1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456
www.bondmarkets.com

360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

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Statement of Micah S. Green

President and CEO
The Bond Market Association

Testimony Before
Chairman Dave Camp
Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

Hearing on Tax-Preferred Bonds

Thank you Chairman Camp and Ranking Member McNulty for the opportunity to represent the municipal bond market at this hearing on tax-preferred bonds. My name is Micah S. Green and I am President and CEO of The Bond Market Association. While Association members include participants in all the fixed-income and credit product markets, our roots are traced to the $2.2 trillion tax-exempt municipal bond market. Our municipal division is one of the most active in the Association and its members underwrite 95 percent of the tax-exempt municipal bonds issued by state and local governments to fund important public infrastructure such as roads, schools and hospitals.

It is important to note at the outset of this statement that Association members play an intermediary role on the municipal markets. Bond dealers and underwriters generally are neither significant long-term investors in, nor end users of, municipal financing. While we believe the tax exemption for municipal securities is efficient and effective, ultimately, our members would underwrite and trade any securities issued by states and localities, no matter the nature of their tax preference. The Association's conclusions in this statement reflect our collective expert view of how the municipal bond market can work most efficiently for all stakeholders—federal taxpayers, state and local governments and investors.

Association members believe the municipal market is an efficient and time-tested tool for delivering federal assistance to state and local governments. Congress has monitored the tax exemption carefully over the years and altered the tax laws governing the market when viewed as necessary. Some of the most notable changes came with the major reforms in the Tax Reform Act of 1986. As a result, the municipal bond market today is a well-functioning system that efficiently provides

federal assistance for governmental and other public purposes—such as the 9/11 and Katrina recovery efforts—specifically approved by Congress.

The tax exemption for municipal bonds has proven its effectiveness, and Congress should not enact changes that will affect it in a fundamental way. There are some aspects of the Internal Revenue Code (IRC), however, that could be modified to further improve the efficiency of the market. For example, interest on certain tax-exempt private-activity bonds is not exempt from the individual alternative-minimum tax (AMT). These "AMT" bonds are used to finance projects with an element of private participation specifically approved by Congress. Potential AMT tax liability causes investors to demand a higher interest rate, which increases the borrowing costs of the issuer. The markets would also benefit from a relaxation of the limits on advance refunding for governmental bonds. This would bring state and local governments greater financial flexibility. Legislative proposals to permit an additional advance refunding have gained significant support in Congress over the last several years.

I. Background of the Municipal Bond Market

Municipal bond issuance by American cities dates to colonial times in the 1700s. In 1812, New York City issued the first publicly recorded municipal bond to finance the construction of a canal. By 1843, U.S. cities had issued a total of $25 million, mainly to finance railroads. The tax status of these bonds was understood by all at the time to be constitutionally based under the doctrine of "intergovernmental tax immunity." In 1895, the Supreme Court explicitly and unanimously affirmed the exemption of interest on state and local bonds. In the case of *Pollack v. Farmers' Loan and Trust Company*, the Court found that a federal tax on interest on municipal securities under the Wilson-Gorman Tariff Act of 1894 was unconstitutional.

The *Pollack* case also held that an income tax more generally failed to apportion taxation uniformly among the states as the Constitution directed. This holding drove Congress to create a system of taxation that could be applied to the entire population in a nondiscriminatory way. The income tax—made possible by the 16th Amendment to the Constitution—became that system. The first IRC adopted after passage of the 16th Amendment specifically exempted interest on state and local bonds from the federal income tax. Municipal bond yields immediately fell in relation to corporate bonds and other taxable securities as investors recognized the economic advantage of owning tax-exempt bonds. Borrowing costs for state and local governments fell correspondingly.

