STATEMENT FOR THE RECORD

United States House of Representatives
Committee on Ways and Means
Tax Policy Subcommittee

Hearing on Tax Reform and Small Businesses:
Growing our Economy and Creating Jobs

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Introduction

The Bond Dealers of America (BDA) appreciates the opportunity to offer its views regarding the critical issue of tax reform and small business. BDA commends the Committee for recognizing a basic truth—the dynamism of the American economy is ultimately dependent on small businesses, which are our leading source of innovation, entrepreneurial energy, and, above all, jobs.

As the only Washington, DC–based trade association representing the interests of "main-street" investment firms and banks active predominately in the U.S. fixed income markets, BDA has a unique perspective on how best to ensure that the capital required to put our small businesses to work is readily available. In particular, our members provide essential assistance to state and local governments and private entities to raise the capital used to pay small businesses—and their employees and suppliers—for their goods and services.

BDA applauds the Committee and Congress for passing last year's sweeping tax reform legislation, the *Tax Cuts and Jobs Act,* which will greatly benefit small businesses by reducing their tax burden, simplifying compliance, and boosting economic growth, and through that greater growth, will expand opportunities for small businesses.

Nonetheless, more work is needed. Tax reform was a major legislative achievement. However, it is also an ongoing task. Now that tax reform has been enacted, policymakers must exercise vigorous oversight to ensure that the changes to the Internal Revenue Code implement sound tax policy, to assess the actual revenue impact of the enacted provisions, and to identify further changes to the tax code that should be enacted. Congress also must remain mindful of provisions of current law that help small businesses to thrive, and be vigilant in protecting those provisions from being made less effective or even eliminated altogether.

In our comments, BDA would like to focus on three tax policy goals that Congress must pursue if it is to ensure capital is readily available for priority projects that engage, make purchases from, or facilitate operation of small businesses:

- Continue the tax-exemption for interest paid on bonds issued by state and local governmental entities.

- Restore the ability of state and local governments to save taxpayer dollars and generate additional funds for infrastructure and other key initiatives by restoring tax-exempt Advanced Refundings (ARs).

- Expand the use of tax-exempt Private Activity Bonds (PABs).

Retain tax exemption for interest paid on state and local government bonds

Since the enactment of the federal income tax in 1913, interest paid on bonds issued by state and local governments has been excluded from taxation. Over the century since, the wisdom of that approach has been repeatedly affirmed.

In principle, the federal government has no business taxing the legitimate governmental functions of state and local government, including the servicing of debt incurred for vital government projects and services.

In practice, the tax exemption for interest paid by state and local governments has reduced their borrowing costs by hundreds of billions of dollars. Further, the proceeds of the tax-exempt bonds, together with concomitant interest savings, have been used to create much of the existing stock of roads, bridges, schools, hospitals, and other key physical and institutional assets that are essential to the operation of our economy and society—assets that largely were built, supplied, or served by small businesses. Had the interest on state and local government bonds been taxable, the cost of those assets would have been vastly higher. In turn, those higher capital costs necessarily would have resulted in higher state and local tax burdens and dramatically fewer infrastructure projects.

Indeed, even consideration of proposals to limit the tax exclusion for interest paid on state and local government bonds has proven extremely disruptive to capital

markets, the projects they finance, and the jobs they create. Past proposals released or discussed in the last two Congresses have sent tremors through the municipal markets and have increased interest rates on tax-exempt bonds. The perceived risk to the tax exemption led some investors to seek higher yields on municipal bonds and to pull much-needed capital and liquidity out of the municipal markets. In turn, if government issuers must pay higher borrowing costs, governments must reduce or abandon infrastructure projects they can no longer afford.

BDA commends the Committee and Congress for recognizing that tax reform did *not* require changes to the tax treatment of interest paid on state and local bonds (with the exception of advance refundings). However, BDA also is mindful that such exemption is a regular target of proposals to raise federal tax revenue. BDA urges the Committee and Congress to be wary of such proposals, and reject any initiatives to ignore the lessons of the past century and tax interest paid on state and local debt.

