



***Statement of Michael Decker
Senior Managing Director, Research and Public Policy
The Securities Industry and Financial Markets Association***

***Subcommittee on Domestic Policy
Committee on Oversight and Government Reform
United States House of Representatives***

March 29, 2007

Good morning Chairman Kucinich, Ranking Member Issa and Subcommittee members. Thank you for the opportunity to be here today to discuss issues related to public financing for the construction of stadiums, convention centers and hotels.

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. We have offices in New York, Washington, and London, and our associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

Our membership includes all major U.S. dealers in state and local bonds issued to finance a wide variety of public infrastructure including schools, roads, airports, water and sewer facilities, mass transit systems, and parks and public buildings, among many others. Our members serve as conduits between state and local governments and the capital markets for investments that create jobs, enhance productivity and improve living standards. As such, we take an active interest in federal policies that affect the ability of states and localities to access the capital markets.

Tax-exempt Bonds and Public Investment

One of the most important tools available to state and local governments to finance public investment is the \$2.4 trillion tax-exempt bond market. The interest on most municipal bonds is exempt from federal income tax for most taxpayers. As a result, the interest rates paid to investors by state and local governments on their bonds are approximately two percentage points lower than they would be otherwise. These lower interest rates save states and localities tens of billions of dollars a year in interest costs and make it possible to finance more investment. The tax-exemption for municipal bonds has its origins in the very first income tax laws enacted by Congress after the adoption of the 16th Amendment to the Constitution in 1913

and is one of the most important forms of aid the federal government provides to states and localities.

Because the federal government foregoes significant tax revenue as a result of the tax exemption, Congress is and should be concerned about how the tax exemption is used. In fact, the Internal Revenue Code (IRC) includes some very restrictive and sometimes complex provisions governing the use of tax-exempt bonds. These cover areas such as arbitrage bonds and the use of tax-exempt financing by states and localities acting as conduits for private companies.

Tax-Exempt versus Taxable Debt

Tax-exempt financing reduces the interest rates paid by borrowers in relation to what they would pay if they issued comparable taxable bonds. Tax-exempt bonds are priced—interest rates are set—based on investors’ expectations for after-tax returns. Because there is no federal income tax on interest income earned by investors on qualified tax-exempt bonds, investors buy the bonds at lower interest rates than they would if interest on the bonds were taxable. However, because there is no tax liability on the interest, after-tax returns earned by investors on tax-exempt bonds is the same as the nominal, pre-tax interest rate paid by borrowers.

If bond issuers—borrowers—had to issue taxable bonds, the interest rates on the bonds would be set based on investors’ after tax returns. Assume investors sought an after-tax return of, say, six percent and were in a 25 percent marginal income tax bracket. Issuers would have to pay an interest rate of eight percent on bonds they sold to satisfy investors’ demand for a six-percent after-tax return. However, if the same borrower issued tax-exempt bonds, the bonds could be sold with an interest rate of six percent to satisfy investors’ demand for a six-percent after-tax return. The issuer would save two percent on their annual borrowing cost. That two percent represents the benefit that accrues to issuers as a result of the federal tax-exemption.

Private Use of Tax-Exempt Bonds

Tax-exempt, private-activity bonds are those that are nominally issued by a state or local government but whose proceeds benefit a private party and where the bonds’ repayment is secured by a private party. Generally, the IRC prohibits the use of private-activity tax-exempt bonds unless the project being financed meets certain targeted uses such as water and sewer systems, airports, low-income rental housing or low- and medium-income mortgage finance, among others. Even then, significant restrictions, such as an annual per-state cap on the overall volume of private-activity bonds, apply. There are relatively few IRC restrictions on the use of non-private-activity—governmental or public purpose—tax-exempt bonds.

The IRC defines private-activity bonds as those where more than 10 percent of bond proceeds are used to finance a private business and more than 10 percent of the repayment of principal and interest is derived from or supported by a private business. These are known as the “private-use” and “private payment” tests. Issues must satisfy both tests in order to be considered private-activity bonds. (An alternative test designates bonds from which more than 5 percent of proceeds are lent to a private party as private activity as well.) In other words, a

state or local government bond is a private-activity bond only if the facility being financed is used principally by a private business *and* the repayment of the bonds is secured by a private business. If a bond is repaid from a public, governmental source of funds, it is not a private-activity bond, regardless of the private use of the facility.

Before 1986 it was common for states and localities to issue bonds for sports stadiums, convention centers and hotels. Generally, those bonds were structured so that repayment of the debt service was secured by the sports team leasing the stadium, companies that used the convention center, or hotel companies that leased or managed the hotel. Indeed, before the enactment of the Tax Reform Act of 1986 (TRA), sports stadiums, convention centers and hotels were allowed uses of private-activity bonds. In the TRA, however, Congress specifically prohibited private-activity bond financing for stadiums, convention centers and hotels. Under current law, if a bond falls under the definition of private-activity bond, it may not be tax exempt unless it meets one of the specific exemptions laid out in the IRC. Those exemptions do not include stadiums, convention centers or hotels. As a result, tax-exempt bonds for stadiums and similar projects cannot be tax exempt if the debt service is secured or paid by private businesses.

