxes

***Tax Provisions Related to the U.S. Territories*[4]**

American Samoa
American Samoa is a non-mirror Code possession and imposes its own local tax code. All nationals are subject to tax as U.S. citizens, with an exclusion provided for American Samoa-sourced income. The Code does not provide relief from double filing, so residents potentially have to file with both the United States and the American Samoa governments.

Guam
Guam uses a mirror system of taxation, so taxpayers are required to file a single tax return to either the United States or Guam, depending on whether they are a United States resident or a Guamanian resident. The United States generally pays the Guamanian treasury certain taxes collected on Guamanian-sourced income and on withholding tax on U.S. federal personnel employed or stationed in Guam. Similarly, Guam pays the U.S. Treasury certain taxes collected from individuals on United States- sourced income.

Northern Mariana Islands
The Commonwealth of the Northern Mariana Islands (CNMI) uses a mirror system of taxation; however, the CNMI also has the authority to rebate the tax imposed by its mirror code with respect to CNMI- sourced income.

Puerto Rico
Puerto Rico is a non-mirror Code possession with its own internal tax laws. A person born in Puerto Rico is a U.S. citizen and is subject to U.S income tax. The Code excludes Puerto-Rican derived income from U.S. taxation provided the taxpayer resides in Puerto Rico for a full taxable year. Income excluded from US gross income, however, is generally subject to Puerto Rican taxation.

U.S. Virgin Islands
The U.S. Virgin Islands (USVI) employs a mirror system of taxation. In general, a resident of the USVI is required to file and pay tax only to the Territory. The USVI may also impose certain local income taxes in addition to taxes imposed by the mirror code. USVI taxes its citizens and residents on their worldwide income. USVI taxpayers receive a foreign tax credit for income taxes paid to the United States, and other possessions of the United States.

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[4] Joint Committee on Taxation, "Federal Tax Law and Issues Related to the United States Territories," May 14, 2012. Available at: https://www.jct.gov/publications.html?func=startdown&id=4427

Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

(Dollars in millions)

The following table reports the value of all long-term tax-exempt bonds issued by states and their localities for physical infrastructure purposes for the last decade. A long-term bond is one issued for a period greater than one year. This table does not include refunding transactions for outstanding bonds.

STATE	Housing[1]	Percent[2]	Utilities[3]	Percent	Transportation[4]	Percent	Education[5]	Percent	Environmental[6]	Percent	Public Facilities[7]	Percent	TOTAL	% of Total Issuances
Alabama	$849	0.60%	$6,486	1.96%	$1,463	0.37%	$9,939	1.19%	$1,153	2.00%	$808	0.76%	$20,698	1.11%
Alaska	$1,760	1.25%	$242	0.07%	$2,505	0.64%	$1,852	0.22%	$0	0.00%	$504	0.47%	$6,863	0.37%
Arizona	$1,434	1.02%	$7,098	2.14%	$7,052	1.80%	$16,918	2.03%	$2,169	3.76%	$2,850	2.68%	$37,521	2.01%
Arkansas	$668	0.47%	$1,899	0.57%	$603	0.15%	$9,825	1.18%	$278	0.48%	$473	0.44%	$13,745	0.74%
California	$14,545	10.33%	$54,616	16.49%	$41,112	10.52%	$116,787	13.98%	$5,125	8.89%	$16,374	15.40%	$248,559	13.35%
Colorado	$3,240	2.30%	$6,798	2.05%	$10,124	2.59%	$17,463	2.09%	$211	0.37%	$3,388	3.19%	$41,225	2.21%
Connecticut	$4,617	3.28%	$1,861	0.56%	$4,376	1.12%	$7,776	0.93%	$480	0.83%	$184	0.17%	$19,294	1.04%
Delaware	$969	0.69%	$177	0.05%	$1,701	0.44%	$4,183	0.50%	$386	0.67%	$43	0.04%	$7,458	0.40%
Florida	$4,600	3.27%	$20,370	6.15%	$27,503	7.04%	$38,525	4.61%	$4,880	8.46%	$4,353	4.09%	$100,229	5.38%
Georgia	$1,585	1.13%	$11,506	3.47%	$8,581	2.20%	$15,684	1.88%	$3,262	5.66%	$1,976	1.86%	$42,595	2.29%
Guam	$0	0.00%	$220	0.07%	$212	0.05%	$138	0.02%	$0	0.00%	$0	0.00%	$570	0.03%
Hawaii	$308	0.22%	$2,162	0.65%	$1,863	0.48%	$471	0.06%	$272	0.47%	$41	0.04%	$5,117	0.27%
Idaho	$1,434	1.02%	$217	0.07%	$720	0.18%	$2,493	0.30%	$64	0.11%	$278	0.26%	$5,207	0.28%
Illinois	$3,829	2.72%	$6,602	1.99%	$15,290	3.91%	$31,724	3.80%	$588	1.02%	$7,857	7.39%	$65,889	3.54%
Indiana	$1,659	1.18%	$6,948	2.10%	$3,939	1.01%	$18,814	2.25%	$3,528	6.12%	$4,204	3.95%	$39,092	2.10%
Iowa	$1,379	0.98%	$1,891	0.57%	$322	0.08%	$8,325	1.00%	$333	0.58%	$566	0.53%	$12,816	0.69%
Kansas	$896	0.64%	$2,761	0.83%	$2,582	0.66%	$6,503	0.78%	$835	1.45%	$987	0.93%	$14,564	0.78%

[1] "Housing" category includes single and multi-family housing.
[2] The percentage recorded represents the state's share of bond issuances for the particular category.
[3] "Utilities" category includes combined utilities, water/sewer, gas, flood control, sanitation, and telecommunications facilities.
[4] "Transportation" category includes air, rail, transit, surface transportation, public parking, and other transportation facilities.
[5] "Education" category includes K-12, higher education, other education facilities, and student loans.
[6] "Environmental" category includes pollution control, solid waste, and recycling facilities.
[7] "Public Facilities" category includes correctional, libraries, stadiums, theatres, parks/zoos, police/fire/corrections, and other government buildings.

Source: Thomson Reuters and SIFMA (2012)

Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

(Dollars in millions)

The following table reports the value of all long-term tax-exempt bonds issued by states and their localities for physical infrastructure purposes for the last decade. A long-term bond is one issued for a period greater than one year. This table does not include refunding transactions for outstanding bonds.

STATE	Housing[1]	Percent[2]	Utilities[3]	Percent	Transportation[4]	Percent	Education[5]	Percent	Environmental[6]	Percent	Public Facilities[7]	Percent	TOTAL	% of Total Issuances
Kentucky	$2,121	1.51%	$3,259	0.98%	$3,151	0.81%	$9,139	1.09%	$790	1.37%	$2,952	2.78%	$21,411	1.15%
Louisiana	$2,429	1.72%	$2,727	0.82%	$5,166	1.32%	$5,890	0.71%	$1,713	2.97%	$1,862	1.75%	$19,786	1.06%
Maine	$1,737	1.23%	$133	0.04%	$1,064	0.27%	$1,718	0.21%	$245	0.42%	$276	0.26%	$5,173	0.28%
Maryland	$4,335	3.08%	$4,103	1.24%	$5,547	1.42%	$4,952	0.59%	$573	0.99%	$1,016	0.95%	$20,525	1.10%
Massachusetts	$5,045	3.58%	$9,146	2.76%	$11,528	2.95%	$29,249	3.50%	$1,085	1.88%	$1,215	1.14%	$57,268	3.08%
Michigan	$1,767	1.25%	$9,727	2.94%	$4,962	1.27%	$29,245	3.50%	$1,508	2.61%	$3,575	3.36%	$50,784	2.73%
Minnesota	$4,575	3.25%	$4,074	1.23%	$4,023	1.03%	$13,205	1.58%	$746	1.29%	$2,118	1.99%	$28,741	1.54%
Mississippi	$984	0.70%	$867	0.26%	$920	0.24%	$3,339	0.40%	$216	0.37%	$1,245	1.17%	$7,571	0.41%
Missouri	$1,578	1.12%	$4,064	1.23%	$5,610	1.44%	$15,982	1.91%	$785	1.36%	$3,870	3.64%	$31,889	1.71%
Montana	$658	0.47%	$82	0.02%	$274	0.07%	$1,558	0.19%	$439	0.76%	$94	0.09%	$3,105	0.17%
Nebraska	$1,200	0.85%	$4,114	1.24%	$506	0.13%	$4,605	0.55%	$114	0.20%	$867	0.82%	$11,406	0.61%
Nevada	$666	0.47%	$5,831	1.76%	$9,868	2.52%	$6,930	0.83%	$360	0.62%	$980	0.92%	$24,635	1.32%
New Hampshire	$1,303	0.92%	$117	0.04%	$816	0.21%	$2,636	0.32%	$174	0.30%	$83	0.08%	$5,128	0.28%
New Jersey	$2,358	1.67%	$5,078	1.53%	$25,821	6.61%	$36,432	4.36%	$1,275	2.21%	$2,432	2.29%	$73,396	3.94%
New Mexico	$2,961	2.10%	$1,834	0.55%	$3,109	0.80%	$5,086	0.61%	$725	1.26%	$335	0.32%	$14,050	0.75%
New York	$21,635	15.36%	$29,191	8.81%	$65,369	16.72%	$56,150	6.72%	$2,861	4.96%	$11,097	10.43%	$186,303	10.00%
North Carolina	$1,546	1.10%	$5,053	1.53%	$4,846	1.24%	$11,461	1.37%	$1,134	1.97%	$1,720	1.62%	$25,760	1.38%
North Dakota	$1,222	0.87%	$762	0.23%	$243	0.06%	$764	0.09%	$265	0.46%	$254	0.24%	$3,509	0.19%
Ohio	$2,496	1.77%	$8,462	2.55%	$5,404	1.38%	$31,510	3.77%	$5,437	9.43%	$4,878	4.59%	$58,187	3.12%
Oklahoma	$1,102	0.78%	$2,159	0.65%	$2,735	0.70%	$8,338	1.00%	$138	0.24%	$468	0.44%	$14,939	0.80%
Oregon	$1,978	1.40%	$3,796	1.15%	$4,134	1.06%	$8,251	0.99%	$119	0.21%	$762	0.72%	$19,039	1.02%
Pennsylvania	$3,588	2.55%	$11,250	3.40%	$12,783	3.27%	$56,808	6.80%	$3,553	6.16%	$1,781	1.67%	$89,762	4.82%
Puerto Rico	$1,862	1.32%	$4,932	1.49%	$7,251	1.86%	$773	0.09%	$0	0.00%	$3,156	2.97%	$17,973	0.97%
Rhode Island	$1,904	1.35%	$995	0.30%	$1,051	0.27%	$3,295	0.39%	$75	0.13%	$465	0.44%	$7,784	0.42%

