April 23, 2012

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch:

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 Senate Finance Committee as you discuss what federal tax reform could mean for state and local fiscal and tax policy. Our comments today highlight three specific areas: (1) maintaining the federal tax exemption on municipal bonds to promote job creation and improving the nation’s infrastructure; (2) ensuring that state and local governments retain the authority to set their own tax policy; and (3) opposing federal preemptions that would grant preferential tax treatment to certain industries and threaten the fiscal health of state and local governments.

Our organizations share a long-standing opposition to any preemption by Congress of 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 revenues 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 account the sources of revenue available and the needs and desires of its residents. More importantly, local officials making these decisions are accountable to the voters and taxpayers in their communities for the expenditure of funds on public services. Our citizens 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.

In today’s difficult economic times, when local governments are facing the fifth straight year of declines in revenue with further declines projected for 2012, local taxing autonomy is crucial in helping to ensure that the needs of local citizens are met. The ability to make tax and other fiscal policy decisions at the local level, without federal interference, enables local officials to provide the quality services our shared citizens expect. In considering any changes to the federal tax code, we simply ask that you respect local authority and that you act to promote the intergovernmental partnership by authorizing the collection of local taxes already owed on Internet and mail-order sales. Accordingly, we call on Congress to immediately pass the *Market Place Fairness Act* (S. 1832).
We also think it is important to maintain the long-standing partnership between the federal government, and states and local governments through the federal tax exemption of interest earned on municipal bonds. Tax-exempt bonds help finance the construction and maintenance of three-quarters of the public infrastructure throughout the United States. This long-standing federal tax policy allows local governments to save approximately two-percentage points on their borrowing costs to finance the vast majority of all public infrastructures in our nation, which translates into savings to local taxpayers.

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

**Maintaining the Federal Exemption on Municipal Bonds**

State and local governments access the tax-exempt bond market to provide essential infrastructure and services to their citizens. Without access to this type of financing, the cost to taxpayers for providing schools, libraries, public buildings and hospitals, roads and bridges and sewers and waterways would be much greater. Tax-exempt bonds are not just a useful means to provide this important public service; they also are a well-established product for investors. More than 75% of municipal bonds are owned by individuals, from an array of income brackets.

Tax-exempt financing has a solid investor base and established legal infrastructure that allows a variety of communities, both small and large, to effectively serve the needs of diverse constituencies. There are over $2.9 trillion in outstanding tax-exempt bonds, issued by 50,000 separate government units.

The federal tax exemption of municipal bond interest is long standing. It is neither a loophole nor a special interest tagalong provision. In fact, Congress has exempted municipal bond interest since the income tax code was promulgated in 1913 and has continued to do so for 99 years.

The role tax-exempt bonds play is a great example of the federal, state and local partnership. State and local governments are responsible for building and maintaining 75% of our country’s infrastructure, with a majority of these projects financed through tax-exempt bonds. The yield an investor receives for tax-exempt bond purchases is usually 200 basis points lower than what they would receive on taxable bond purchases. However, because of the tax benefit, municipal bonds become a comparable investment, and one known to be among the safest in the world. This allows governments to borrow at a lower rate, saving billions of taxpayer dollars. The cost to the federal government of not taxing these investments is insignificant compared to the overall benefit that tax-exempt bonds provide for each community. In fact, tax-exempt bonds are the best way to integrate the 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.

The only logical way for the federal government to be a partner in infrastructure funding is by supporting the tax-exemption of municipal securities.

Congress and national leaders often discuss the need for shoring up our country’s infrastructure. The American Society of Civil Engineers reports that it will cost state and local governments $2.2 trillion over the next five years to meet physical infrastructure needs. At this time, when infrastructure demands are great, yet direct federal assistance to state and local governments is shrinking, the ability of states and localities to issue tax-exempt bonds becomes more significant. Without these bonds, state and local...
governments and taxpayers will struggle with increased borrowing costs, and financing for infrastructure construction and maintenance will 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.

Unfortunately, there are several tax proposals circulating that would dampen the effectiveness of the bond market, creating higher borrowing costs for state and local governments, less investment in infrastructure, and fewer jobs. This comes at a time when state and local governments are still struggling to recover from the Great Recession. Many local governments are facing budget shortfalls that continue to force them to make deeper cuts in critical public services and delay infrastructure investments.

