HEARING ON THE USE OF TAX-PREFERRED BOND FINANCING

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

MARCH 16, 2006

Serial No. 109–56

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

30–622 WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

E. CLAY SHAW, JR., Florida
NANCY L. JOHNSON, Connecticut
WALLY HERGER, California
JIM MCCRERY, Louisiana
DAVE CAMP, Michigan
JIM RAMSTAD, Minnesota
JIM NUSSLE, Iowa
SAM JOHNSON, Texas
PHIL ENGLISH, Pennsylvania
J.D. HAYWORTH, Arizona
JERRY WELLER, Illinois
KENNY C. HULSHOF, Missouri
RON LEWIS, Kentucky
MARK FOLEY, Florida
KEVIN BRADY, Texas
THOMAS M. REYNOLDS, New York
PAUL RYAN, Wisconsin
ERIC CANTOR, Virginia
JOHN LINDER, Georgia
BOB BEAUPREZ, Colorado
MELISSA A. HART, Pennsylvania
CHRIS CHOCOLA, Indiana
DEVIN NUNES, California

CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM MCDERMOTT, Washington
JOHN LEWIS, Georgia
RICHARD E. NEAL, Massachusetts
MICHAEL R. MCNULTY, New York
WILLIAM J. JEFFERSON, Louisiana
JOHN S. TANNER, Tennessee
XAVIER BECERRA, California
LLOYD DOGGETT, Texas
EARL POMEROY, North Dakota
STEPHANIE TUBBS JONES, Ohio
MIKE THOMPSON, California
JOHN B. LARSON, Connecticut
RAHM EMANUEL, Illinois

ALLISON H. GILES, *Chief of Staff*
JANICE MAYS, *Minority Chief Counsel*

SUBCOMMITTEE ON SELECT REVENUE MEASURES

DAVE CAMP, Michigan, *Chairman*

JERRY WELLER, Illinois
MARK FOLEY, Florida
THOMAS M. REYNOLDS, New York
ERIC CANTOR, Virginia
JOHN LINDER, Georgia
MELISSA A. HART, Pennsylvania
CHRIS CHOCOLA, Indiana

MICHAEL R. MCNULTY, New York
LLOYD DOGGETT, Texas
STEPHANIE TUBBS JONES, Ohio
MIKE THOMPSON, California
JOHN B. LARSON, Connecticut

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

CONTENTS

	Page
Advisory of February 27, 2006 announcing the hearing	2

WITNESSES

Shaw, Hon. E. Clay Jr., a Representative in Congress from the State of Florida	5
Brady, Hon. Kevin, a Representative in Congress from the State of Texas	9
U.S. Department of the Treasury, Eric Solomon, Acting Deputy Assistant Secretary for Tax Policy	11
Congressional Budget Office, Donald Marron, Ph.D., Acting Director	25
Government Finance Officers Association, Carla Sledge	33
National Association of Bond Lawyers, Walter St. Onge, III	40
The Bond Market Association, Micah Green	44

SUBMISSIONS FOR THE RECORD

Aeration Industries International, Chaska, MN, Dan Durda, letter	58
American Forest and Paper Association, David Koenig, statement	58
American Public Power Association, statement	61
Clark, Jonathan, Hach Company, Loveland, CO, letter	65
Durda, Dan, Aeration Industries International, Chaska, MN, letter	58
Egger, Fritz, JWC Environmental, Costa Mesa, CA, letter	65
Environment One Corporation, Niskayuna, NY, Philip Welsh, letter	64
Flowserve, Taneytown, MD, James Sivigny, letter	64
Hach Company, Loveland, CO, Jonathan Clark, letter	65
JWC Environmental, Costa Mesa, CA, Fritz Egger, letter	65
Koenig, David, American Forest and Paper Association, Tax Exempt Bonds Recycling Coalition, statement	58
Large Public Power Council, Noreen Roche-Carter, letter	66
National Association of Higher Educational Facilities Authorities and National Council of Health Facilities Finance Authorities, joint letter	69
National Association of Local Housing Finance Agencies, statement	70
National Association of Water Companies, statement	73
National Council for Public-Private Partnerships, statement	75
National Council of Health Facilities Finance Authorities and National Association of Higher Educational Facilities Authorities, joint letter	69
National Council of State Housing Agencies, Barbara Thompson, statement	75
Rebori, Robert, Smith and Loveless, Inc., Lenexa, KS, letter	79
Roche-Carter, Noreen, Large Public Power Council, letter	66
Simons, Steven, Wellesley, MA, statement	78
Sivigny, James, Floweserve, Taneytown, MD, letter	65
Smith and Loveless, Inc., Lenexa, KS, Robert Rebori, letter	79
Tax Exempt Bonds Recycling Coalition, David Koenig, statement	58
Thompson, Barbara, National Council of State Housing Agencies, statement	75
U.S. Conference of Mayors, statement	80
Water and Wastewater Equipment Manufacturers Association, Inc., statement	82
Water Partnership Council, statement	83
Welsh, Philip, Environment One Corporation, Niskayuna, NY, letter	64