Source: Thomson Reuters and SIFMA (2012)

Tax-Exempt Issuance in the States for Infrastructure, 2003-2012

(Dollars in millions)

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STATE	Housing[1]	Percent[2]	Utilities[3]	Percent	Transportation[4]	Percent	Education[5]	Percent	Environmental[6]	Percent	Public Facilities[7]	Percent	TOTAL	% of Total Issuances
South Carolina	$580	0.41%	$3,774	1.14%	$4,041	1.03%	$15,428	1.85%	$272	0.47%	$665	0.63%	$24,760	1.33%
South Dakota	$2,004	1.42%	$433	0.13%	$33	0.01%	$1,326	0.16%	$39	0.07%	$356	0.33%	$4,191	0.23%
Tennessee	$3,166	2.25%	$3,408	1.03%	$824	0.21%	$7,687	0.92%	$87	0.15%	$3,063	2.88%	$18,236	0.98%
Texas	$4,208	2.99%	$48,915	14.77%	$44,682	11.43%	$105,260	12.60%	$5,305	9.20%	$4,568	4.29%	$212,938	11.43%
Trust Terr.[8]	$0	0.00%	$0	0.00%	$7	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$7	0.00%
Utah	$2,108	1.50%	$3,142	0.95%	$2,815	0.72%	$6,368	0.76%	$32	0.06%	$655	0.62%	$15,120	0.81%
Virgin Islands	$0	0.00%	$109	0.03%	$64	0.02%	$2,804	0.34%	$0	0.00%	$7	0.01%	$2,984	0.16%
Vermont	$644	0.46%	$0	0.00%	$18	0.00%	$21	0.00%	$74	0.13%	$94	0.09%	$851	0.05%
Virginia	$7,259	5.15%	$5,526	1.67%	$7,189	1.84%	$14,548	1.74%	$464	0.80%	$1,917	1.80%	$36,904	1.98%
Washington	$2,446	1.74%	$7,845	2.37%	$11,502	2.94%	$15,653	1.87%	$537	0.93%	$1,790	1.68%	$39,773	2.14%
West Virginia	$484	0.34%	$715	0.22%	$686	0.18%	$2,565	0.31%	$1,646	2.85%	$549	0.52%	$6,646	0.36%
Wisconsin	$2,031	1.44%	$3,682	1.11%	$2,869	0.73%	$8,011	0.96%	$395	0.68%	$231	0.22%	$17,219	0.92%
Wyoming	$1,102	0.78%	$88	0.03%	$6	0.00%	$775	0.09%	$936	1.62%	$69	0.06%	$2,976	0.16%
TOTAL	$140,852	7.6%	$331,245	17.8%	$390,860	21.0%	$835,181	44.8%	$57,680	3.1%	$106,349	5.7%	$1,862,166	100%

[8] American Samoa & Commonwealth of Northern Mariana Islands

Source: Thomson Reuters and SIFMA (2012)

NATIONAL ORGANIZATION OF
SOCIAL SECURITY CLAIMANTS' REPRESENTATIVES
(NOSSCR)

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Executive Director
Nancy G. Shor

Written Statement for the Record
on behalf of the
National Organization of Social Security Claimants' Representatives

Hearing on the Challenges of Achieving Fair and Consistent Disability Decisions

Subcommittee on Social Security
House Committee on Ways and Means

Hearing date: March 20, 2013

Submitted by:

Nancy G. Shor, Executive Director
Ethel Zelenske, Director of Government Affairs

* * *

Founded in 1979, NOSSCR is a professional association of attorneys and other advocates who represent individuals seeking Social Security disability and Supplemental Security Income (SSI) disability benefits. NOSSCR members represent these individuals with disabilities in proceedings at all SSA administrative levels, but primarily at the hearing level, and also in federal court. NOSSCR is a national organization with a current membership of more than 4,000 members from the private and public sectors and is committed to the highest quality legal representation for claimants.

At the March 20, 2013, hearing and at previous hearings held by the Subcommittee, much has been said about the Social Security Disability Benefits Reform Act of 1984 ("DBRA"), Pub. L. No. 98-460. The Act has been frequently mischaracterized and inaccurately describes what it did – and did not – legislate. We are submitting this Statement for the Record to provide information regarding key provisions of DBRA and to provide background regarding the policies that were in effect at SSA prior to DBRA's passage.

BACKGROUND

The Social Security Disability Benefits Reform Act of 1984 was passed by a unanimous, bipartisan vote in both the House of Representatives (402-0) and the Senate (99-0) in September 1984. President Reagan signed the law on October 9, 1984, when it became Pub. L. No. 98-460.

The bill was described by Members of Congress from both parties as a necessity to end the chaos then swirling around the Social Security disability determination process. On the day the bill was passed, then Rep. J. J. Pickle (D-TX), a previous Chairman of this Subcommittee, stated on the floor of the House: "… [T]oday the program is in a state of chaos and if we do not act immediately to restore order, it will utterly collapse. Perhaps my cry of alarm sounds exaggerated. It is not."

In the early 1980s, the process was in crisis. Hundreds of thousands of disabled individuals, including tens of thousands with mental impairments, had their benefits improperly terminated; thousands of claimants with mental impairments were improperly denied benefits; 29 States refused to follow the Social Security Administration's (SSA) instructions for termination of benefits; federal courts were clogged with appeals; 200 federal courts across the country threatened the government with contempt of court citations for refusing to pay benefits when ordered.

Representatives and Senators, on a bipartisan basis, noted the need for the legislation. A key Republican Conference Committee member, Rep. Willis Gradison (R-IA), stated that the bill "makes necessary reforms in the administration of the social security disability program … I am hopeful that these initiatives will make significant strides toward reestablishing the integrity of the disability program and ending beneficiary trauma."

Floor statements in the Senate upon passage of the conference report were no less fervent. Sen. Robert Dole (R-KA), the Chairman of the Senate Finance Committee at the time, stated: "In my view, the conference report is a major accomplishment, representing the culmination of more than 2 years of congressional deliberation on the very difficult and emotional issue of disability insurance reform. It … is intended to clear up the chaotic situation in the State disability agencies and the Federal courts.

In this Statement, we will discuss the major provisions of DBRA, addressing what the Act provided and the background necessitating the change.

MENTAL IMPAIRMENTS

Section 5 of DBRA had two main provisions regarding mental impairments: (1) SSA was required to revise the listings of impairments for mental disorders; and (2) "The revised criteria and listings, "alone and in combination with assessments of the residual functional capacity of the individuals involved, shall be designed to realistically evaluate the ability of a mentally impaired individual to engage in substantial gainful activity in a competitive workplace environment."

Explanation. After years of litigation, GAO investigations, and Congressional hearings, Congress passed Section 5 of DBRA, requiring SSA to overhaul its procedures for adjudicating Title II and SSI disability claims based on mental impairments. The legislation did not change the basic statutory definition of disability, namely, that "disability" is the "inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months." 42 U.S.C. § 423(d)(1)(A).

DBRA did require SSA to issue new listings of impairments for mental disorders and develop new procedures for evaluating residual functional capacity for individuals with mental disorders whose impairments did not meet a listing.

Before DBRA, SSA relied upon outdated concepts of mental impairment and terminology that did not reflect current medical practice. SSA policy focused on current signs and symptoms and relied only on activities of daily living, which are not good measures of the ability to function in a work-setting for an individual with a mental impairment. This prejudiced (1) individuals whose signs and symptoms were in remission or were controlled by treatment, but who still were unable to work and (2) individuals who had the requisite current signs and symptoms but could engage in simple activities of daily living.

SSA's policies and procedures in the early 1980s were exemplified by its psychiatric review form used to decide disability claims based on mental impairments. The form used a numerical severity rating of 17 signs and symptoms, supplemented only by reports of activities of daily living. It had no space for consideration of evidence relevant to the ability to work. A separate assessment of residual functional capacity, as required by the regulations, was not performed because it was considered "redundant." As a result, there was no individualized, realistic evaluation of the ability to work. The courts found SSA's procedures unlawful.[1]

SSA's procedures for assessing mental impairments had an extremely harmful impact on claimants. In two years (1981 and 1982), more than 80,000 beneficiaries with mental illness had their benefits terminated, for many, their only source of income. Tens of thousands new claimants had their applications denied. The 1984 legislation was a response to correct this terrible situation.

Even before enactment of Pub. L. No. 98-460, SSA convened a work group of representatives from national professional organizations focused on mental disabilities. Most of the group's recommendations were adopted by SSA to implement the provisions of section 5(a). For example, the new listings were more closely tailored to follow the edition of the American Psychiatric Association's Diagnostic and Statistical Manual current at that time. The changes reflected current thinking about mental impairments and included: (1) expanding the diagnostic categories (the "A Criteria") from just four to eight; (2) revising the functional criteria (the "B

[1] *City of New York v. Heckler*, 578 F. Supp.1109 (E.D.N.Y. 1984); *Mental Health Ass'n of Minn. V. Schweiker*, 554 F. Supp. 157 (D.Minn. 1982). Both decisions were affirmed on appeal. *City of New York* was appealed to the U. S. Supreme Court by SSA and was affirmed on other grounds (related to the class action).

Criteria") to include criteria related to the requirements of work; and (3) giving greater importance to the overall degree of limitation, rather than the number of individual activities.