While the Supreme Court had recognized the tax exemption for municipal bonds as a constitutional right, Congress still made several attempts to revoke that status. In 1923, lawmakers proposed a constitutional amendment to authorize a federal tax on municipal bond interest. The measure passed the House but not the Senate and was soon forgotten. Other similar but less serious efforts to alter the tax exemption also stalled in Congress in the 1930s and 1940s. The initial AMT legislation proposed in

1969 would have made all municipal bond interest taxable for AMT payers. Under the revisions to the AMT enacted in 1986, only interest on private-activity bonds, as noted above, is included.

In the 1970s, Congress also looked at giving state and local governments the option to issue taxable bonds and receive an interest subsidy from the federal government. The state and local governments opposed the idea largely based on the concern it would give a federal bureaucracy control over local financing decisions. The risk also existed that Congress could withdraw the subsidy after the bonds were issued.

The constitutional basis for the tax exemption was overturned by the Court through the decision in the case of *South Carolina v. Baker* in 1988. That decision upheld a provision of the Tax Equity and Fiscal Responsibility Act (TEFRA) that made registration a condition of the tax exemption. The Court also specified that the ability to grant and maintain the tax exemption for municipal bonds rests solely with Congress.

Municipal Bonds are an Efficient Form of Federal Assistance

One of the principal reasons Congress has maintained the special status of municipal bonds is the public policy objective of providing federal assistance for the financing by state and local governments of projects such as schools, roads, hospitals, government buildings, low-income housing and many others. As the Anthony Commission, a panel made up of lawmakers, state and local government officials and market participants, found in the early 1990s, each of these projects in turn foster economic growth and development in our communities. This raises tax revenue and lowers the cost of government services, which would otherwise need to be provided by a bureaucracy of the federal government.

Of the options available to Congress, the tax exemption on municipal bonds is clearly the most efficient way to provide financial assistance to state and local governments. The main alternative, the congressional appropriations process, has a single advantage from the perspective of states and localities. It would be a cash grant. But for a number of reasons, the fact a municipal bond must be repaid brings great efficiency to the financing of public infrastructure. By contrast, the appropriations process is slower, less focused and more susceptible to political pressure that can distort the allocation of resources.

At a minimum, appropriations require Congress to take two actions. First, a project must be authorized. Second, money to fund the project must be officially designated—or appropriated. To achieve just these initial steps involves overcoming routine obstacles such as the congressional schedule and political competition from constituencies of other appropriations candidates. Sound projects can lose out as limited federal resources are directed to earmarked projects that may be economically less worthy. It is common for a significant time lag to occur between the authorization and appropriation steps, a period in which project costs can only grow. The wait for federal funding can leave state and local governments uncertain of how

to best allocate their own infrastructure funding resources for years at a time. And while local input can be involved in the appropriations process, decision making on important details of projects is often far removed from the local level.

Once a project is authorized and appropriated, it faces a different set of obstacles associated with the federal bureaucracy tasked with its implementation. This usually takes the form of a lengthy review meant to ensure the project conforms to an agency's rules.

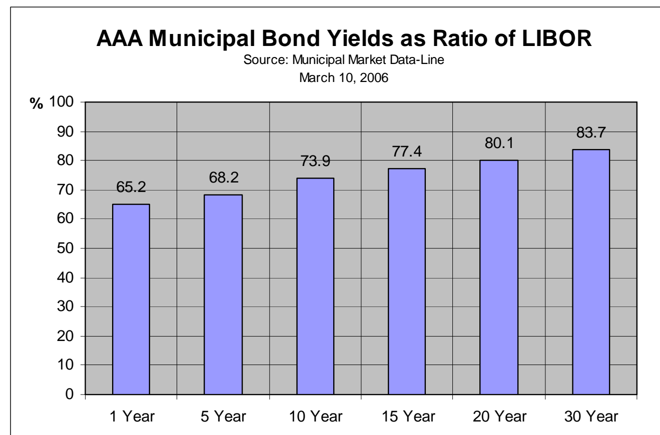
By contrast, decisions as to which specific projects receive municipal bond financing are appropriately made at the state or local level. Often voters themselves make the decision through referenda. In other cases, the question is left to a political body—a state legislature or city council—that answers to the voters. In making the decision to issue municipal bonds, governments typically analyze other funding options such as raising fees or taxes. The process provides a sort of political test to judge the importance of the project to the community. This is a solely local test. Individual financing decisions do not depend on input from or the approval of the federal government as long as the project being financed meets the guidelines established by Congress for the appropriate use of the tax exemption.