HEARING ON THE USE OF TAX-PREFERRED BOND FINANCING

THURSDAY, MARCH 16, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:31 a.m., in room 1100, Longworth House Office Building, Hon. Dave Camp (Chairman of the Subcommittee), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
February 27, 2006
SRM–6

CONTACT: (202) 226–5911

Camp Announces Hearing on The Use of Tax-Preferred Bond Financing

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the use of tax-preferred bond financing. **The hearing will take place on Thursday, March 16, 2006, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Tax Reform Act of 1986 (the "1986 Act") (P.L. 99–514) made significant modifications to the rules for tax-exempt bonds in an effort to limit the use of tax-preferred bond financing to support private activities. Many of the rules enacted as part of the 1986 Act reflect the intent to limit bond financing to those activities that were viewed to have a significant public benefit.

The last 20 years have seen an expansion of the use of tax-preferred bond financing through increases in the amount of private activity bonds that States can issue and the addition of activities that qualify for tax-preferred bond financing. Most recently, legislation has been enacted to provide tax-exempt and tax-credit bond financing to assist in the Hurricane Katrina recovery and rebuilding efforts. Furthermore, additional proposals to further expand the availability of tax-preferred bond financing to other activities emerge on a regular basis.

In announcing the hearing, Chairman Camp stated, "In recent years, there has been an expansion of the permitted uses of tax-preferred bond financing. This hearing provides an opportunity for us to comprehensively review this area to determine how this financing is used today."

FOCUS OF THE HEARING:

The purpose of this hearing is to undertake a comprehensive review of tax-preferred bond financing to determine:

(i) the relative economic efficiencies and costs to the Federal Government of financing activities through tax-exempt and tax-credit bonds;

(ii) whether tax-preferred bond financing supports business activities offering a significant public benefit;

(iii) the effect of the expansion of the use of tax-preferred bond financing on the ability to properly prioritize those activities most deserving of such financing; and

(iv) the effect of such expansion on the ability to oversee and administer the use of tax-preferred bond financing.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, March 30, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman CAMP. Good morning. The hearing will come to order and I'd ask our guests to find seats please. Good morning, as part of The Committee on Ways and Means's continuing exploration of tax-exempt options, Chairman Thomas asked the Subcommittee on Select Revenue Measure to undertake a comprehensive review of the use of tax-preferred financing. Responding to the Chairman's request provides this Subcommittee with a valuable opportunity to examine an area that has seen significant change since the Tax Reform Act of 1986.

So, in this regard the last 20 years have seen an expansion in the use of tax-preferred bond financing through increases in private activity bonds that states can issue and the addition of activities that qualify for tax-preferred bond financing.

Most recently, legislation has been enacted to provide tax-exempt tax credit bond financing to assist in the Hurricane Katrina recovery and rebuilding efforts. Furthermore, additional proposals to further expand the availability of tax-preferred bond financing to other activities emerge on a regular basis.

The treatment and use of tax-preferred bond financing will be an important consideration in the full Committee's evaluation of the many options to reform the Federal Tax Code.

I want to welcome our witnesses' views on these important issues, and the Chair now recognizes the Ranking Member, Mr. McNulty, for a statement.