For those individuals who did not have a listing-level impairment, SSA revised its procedures for assessing residual functional capacity, i.e., what the individual could do in light of his/her limitations. The statute requires an individualized assessment of ability to work. As noted above, in the early 1980s, a separate assessment of residual functional capacity (RFC), as required by the regulations, was not performed because it was considered "redundant." SSA policies had a presumption that a claimant with a mental impairment under the age of 50 who did not have a listing-level impairment would likely retain the RFC for unskilled work.

The policy guidance issued in response to litigation and Pub. L. No. 98-460,[2] which is still in effect, emphasizes the importance of the RFC assessment and that the failure to meet a listing does not equal the ability to perform at least unskilled work. Significant changes related to the RFC assessment include:

- The loss of key work-related capacities can be disabling, which are the ability to: (1) understand, carry out, and remember instructions; (2) respond appropriately to supervisors and co-workers; and (3) respond appropriately to pressures in a work setting.
- The role of stress. The guidance rejects the notion that individuals with mental impairments are able to engage in low stress, unskilled work. Since the response to work pressures is highly individualized, no assumptions can be made. Some individuals may have difficulty adjusting to even low stress work.
- New forms, drafted by the same group that worked on the listings, which require the reviewing psychiatrist or psychologist to evaluate 20 separate components of work functioning, including specific aspects of work, e.g., ability to perform within a schedule, to maintain regular attendance and to be punctual, and to accept instructions and respond appropriately to supervisors.

MULTIPLE IMPAIRMENTS

Section 4 of DBRA provided that SSA shall consider combined effect of all impairments to determine severity, "without regard to whether any such impairment, if considered separately, would be of such severity." This provision has been codified at 42 U.S.C. § 423(d)(2)(B).

Explanation. Prior to passage of DBRA, SSA did not consider the combined effects of multiple impairments in evaluating disability. SSA went so far as to state, in a 1982 policy statement,[3] that it would not consider the combined effects of "non-severe" impairments. This policy resulted in serious inequities for individuals suffering from a variety of serious problems, where a single one did not meet the test as a "severe" impairment under the regulatory sequential evaluation of disability. The federal courts rejected this approach in a number of individual and class actions.

[2] Social Security Rulings (SSR) 85-15 and 85-16.
[3] SSR 82-55.

Upon passage of the law, floor statements further clarified the need for this provision. Rep. Pickle stated: "Under the conference agreement, the effect of a combination of impairments, not one of which alone may be disabling, may now be considered when determining whether the person's impairment is medically severe enough to qualify him for benefits."

Rep. Silvio Conte (R-MA) stated: "There are many individuals, particularly the elderly, who suffer from a variety of medical conditions. Though each separate impairment might not be severe enough to prohibit someone from working, the combination of conditions can be totally disabling."

EVALUATION OF PAIN

Section 3(a)(1) of DBRA amended 42 U.S.C. § 423(d)(5) by adding the following:

> An individual's statement as to pain or other symptoms shall not alone be conclusive evidence of disability as defined in this section; there must be medical signs and findings, established by medically acceptable clinical or laboratory diagnostic techniques, which show the existence of a medical impairment that results from anatomical, physiological, or psychological abnormalities which could reasonably be expected to produce the pain or other symptoms alleged and which, when considered with all evidence required to be furnished under this paragraph (including statements of the individual or his physician as to the intensity and persistence of such pain or other symptoms which may reasonably be accepted as consistent with the medical signs and findings), would lead to a conclusion that the individual is under a disability.

Explanation. Under the policy in effect at the time, pain and other subjective symptoms, such as dizziness or numbness, were taken into account ***only*** if fully explained by laboratory or other diagnostic procedures. If not fully explained, debilitating pain, even where corroborated and credible, was discounted. Pain and other symptoms cannot always be fully explained by conventional diagnostic techniques. Rep. Conte, on the floor of the House the day the Conference Report was voted out, stated: "Another problem with present law is the fact that many disability recipients allege pain that cannot be found using regular medical techniques. That does not mean, however, that these people are not suffering pain …."

Section 3(a)(1) technically expired on December 31, 1986. The conferees in 1984 stated that the standard in DBRA was only intended to codify SSA's policy on pain at the time. During the same period, there were multiple court cases challenging the standard that SSA used in evaluating pain, which was not well-articulated and did not, in practice, follow the standard in DBRA. As a result, the courts stepped in to fill the void caused by SSA's failure to promulgate comprehensive rules for evaluating subjective symptoms like pain. Case law precedent in different federal circuits shared a basic view: (1) If there is an underlying medical condition and the person's pain is "reasonably related" to that condition, then it must be considered; and (2) If the person's statements are found not credible, then the adjudicator must state the reasons.

The extensive circuit case law played an important role in development of SSA's comprehensive regulations, issued in November 1991.[4] These regulations drew from the body of case law in providing a detailed framework for evaluating subjective symptoms, including pain. In the summary to the final rule, SSA states:

> These expanded regulations incorporate the terms of the statutory standard for evaluating pain and other symptoms contained in section 3 of the Social Security Disability Benefits Reform Act of 1984 (Pub. L. 98-460).

The preface to the final rule further explains:

> The policy for the evaluation of pain and other symptoms, as expressed in the statutory standard and clearly set forth in these final rules, requires that: (1) For pain or other symptoms to contribute to a finding of disability, an individual must first establish, by medical signs and laboratory findings, the presence of a medically determinable physical or mental impairment which could reasonably be expected to produce the pain or other symptoms alleged; and (2) once such an impairment is established, allegations about the intensity and persistence of pain or other symptoms must be considered in addition to the medical signs and laboratory findings in evaluating the impairment and the extent to which it may affect the individual's capacity for work.

Under this standard currently used by SSA, allegations of pain alone are not sufficient to establish disability. As noted by Arthur Spencer, SSA Associate Commissioner for Disability Programs, in his written statement for the March 20, 2013 hearing:

> … I would like to remind the Subcommittee of a salient feature of the DI program. An applicant (claimant) cannot receive disability benefits simply by alleging pain or other non-exertional impairments or limitations. We require objective medical evidence and laboratory findings that show the claimant has a medical impairment that: 1) could reasonably be expected to produce the pain or other symptoms alleged, and 2) when considered with all other evidence, meets our disability requirements.

CONCLUSION

During the early 1980s, the Social Security and SSI disability determination process was in chaos. Congress held numerous hearings and considered a number of bills to address the situation, deliberating over the course of several years. It finally passed – unanimously in both Houses of Congress – the Social Security Disability Benefits Reform Act of 1984, Pub. L. No. 98-460. As this Congress considers the challenges facing the process today, it is important to keep in mind the circumstances that led to the passage of the 1984 legislation.

[4] 56 Fed. Reg. 57928 (Nov. 14, 1991). The notice of proposed rulemaking was published in September 1988. 53 Fed. Reg. 35516 (Sept. 14, 1988).



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Statement for the Record of
John Janney, General Manager
Public Utility District No. 1 of Chelan County, Washington
United States House of Representatives
Committee on Ways and Means
Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments
March 28, 2013

Public Utility District No. 1 of Chelan County (Chelan PUD) appreciates this opportunity to provide a written statement for the record on the importance of tax exempt financing to public power. As a municipal corporation, Chelan PUD utilizes municipal bonds to finance our generation and infrastructure projects. A restriction on tax exempt bonds would be felt in terms of higher financing costs by us, and by extension, our public power customers.

In 2012, President Obama's budget proposal would have capped the deductibility of municipal bond interest at 28%. The proposal also would have taken the unprecedented approach of applying the tax retroactively to existing bonds. Subsequently, the status of tax exempt municipal bonds was reportedly at risk during "fiscal cliff" negotiations, and is now expected to be part of the discussions surrounding comprehensive tax reform.

As a public power utility, Chelan PUD cannot issue stock. Tax-exempt financing is an essential tool in financing the capital-intensive nature of our electric utility services. We are concerned that imposing tax on the interest of municipal bonds will result in investors demanding higher interest rates on municipal bond issuances in order to compensate for lost benefits and uncertain tax treatment. This would increase the cost of financing our capital intensive electric infrastructure. Likewise, it would increase the costs of our investments in environmental enhancement that support our continued ability to generate electricity from hydropower.

The mission of not-for-profit public power utilities is to provide safe, affordable and reliable electricity to our customers. As hydroelectric project owners, we also invest in environmental enhancements and fish facilities associated with our generation projects. We have relied on tax exempt municipal bonds as our primary financing tool for decades; it remains a critical financial tool for the future as we continue to invest in public power infrastructure and environmental obligations. Examples of fairly recent bond issues include:

Project/Year	Yield	Amount Financed
Upgrades to the Lake Chelan Hydroelectric Project, including plant modernization and fish-related facilities (2009)	3.00%	$6.54 million
Rocky Reach System Hydroelectric Project environmental enhancements (2009)	4.66%	$15.9 million
Rock Island System Hydroelectric Project environmental enhancements (2009)	4.62%	$14 million

To offer a broader overview, Chelan PUD had $631 million of tax-exempt bonds in its debt portfolio at the end of 2012. In the current market, there is a 70 – 75 (or .70% to .75%) basis point differential between taxable and tax exempt rates using current 30 year spreads. Assuming Chelan PUD did not have the benefit of tax exempt financing, and the $631 million of tax-exempt debt had been financed at current taxable rates, the interest rate differential would equate to about $4.4 million – $4.7 million per year in additional interest expense - all other factors being equal. This would equate to an estimated 4.3% - 4.6% rate increase to our retail customers. In this hypothetical example, we used current interest rate spreads. Historically spreads have been wider, so this is likely a conservative figure.

It is important to recognize that interest on municipal bonds is exempt from federal tax and has been for a century. Similarly, interest on federal bonds is exempt from state and local tax. Congress should preserve this intergovernmental sovereignty and avoid changes that would 1) increase costs to local governments in an attempt to raise federal revenue or 2) result in a loss of local control over financing decisions.