One of the tax proposals circulating would cap certain tax deductions and exclusions for high income taxpayers, including tax-exempt interest on municipal securities. This cap would effectively amount to a tax on tax-exempt bonds - for both new issuances and bonds that are outstanding. Such a retroactive policy shift has never occurred before in this market, and would have the detrimental effect on investor’s appetite for tax-exempt bonds. This would drive up the borrowing costs of state and local governments. Similarly, the proposal to place an additional sliding cap on the benefits of deductions and exclusions, including tax-exempt bonds, would also be detrimental to local governments. This sliding cap would change from year to year and would be especially troubling for tax-exempt bonds, since it would be virtually impossible for investors to predict the tax rate for their municipal bond interest income over the life of their investments and would create a strong disincentive to buy tax-exempt municipal bonds.

Other proposals to replace tax-exempt bonds with tax credit bonds or direct subsidy bonds also would raise costs for state and local governments and their citizens. These programs work best as a complement to -- not a replacement of -- tax-exempt bonds. Congress should carefully look at how various tax credit bond programs have worked in practice versus in theory, when reviewing their role in the marketplace.

Simply, the tax-exempt bond market is a smart, cost-effective investment for state and local governments, investors and the federal government. No amount of appropriations or other financing tools match their effectiveness for financing infrastructure needs that serve individual communities and the country at large.

**Ensuring that State and Local Governments Retain the Authority to Set Their Own Tax Policy Based on the Needs of Their Constituents**

**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.

**Encourage State and Local Sales Tax Collection**

As the increasing strength of electronic commerce creates exciting new marketplaces, it has also put traditional retail outlets at an unfair disadvantage because of outdated and inequitable tax and regulatory environments. The Supreme Court’s decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) left state and local governments unable to adequately enforce their existing sales tax laws on sales by out-of-state catalog and online sellers. But Congress, with its clear constitutional authority to regulate interstate commerce, can give states and local governments the option to require sellers who do not have a physical presence in their jurisdiction to charge and collect sales taxes from their customers.

We urge support for the bipartisan Enzi-Durbin-Alexander *Market Place Fairness Act* (S. 1832), which would give state and local governments the option to collect the sales taxes they are already owed under current law from out-of-state businesses, rather than rely on customers to pay those taxes to the states. While brick-and-mortar retailers collect sales taxes from customers who make purchases in their stores, many online and catalog retailers do not collect these same taxes. This puts main street retailers at a five to ten percent competitive disadvantage to remote sellers. It is significant to note that customers are already required to pay taxes when they make online purchases, just like when they make purchases in a store; however, most taxpayers are not aware of this responsibility, and states and localities do not currently have the resources to enforce the payment of the tax. The *Market Place Fairness Act* does not impose a new tax, but would provide states and localities with a mechanism to require the collection of sales and use taxes on Internet and mail-order sales. This would help to level the playing field for brick and mortar stores on main street.

At a time when local governments are still facing tough choices to close budget gaps projected for fiscal years 2012 and 2013, collecting an estimated $23 billion owed in sales taxes a year would mean more money for investment in local infrastructure and basic services, just what the economy needs to generate more jobs. Although we have pushed for collection of remote sales taxes for over a decade, there is no time better than now for Congress to enact the *Market Place Fairness Act*, S.1832, into law.
Oppose federal initiatives that would grant certain industries preferential tax treatment and threaten the fiscal health of states and local governments

State and local governments continue to witness a growing parade of various industries actively urging Congress to preempt state and local government taxing authority of their particular industry. From the wireless industry, to the rental car industry, to online travel companies, these businesses are asking Congress for preferential tax treatment at the expense of local communities, individuals and families. The state and local government community strongly opposes any federal preemption of its taxing authority. If Congress were to grant any one industry’s request for federally mandated tax favoritism it would open the door for other industries to request similar special exemptions or protections from state and local taxing authority. Such actions by Congress would cause great damage to the entire existence of independent state and local taxation authority in our system of federalism, as well as to the fiscal health of state and local governments - all while purporting to solve a host of problems that simply do not exist.

These preemption measures, particularly when taken together, would set an unprecedented and dangerous new standard for federal intervention into state and local government tax classifications. While they purport to address only ‘discriminatory’ taxation, their standard for federal intervention becomes that every industry sector and every service has to be taxed at the same rate. Such a standard for ‘discriminatory’ state and local taxes would mean, contrary to long-established precedent, that the federal government has the power to preempt all state and local tax classifications and to impose a federally-mandated state and local tax code of only a single rate for all business. This would result in the end of state and local tax classification authority; significantly undermining the ability of state and local governments to balance their budgets, and redistributing the tax burden among those taxpayers least able to bear the burden. The power of the federal government to preempt state and local taxes is ultimately the power to destroy state and local governments – a power that cannot be reconciled with our basic system of federalism.

