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## National Governors Association Urges Preservation of Municipal Bond Exclusion.

Lawmakers should preserve the municipal bond interest exclusion and the state and local tax deduction to avoid disrupting infrastructure investment and to protect states from federal encroachment, the National Governors Association said in a July 23 letter to leaders of the Senate Finance Committee.

July 23, 2013

The Honorable Max Baucus

Chairman

Committee on Finance

United States Senate

Washington, D.C. 20510

The Honorable Orrin Hatch

Ranking Member

Committee on Finance

United States Senate

Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch:

On behalf of the nation's governors, we write to urge the Senate Finance Committee specifically, and the Congress generally to preserve the exclusion from income on interest earned from municipal bonds in comprehensive tax reform. We also urge Congress to maintain the deductibility from federal income for state and local taxes.

In anticipation of comprehensive federal tax reform, the nation's governors earlier this year released guiding principles, which are attached. The principles anchor our position that preserving these original elements of the federal tax code are critical to help grow the economy, ensure tax code fairness, and promote other important policy objectives.

Preserve Municipal Bond Interest Exclusion

Governors believe that 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.

Eliminating or placing income caps on itemized deductions and exemptions would have the unintended consequence of chilling supply and demand for municipal bonds. It would also limit the flexibility of state and local governments to adjust tax policy in response to uncontrollable economic pressures, which could among other outcomes increase risk concerns for bondholders. Individual and retail investors in municipal bonds would seek higher yields to offset ending the exclusion or imposing a deductibility cap and both would lower municipal bond supplies because state and local issuers, especially small and occasional issuers, could not afford higher interest rate costs.

Governors also believe that 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 infrastructure and public projects. States and local governments own and operate the vast majority of the nation's infrastructure systems and contribute nearly 75 percent of the annual cost to operate and maintain them. If issuing municipal bonds becomes cost-prohibitive for states and local governments because of changes to the federal tax code, then the likelihood of financing new infrastructure projects falls because the alternatives include higher taxes and user fees, or just shelving proposed projects, which would result in lost jobs and reduced economic growth because of declining infrastructure capacity.

The federal tax code should encourage expansion, not contraction, of financing options because there is no effective substitute bond program or direct federal appropriation that could replace the robustness that the municipal bond market provides to the broad range of municipal issuers.

Eliminating or limiting the interest exclusion on interest for outstanding municipal bonds could also create market disruptions, including with new issuance sales, because ending the exclusion breaches the implied promise from the federal government that the exclusion would remain during the life of outstanding bonds. This could trigger call provisions in bond indentures putting state and local issuers at financial risk.

Eliminating the exclusion would hurt all bondholders, not just those in high tax brackets because the value of all outstanding bonds would fall. In contrast to the assumptions by supporters of eliminating the interest exclusion, investors would not likely rebalance their portfolios fully into taxable bonds, but instead would seek other ways to shield investment income from taxation, which would lower federal tax revenue estimates from eliminating or capping the interest exclusion. The mere discussion about altering the tax treatment of municipal bonds injects uncertainty and creates risk concerns for investor who will demand risk premium on future bond issues.

Alternatively, the central argument for eliminating the municipal bond interest exclusion is fiscal efficiency. Efficiency proponents argue that the current process for setting municipal bond yields generally leads to higher rates than what higher-income taxpayers would actually demand as investors. This spread represents lost federal tax revenue that benefits high-income investors primarily rather than accruing to the state and local issuers in lower borrowing costs. Proponents argue that instead of tax-exempt bonds, a taxable bond program with a direct federal subsidy to issuers that covers a portion of interest paid investors would be more efficient. The temporary Build America Bonds (BABs) program authorized under the 2009 Recovery Act was a direct subsidy bond program.

In addition to the counter-arguments above against taxable bonds as a substitute, the fact the BABs subsidy is subject to the sequester and the congressional appropriations process would only add to the uncertainty — and thus the costs to state and local issuers — of replacing the current exemptions with taxable bonds. This is particularly troublesome for those issuers from smaller states

and communities that would face increased debt issuance costs if the only option to finance public projects was reliance on a taxable and tax credit market.

Governors remind Congress that federal tax policies and tax expenditures serve public policy purposes that are 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. 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.

Protect State and Local Tax Deductibility

Governors also believe that 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.

State linkages to the federal tax code remain strong and eliminating federal deductibility for state and local property, sales, and income taxes could limit the ability of state and local governments to adjust tax policy in response to uncontrollable economic pressures, which could increase concerns of risk for bondholders. It would effectively increase marginal tax rates for taxpayers that, absent an offset for equity purposes, could create an economic drag.

Shifting the intergovernmental balance of income taxation in such a manner could damage administrative viability and limit state control of their tax systems because of federal encroachment into the traditional tax base of states.

Refresh Federalism

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

[S]tate and local governments increasingly have been treated like ‘just another special interest group’ rather than as a partner in a federal system of government. . . . The federal government must recognize that its judicially unfettered power to control the tax exemption of state and local government bonds must be exercised with the full recognition of the impact on state and local taxpayers as well as on the federal Treasury. . . . State and local governments cannot fulfill their responsibilities to provide public services and meet federal standards and mandates without the cooperation of the Congress and the Administration.

Written nearly 25 years ago by the bipartisan Anthony Commission on Public Finance, whose membership included Democratic Governor Bill Clinton of Arkansas and Republican Governor Carroll Campbell of South Carolina, those words remain germane today.

We do not believe that it is the intent of Congress through comprehensive tax reform to undermine the ability of state and local governments to meet the needs of the citizens we all serve. Instead, we are confident that, like the Anthony Commission stated: “the overwhelming majority of members of Congress are sympathetic to the needs of state and local governments and wish to promote their ability to borrow on an effective and efficient low-cost basis.”

Sincerely,

Governor Tom Corbett

Chair, Economic Development and

Commerce Committee

Governor Steven L. Beshear

Vice Chair, Economic Development

and Commerce Committee

National Governors Association

Washington, DC

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