As Congress contemplates comprehensive tax reform, we hope that the Ways and Means Committee will recognize the importance of tax exempt financing to electric utility infrastructure and environmental projects. We would be happy to provide additional information at any time.

Contact Information

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City of Palo Alto
Office of the Mayor and City Council

March 25, 2013

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member, Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Re: Tax Exempt Municipal Bonds

Dear Mr. Chairman and Ranking Member:

On behalf of the residents of the City of Palo Alto, California, I would like to thank you for holding the recent hearing entitled "Tax Reform and Tax Provisions Affecting State and Local Governments." The City of Palo Alto is very concerned about proposals to cap or eliminate the tax exempt status of municipal bonds.

The City of Palo Alto utilizes tax-exempt municipal bonds to finance public infrastructure that generates jobs and promotes economic growth in our community. Recent examples include the issuance of $76 million in General Obligations Bonds for new libraries and a community center. Without tax exempt status and using taxable bonds, the City would have incurred an additional $30 million in interest expense over a 30 year period. Over the past decade, state and local governments across the country have financed over $1.65 trillion in public improvements, utilizing these bonds for schools, hospitals, transit and infrastructure for water, roads, and public power.

Proposals to limit or eliminate tax deduction for municipal bonds will increase the cost of borrowing for state and local governments. Last year's proposal by the Administration to cap the deduction at 28 percent would have increased bond financing costs by 70 basis points (.7 percent), requiring issuers to pay more in interest in order to attract the same investors. Such a cap would result in an additional $55 million in interest costs to the City of Palo Alto over a 30 year period for replacing obsolescent police, fire and wastewater treatment facilities. Eliminating the tax exemption would increase bond interest rates by two percent, dramatically increasing the cost of public infrastructure and facilities.

While the federal government forgoes $32 billion annually in lost tax receipts because of the exemption of municipal bonds, much of that loss would be transferred to state and local governments in increased borrowing costs without the exemption. Additionally, many projects (totaling $179 billion in 2012) would become more expensive, delayed, or not built without tax-exempt municipal bonds. Capping or eliminating the tax-exemption for municipal bonds restricts economic development and impedes job growth.

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The investment that the federal government can make in public infrastructure and facilities is constrained by federal debt and deficits. At a time when state and local governments are required to bare much if not all the cost for infrastructure improvement, it is unfortunate and ironic that leaders in Washington would propose to curtail the most effective means for financing those improvements.

By curtailing the tax exemption for municipal bonds, the federal government will be undermining a significant challenge it faces: the rehabilitation and replacement of the nation's eroding infrastructure. In 2009, four years ago, the American Society of Civil Engineers (ASCE) estimated the U.S. needed an additional $1.2 trillion of infrastructure spending over the next 5 years. The Engineers assigned a report card grade of "D" to the condition of the nation's infrastructure. Similarly, local jurisdictions such as Palo Alto face a plethora of needs such as replacing gas and water mains, public safety facilities, bridges, and antiquated buildings.

Tax exempt municipal bonds are an effective means of attracting private investment to public projects. The tax-exemption for these bonds has existed since federal income tax was promulgated 100 years ago. We strongly oppose any changes made to the tax exempt status of municipal bonds and would encourage you reject any such proposals in a future tax package the committee may consider. Thank you for your attention to this important issue.

Sincerely,

H. Gregory Scharff

Cc: The Honorable Anna Eshoo
The Honorable Dianne Feinstein
The Honorable Barbara Boxer
Palo Alto City Council
James Keene, City Manager

The following is the official statement of the National Association of REALTORS® for the Ways and Means Hearing entitled, “TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY” held on March 19, 2013.

Attribution for this statement should be made to the National Association of REALTORS® or Gary Thomas, 2013 President of the National Association of REALTORS®.

Please feel free to contact me should you have any questions about this submission.

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STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®

SUBMITTED FOR THE RECORD TO THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

HEARING ON

TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

MARCH 19, 2013

The NATIONAL ASSOCIATION OF REALTORS® (NAR) is America's largest trade association, with one million members. NAR represents a variety of real estate professionals engaged in all aspects of the residential and commercial real estate industries. Their activities include real estate sales and brokerage, property management, residential and commercial leasing and appraisal. A REALTOR®'s business is a highly personal, hands-on, face-to-face model, focused on a family's fundamental needs for shelter. Real estate investment and operations provide locations where the commerce that drives the economy is conducted.

As professionals who deal in the exchange of real property, REALTORS® are constantly aware of the balance between providing sufficient local services while not overburdening property owners with tax obligations. Most importantly REALTORS® believe that real estate should be subject to a single level of taxation.

Preserving the Deduction for State and Local Taxes

The income tax system of the United States has provided a deduction for state and local taxes since its inception. To do otherwise would violate two fundamental and widely accepted principles of good tax policy – the avoidance of double taxation and recognizing the taxpayer's ability to pay.

Double Taxation. Taxes paid at the state and local levels to benefit the general public are in nature and purpose similar to the federal income tax in that they fund essential government functions. Therefore, allowing a deduction for these state and local taxes for federal income tax purposes is essential to avoiding double taxation on the same income (or a tax on a tax). Federal tax law follows this same principle in connection with payments of taxes to other nations. Only in this case, the law goes even further and provides taxpayers with a choice of claiming a deduction for foreign taxes paid, or taking a credit, which is a dollar-for-dollar reduction in tax owed.

Ability to Pay. While state and local taxes vary greatly, two aspects of them that do not vary are that they are ubiquitous throughout the nation, in one form or another, and they are largely involuntary. It is true that we can exercise some degree of choice of how much we pay in state and local taxes by deciding where we live and what we buy. However, avoiding these levies altogether is not a practical option. Obviously, paying taxes to state and local governments leaves taxpayers without the income used to pay the taxes. The extraction of state and local taxes is tantamount to the money never being earned by the taxpayer in the first place. Our tax system recognizes this fact by providing a deduction for the payment of these taxes.

Eliminating the deduction for state and local taxes would fly in the face of these fundamental tax policy principles that have been ingrained in our income tax law from its beginnings.

Promoting Home Ownership

If one were designing a tax system for the first time, one might come up with something that is remarkably different from what we have today. But we're not starting from scratch, particularly in the context of housing. Our tax system has, from its inception, featured a deduction for real property taxes. The value of this deduction, along with the mortgage interest deduction, is deeply embedded in the price of a home. While economists agree that there is no accurate measure of the value of these embedded tax benefits, they all generally agree that the value of a particular home includes tax benefits.

The NATIONAL ASSOCIATION OF REALTORS® remains committed to preserving current law incentives for homeownership. Moreover, REALTORS® emphasize that there could not be a worse time for even considering changes to these incentives. With the housing market just recently beginning to show signs of life, and the housing finance system still staggering from the horrors of the market crash that began in 2007, we can see no benefit to tax law changes that could stymie the nascent housing recovery and put the brakes on one of our economy's major growth engines.

Moreover, real estate is the most widely-held category of assets that American families own, so changes to its tax treatment will have far-reaching consequences in the economy, as well as on the retirement prospects of homeowners. Any change that would erode the value of the tax incentives to homeownership could represent a net tax increase on a group of Americans that currently pays 80 to 90 percent of all federal income taxes.

Importance of the Real Property Tax Deduction

Along with other state and local taxes, the Internal Revenue Code has provided a deduction for real property taxes paid since its enactment in 1913. To be deductible, a real property tax must be levied for the general public welfare. Thus, taxes paid for local improvements such as sidewalks and similar betterments that directly benefit the property are not deductible.

For homeowners, real property taxes represent an unending obligation, at least as long as they own their homes. The other major deduction for most homeowners, the mortgage interest deduction, does not continue after the mortgage is paid off, and it usually diminishes as the mortgage is being paid. Property taxes, on the other hand, often increase over the years, as assessments on property increase and as local governments increase their levy rates. For these reasons, the deduction for real estate property taxes is often the largest one claimed by homeowners. In fact, more taxpayers claim the real property tax deduction than claim the deduction for mortgage interest (in 2010, 41.1 million wrote off real property taxes while 36.7 million deducted mortgage interest).

Answering the Critics

Critics: Only a third of taxpayers itemize deductions. While it is true that in any particular year only about a third of individuals itemize deductions, this figure is a snapshot. Over the course of an owner's tenure in a home, an individual may itemize in the early years of homeownership, when the mortgage interest expense is high relative to the principal paid, but then not itemize in later years. Mortgages get paid off, other itemized deductions rise and fall, individuals down-size, divorces occur, a spouse dies or needs to simplify his or her living arrangements. These and other life events may convert itemizers into standard deduction taxpayers.

A survey conducted for NAR in 2011 by the Harris polling organization projected homeowners' understanding and utilization of the mortgage interest deduction. That survey showed that 54 percent of homeowners polled currently claimed the mortgage interest deduction, but an additional 16 percent had taken it in the past. Thus, over time, at least 70 percent of homeowners have claimed mortgage interest as an itemized deduction. Including in these figures the deduction for real property taxes only increases these percentages, since all homeowners pay property taxes.

Moreover, one can easily argue that those who utilize the standard deduction – both homeowners and renters – are actually receiving the benefit of the deduction for mortgage interest and for property taxes. This is because the standard deduction, which is a simplification measure added to the tax law by Congress in 1944, is based on a composite basket of typical deductions, including the mortgage interest deduction and the state and local taxes deduction. The legislative history clearly shows that Congress intended the standard deduction to be a proxy for allowable itemized deductions, both when it was adopted and when it has subsequently been increased. Thus, the notion that only those who itemize get the benefit of these homeowner incentive deductions is incorrect. In fact, those who claim the standard deduction actually receive a proportionally deeper subsidy than those who itemize. For example, a married couple's total state and local tax, mortgage interest, and charitable contributions might be $10,000. With the standard deduction currently at about $12,000, the standard deduction couple would be receiving tax benefits for $2,000 in expenditures they never made. If they were in the 28 percent bracket, that would amount to a $560 tax "freebie." ($2,000 excess x 28%).