The Debate Over Stadium Financing

There is a long history of public bond financing of local, professional sports facilities. Cleveland Municipal Stadium, built in 1931 and home of the Cleveland Indians for 60 years and the Cleveland Browns for 50, was financed with \$2.5 million bonds approved by voters in a referendum and issued by the city of Cleveland. Jacobs Field, the Cleveland Browns Stadium and Quicken Loans Arena were also financed with bonds approved under voter referenda. The Rock and Roll Hall of Fame was also built with tax-exempt bonds, but because the Hall of Fame is a 501(c)(3) nonprofit corporation, it was not required to use city-supported financing. Both Qualcomm Stadium, completed in 1967 and home of the San Diego Chargers, and Petco Park, opened in 2004 as the home of the San Diego Padres, were financed with tax-exempt bonds approved under voter referenda.

Despite the prohibition on *private-activity* bond financing for stadiums, arenas, convention centers and hotels, state and local governments still sometimes issue tax-exempt bonds for these uses. These bonds are structured so that debt repayment is secured not by revenues derived from businesses that use the facilities but by public revenue sources such as taxes, lottery revenue or other sources. As a result, these bonds are not private-activity bonds and their use for financing stadiums or similar projects is not restricted under the IRC. However, because they are supported by public resources, these bonds are often subject to a more rigorous public approval process than private-activity bonds, including in some cases referenda or approval by a legislative body. It is as a result of Congress' 1986 prohibition on private-activity bond financing for professional sports facilities, convention centers and hotels that the only option states and localities have under current law to use tax-exempt financing for stadiums and similar projects is to commit public resources to the bonds' repayment. Also, even in years where the level of financing for sports facilities, convention centers and similar facilities has been relatively high, these facilities comprise a small portion of the overall municipal bond market. For example, total "new money" tax-exempt financing for sports facilities and

convention centers in 2006—the highest-volume year for these facilities in the last decade—was less than one percent of total municipal debt issued.

Table. Issuance of “New Money”¹ Tax-exempt Bonds for Stadiums, Sports Complexes and Civic and Convention Centers (\$ millions)²

	Stadiums and Sports Complexes	Civic and Convention Centers
1997	1,013.4	114.3
1998	829.8	557.7
1999	579.5	35.7
2000	614.6	459.0
2001	1,029.2	557.9
2002	396.8	315.1
2003	364.2	64.9
2004	274.9	91.9
2005	1,006.9	248.8
2006	2,541.6	1,051.6

Since the enactment of the TRA, some federal policy-makers have proposed restricting the use of all tax-exempt bonds, private activity and public purpose, for financing stadiums, arenas, civic and convention centers and hotels.³ However, these proposed restrictions would supersede a long-standing and well established policy for federal financial support of state and local decision-making regarding new investment and the commitment of public resources.

In the TRA, Congress established a two-part test of private activity specifically to allow states and localities to finance with public sources of funds projects dedicated predominantly to private use. Congress wisely established this definition of private-activity bonds to allow states and localities the flexibility to dedicate public debt capacity to otherwise private projects to meet local demands and still retain the tax-exemption for bond financing. Even though Congress eliminated *private* tax-exempt financing of stadiums in 1986, in establishing a two-part test of private activity, Congress also arguably foresaw projects where state or local governments’ desire to dedicate public resources and retain tax-exempt financing, such as with stadiums as they are currently financed.

Some have argued that Congress’ intent with the TRA was to eliminate *all* tax-exempt financing for professional sports stadiums, not simply private-activity bonds. Congress, in fact, did not create a legal barrier to municipal stadium financing using public resources. In a private-activity bond transaction, the municipality acts only as the nominal issuer. The bond offering does not pledge any public source of funds as the source of repayment for the bond.

¹ “New Money” municipal bonds are distinct from “refunding” bonds. New money bonds are issued to finance new investment projects. Refunding bonds are issued to refinance outstanding debt for projects already constructed.

² These totals may include bonds issued for projects other than professional sports facilities. Sports stadiums and arenas for most colleges and universities, for example, may be financed with tax-exempt bonds not supported by public resources and not used by professional teams. Source: Thomson Financial SDC Platinum

³ See, for example, Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005, pages 353-358.

Investors who purchase private-activity bonds understand the security does not legally represent an obligation of the municipality but of the entity generating the revenue pledged as the bond's source or repayment. The choice on the part of a state and local government to use its debt capacity to finance sports stadiums and similar projects was not addressed by Congress in the TRA. Restricting the public use of tax-exempt financing for stadiums and similar projects would effectively usurp the tax-exempt financing authority of state and local governments provided in the IRC. Under current law, state and local governments are free to issue tax-exempt bonds whose repayment is secured by a public source of funds and allow the proceeds to be used to finance the construction of stadiums, convention centers and hotels.

Some have also claimed that stadiums deserve unique treatment under the tax-exempt bond rules because the scarcity of professional sports teams allows team owners to pressure state or local government to provide an economic benefit to the team. However, this is the type of decision that is appropriately made by the governing entities whose bonding capacity is being utilized. Judgments about who benefits most in municipal stadium financing transactions are subjective. Sports teams can generate employment and other economic development whose benefits can multiply throughout a city or region in ways that cannot be easily quantified. Ultimately, it is the role of local—not federal—government to decide whether the benefit of public, not private, stadium financing is worth the associated cost.

Summary

Decades of legislative refinement of federal laws governing tax-exempt bond financing and state and local decision making have resulted in rules whereby the federal government, through the tax exemption, provides financial support for capital investment by states and localities. The decision of whether and how to finance and build projects such as stadiums, arenas, convention centers and hotels is a decision best made at the local level. Local citizens and lawmakers are best positioned to evaluate the potential economic benefits of particular projects and determine whether projects are deserving of local public resources. Congress should not tamper with the federal-state-local partnership embodied in the rules governing public-purpose tax-exempt financing.