United States Senate
Committee on Finance

Hearing on

"Tax Reform: What it Means for State and Local Fiscal Policy"

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The Bond Dealers of America (BDA) is pleased to submit this statement to the United States Senate Finance Committee as a part of its written record of the April 25, 2012 hearing to examine "Tax Reform: What it Means for State and Local Fiscal Policy."

The Bond Dealers of America is the only Washington, DC-based organization that represents the unique legislative and regulatory interests of national, middle-market dealers of fixed-income securities. BDA members work directly with municipal and state governments and financing agencies to facilitate the flow of capital used to fund capital projects that are critical to the economic livelihood and employment base throughout the country.

BDA members work closely with municipal and state governments to facilitate the issuance of municipal bonds—including tax-exempt bonds, tax-credit bonds, bank-qualified bonds, direct subsidy bonds and refundings. BDA broker/dealers often act as advisors to governments to assist them in determining which type of bond is the most effective from both financing and tax perspectives.

Tax-exempt municipal bonds are the cornerstone of state and municipal finance. Tax-exempt municipal bonds are the most accessible and effective source of financing for state and local governments. Currently, there is $3.7 trillion worth of capital in the municipal market, with roughly 70 percent of the outstanding bonds held by individuals either through direct investment or indirectly through mutual funds. Tax-exempt bonds are issued by thousands of governmental entities, including States, counties, cities, municipal water, sewer, and electric utilities, and agencies formed for various other purposes including health care, higher education, airports, ports, and housing. Nearly all long-term tax-exempt bonds are issued to finance capital expenditures. Short-term borrowings are used by some cities, counties, and States to help better match expenditures with tax revenues, since tax revenues may come in unevenly throughout the year.

Interest on municipal bonds has been exempt from federal income tax since the first federal tax code was adopted in 1913. Throughout dozens of tax debates, Congress has chosen again and again to preserve the tax-exemption for municipal debt as a sign of the federal government's commitment to maintain the delicate balance between the federal and state governments and to sustain the state and local government role in contributing to a strong national economy.

The importance of retaining the current tax law treatment for municipal bonds. Proposals to limit or eliminate the tax-exemption for municipal bonds have grown out of debate at the federal level on ways to reduce the federal debt and deficit to put the federal government on a path to fiscal stability. The current Administration has proposed limiting the value of itemized deductions (including tax-exempt interest) to 28 percent for individuals in the highest income class. The Simpson-Bowles Commission recommended elimination of the federal tax deduction for tax-exempt interest. These proposals have been structured to raise a significant amount of revenue for the federal government and to, in the case of the Administration's proposal, insure that all income classes receive a commensurate benefit from the deduction.

BDA believes proposals to limit or eliminate the tax-exempt status for municipal bonds are misguided from both economic and policy perspectives. Economically, state and local

governments are just now beginning to emerge from the recession and are rebuilding their historically strong balance sheets. Unlike the federal government, every state (except Vermont) is required by its state constitution to annually balance its budget. States cannot sell debt to finance budget gaps and must turn to spending cuts or tax increases to balance their books. These fiscal restrictions combined with an increasing responsibility passed down from the federal government to fund federal programs like Medicaid and education have strapped many state and local government treasuries. For decades, state and local governments have relied upon effective, low-cost tax-exempt municipal bonds as a means to fund capital projects that provide critical services and create jobs—and the billions of dollars in financing costs governments have saved by utilizing tax-exempt financing has been used by state and local governments to fund and expand capital projects, maintain essential programs, or reduce taxpayer burdens.

BDA believes—unequivocally—for these simple reasons that the current tax law treatment of interest on municipal bonds must remain unchanged. Eliminating this valuable exemption would rattle capital markets, dramatically increase the cost of financing infrastructure improvements across the country, and force state and local governments to shift billions of dollars of increased financing and administrative costs to taxpayers in the form of higher taxes or higher user fees—not just to taxpayers who invest in bonds, but *every* taxpayer.

The Potential Impact of Limiting or Eliminating the Tax-Exemption for Municipal Bonds. All levels of government benefit from a vibrant, stable capital market for financing state and local government infrastructure. The benefits of tax-exempt financing are well-documented whereas the potential risks of instability are sometimes ignored.

a. The cost of financing capital projects could increase exponentially. It is indisputable that limiting or eliminating the tax-exemption for interest on municipal bonds would increase the cost of municipal debt and hinder infrastructure development. Without access to tax-exempt financing, market analysts estimate the yields that state and local governments would be compelled to pay to attract investors could increase as much as 25-50 basis points, which may make projects too expensive to undertake or could force state and local governments to defer or downsize some infrastructure projects. Additionally, yields on debt may need to rise even further if investors abandon municipal bonds in favor of higher yields in corporate bonds or other investment vehicles. Such activity could leave state and local governments without adequate sources of cost-effective financing to devote to capital projects.

b. Taxpayers—not governments—would bear the increased costs of financing. In a municipal market worth $3.7 trillion, state and local governments have been able to save over $700 billion in financing costs directly tied to tax-exempt bonds. If tax-exempt municipal bonds are eliminated as a financing mechanism for capital projects, state and local governments and issuers will have little choice but to use more expensive forms of capital financing (i.e., taxable bonds and tax-credit bonds) and pass-on additional financing costs they incur to every taxpayer in the form of higher taxes and fees (for example, higher property taxes, sales taxes, and utility fees).

c. Small issuers will lose market access. Tax-exempt municipal bonds are widely used by state and local governments, but, nationwide, local government issuances of these bonds outpace

those issued at the state level. In 2011, 55 percent ($155.9 Billion) of tax-exempt bonds were issued by local governments, while 42 percent ($120.7 Billion) were issued at the state level. (Educational institutions, direct issuers and electric cooperatives account for the remaining 4 percent ($11.1 Billion).[1] The use of tax-exempt financing by small communities represents a key component in their fiscal plans. Requiring small communities to issue taxable rather than tax-exempt debt could increase interest costs by 25 percent. Issuance costs can be further impacted by the frequency that an issuer goes to market, e.g. municipalities that issue bonds less often and whose credit standing is not analyzed frequently could face higher administrative costs and yield demands than large issuers whose fiscal condition is well-known to investors and underwriters. Further, without access to the tax-exempt market, small issuers will find it increasingly difficult to compete for investors in other markets as the attractive nature of large issuances offered by states or metropolitan cities will overshadow those of small issuers, further driving-up yields and the cost of financing in general.

Summary

The municipal market is 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 municipal bonds play in providing states and municipalities with cost-effective financing for capital projects, including roads, bridges, schools, community health and higher education facilities. Insuring that states and municipalities 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.

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[1] Source: Thomson Reuters (based on data available on April 9, 2012).