Critics: The "wealthy" predominantly benefit from the real property tax deduction. Because real property taxes are assessed based on property values, one would expect the deduction to be much more utilized at higher incomes. Moreover, most local governments grant real property tax relief to lower-income taxpayers. Surprisingly, however, in 2012 three-quarters of the value of real property tax deductions went to taxpayers with incomes of less than $200,000, according to an estimate prepared by the staff of the Joint Committee on Taxation. The typical real estate tax deduction beneficiary has an adjusted gross income slightly less than $81,000. In addition, the tax law already includes a provision designed to limit the tax benefit of the real property tax deduction to the "wealthy." Specifically, the deduction is disallowed for purposes of the alternative minimum tax.

Conclusion

The National Association of REALTORS® encourages the Committee to retain the federal deduction for state and local taxes in its effort to reform the federal income tax. Seventy-Five million homeowners pay property taxes and all of them, either through the standard deduction, or by itemizing their returns, avoid being taxed twice by government on the value of their most important asset.

Sustainable Water
Infrastructure
Coalition

Statement Submitted for the Record

Sustainable Water Infrastructure Coalition

before the

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Regarding

"Tax Reform and Tax Provisions Affecting State and Local Governments"

March 19, 2013

Chairman Camp, Ranking Member Levin and Members of the Committee: The Sustainable Water Infrastructure Coalition (SWIC) appreciates the opportunity to submit written testimony on tax reform and tax provisions affecting state and local governments.

SWIC is an alliance of corporations, public organizations, private and public water and wastewater service providers, construction contractors, pipe and equipment manufacturers and distributors, engineering companies, labor unions, financial institutions, and other business organizations working to advance sustainable water and wastewater infrastructure policy through public awareness, education and advocacy.

Cities, towns and communities across the nation face major challenges over the next 20 years to replace aging and worn out water and wastewater systems, which are vital to maintaining public health and building local economies. Capital investment for such projects will be difficult as many states and local governments face budget deficits, revenue shortfalls and opposition to new taxes.

Water and Wastewater Infrastructure Today

The American Society of Civil Engineers (ASCE) released on March 19 its latest report card on the condition of the nation's infrastructure. Water and wastewater infrastructure received a grade of "D," meaning there is a "strong risk of failure."[1] Local governments understand the impact of the nations failing infrastructure and face an average of 650 water main breaks per day. Moreover, nearly two trillion gallons of treated drinking water is lost to broken or leaking pipes at a cost of $2.6 billion per year[2] and 900 billion gallons of raw sewage leaks into waterways and watersheds annually.[3]

Root of the Problem

On one hand, local governments are understandably reluctant to increase user rates for water and wastewater infrastructure and services. On the other is a mounting and unavoidable need for capital investment to repair and replace aging or obsolete infrastructure and build new facilities to ensure compliance with ever-increasing federal and state regulatory standards. This dilemma is the result of unfunded federal mandates and decades of delay in providing capital investment in infrastructure that is now at or nearing the end of its useful life.

Funding Gap

The U.S. EPA raised awareness of the infrastructure crisis in 2002 with its study entitled *The Clean Water and Drinking Water Infrastructure Gap Analysis*. The report analyzed projected water and wastewater infrastructure investment need to current spending levels over a 20-year period and found an investment gap of $271 billion for Clean Water (wastewater) and $263 billion for Drinking Water. EPA's current reports indicate 20-year capital improvement need of $334.8 billion for drinking water and $298.2 billion

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[1] American Society of Civil Engineers' 2013 Report Card for America's Infrastructure
[2] Value of Water, ITT Corporation, 2012
[3] Washington Post, "Billions needed to upgrade America's leaky water infrastructure," Ashley Halsey III, , January 2, 2012, P1

need for wastewater.[4] The 2007 data includes the following unmet infrastructure investment needs, which threaten safe drinking water and clean watersheds.

Michigan - $15.2 billion
California - $68 billion
New York - $55.7
Texas - $34 billion
Florida - $28.57 billion
Ohio - $25.7 billion
New Jersey - $24.5 billion
Pennsylvania - $23 billion
Illinois - $21.9 billion
Washington - $14.4 billion
Wisconsin - $11.8 billion

Spending Forecast
The U. S. Conference of Mayors report on projected costs of water infrastructure is even more alarming. The 2010 report forecasts future spending for public water and wastewater systems will range between $2.5 and $4.8 trillion over the next twenty years. Projected spending is almost double the $1.6 trillion local governments have invested in the past 53 years. The report also found that "cities provide the overwhelming majority of public water and wastewater investment – accounting for more than 95% of total expenditures for these public services."[5]

Tax-exempt Bonds
The primary source of federal financial support for water and wastewater infrastructure is tax-exempt municipal bonds. These bonds represent a long-standing partnership among federal, state and local governments in building and maintaining the nation's public infrastructure. Over the past decade, state and local governments financed more than $1.65 trillion of infrastructure investment with tax-exempt bonds -- $258 billion for water and wastewater facilities.[6]

The federal tax code classifies state and local tax-exempt bonds as either governmental purpose bonds, which limit private participation, or private activity bonds, which allow for private participation. In general, the interest on governmental bonds is exempt from federal taxation, whereas the interest on private activity bonds is not unless they are issued for projects that benefit the general public, called "qualified private activities." Tax-exempt bonds for governmental purposes and for qualified private activities provide lower cost capital for infrastructure because the bond buyer does not have to include the interest income from the bond in federal gross income and thus is willing to accept a lower interest rate for the bond. Essentially, the lower interest rate arising from the federal tax-exemption subsidizes state and local investment in infrastructure projects.

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[4] U.S. Environmental Protection Agency, "Drinking Water Needs Survey and Assessment, Fourth Report to Congress," Feb 2009. Clean Watersheds Needs Survey, 2008 Report to Congress, Jan 2008.
[5] U.S. Conference of Mayors, "Trends in Local Government Expenditures on Public Water and Wastewater Services and Infrastructure: Past, Present and Future," March, 2010
[6] U.S. Conference of Mayors, "Protecting Bonds to Save Infrastructure Jobs 2013," February, 2013

Qualified PABs for Water and Wastewater Infrastructure

Congress controls the use of state and local debt for private activities by restricting the type of private activity and by providing an annual state volume cap limit. Projects for the furnishing of water are qualified activities only if the water is made available to the general public. The same restrictions apply for "sewage" facilities. Generally, the public use restrictions for the furnishing of water and sewage do not constrain access to PABs for most water and wastewater projects. However, the state volume caps do. Historically, the issuance of tax-exempt private activity bonds for water and wastewater projects is only 1% of all issuance, even though the need is much greater. The housing sector receives the majority of PAB issuance.[7]

Some categories of critical infrastructure are not subject to state volume caps. For example, publicly owned projects financed with tax-exempt private activity bonds for airports, ports and solid waste facilities are not subject to the state volume cap.

Solid Waste Example

During the 1980s, state and local governments faced declining landfill capacity and rapidly increasing disposal costs. Congress responded by eliminating the tax-exempt private activity bond volume cap on municipal solid waste projects in the Tax Reform Act of 1986. Elimination of the state volume cap made private activity bonds an available source of funding for solid waste facilities. Between 1896 and 2010, 41% of the $467 billion bonds issued in the solid waste industry were tax-exempt private activity bonds. The infusion of private capital helped solve the solid waste infrastructure crisis and provides an example of what could happen if water and wastewater projects were removed from the restrictive volume cap.[8]

Eliminate PAB Cap for Water and Wastewater Projects

Since 1986, private activity bond issuance has amounted to only 1% of total bond issuance for water and wastewater facilities. Removing the state volume cap on PABs for water and wastewater infrastructure would increase private capital investment and enable more public-private partnerships. "Public-private partnerships not only optimize the development, construction and long-term operation of the project, but also apportion sharing of risks between the public and private partners."[9] Removing the PAB volume cap for water and wastewater projects "will increase capital investment in the nation's water infrastructure by up to $5 billion per year over time through public-private partnerships," according to former U.S. EPA Administrator Stephen Johnson.[10]

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[7] U.S. House Transportation and Infrastructure Subcommittee on Water Resources and Environment, hearing on "The Future of Alternative Water Supplies: *Financing Water Infrastructure Projects,"* Testimony of Stephen E. Howard, Barclays Capital, March 12, 2012.
[8] ibid.
[9] ibid.
[10] U.S. Senate Appropriations Committee, hearing on "Fiscal Year 2009 Budget Request," Testimony of Stephen L. Johnson, Administrator, U.S. EPA, March 4, 2008.

In 2001, the U.S. EPA's Environmental Financial Advisory Board recommended that private activity bonds for water and wastewater facilities be exempted from the state volume cap after recognizing that "state volume caps were constraining tax-exempt financing in a way that was limiting the supply and/or increasing the cost of investment funds."[11]

Legislation to Remove Water/Wastewater PAB Cap
Last Congress, Representatives Bill Pascrell (D-NJ) and Geoff Davis (R-KY) introduced H.R. 1802, the *Sustainable Water Infrastructure Investment Act*, to provide for the removal of water and wastewater projects from the PAB state volume caps, similar to the exception that Congress granted to solid waste facilities in the Tax Reform Act of 1986. The bill, which leverages private capital investment in public infrastructure, received bipartisan support from 101 cosponsors and is supported by more than 80 public and private organizations involved with the water and wastewater sectors, including the U.S. Chamber of Commerce, the National Association of Manufacturers, the U.S. Conference of Mayors, the National League of Cities and the National Governors Association. Over the past several years, the legislation passed the U.S. House of Representatives twice and last year a five-year version of the measure received unanimous support from the Senate Finance Committee and passed the U.S. Senate with bipartisan support as part of the Transportation reauthorization bill.

