April 5, 2016

The Honorable Kevin Brady
Chairman
House Ways & Means Committee
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
House Ways & Means Committee
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Levin:

On behalf of the organizations listed above representing our nation's cities, towns and counties, we appreciate the opportunity to submit the following comments to the House Ways and Means Committee as the committee begins work on examining the federal tax code. Our comments highlight two specific areas: (1) maintaining the federal tax exemption on municipal bonds to promote job creation and improve the nation's infrastructure; and (2) ensuring that state and local governments retain the authority to set their own tax policy.

We think it is important to continue the long-standing partnership between the federal government and state and local governments through the federal tax exemption on municipal bond interest. This long-standing federal tax policy, promulgated in 1913, is neither a loophole nor a special interest tagalong provision, but rather a fundamental component of our intergovernmental partnership and a safe and reliable investment. The exemption needs to be maintained in order to provide much-needed and irreplaceable resources to finance the nation's infrastructure needs. Through this critical financing tool, state and local governments are able to save approximately two-percentage points on their borrowing costs to finance the vast majority of all public infrastructure in our nation, which translates into a substantial savings to local taxpayers.

Our organizations share a long-standing support for the preservation of the well-established federal, state and local partnership embodied in federalism, and opposition to any preemption by Congress of state and local taxing authority. How to levy taxes fairly, how to ensure there is no discrimination among companies that provide different forms of the same service, and how to protect local government resources are all matters that should be resolved at the state and local level. Local governments exercise their taxing authority to the extent provided by state law. As a result, local taxing authority and practices differ from state to state, and from county to county and city to city within a state.

This means that every local government tailors its tax policy by taking into consideration the interests of its residents and local circumstances, and how best to address them. More importantly, local officials making these decisions are immediately accountable to the voters and taxpayers in their communities for the expenditure of funds on public services. The residents of the communities we serve already have the power to change locally imposed taxes and do not need to be subjected to a one-size-fits all federal tax policy.

The following is a more detailed discussion of our policies related to these issues.

Maintain the Federal Exemption on Municipal Bonds

State and local governments of all sizes access the tax-exempt bond market to provide essential infrastructure. Through the tax-exemption, the federal government continues to provide critical support for the federal, state and local partnership that develops and maintains essential infrastructure, which it cannot practically replicate by other means. State and local governments provide three-quarters of the total investment in infrastructure in the United States, and tax-exempt bonds are the primary financing tool used by over 50,000 state and local governments and authorities to satisfy these infrastructure needs. State and local governments issue approximately 11,600 bonds a year totaling roughly $300 billion on average. This has allowed state and local governments to finance more than $3.5 trillion in infrastructure investment over the last decade through the capital markets.

Our citizens, communities and public, private and non-profit sectors benefit in many ways from the issuance of these bonds, as they are used to build and maintain schools to support an educated workforce, and to build our roads, public transportation systems and airports, all of which are essential for supporting commerce. They also help to address the country's water infrastructure, public utilities, health care and affordable housing needs, as well as provide public safety infrastructure that ensures local and national security. Elected bodies at the state and local levels or the voters themselves approve these financings for specific long-term capital projects, not to support general government functions, such as maintaining employees or keeping the lights on.

As the federal government continues to develop concepts to reform national tax policy and reduce the deficit, several proposals have been offered that would replace, limit, or eliminate the tax-exempt status of municipal bonds. Some who support these proposals have suggested that those who truly benefit from the tax exemption on municipal bonds are wealthy investors. These claims mischaracterize municipal investors and the true beneficiaries of municipal bonds, who are –

- state and local governments that need the support of investors to finance critical infrastructure;
- taxpayers across the country who depend on this infrastructure for reliable transportation systems, schools, public health facilities, energy, clean water and affordable housing;
- the federal government, which gets quite a bargain on their partnership with state and local government to provide the nation's infrastructure through the exemption; and
- investors who buy bonds for many reasons, including the safe nature of these financial products.

With regard to the identity of municipal investors, 2010 IRS data indicates that 57 percent of tax-exempt income is reported by earners over the age of 65. These are individuals who are largely on fixed incomes, expecting the secure return on investment that municipal bonds provide. Municipal bonds are the second safest investment, aside from U.S. Treasuries, with state and local governments having nearly a zero default rate. 2010 IRS data also indicates that 52 percent of all bond interest paid to individuals went to those with incomes of less than $250,000. Finally, it is worth noting that 72.4 percent of the total outstanding municipal debt is held by individual investors, either directly or through mutual funds and money market funds (Source - 2010 Thomson Reuters). These are people who want to support the long-term infrastructure needs of their communities through a direct investment, the financing proceeds of which cannot be replaced by any source, including the federal government, or state or local governments.