The process of issuing a municipal bond requires more than just political approval by a state or local government. The bonds are contracts to pay interest and repay principal, so the issuer must maintain the confidence of investors that payments will be made. While the majority of municipal bonds are held directly or indirectly by individuals, it remains a market dominated by professional, sophisticated investment managers. They perform careful due diligence on all investments. Most bonds are reviewed and rated by a credit rating agency. A majority of new bonds are insured by a bond insurance company, which performs its own financial analysis of the viability of a project before providing credit insurance coverage. Market participants would not invest in—and underwriters could not bring to market—bonds that were not adequately backed by fees, a specific tax or the broader taxing authority of a state or local government. This market test of municipal bonds also contributes to the market's overall efficiency by providing a check against wasteful or infeasible projects that would amount to a misuse of federal assistance and public resources. The incentive to issue bonds only for the most necessary and appropriate uses is reinforced by the fact that bonds are fundamentally loans that must be repaid.

Some critics of the tax exemption for municipal bonds claim it sacrifices part of the subsidy intended for issuers as a windfall to investors. The analysis of returns realized by tax-exempt investors to support this argument typically involves hypothetical examples suggesting that certain investors earn excess after-tax returns on tax-exempt bonds because they pay taxes at high marginal rates. The rates are sometimes shown to be higher than the "break-even" tax rate implied by the ratio of tax-exempt to taxable yields. If the ratio is at 85 percent, for example, then an investor in a tax-exempt security would earn a pre-tax return equal to 85 percent of the yield available on a similar taxable bond. With a maximum marginal tax rate of

35 percent, the investor would appear to be earning a higher after-tax return on the tax-exempt security than possible on the comparable alternative taxable security. The difference, critics of the tax exemption for municipal bonds have argued, represents a windfall to investors at the expense of taxpayers that would not exist in an efficient market.

There are two key problems with this efficiency metric. First, it assumes a marginal tax rate for municipal bond investors that is too high given the ability of investors to achieve lower effective marginal tax rates as a result of the 15 percent rate on qualified dividends and long-term capital gains. A more realistic effective tax rate to use to compare taxable and tax-exempt investments would be 25 percent, a blend of the lower rate on dividends and capital gains and the highest marginal rate on interest and other income. Second, this approach typically uses U.S. Treasury securities as the comparable taxable yield to measure the municipal yield ratio. But the difference in yield between Treasuries and municipal bonds is a factor of much more than just the tax-exemption. Treasuries are more liquid[1] and of better credit quality than any other security in the world. The Treasury market is homogenous, deep and global. Treasuries are active speculative and trading instruments held by institutional investors all over the world. The municipal bond market, on the other hand, is fragmented and less liquid. It is a diverse market with tens of thousands of issuers and millions of outstanding issues and maturities, many of them very small. It is a market confined to U.S. investors—predominantly individuals or their proxies. Comparing municipal yields to Treasuries inaccurately suggests tax-exempt investors earn a greater return relative to taxable investments than is the case. The London Interbank Offered Rate (LIBOR) is a better benchmark with which to compare tax-exempt yields because it represents the interest rate highly rated banks generally pay. Banks are closer to the credit profile of municipal issuers than the U.S. government. If LIBOR is substituted for Treasuries, the same comparison shows tax-exempt municipal investors earning a much lower proportion of the yield on taxable securities. For yields at a 15-year maturity—about the average maturity for municipal bond issues—the average municipal-LIBOR yield ratio on March 10 was about 77 percent. This suggests that an average municipal bond investor was virtually indifferent between holding a tax-exempt or taxable security.