Job Creation and Economic Activity
While it is true that investment in water and wastewater infrastructure enhances public health and environmental protection, it also creates high-paying jobs, generates significant economic activity and expands the local tax base. Industry studies have indicated that every $1 billion invested in water and wastewater infrastructure creates up to 28,000 new jobs[12] with average annual earnings of more than $50,000 and increases demand for products and services in other industries by more than $3 billion. Due to a ripple effect that construction employment offers, investment in water infrastructure generates measureable employment in hundreds of standard industry classifications recognized by the US Census Bureau.[13]

Moreover, a $1 billion investment also generates more than $82 million in state and local tax revenue at a time when states and local communities need it most. In fact, according to *The Economic Impact and Financing of Infrastructure Spending*, released by the Associated Equipment Distributors in 2012, "investing $1.00 in sewer systems and water infrastructure returns a full $2.03 in tax revenue to federal and state/local governments, of which $1.35 specifically accrues at the federal level." By all accounts, investment in our underground environmental infrastructure pays off on many levels.[14]

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[11] Environmental Financial Advisory Board, "Private Sector Initiatives to Improve Efficiencies in Providing Public-Private Environmental Services, U.S. EPA, June 2001
[12] Associated General Contractors of America, "Build Now for the Future, A Blueprint for Economic Growth," Washington, DC, 2010
[13] Clean Water Council, "Sudden Impact: An Assessment of Short-Term Economic Impacts of Water and Wastewater Construction Projects in the United States," Washington, DC, P10
[14] Associated Equipment Distributors, "The Economic Impact and Financing of Infrastructure Spending," Washington, DC, 2012, p3

In closing, SWIC appreciates the opportunity to offer comments on the important role of tax-exempt bonds in financing the nations aging infrastructure and encourages the committee to preserve the tax-exemption on municipal bonds and remove water and wastewater projects from the PAB state volume cap to help municipalities contain costs and provide much needed access to capital. For more information, please visit: www.sustainablewaterinfrastructure.org or contact:

Mr. Edmund DeVeaux, Chairman, Edmund.DeVeaux@UnitedWater.com
Mr. Eben Wyman, Co-Executive Director, eben@wymanassociates.net
Mr. Bruce Morgan, Co-Executive Director, bruce@waterpolicyassociates.com

Supporters of Legislation to Remove Water Private Activity Bonds from State Volume Caps

Amerex
American Concrete Pavement Association
American Concrete Pipe Association
American Concrete Pressure Pipe Association
American Council of Engineering Companies
American Iron and Steel Institute
American Public Works Association
American Rental Association
American Road and Transportation Builders Assn.
American Society of Civil Engineers
American Subcontractors Association
American Supply Association
American Water
American Water Works Association
Associated Equipment Distributors
Associated Equipment Manufacturers
Associated General Contractors of America
Associated General Contractors of Texas
Atlantic States Pipe
Construction Management Association of America
Barclays
Bond Dealers of America
Bond Market Association
California Association of Sanitation Agencies
Carlyle Infrastructure Partners
Caterpillar
CDM
Clow Valve Company
Coca Cola Company
Design Build Institute of America
Design Professionals Coalition
Distribution Contractors Association
Dow Chemical Company
Ductile Iron Pipe Research Association
EJ Company
Environment One
General Electric
Gulf Coast Waste Disposal Authority
HDR Engineering
Infrastructure Management Group
Interlocking Concrete Pavement Institute
International Private Water Association
International Union of Operating Engineers
ITT Industries
Jacobs Engineering
John Deere
Kennedy Valve
Laborers-Employers Coop and Education Trust
Laborers International Union of North America
Manchester Tank
Mason Contractors Association of America
McWane
Michigan Infrastructure & Transportation Association
Mueller Water
NAIOP
National Asphalt Pavement Association
National Association of Manufacturers
Nat'l. Assn. of Regulatory Utility Commissioners
National Association of Sewer Service Companies
National Association of Towns and Townships
National Association of Water Companies
National Association of Women in Construction
National Council for Public-Private Partnerships
National Governors Association
National Precast Concrete Association
National Society of Professional Engineers
National Stone, Sand & Gravel Association
National Utility Locating Contractors Association
NUCA Representing Utility and Excavation Contractors
Pacific States Cast Iron Pipe Company
Parsons Brinckerhoff, Inc.
Plastics Pipe Institute
Plumbing-Heating-Cooling Contractors Association
Portland Cement Association
Poseidon Resources Corporation
San Antonio Water System
Siemens
SPI: The Plastics Industry Trade Association
Texas Rural Water Association
Texas Water Development Board
Tyler Pipe
United Rental
United Water
Uni-Bell PVC Pipe Association
US Chamber of Commerce
US Conference of Mayors – Mayors Water Council
Valve Manufacturers Association
Veolia Water
Vermeer Corporation
Vinyl Institute
Water and Sewer Distributors of America
Water and Wastewater Equipment Manufacturers Association
Water Environment Federation
WaterReuse Association
Watts Water Technologies

April 2, 2013

Congressman Dave Camp
Chairman, U.S. House Committee on Ways and Means
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Camp:

Thank you for the opportunity to provide our comments to be included in the record of your March 19, 2013 hearing focusing on “Tax Reform and Tax Provisions Affecting State and Local Governments.”

Tacoma Public Utilities (TPU) is the municipally owned utility of the City of Tacoma. TPU provides electric service to nearly 170,000 customers in the City of Tacoma and surrounding communities. Additionally, TPU provides drinking water service to more than 96,000 customers in the City of Tacoma and incorporated and non-incorporated communities throughout Pierce and King Counties in Washington State.

Municipal bonds continue to play a vital role in building our communities and the American economy. They finance three-quarters of all infrastructure investment in the U.S. -- building schools, drinking water facilities, hospitals, roads, bridges, and energy transmission lines -- the very infrastructure we depend on to maintain our quality of life and promote commerce. Municipal bonds have helped ensure that public utility customers have reliable access to clean drinking water, electricity for their homes and businesses, and other vital services necessary for a growing economy.

Utility customers we serve reasonably expect to have reliable access to clean drinking water and electricity. Meeting that basic standard requires a strategic plan of maintenance and construction of necessary capital facilities. Over the next 10 years, our power and water utilities expect to rely heavily on municipal bond financing as we invest nearly $700 million on facility maintenance and construction. These capital improvements include construction projects necessary to meet federal requirements to generate hydroelectricity and ensure reliability for our customers. Additionally, TPU is using municipal bonds to complete construction of our new $200 million Green River Drinking Water Filtration Facility. This new facility will ensure compliance with new federal regulatory requirements and provide safe, high-quality drinking water to hundreds of thousands of residents in the Puget Sound area.

Based on current projections, our customers would be exposed to a nearly $40 million increase in rates over the next 10 years if we lost access to tax-exempt municipal bonds. Because we spread our costs uniformly over all water and electricity consumed by our customers, this would amount to a regressive ‘flat’ tax on all utility customers. As our economy recovers, our customers should not be saddled with this type of regressive tax or additional limitations on our ability to build these vital facilities.

Fiscal challenges at all levels of government have made infrastructure investment more challenging. Current policy on tax-exempt municipal bonds spurs job creation, grows our tax base and promotes economic growth. We urge your Committee and Members of Congress generally to take a broader view in regard to this long-standing policy and maintain current law as it relates to tax-exempt municipal bonds.

Thank you for the opportunity to provide our views on this important issue. Should you have any questions, please contact Clark Mather at Tacoma Public Utilities at 253-441-4159.

Sincerely,

William A. Gaines
Director/CEO, Tacoma Public Utilities

CC: Sen. Patty Murray
Sen. Maria Cantwell
Cong. Jaime Herrera-Beutler
Cong. Derek Kilmer
Cong. Dave Reichert
Cong. Adam Smith
Cong. Denny Heck

List of organizations represented

This page is meant to respond to committee direction that, "All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness."

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Statement of

The Associated General Contractors of America

to the

Committee on Ways and Means

U.S. House of Representatives

For a hearing on

"Tax Reform and Tax Provisions Affecting State and Local Governments"

March 19, 2013

AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

Building Your Quality of Life

AGC is the leading association in the construction industry. Founded in 1918 at the express request of President Woodrow Wilson, AGC now represents more than 33,000 firms in nearly 100 chapters throughout the United States. Among the association's members are approximately 7,500 of the nation's leading general contractors, more than 12,500 specialty contractors, and more than 13,000 material suppliers and service providers to the construction industry. These firms engage in the construction of buildings, shopping centers, factories, industrial facilities, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, hospitals, water conservation projects, defense facilities, multi-family housing projects, municipal utilities and other improvements to real property.

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
2300 Wilson Boulevard, Suite 400 • Arlington, VA 22201 • Phone: (703) 548-3118 • FAX: (703) 548-3119

Statement of
The Associated General Contractors of America
Committee on Ways and Means
United States House of Representatives
March 19, 2013

The Associated General Contractors of America (AGC) is pleased to write today to explain the many Federal tax provisions that affect State and local governments and form the tools that could and should be active in the infrastructure financing toolbox.

Founded in 1918 at the express request of President Woodrow Wilson, AGC is the leading association in the construction industry representing more than 30,000 firms in nearly 100 chapters throughout the United States. Among the association's members are approximately 7,500 of the nation's leading general contractors, more than 12,500 specialty contractors, and more than 13,000 material suppliers and service providers to the construction industry. These firms engage in the construction of buildings, shopping centers, factories, industrial facilities, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, hospitals, water conservation projects, defense facilities, multi-family housing projects, municipal utilities and other improvements to real property. Many of these firms are small and closely-held businesses.

While private construction is finally recovering from the recession, public construction markets like transportation, water and wastewater have been shrinking. Federal funding cuts in the recently enacted sequestration and appropriations bills, along with tight local government budgets, mean public construction is poised to decline further in 2013 and beyond. These decreases threaten to worsen the already high unemployment rate in the construction industry, which stood at 15.7 percent in February, roughly double the rate for the overall economy. Volatile prices for materials and diesel fuel have cut into the already slim margins most firms are working on and jeopardized the solvency of some.

Even before the current economic downturn, many of our cities and towns, which include everything from large urban to small rural communities, had experienced substantial challenges in finding money to repair and replace infrastructure that is quickly reaching the end of its useful life. Many communities do not currently have the financial resources to make the necessary investments to meet growing infrastructure needs.