Restore Advance Refundings

BDA is deeply concerned that the *Tax Cuts and Jobs Act* repealed tax-exempt advance refunding bonds upon enactment of the legislation. The repeal of this provision is working against the stated goal of the tax reform legislation—that is, to energize the economy and lower the tax burden of middle-class Americans. Moreover, that major change deprives state and local governments of an essential tool that has been widely used to help finance America's infrastructure and generate capital that is spent with small businesses.

State and local governments routinely refinance their outstanding debt obligations, just as corporations and homeowners do. The advance refunding technique allows state and local government issuers to refinance, and thus benefit from lower interest rates, when the outstanding bonds are not currently callable. It is important to note that, under previous law, tax-exempt bonds could be issued to advance refund an outstanding issuance only once, a significant restriction on these transactions.

According to recent Government Finance Officers Association data, between 2012 and 2017, there were over 9,000 advance refunding issuances nationwide, saving taxpayers over $14 billion in the five-year period. We note that this represents the "present value" measurement of the savings—actual savings were substantially greater.

Advance refundings are of particular benefit to small issuers. For example, in Montgomery County, TX, six advance refundings for bonds used to finance Conroe primary and secondary education needs resulted in savings of over $20 million dollars. In North Barrington, IL, the city was planning to advance refund a $6,200,000 issuance that would save the village $310,000. This is currently on hold

due to the repeal of the cost saving tool. In Eden Prairie, MN a $250,000 issuance of general purpose bonds was advance refunded.

Critical public policy considerations strongly support restoration of advanced refundings. Moreover, BDA believes that ARs may be reinstated without an unacceptable tax revenue impact—in particular, the BDA believes that data unavailable at the time tax reform was enacted will demonstrate that the projected federal savings from the repeal of advance refundings in the tax bill will be lower than the Joint Committee on Taxation estimate of $17 billion, largely due to the rush of issuers into the market in the latter part of 2017 and slowly rising interest rates.

Representative Hultgren, Representative Ruppersberger, and others recently introduced H.R. 5003, a bipartisan bill to reinstate tax-exempt advance refunding bonds. As explained by the bill's sponsors, "the legislation would restore advance refundings so that states and local governments can take advantage of favorable interest rates and more efficiently manage their financial obligations." H.R. 5003 has been referred to the Committee on Ways and Means. BDA strongly urges the Committee to report the bill favorably at the earliest opportunity, and for Congress to pass the legislation so that it may be signed into law.

The loss of advance refundings will severely impact the financing of core public services and infrastructure in states and localities that must deal with rapid growth and inadequate or aging infrastructure.

For example, in Texas, more than 50 issuers including cities, schools hospitals, and water and public transportation boards in the five largest counties in Texas (Bexar, Dallas, Harris, Tarrant, and Travis) will lose the ability to advance refund an estimated $6.6 billion dollars in bonds over the next two years. The repeal of this vital financing tool translates into a loss of millions of dollars that could have been reinvested back into these communities or used to reduce the burden on local taxpayers. Similarly, the Port of Galveston, which was planning to advance refund an $11.3 million issuance in bonds that would produce a cost savings of $450,000, will not be able to do so.

Though the negative consequences of the repeal of advance refundings already are clear, the extent of that impact will not be fully evident for some time. Due to the low interest rates at the end of 2017 and the pending repeal of the ability to advance refund bonds, many state and local governments refinanced their bonds prior to year-end. As a result, there will be a relatively short period during 2018 before state and local governments feel the real impact of this change in law. However, as time passes and interest rates continue to rise, repeal of advance refundings is certain to have significant, long-lasting impacts on state and local governments.

In the long term, state and local governments will be greatly disadvantaged by the loss of the ability to issue tax-exempt AR bonds. Most importantly, they will have lost the most efficient mechanism to take advantage of low interest rates to

refinance higher rate debt in advance of when such debt can be called. The inability to lock in lower interest rates when they are available will, simply stated, result in increased costs to these governmental entities and increased tax burdens on their residents. Moreover, at a time of relatively low, but steadily increasing, interest, state and local governments have lost an important means of restructuring their outstanding debt to respond to short or long-term fiscal issues (which can include both paying off their debt more quickly or restructuring debt to deal with short term financial difficulties).