[1] In the capital markets, liquidity refers to the ability to easily buy or sell an asset quickly and with a minimal transaction cost. Treasuries are more liquid than municipal bonds because they are more homogenous, are issued in very large issue sizes, and posses zero credit risk. To the degree a bond lacks liquidity, investors demand a liquidity premium in the form of higher yield.

But even using LIBOR as a benchmark, however, overstates the ratio. LIBOR effectively represents noncallable bank bond yields. Correcting for the unique characteristics and features of municipal bonds such as call options and generally small issue sizes discussed below, municipal yields would be lower and the ratio to LIBOR lower. Note in the above graph that yield ratios for maturities greater than 15 years are above what would be expected given the presumed 25 percent marginal tax rate for municipal bond investors. These higher yield ratios largely reflect the heightened call risk to investors associated with buying longer-term municipal bonds.

Viewed in this light, the municipal market is very efficient relative to taxable yields.

When considering the relative efficiency of the municipal market in general, it is important to remember there is no practical alternative as a means of delivering federal assistance. Tax-credit bonds, as discussed below, are not a more efficient alternative. And leaving state and local governments to finance all infrastructure projects through the taxable markets by eliminating the tax exemption completely would lead to dramatically higher borrowing costs.

Municipal bond issuers represent numerous and diverse credit risks. They have unique financing needs filled by issuing small groups of bonds in serial maturities, or series of bonds with sequential maturities. This approach provides level debt service payments for state and local borrowers similar to a self-amortizing mortgage loan. It also contributes to market fragmentation. Consider that 74 percent of municipal bonds issued are for $1 million or less.[2] Large, institutional investors who dominate the taxable bond market simply are not interested in such a heterogeneous, diverse market dominated by millions of small issues. In addition, most municipal bonds include call provisions that give issuers financial flexibility but also cause investors to demand higher yields. While these terms of issuance suit the financing needs of state and local governments, they would also make municipal bonds unattractive to institutional investors in the taxable bond market. All but the very largest of municipal issuers would have to pay significant premiums to investors in the form of higher yields, which of course mean higher borrowing costs.

Moreover, the marginal buyer of a fully taxable instrument reflected in Treasury or Libor yields is not a taxed U.S. investor. The market for taxable U.S. credit instruments such as Treasury, agency or corporate securities is dominated by four categories of investors: non-U.S. central banks, foreign non-U.S. private investors, pension funds that pay no taxes, and life insurance companies that have very low marginal tax rates on investment income and do not benefit from the tax exemption on municipal bonds. Individual investor ownership of taxable fixed-income instruments has dropped dramatically in recent years[3] and to the extent that it still exists, it is mostly in tax-deferred accounts like 401(k)s and IRAs. In short, taxable bond yields are kept low by demand from foreign sources. Surplus demand for dollar

[2] *Report on Transactions in Municipal Securities* (page19), Office of Economic Analysis, U.S. Securities and Exchange Commission, July 1, 2004.
[3] *Flow of Funds,* Z.1, (page 15), Federal Reserve Board, March 9, 2006.

debt securities among non-U.S. buyers is holding yields on large, liquid taxable investments down by 50 basis points or more. U.S. borrowers such as the federal government, corporations and the government-sponsored enterprises like Fannie Mae and Freddie Mac benefit from this situation through lower borrowing costs. Most of this benefit would not be available to the bulk of state and local issuers, however, if they were to issue taxable securities. The institutions that dominate the taxable bond market are not interested in assets with the characteristics of municipal bonds.

II. Congress and the Municipal Market

While the tax exemption for municipal bonds faced the occasional threat from Congress over the course of the 20th century, it was not until the late 1960s that lawmakers enacted significant use restrictions on the market. Congress, in 1968, limited the issuance of tax-exempt bonds that benefit private parties to financings for a specific list of eligible projects and in 1969 limited the use of municipal bond proceeds for “arbitrage” purposes, or to invest in higher-yielding securities. In 1984, lawmakers imposed the first cap on the volume of private-activity bonds that can be issued by each state.