For transportation infrastructure, the Federal Highway Administration (FHWA) estimates in its 2010 Conditions and Performance Report that to eliminate the nation's bridge backlog by 2028, we would need to invest $20.5 billion annually, while only $12.8 billion is currently being spent. The challenge for federal, state, and local governments is to increase bridge investments by $8 billion annually to address the identified $76 billion in needs for deficient bridges across the United States. Additionally, 42 percent of America's major urban highways remain congested, costing the economy an estimated $101 billion in wasted time and fuel annually. While the conditions have improved in the near term, and federal, state, and local capital investments increased to $91 billion annually, that level of investment is insufficient and still projected to result in a decline in conditions and performance in the long term. Currently, the Federal

Highway Administration estimates that $170 billion in capital investment would be needed on an annual basis to significantly improve conditions and performance. Ridership on America's public transit infrastructure has increased 9.1 percent in the past decade while conditions on these systems have deteriorated. Deficient and deteriorating transit systems cost the U.S. economy $90 billion in 2010, as many transit agencies are struggling to maintain aging and obsolete fleets and facilities.

In the case of water and wastewater infrastructure, needs continue to multiply as age and chronic underinvestment in federal water infrastructure financing programs (like the EPA's State Revolving Loan Fund Program) are compounded by an evolving and expanding regulatory landscape. State and local governments will continue to bear the brunt of this double-edged problem and many face significant practical and political challenges to enacting rate structures to raise adequate capital and make the improvements that are needed. EPA projects that more than $600 billion is needed in infrastructure improvements over the next 20 years simply to keep pace, yet consistent dwindling of federal commitment to water infrastructure programs has resulted in a gap in funding of more than $20 billion annually.

When the federal government began mandating quality standards for drinking water and wastewater discharge through legislation like the Clean Water Act and Safe Drinking Water Act, it also recognized that forcing local governments to spend billions of dollars to upgrade facilities and equipment to comply with regulatory burdens was impractical. The EPA's SRF program is the vehicle the government uses to avoid foisting the burden of maintaining national water standards onto local ratepayers alone. Given that it is in the federal interest to set water quality standards, then so too must it be in the federal interest to provide financing and flexibility to help operators so they can meet those standards. This is even more salient now with the sharp drop-off in State revenues and lack of budgetary flexibility most states have due to balanced budget requirements.

Public investments in infrastructure also are often the best way to ensure the health, safety and economic vitality of sparsely populated rural communities. Many rural communities, indeed many rural states, lack the resources needed to finance the construction of major infrastructure projects like interstate highways, advanced wastewater treatment plants, or safe drinking water filtration systems. The federal government is uniquely suited to supporting infrastructure investments in these rural communities, especially when so much of our nation depends on the commercial traffic that travels through them and the agricultural products that come from them. In fact, 27 states rely on federal funds for 25 to 40 percent of their state highway capital investments annually and 14 states rely on federal funds for over 40 percent of their annual highway capital investments, of which 10 are over 65 percent.

Economic Advantages

Spending on construction creates jobs. We at the Associated General Contractors of America found that for every $1 billion in spending on infrastructure, 28,500 jobs are created in construction and construction-related activities which includes 9,700 (34%) direct construction jobs; 4,600 (16%) indirect jobs in supplier industries (mining, manufacturing and services); and 14,300 (50%) induced jobs resulting from purchases out of the additional income of workers and owners in the directly and indirectly supported industries. The U.S. Conference of Mayors found that every job created in water and sewer infrastructure creates over three additional jobs in the national economy to support that job.

Federal support for drinking and wastewater systems also delivers a tremendous return for taxpayers by lowering healthcare costs, reducing the cost of cleaning up polluted waterways, and contributing to increased economic vitality. Robust water infrastructure provides a solid foundation for business that wells and septic systems simply cannot. Regular federal investments in infrastructure also save taxpayers money as it costs a lot less to maintain infrastructure than it does to repair it. The cost of replacing water pipes through routine maintenance is typically between $100 and $300 per linear foot. The cost to repair a water main break is approximately $1,500 per linear foot, not including the costs of flooding damage, closures of businesses, and health hazards to those in the area.

Tools in the Toolbox

There are several infrastructure financing options that have been suggested or have been in use at one time, but none that have remained consistent or expanded over the last several decades. There needs to be stability and predictability for state and local governments, which would allow them to create long-term construction plans, which in turn give stability and predictability in the water and wastewater construction markets. Giving municipalities and their contractor partners access to all the tools in the infrastructure financing toolbox will help achieve this.

<u>Transportation</u>

Two national policy commissions established by SAFETEA- LU, the U.S. DOT, AASHTO and other groups have reached the same conclusion – "Without changes to current policy and accompanying revenue enhancements, it is estimated that revenues raised by all levels of government for capital investment will total only about one-third of the roughly $200 billion necessary each year to maintain and improve the nation's highways and transit systems." The purchasing power of the federal highway revenues has decreases nearly 50 percent since the last gas tax increase in 1993, further contributing to the backlog of needs.

To address these increasing transportation infrastructure needs both National, Bipartisan Commissions established in SAFTEA-LU, as well as the Simpson-Bowles Deficit reduction committee recommended increasing the federal motor fuels tax. The recommendations range from a minimum increase of 15 cents per gallon up to 40 cents per gallon.

Eventually the nation must shift to a more sustainable funding mechanism for surface transportation. AGC recommends maintaining a user fee-based system for transportation investment. The user fee should be increased and supported by including an inflation index. Additional user fees such as a sales tax, oil exploration fee, registration fees, customs fees on imported freight and others should be considered. Establishing user fees tied directly to miles driven has many long term benefits. The mileage-based fee is a fair and equitable in that all can be charged the same amount based on actual usage regardless of the type of fuel used in the vehicle and the efficiency of the vehicle. This method also has the benefit of being relatively easy to administer. It also meets other national policy objectives by offering a means to alleviate congestion and promote economic development, environmental sustainability, equity, and quality of life.

Water and Wastewater

While increased appropriations would go a long way toward alleviating the short-term problem, they would not solve the long-term problems of market instability and unpredictability. With the volatility inherent in the annual appropriations process, a sustainable, long-term funding mechanism is needed to provide market certainty for construction firms and local water authorities. This new long-term funding mechanism should be multi-year and utilize the existing successful SRF framework to move funds from the federal to state and local levels. This long-term mechanism should also embrace the “user pays” concept that other infrastructure funding mechanisms have implemented with success to create a budget-neutral, user-fee financed, clean water trust fund. The best long-term solution would be to establish this national clean water trust fund, to be financed by a wide array of small broad-based user fees.

There is ample precedent for dedicated federal trust funds to tackle problems too big for states to handle alone. The GAO has identified more than 120 federal trust funds in operation. These trust funds help ensure funding for other critical projects, including highways, airports, harbor maintenance, and inland waterways. But in this case we can use the model of the highway trust fund that has been extremely successful to build a dedicated long-term, sustainable, off-budget source of funding for water infrastructure such as a trust fund, which would create market certainty in the water and wastewater markets.

Polling has shown that people believe that the government has a responsibility to provide clean water. In fact, 86 percent of Americans support legislation by the U.S. Congress that would create a long-term, sustainable, and reliable federal trust fund for clean and safe drinking water infrastructure. The Government Accountability Office (GAO) in 2009 released a report entitled “Options for a Clean Water Trust Fund” which acknowledges that our nation faces tremendous challenges in replacing and rehabilitating our water infrastructure. As the GAO’s report states, a trust fund for water infrastructure may not be the only solution to our water infrastructure needs in America but it would establish a multi-year commitment to address the nation’s pressing water needs.

While a trust fund would be the best solution, it is still only one tool in the toolbox of financing and funding mechanisms that Congress should make available for use by state and local governments. Alternative and creative methods of financing water infrastructure must be embraced in these tough times. As traditional methods of funding fall out of favor, it is important to seek fresh and creative approaches. However, it is crucial to note that these creative and alternative mechanisms should supplement, rather than replace, the traditional financing mechanisms, such as the SRF, which are already proven to work.

Bonds

One such creative mechanism is the highly successful, but short lived, Build America Bonds

(BAB) program in the Recovery Act. BABs are taxable bonds for which the U.S. Treasury Department pays a 35 percent direct subsidy to the issuer to offset borrowing costs. The program financed nearly $38 billion in water, sewer, and utility infrastructure projects and over $46 billion in transportation projects over the two years it was active. This popular program could be resurrected, perhaps with a lower direct subsidy to reduce upfront costs to the federal government.

Another method of directing funds to infrastructure would be to secure access to private investment in water infrastructure**.** Private activity bonds (PABs) can be an important tool for financing infrastructure investments in our communities by providing long-term financing for capital-intensive infrastructure projects. PABs are a form of tax-exempt financing available to entities like state or municipal governments that want to partner with a private party to meet a public need. Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes, which allows the interest rates on such bonds to be lower. This, in turn, lowers the borrowing costs for the beneficiaries of such financing.

Congress controls the total volume of tax-exempt bonds by limiting issuance in each state with an annual cap – for example, in 2011 the volume cap for a state was the greater of either $95 per resident, or $277.8 million. Construction projects should be removed from this annual volume cap, allowing those projects to no longer have to compete with the dozens of other categories of public spending these bonds finance. Exceptions from the volume cap are currently provided for other governmentally owned facilities such as airports, ports, high-speed intercity rail, and solid waste disposal sites.

PABs employ the best features of successful public-private partnerships, spreading risk and encouraging innovation. By reducing a government's project management burdens and its risk (with PABs, the private entity assumes much of the financial risk and administrative responsibility), multi-year projects and a broader project load become more feasible as the government has more resources to allocate. Also, PABs do not affect the municipality's bond rating, as the private entity retains the financial risk, an important benefit of PABs for municipalities.

Amid all these new ideas and methods for financing the nation’s infrastructure, we must not forget one of the oldest and most popular methods of financing infrastructure at the state and local level, the tax exempt municipal bond. AGC believes that it is crucial that these bonds remain tax exempt and that Congress reject proposals to cap or remove this tax exemption.