Some examples of proposals that have been introduced that would preempt state and local taxes are as follows.

The Wireless Tax Fairness Act of 2011 would ban new state and local taxes on wireless communications for a period of 5 years. As justification for this special tax treatment, proponents of the measure use data that consistently inflates state and local tax burdens relative to other businesses by unfairly mixing taxes with user fees and failing to disclose that the industry pays virtually no corporate income taxes. Moreover, the wireless industry has yet to present any data indicating that state and local wireless taxes have had any adverse effect on wireless service subscribership, revenue or investment. Quite the contrary, the wireless industry has experienced 100% growth between 2006 and 2011, even as the industry complains about its state and local tax burden.

Furthermore, provider claims that state and local taxes hinder activities such as broadband deployment are completely without merit. In reality, provider decisions to deploy a network are purely economic; providers will only target areas of deployment where they will reap the greatest return on investment.
The End Discriminatory State Taxes for Automobile Renters Act of 2011 would preempt state and local governments’ ability to impose ‘discriminatory’ taxes on automobile rentals and property related to renting automobiles. Yet, once again, the determination that a tax is ‘discriminatory’ is made without any reference to the factors that state and local policymakers use to evaluate local needs and the best manner to distribute the local tax burden, including offsetting exemptions that may be favorable to the rental car industry. Finally, the fundamental principle of federalism vests states and localities with the responsibility of providing services and raising funds to pay for those services. Fees may be placed on cars rented from airport locations that are used for capital improvements and tourism campaigns that directly benefit the rental car companies themselves. Rental car taxes are also imposed throughout the United States by cities, counties and states, with the proceeds used to pay for a variety of government services and programs.

Online Travel Companies (OTC) such as Expedia and Travelocity continue their behind the scenes efforts to have legislation favorable to their industry introduced at the federal level, at the expense of state and local taxpayers and the hotel industry. Such legislation would provide the OTC’s with a tax loophole by allowing them to pay state and local taxes based on the lower, wholesale rate they pay hotels for room rentals, rather than on the higher, retail rate these companies charge customers, putting in-state hotels that remit taxes on the retail rate at a competitive disadvantage. It is estimated that state and local governments are losing $275 million to $400 million in revenue each year because OTC’s fail to collect and remit to states and localities the appropriate amount of tax on hotel room bookings.

The Digital Goods and Services Tax Fairness Act of 2011 would regulate state and local governments’ taxation of downloaded music, movies and online services. The bill would seek to ban ‘multiple’ and ‘discriminatory’ taxes on digital goods and services, even though there is no concrete evidence of this practice by state and local governments; another bill with a solution in search of a problem. Moreover, the measure could potentially disrupt fundamental features of state and local sales taxation and open up major tax-avoidance opportunities for some large multistate corporations. Furthermore, the Internet Tax Freedom Act enacted in 1998 already bans such multiple and discriminatory taxation of electronic commerce, including digital goods and services.

The Business Activity Tax Simplification Act of 2011 would redefine what constitutes physical presence to limit a state’s ability to impose various taxes on businesses conducting activity within the state. Groups such as the National Governors Association have spoken out against the bill, characterizing it as an unwarranted intrusion into state affairs that will harm their ability to manage their finances during a critical and delicate time of economic recovery. The bill is estimated to cost states and localities $3 billion annually in revenue.

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, transit systems, water and sewer systems, hospitals and roads and bridges. 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 would be significantly higher; and it would, in many cases, force local
governments to delay the financing of essential projects that create jobs and economic growth. We therefore strongly urge you to continue to maintain the federal income tax exemption for municipal bonds.

It is also important to adopt reforms that will 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. We would also strongly urge you to immediately pass the Market Place Fairness Act, S. 1832, a bipartisan bill that would assist state and local governments collect $23 billion that is already owed to them on internet and mail-order sales. This would help state and local governments make needed investments in infrastructure improvements and other critical areas.

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. By granting any one industry’s request for federally mandated favorable tax treatment, Congress would open the floodgate to many other similar requests, which would further erode state and local revenues and undermine their tax policy.

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 association’s legislative representatives.

Sincerely,

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The United States Conference of Mayors - Larry Jones, 202-861-6709
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