Tax Reform Act of 1986

With the sweeping reforms of the 1986 Act, Congress significantly tightened the restrictions and limitations it had begun to implement in the previous decades. The changes effectively reversed key rules dealing with private use and arbitrage. The 1986 Act also restricted the ability of issuers to advance refund[4] municipal bonds and eliminated banks as a source of demand by extending the *pro rata*[5] rule.

The 1986 Act reduced the types of projects eligible for tax-exempt “private-activity bonds” and significantly reduced the levels of private benefit required to trigger those tightened limitations. Prior to 1968, state and local governments had the discretion to issue tax-exempt bonds for virtually any purpose. The restrictions put in place in 1968, 1969 and 1986 defined the public purposes that are eligible to benefit from the lower cost financing. And where up to 25 percent of a bond’s proceeds could be associated with private use before the 1986 Act, the limit is now 10 percent of a bond’s proceeds. This change effectively limited the ability to use municipal bonds to fund activities with an element of private participation to instances where the bond is solely dedicated to a qualified private purpose.

The 1986 Act also created a new approach to regulating how bond proceeds can be invested. Instead of generally unrestricted investment with the exception of the escrow fund in an advance refunding, all investment became restricted or subject to a rebate unless specifically excepted. As in 1969, this policy was driven by the practice of some issuers to use earnings from the investment of bond proceeds to

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[4] An advance refunding occurs when a new tax-exempt bond and the existing bond it was issued to repay are both outstanding for more than 90 days.

[5] *Pro rata* refers to the requirement that corporations disallow that portion of their interest expense deduction associated with investment in tax-exempt municipal bonds. Corporations not involved in the business of lending are exempt from the rule if tax-exempt bonds comprise no more than 2 percent of their assets.

offset the costs of bond-financed projects. In the context of the 1986 Act, almost all such earnings were viewed as an abuse of the tax exemption and Congress sought almost total elimination of arbitrage earnings.

The 1986 law also imposed arbitrage rebate requirements on state and local governments. In addition to the requirement to restrict the yield on the investment of bond proceeds, any arbitrage that might be inadvertently earned must now be rebated to the federal Treasury. Unfortunately, the calculations for determining whether and how much to rebate can be extremely complex. For small, infrequent issuers, the costs associated with complying with the rebate requirements can be significant. The exceptions to the arbitrage rebate requirement in the 1986 Act were for issuers who sell less than $5 million in bonds annually or in cases where bond proceeds to finance construction are spent within a predetermined time period. In the 20 years since the 1986 Act, the industry has sought changes to the arbitrage provisions such as an increase in the threshold amount for determining who is a small issuer to account for inflation.

The 1986 Act also cut back on the ability of issuers of tax-exempt municipal bonds issued for governmental purposes to conduct “advance refundings,” or refinancing transactions where refunding bonds are issued before the bonds being refunded are currently callable. Instead of no refunding restrictions, under the 1986 Act, state and local governments could advance refund governmental debt only a single time.

In limiting governmental issuers to a single advance refunding, Congress reduced the cost in lost revenue to the Treasury but also limited the financial flexibility of state and local governments. The economic environment from 2001 to 2004 put the negative aspect of the single advance refunding policy into a clear focus. Low market interest rates combined with budget pressure created both the need and the opportunity for many state and local governments to enter advance refunding transactions. If issuers had the ability to take an additional advance refunding at that time, it would have eased their financial strains and possibly eliminated the need for other revenue raising options—such as tax increases. For the past decade, the Association has advocated permitting an additional advance refunding precisely to provide state and local governments important financial flexibility. Such a policy would not be a return to the unlimited advance refunding authority prior to the 1986 Act, but would allow state and local governments to maximize fiscal efficiency.