There are no alternatives to advance refundings that are as effective in terms of cost or risk. State and local governments are, wisely, hesitant to use interest rate swaps. Similarly, other alternatives are more costly than ARs and will not be able to provide an effective replacement for advance refunding bonds.

Expand the use of Private Activity Bonds

Bonds issued by state and local governments may be classified as either governmental bonds or Private Activity Bonds. Governmental bonds are bonds that are primarily used to finance governmental functions or which are repaid with governmental funds. PABs are bonds in which the state or local government provide financing to nongovernmental persons (e.g., private businesses or individuals) or for public projects that have significant nongovernmental involvement. The exclusion from income for state and local bonds does not apply to private activity bonds unless the bonds are issued for certain permitted purposes and other Internal Revenue Code requirements are met.

One requirement for most PABs is the “volume cap” limitation. If, during a given year, an issuing authority issues more qualified private activity bonds than its allocable volume cap, the tax-exempt status of those excess bonds is jeopardized. For calendar year 2018, the amounts used under Internal Revenue Code section 146(d) to calculate the state ceiling for the volume cap for private activity bonds is the greater of (1) $105 multiplied by the State population, or (2) $311,375,000. However, not all private activity bonds are subject to the volume cap limitation. For example, bonds used to finance airports, public education facilities, docks, wharves, and certain other government-owned facilities are not subject to the cap.

Private activity bonds are used for a qualified purpose if 95 percent or more of the net bond proceeds are to be used for one or more defined qualified purposes. The qualified purposes are described in Sections 142 through 145 and 1394 of the Internal Revenue Code. For purposes of the 95 percent requirement, issuance costs financed with bond proceeds are generally treated as not being used for a qualified purpose.

The U.S. has compelling, unmet infrastructure needs, but state and local governments do not have the fiscal means to address those needs without substantial private sector engagement. Tax-exempt PABs facilitate greater private

sector involvement in infrastructure projects and programs that, in turn, provide important public benefits that should be preserved and enhanced. Expanding the use of current infrastructure financing tools like PABs, rather than creating new financing methods (and resulting bureaucracies) such as a federal infrastructure bank, would help state and local governments partner with private entities in general—and small businesses in particular—to meet pressing infrastructure and other needs.

The *Tax Cuts and Jobs Act* recognized the benefit of PABs and, thus, did not adopt proposals to further limit, or even ban, their use. BDA urges the Committee and Congress to act on those acknowledged benefits of PABs and provide state and local governments additional flexibility to utilize PABs efficiently and effectively, and at low cost for the taxpayer.

Towards that end, BDA strongly supports expanding of the types of infrastructure facilities that are eligible to use tax-exempt PABs, lifting the PAB volume caps, and eliminating other restrictions on the use of PABs, such as the governmental ownership requirement for certain eligible facilities that apply under current law.

Significantly, each of those policy objectives are emphatically endorsed by the Trump Administration's "Legislative Outline for Rebuilding Infrastructure in America". The White House expressly calls for multiple steps to "Create Flexibility and Broaden Eligibility to Facilitate use of Private Activity Bonds", which it states, correctly, "would allow for greater Federal leverage and therefore more efficient infrastructure improvements." BDA very much concurs with the Administration's recommendations.

Conclusion

For over 100 years, municipal bonds have served as the primary financing mechanism for public infrastructure. Nearly three-quarters of the nation's core infrastructure is built for state and local governments, which engage small businesses to do much of the work. Imposing an unprecedented federal tax on state and local bonds, including advance refundings, will make these critical investments more expensive, and thus more infrequent or modest in scale. The Internal Revenue Code should affirm the benefits of tax-exempt bonds for state and local governments, and not unnecessarily impede their use.