Under the federal tax code, investors do not pay federal income tax on interest earned from most bonds issued by state and local governments. This tax exemption for municipal bond interest has been in law since the federal income tax was promulgated 100 years ago, and these tax-exempt bonds have resulted in trillions of dollars of infrastructure investment since as state and local governments receive a lower interest rate on their borrowing than they would if their interest was taxable to investors.

A recent report by the National Association of Counties, National League of Cities, and National Conference of Mayors concludes that tax-exempt municipal bonds are the most important tool in the U.S. for financing investment in schools, roads, water and sewer systems, airports, bridges and other vital infrastructure. State and local governments financed more than $1.65 trillion of infrastructure investment over the last decade (2003–2012) through the tax-exempt bond market. In 2012 alone, more than 6,600 tax-exempt municipal bonds financed over $179 billion worth of infrastructure projects. In typical market conditions, the tax exemption can save states and localities up to two percentage points on their borrowing rates.

The study goes on to explain that for the proposal to enact a tax-benefit cap of 28 percent for certain taxpayers on many itemized deductions and exclusions, including tax exempt interest, the effect would be a partial tax on interest that would otherwise be exempt from income tax. In effect, the tax-exempt bond market would no longer be entirely tax-exempt. If this proposal to impose a 28-percent benefit cap on tax exempt interest had been in effect during the last decade, it is estimated that this would have cost states and localities an additional $173 billion in interest expense for infrastructure projects financed over the past ten year period. For a complete removal of the tax-exempt status the impact would be even worse, accruing an additional $495 billion of interest expense on state and local governments. These proposals are absolutely inconsistent with the dire infrastructure needs problem and ever-shrinking pool of federal support. Given the tremendous economic, environmental, and public health benefits of infrastructure construction and grim situation that our current infrastructure backlog represents, why enact such self-punishing policies?

Concluding Remarks

AGC thanks the Committee for the opportunity to submit this statement for the record. There is a menu of financing tools available to Congress that is as wide in variety as it is deep in financial potential. However, it is critical to remember that infrastructure financing is not, and should not be, a zero-sum operation. None of these options is mutually exclusive with the others, and indeed many would work better when combined. AGC believes that all should be available to spread the financing burden among as strong a foundation as possible to help these critical sectors of our nation’s infrastructure.

AGC of America believes the approach outlined above must be taken to give every locality – from the smallest rural towns to the biggest urban centers – the widest range of possible mechanisms to fund construction. These ideas range from new programs to be created and old programs that should come back to existing ones that could be modified and existing programs that should remain untouched. Many of these options have been sporadically available in the past and remain good ideas waiting to come off the shelf. A true solution to the infrastructure financing crisis would include making all of these options available all the time. Permanent long-term solutions are the only way to avert further crisis, let municipalities and contractors plan for the future, and truly safeguard our economy, environment and health.

The Minnesota Service Cooperatives

Working Together in the Spirit of Cooperation . . .

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March 19, 2013

RE: **Written Statement for the Record**
U.S. House Ways and Means Committee
Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

Chairman Camp, Ranking Member Levin, and Members of the Committee:

We urge the committee to include in tax legislation this year a provision to correct the effect on local government employees of Revenue Ruling 2006-36 relating to health reimbursement arrangements (HRAs) and the forfeiture on death of accounts held in voluntary employees' beneficiary association (VEBA) trusts, and in trusts for which income is not includable under Section 115 of the Internal Revenue Code ("funded HRAs"). In 2008, Congress corrected this problem for state-level employees and we believe that Congress should correct it for local-level public employees as well.

Hundreds of local governments in Minnesota use funded HRAs both for active employees and retirees. These programs benefit tens of thousands of local government employees and retirees. To be eligible for contributions to funded HRAs, employees must be enrolled in employer-sponsored group health plans. No employees or retirees are allowed to choose between taxable cash compensation and employer contributions, but taxable compensation is often less when employers make contributions to funded HRAs. Employees vest in their HRA contributions, and they are permitted to direct notional investments in their accounts. Peer reviewed research in Minnesota demonstrates that the use of funded HRAs reduces trend in health care inflation while increasing utilization of preventive care.

When first introduced in Minnesota, funded HRAs allowed participants without spouses or tax dependents to designate beneficiaries of their accounts upon death. As with any health plan that permits coverage for non-dependents, funded HRAs were designed so that the "imputed value" of coverage for a beneficiary would be taxable to the participant on death. Prior IRS guidance provided a simple mechanism where the VEBA withheld and forwarded income and employment taxes. In this manner, the IRS collected its tax on death, and adult children, grandchildren or other beneficiaries of participants could use the balance for reimbursement of medical expenses.

Revenue Ruling 2006-36 broke with established precedent regarding the right to provide health coverage for non-dependents subject to imputed income rules. Instead, it required that these accounts be forfeited on death. Many employees and retirees had already built significant savings in these arrangements with the reasonable expectation that they would be treated the same under the tax law as other participants in group health plans. Revenue Ruling 2006-36 is bad tax policy, because it treats similarly situated public employees differently without a good reason. It also results in bad health policy, since funded HRAs help reduce health care costs and encourage preventive care.

Public Law 110-458 (H.R. 7327), the Worker, Retiree, and Employer Recovery Act of 2008, exempted from the forfeiture requirement HRA plans for certain public employees participating in state public retirement systems. These plans are virtually identical to HRA arrangements administered by local units of government. But the law is narrowly drafted to benefit a relatively small number of employees while providing disparate treatment to similarly situated individuals in local units of government. This year, Congress should finish the job and fix the problem for local government employees.

We strongly support the enactment of legislation like the bills introduced in the last Congress as H.R. 2698 (Reichert) and S. 1366 (Cantwell). Such legislation would bring fairness where it is needed. These bills do not require that income be imputed to decedents, but the impact of funded HRAs in reducing trend means that participants will pay less for health care in the long run. This means that fewer dollars will be shielded from taxation, and more will be paid to participants in the form of taxable wages.

Because we believe that the use of funded HRAs amounts to good public policy both from a tax standpoint and from a health care cost containment standpoint, we would support changing the law for state and local plans going forward. However, we do very much support the substantial partial corrections offered in the Reichert and Cantwell bills, which would apply to plans in place prior to 2008, when the unexpected Revenue Ruling was issued. At a minimum, we would request a clarification that reimbursements to non-dependents from funded HRAs on death may be permitted where the value of coverage is imputed to the decedent.

We would be happy to provide the Committee with further information at any time.

Sincerely,

Jeremy Kovash
Executive Director / CEO
Lakes Country Service Cooperative

WASHINGTON PUBLIC UTILITY DISTRICTS ASSOCIATION
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April 2, 2013

The Honorable David Camp
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Re: Written statement submitted for 3/19/13 Committee Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

Dear Chairman Camp and Ranking Member Levin:

Thank you for the opportunity to submit written comments regarding tax reform and tax provisions affecting state and local governments. On behalf of the Washington Public Utility Districts Association, I would like to express support for preservation of tax-exempt municipal financing to ensure state and local governments, including public utility districts, are able to continue to use this important tool for investments in infrastructure that supports critical services. Our members are community-owned utilities that provide not-for-profit electrical, water and wastewater, and wholesale telecommunications services to residential, business and industrial customers in more than 26 counties across Washington. Public utility districts utilize tax-exempt municipal financing to make necessary investments that help keep the state—and the nation as a whole—economically competitive by ensuring delivery of reliable and affordable services.

Recent proposals calling for elimination or limitation on deductions of interest on tax-exempt municipal financing to reduce federal spending would impact the ability of public utility districts to make infrastructure investments to maintain essential services as well as meet federal mandates for electric reliability, fish and wildlife mitigation, and water quality. At a time when local and state governments face serious budget constraints, any effort by Congress to tax municipal bonds would add further economic hardship to the people who rely on vital local services.

Over the next five years, Washington State PUDs are expected to invest over $500 million in infrastructure. These investments include equipment upgrades to ensure system reliability, expansion of systems to provide for increased capacity that will support economic development, and technological improvements that will improve efficiency and performance. Investments such as new substations, water treatment facility improvements, installation of pipelines, and installation of fiber optic cable in rural areas that are currently un-served are not small expenditures, but necessary. The continued availability of tax-exempt municipal bonds plays a critical role in the ability of PUDs to make these investments.

We understand that Congress has difficult choices to make, but believe elimination or limitation on deductions of interest on tax-exempt municipal financing would have far reaching consequences that would outweigh any benefit. As not-for-profit, locally-controlled utilities owned and held accountable by the communities they serve, our member PUDs know the value of investing in systems to ensure safety and reliability. Failure to maintain and improve electrical, water and wastewater, and telecommunications systems in a timely manner can result in service disruptions and risks to public safety. Our member PUDs also know the importance of maintaining affordable service so businesses can thrive and people can maintain comfort in their homes. They know that infrastructure investments support the economy, putting people to work and, they know that tax-exempt municipal financing is critical to achieving these goals by providing a tool that allows investments to be made while minimizing the financial impact on ratepayers.

The Washington PUD Association encourages support of tax-exempt municipal bonds and we appreciate the opportunity to provide comments on this important issue.

Sincerely,

George Caan, Executive Director
Washington PUD Association

Cc: Representative Suzan DelBene
Representative Rick Larson
Representative Jaime Herrera Beutler
Representative Doc Hastings
Representative Cathy McMorris Rodgers
Representative Derek Kilmer
Representative Jim McDermott
Representative Dave Reichert
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Benton County PUD
Chelan County PUD
Clallam County PUD
Clark Public Utilities
Cowlitz County PUD
Douglas County PUD
Energy Northwest
Ferry County PUD
Franklin County PUD
Grant County PUD
Grays Harbor County PUD
Jefferson County PUD
Kitsap County PUD
Kittitas County PUD
Klickitat County PUD
Lewis County PUD
Mason County PUD No. 1
Mason County PUD No. 3
Okanogan County PUD
Pacific County PUD
Pend Oreille County PUD
Skagit County PUD
Skamania County PUD
Stevens County PUD
Thurston County PUD
Wahkiakum County PUD
Whatcom County PUD