Another key change made by the 1986 Act eliminated banks as a source of demand and left the municipal bond market dependent largely on individual investors. Prior to the 1986 Act, banks could deduct from taxes 80 percent of the interest cost associated with investment in tax-exempt bonds. Under the changes, banks are automatically disallowed a portion of their interest expense deduction for holding all but a few excepted tax-exempt bonds. Banks, which had been a key source of institutional demand, ceased to invest in tax-exempt bonds (with the exception of qualified small issue bonds). Being restricted to a largely retail investor base—individuals are the beneficial owners of 70 percent of municipal bonds—increased

issuer borrowing costs. Retail investors purchase bonds in smaller quantities than institutional buyers which makes them more expensive to distribute.

Attempts to Raise Taxes on the Municipal Markets

Many of the restrictions placed on the use of tax-exempt financing in the 1970s and 1980s were reasonable responses to perceived abuses of the tax exemption. Some proposals, however, have represented unjustified restrictions on the tax exemption. In December 1995, the Clinton Administration proposed a number of provisions intended to raise government revenue that would amount to huge tax increases on the municipal market. The proposals would have increased the amount of tax property and casualty insurance companies pay on what is otherwise tax-exempt income. In addition, the proposals would have discouraged corporations from buying municipal bonds by limiting interest expense deductions for any corporation that earned any tax-exempt interest, even if the corporation did not borrow to finance the purchase. Corporations, and property and casualty insurance companies in particular, are a critical source of demand in the municipal market. This is especially true for certain sectors of the market. Congress ultimately rejected the proposals.

III. The Municipal Market Today

The 1986 Act and its predecessors eliminated inappropriate loopholes and potential for abuse from the municipal market and put in its place an efficient mechanism for delivering federal assistance to state and local governments. The market, however, continues to face challenges under the continuing oversight of Congress. Issues under consideration currently include whether certain groups or purposes qualify for the tax exemption, potential alternatives to the tax exemption and the fundamental efficiency of the municipal market.

Current Threats

Just over a year ago, the staff of the Joint Committee on Taxation issued a report identifying $13.5 billion in municipal bond market tax increases as options for Congress to consider in seeking to improve tax compliance. In general, these provisions—such as the proposal to eliminate advance refunding—did not address concerns of abuse. Instead they represented changes in tax policy. The Association joined with a coalition of state and local governments and other bond market participants in opposition to the proposals. We have worked with Congress to assure those provisions likely to be enacted are implemented with minimum market disruption. For example, Congress is likely to adopt new restrictions on pooled bond financing. The Association is seeking to have state-level bond pools, which have not been identified as a source of compliance problems, exempted from the new restrictions. The Association is also urging Congress to change a proposal to have issuers report taxpayer identification information to the IRS, making it a reporting requirement of Association members instead. Association members are currently required to provide the same information for taxable bonds.

In our view, the IRS and Members of Congress are also concerned with whether certain tax-exempt issuers are using tax-exempt financing for purposes not intended under the current code. Audit programs in the area are ongoing. To the extent such audits reveal real abuse of the tax exemption, the Association supports the appropriate enforcement action. Limited noncompliance by certain issuers, however, is not a problem that requires broad legislative action.

Alternative Financing: Tax-Credit Bonds

The Subcommittee has asked about the relative efficiency of tax-credit bonds as a means of financing public infrastructure projects. Congress has only authorized three tax-credit bond programs to date for a total of $5.15 billion, though far less has actually been issued. From that limited experience, however, it is possible to draw two clear conclusions about such a form of financing. First: tax-credit bonds—which provide investors a return in the form of a tax credit, not an interest payment—can provide a deeper subsidy than traditional tax-exempt bonds. Second: tax-credit bonds would not constitute a more effective alternative to providing federal assistance than traditional tax-exempt bonds.