Proposals to reduce or repeal the tax exemption would have severely detrimental impacts on national infrastructure development and the municipal bond market, raising costs for state and local borrowers and taxpayers. For example, a 2013 report (included in Appendix A) released by the National Association of Counties, National League of Cities, U.S. Conference of Mayors and Government Finance Officers Association estimates that if a 28 percent cap on the tax exemption of municipal bond interest had been in place from 2003 – 2012, state and local governments would have faced an additional $173 billion in interest expense for infrastructure investment. If the exemption had been fully repealed during that same time period, the additional interest expense for state and local governments would have been $495 billion. Given the severe budget constraints that state and local governments have faced since the national financial crisis of 2008, it is very likely that many of the infrastructure projects funded through tax-exempt bonds would not have been possible.

Congress and national leaders often discuss the need to improve our country's infrastructure, and are keenly aware of the enormous expense associated with these improvements. The American Society of Civil Engineers reports that it will cost state and local governments $3.6 trillion over the next four years to meet our nation's physical infrastructure needs. At a time when infrastructure demands are great and direct federal assistance to state and local governments to support infrastructure development is shrinking, the ability of states and localities to issue tax-exempt bonds is critical. Without the exemption, the fate of national infrastructure financing will be uncertain, causing infrastructure construction and maintenance to stagnate. Businesses and communities that depend on infrastructure for commerce, public safety, job creation and the development of an educated workforce will suffer, no doubt jeopardizing the country's already fragile economic recovery.
Proposals to cap or repeal the exemption would also introduce uncertainty into the municipal market, causing investors to fear additional federal intervention in the market where none has existed for the past 103 years. Ultimately these investor concerns translate into demands for higher yields from and increased costs to state and local governments. If these entities are unable to satisfy investor yield demands, then either needed infrastructure projects will not move forward or the costs of these projects will be passed on directly to state and local tax and rate payers.

Meanwhile, as other proposals to replace tax exempt bonds with tax credit or direct subsidy bonds have also gained some attention, it is important to note that these proposals would also create uncertainty and instability in the market, and more importantly, the costs of issuance for a majority of governments, especially smaller governments, would rise should such proposals be enacted. These costs would then be passed along to taxpayers.

The tax exemption on municipal bonds is a smart, cost-effective and safe mechanism for state and local governments, investors and the federal government to partner in building and maintaining national infrastructure. No amount of appropriations or other financing tools exist that match their reliability or capital production capability to support each of our unique communities and the country at large. The cost to the federal government of not taxing these investments is insignificant compared to the overall benefit that tax-exempt bonds provide. In fact, tax-exempt bonds are the best way to implement the infrastructure needs of each community effectively, as the decision to issue bonds for various projects is determined and approved by either the citizens themselves or their elected legislative bodies.

Furthermore, as Congress looks to also address corporate tax reform, it is important to note that any actions that would further limit incentives for banks and corporations to purchase municipal bonds will actually negatively impact taxpayers, not solely the targeted private sector entities. In 1986 Congress limited the incentives for banks and corporations to purchase municipal bonds. This has resulted in a shrinking corporate investor base for municipal securities. If this base is further eroded, other investors will demand more yield, which will increase issuance costs, and curtail the attractiveness of municipal securities. This would result in the opposite goal of improving our nation's infrastructure.

For these reasons we urge Congress to reject any proposals to tax interest income from local government tax-exempt bonds, including doing so indirectly by enacting caps or increased proration, which will diminish the value of the tax exemption to institutional investors and increase costs to state and local governments and taxpayers. Alternatively we recommend that Congress consider making modifications to the tax code to increase national infrastructure investment by incentivizing the purchase of government issued tax-exempt bonds. While a significant appetite remains for these securities, modifying the 2 percent de minimus rule for financial institutions is one solution that would provide such an additional incentive.