Tax-credit bonds are an unusual security with limited investor demand. Under existing programs, the issuance of tax-credit bonds is subject to conditions—such as a 10 percent matching contribution requirement for Qualified Zone Academy Bonds (QZAB)—and the bond itself has limited flexibility. The Association has commented extensively on tax-credit bond programs in the past, recommending structural changes that would win the securities greater market acceptance. But even if Congress adopted all of these suggestions—newer, limited programs have made key improvements—tax-credit bonds would still lack a broad enough investor base to assure an efficient market.

Congress first authorized tax-credit bonds in 1997 to provide financing for improvements to public schools. Since then, lawmakers have authorized only two new tax-credit bond programs: $800 million for the Clean Renewable Energy Bond (CREB) program and $350 million to aid the state and local governments in the Gulf Coast. CREBs were enacted as part of the Energy Policy Act of 2005. The Gulf Opportunity Zone Act authorized $200, $100 and $50 million in tax-credit bonds for Louisiana, Mississippi and Alabama respectively.

At this writing, members of Congress have proposed a number of tax-credit bond initiatives totaling billions of dollars. This includes $225 million in Rural Renaissance tax-credit bonds in the Senate's tax reconciliation bill.

QZABs, the only program under which tax-credit bonds have been issued, have several critical flaws that the Association has addressed before this and other congressional committees. For example, the timing of the annual tax-credit may not match the needs of the investor. Only banks, insurance companies and firms actively engaged in lending are eligible to invest in the bonds, which limits demand and drives up borrowing costs. The limited authorized issuance, the inability to separate the tax

credit from the underlying bond and restrictions on qualified investors all hinder the liquidity of the security. Because of all the limitations associated with tax-credit bonds, no QZAB issues have resulted in zero-cost financing as designed. In all cases, issuers have been required to offer additional compensation to attract investors.

CREBs and the tax-credit bonds authorized in the Katrina-relief legislation—along with many proposed tax-credit bond programs—reflect most of the Association's concerns. The inability to strip the credit and the small size and limited duration of the program, however, remain as components of the programs and therefore obstacles to broader market acceptance. While these tax-credit bond programs achieve the policy goal of providing financing for a particular purpose, they do so in a less efficient way than would traditional tax-exempt financing or a direct appropriation. Such programs also add an additional cost in the form of a new layer of federal bureaucracy to the process of financing public infrastructure.

As noted above, even if such a tax-credit bond could be stripped and issued in unlimited supply, along with other structural changes needed to achieve maximum market acceptance, it would still remain a less efficient alternative than the traditional tax-exempt market. The liquidity premium inherent in municipal bonds would only be exacerbated for the even more unique tax-credit bonds. Demand would be limited largely to property and casualty insurance companies and a few other investors with an interest in long-duration tax-preferred bonds. If tax-credit bonds were issued in substantial quantities, the market would quickly become saturated. Issuer borrowing costs would rise as sagging marginal demand would force them to raise yields to lure back investors.

The 2005 Tax Reform Panel Recommendations

In 2005, President Bush appointed his Advisory Panel on Federal Tax Reform, with a mandate to focus on a fairer and more broadly based tax code that promotes long-run economic growth. Most tax reform discussions in recent years have included proposals to reduce or eliminate taxes on savings and investment—a policy with potentially huge benefits for the economy overall. The promotion of savings and investment is important for our economy, but eliminating taxes on savings and investment would also have implications for the tax-exempt municipal bond market and for the finances of state and local governments.

It is widely recognized that the transition to a new tax system represents perhaps the most serious challenge in the debate. Policymakers must consider whether the economic and social benefits of a simpler and more streamlined tax code will outweigh the difficulties that some will face in moving from the current to the new system.

In its final report, the President's Advisory Panel proposed two options, one of which—the *Simplified Income Tax Plan*—would render otherwise tax-exempt municipal bonds taxable for corporations. This provision would significantly raise borrowing costs for state and local governments.

Corporations hold approximately 30 percent of outstanding tax-exempt bonds, and taking them out of the market would drastically raise the cost to states and localities of financing public infrastructure financed with municipal bonds. The proposal would leave the market dependent on individual investors as the single source of demand for municipal bonds. The problems raised by the Panel's proposal would be magnified for state and local governments if another provision, the elimination of deductions for state and local taxes, is also enacted.

The Panel did recommend eliminating the individual AMT as part of both plans, a policy the Association actively supports.

IV. New Uses for Tax-Exempt Private-Activity Bonds

When faced with a crisis twice in the past five years, Congress chose tax-exempt private-activity bonds as one of the many means of providing federal financial assistance. In the wake of the terrorist attacks of September 11, 2001, Congress created the Liberty Zone in lower Manhattan and authorized $8 billion in special tax-exempt private-activity bonds to aid in the long-term reconstruction of the area. These Liberty Zone bonds were made available generally for non-residential real property and residential rental property with a set percentage of lower-income tenants. The legislation also permitted some issuers of governmental bonds affected by the attacks to utilize an additional advance refunding.

Following Hurricane Katrina, Congress tailored a package of tax-exempt bond provisions similar to but more robust than those provided in the Liberty Zone to address the reconstruction needs of the Gulf Coast. Congress correctly recognized the scale of devastation in the wake of Katrina was so great that reconstruction will require the resources of the capital markets. The tax-exempt private-activity bonds authorized in the Gulf Opportunity Zone Act, GO Zone bonds, can be used to finance non-residential real property and qualified residential rental property in the affected area. To date, $58.25 million in GO Zone bonds have been issued by the Mississippi Home Corporation, that state's housing finance agency. The GO Zone Act also permits an additional advance refunding for all governmental and 501(c)(3) issuers in the GO Zone subject to the statewide volume caps. Importantly, the GO Zone Act also authorized one advance refunding for tax-exempt private-activity bonds issued to finance airports, docks and wharves—a significant shift in tax policy that recognizes the importance of advance refunding as a financial tool.

Congress has clearly shown faith in the ability of the municipal bond market to effectively deliver federal assistance in recent years to include public education facilities, green buildings and road and rail-truck transfer facilities. The latter authorization, in particular, clears the way for the expanded use of public-private partnerships for a critical area of public infrastructure.

Looking Ahead

In the case of the Liberty Zone and GO Zone, one of the policies Congress chose to deliver federal assistance was advance refunding authority. This recognition of advance refunding as an important financial tool for state and local governments suggests Congress should pass legislation granting an additional advance refunding for all municipal bonds.

For similar reasons, the Association believes Congress should exempt all tax-exempt private-activity bonds from the individual AMT. This policy also has a limited congressional endorsement in both the Liberty and GO Zone programs. Liberty and GO Zone bonds are not subject to the individual AMT, an advantage that saves issuers from 15 to 25 basis points[6] in borrowing costs.

Congressional revenue scorers might view such a policy shift as losing revenues, but in practice any revenue loss would at most be only transitory. As more investors are snared by the growing reach of the AMT, they will realize the tax exposure they face in owning private-activity bonds subject to the AMT. Such investors will move out of tax-exempt private-activity bonds and into municipal bonds not subject to the AMT. This will contribute to already shrinking demand for AMT bonds and drive issuer borrowing costs higher. This dynamic also means it is likely that exempting all private-activity bonds from the AMT would not lead to a significant revenue loss for the Treasury, at least beyond the near term. In the meantime, the AMT denies tax-exempt private-activity bond issuers of the ability to borrow at the lowest cost possible. Short of repealing the individual AMT altogether, the Association urges Congress to exempt private-activity bonds from both the individual and corporate AMT.

V. Conclusion

Tax-exempt municipal bonds are a proven national resource. Tax-exempt municipal bonds provide the financing for public infrastructure such as schools, roads and hospitals that improve the lives of Americans every day. Congress has carefully reviewed the municipal bond market over the last several decades and shaped a system it trusts to provide critical federal assistance quickly and directly.

Municipal bonds benefit all Americans.

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[6] A basis point is one hundredth of a percentage point.