Another recommendation to increase infrastructure investment, particularly in smaller and more rural jurisdictions, is to increase the bank qualified debt limit from $10 million to $30 million. Bank qualified bonds are particularly useful to smaller governments, as they have historically enabled these jurisdictions to finance infrastructure at lower costs than traditional bond financing. For example, bank qualified bond issuers save between 25 and 40 basis points on an average. On an average 15-year, $10 million bank qualified debt financing, an issuer could expect to save between $232,000 and $370,000. Raising the bank qualified debt limit to $30 million, as outlined in *HR 2229 – Municipal Bond Market Support Act*, would save issuers between $696,000 and $1.1 million on a $30 million bank qualified bond issue. This is a substantial savings for our nation's smaller governments, which can be used to maintain and improve valuable community services and finance other much-needed capital improvement projects.

The tax exemption on municipal bonds has a long history of success, having been maintained through two world wars and the Great Depression, as well as the recent Great Recession. It continues to finance the majority of our nation's infrastructure needs for state and local governments of all sizes when no other source exists to do so. We cannot afford to abandon the great success of this important instrument now.

Preserve Federal Deduction of State and Local Taxes

We oppose the elimination or reduction, phased or otherwise, of state and local tax deductions. The deductibility of personal state and local income, property and sales taxes on federal tax returns recognizes the historic relationship of the federal, state, and local governments and the fact that all levels of government provide vital services. The elimination or reduction of state and local tax deductions would only increase state and local taxes for citizens.

Since the federal income tax was adopted in the early 20th century, there has been recognition that independent state and local government tax structures should be respected. State and local tax deductibility has contributed to the stability of tax revenues that are reliable and flexible. As state and local governments must balance their budgets, any change that disrupts the stability of their tax structure could only harm their ability to provide essential services, especially during recessions. The deductibility of state and local taxes supports their efforts to set tax rates at levels that efficiently match the service demands of their residents across a range of incomes and needs. Deductibility of these taxes also minimizes unhealthy market swings during times of economic change.

One key example of the importance of state-local tax deductibility is housing. Housing is a highly valued asset for residents and communities. Should deductibility of property taxes be eliminated or reduced, more volatility would be introduced into the housing sector, and could well reduce property tax revenues if such a change further curbed housing sales and prices. Historically, the deductibility of the property tax has often been a positive element in stabilizing housing values and markets. The recent economic downturn and the related housing crises are important reminders that property tax deductibility can support a housing recovery and, in time, restore government property tax revenues.

CONCLUSION

In summary, our several organizations understand the need for tax reform to address the rising federal deficit and to promote jobs and economic growth. As you discuss various tax reform proposals, we would strongly urge you to consider the impact any changes will have on critical infrastructure that residents in all local communities have come to depend on - schools, water and sewer systems, hospitals, road, bridges and public transportation systems. Local governments have been able to finance infrastructure projects at a reasonable interest rate through issuing tax-exempt municipal bonds. Without this type of financing, the cost to taxpayers to support these much-needed projects would be significantly higher, and in many cases, would force local governments to delay essential projects that create jobs and economic growth. We therefore strongly urge you to continue to maintain the federal tax exemption on municipal bond interest.

It is also important to ensure that any federal tax reforms allow local governments to retain authority over their own tax policy. We urge that you maintain the deductibility of personal state and local property, sales, and income taxes on federal tax returns. This recognizes the historic partnership that exists between federal state and local governments. The elimination or reduction of these deductions would only increase the cost of state and local taxes for citizens.

Finally, we would strongly urge you to oppose federal initiatives that would preempt state and local taxing authority and grant certain industries preferential tax treatment at the expense of other taxpayers. Granting any one industry's request for federally mandated favorable tax treatment would only welcome many other similar requests, which would further erode state and local revenues, undermine their tax policies and dismantle federalism.

We appreciate the opportunity to submit this testimony on behalf of this country's counties, cities and towns. If you have questions, please feel free to contact any of our associations' legislative representatives.

Sincerely,

National Association of Counties – Michael Belarmino, (202) 942-4254

National League of Cities – Carolyn Coleman, (202) 626-3023

International City/County Management Association – Joshua Franzel, (202) 682-6104

Government Finance Officers Association – Dustin McDonald, (202) 393-0208

APPENDIX A

Protecting Bonds to Save Infrastructure and Jobs 2013

A Report by the:

National Association of Counties
National League of Cities
U.S. Conference of Mayors
Government Finance Officers Association