Mr. MCNULTY. Thank you, Mr. Chairman. I ask unanimous consent to submit the text of my own statement for the record.

Chairman CAMP. Without objection.

[The prepared statement of Mr. McNulty follows:]

Opening Statement of The Honorable Michael R. McNulty, a Representative in Congress from the State of New York

Today, the Subcommittee on Select Revenue Measure begins the second session of the 109th Congress with a hearing on tax-preferred bond financing. I am pleased that the Committee is acting to followup on Chairman Thomas' promise to conduct a comprehensive review of how tax-exempt bonds and tax-credit bonds have been used to finance public and private activities.

States and localities have an outstanding record in the use of tax-preferred financing. Tax-exempt bonds support many important community priorities, including financing for our public schools, airports, roads, hospitals, veterans' housing, water and sewage facilities, hazardous waste disposal, and the low-income rental housing market. I look forward to discussing how tax-exempt financing is being used by our state and local governments and how their priorities in critically-needed areas are being met.

In recent years, the Congress has enacted various tax provisions to expand the availability of tax-preferred financing, including for public school construction and renovation, energy conservation efforts, and rebuilding following the hurricanes of 2005.

I thank Subcommittee Chairman Camp for scheduling this hearing. I welcome all the witnesses appearing today and look forward to your expert views on the issues before us.

I yield back the balance of my time.

Mr. MCNULTY. I just want to elaborate a little bit on that. I know that questions have been raised on the use of tax-exempt bonds through the years. My hope is, that as a result of this hearing and subsequent action by the Subcommittee and the Committee, that there is no retreat from financing projects that advance the public good.

My experience as a Member of Congress and as a State Legislator, and especially as a Mayor, has shown that tax-exempt bonding has been used for vital projects, such as roads, bridges, schools, hospitals, housing, airports, and energy projects. I know there has been some question about the use tax-exempt bonds for such things as high-speed rail.

I happen to believe that with the cost of fuel today and the concerns about auto emissions and so on, that if ever there was a time to move in that direction, the time is now.

I am concerned generally about the passenger rail system in this country. I'll give an example. I live in Albany, New York, and when I go to New York City, I certainly don't take the plane to go down there, because you have to drive all the way in there from the airport. I take the train and I ride down that scenic route down the Hudson River, and then end up in Midtown.

Part of the problem is when you get about 30 miles north of New York City you have to slow down to about 40 miles an hour because of the condition of the road bed. I think it's a disgrace the way we've let rail service in this country deteriorate through the years.

Another example, I lived in Italy for about a year back in the sixties when I was going to school. The passenger rail system in Europe in the sixties was better than then the passenger rail service in The United States of America today. Decades ago, other industrialized nations went to high-speed trains and bullet-trains and we're still nickel-and-diming Amtrak and I just think we need to change that.

In summary, Mr. Chairman, my position is that tax-exempt bonding benefits states and local governments. It benefits the purchasers of the bonds and it benefits the general public, and it is a relatively small cost to the Federal Government. I certainly think it's much better than Members of Congress coming down here and asking for more earmarks, and I think that we should continue to use and expand the use of tax-exempt bonds. I hope, Mr. Chairman, we can affirm, and in some instances expand the use of tax-exempt bonds for projects that accrue to the public good.

Chairman CAMP. The Chair has been informed that we're going to have a series of votes for at least an hour and a half. So, what we're going to try to do is at least have our member panel, as quickly as possible, make your remarks and then we'll recess the Committee for this lengthy series of what may be up to ten votes. We're grateful that two distinguished Members of the Committee on Ways and Means are here, the Honorable E. Clay Shaw, from Florida, and the Honorable Kevin Brady from Texas. Congressman Shaw, why don't you begin your testimony and we'll see how far we can get. You may begin.

Mr. SHAW. I will give you every bit of my cooperation to expedite this process. I have a written statement that I ask with unanimous consent be placed into the record.

Chairman CAMP. Without objection.

STATEMENT OF THE HONORABLE E. CLAY SHAW, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. SHAW. As a Mayor I know the problems of upgrading the utilities, particularly with new Environmental Protection Agency requirements. It's estimated that between five and six hundred billion dollars will be necessary to upgrade the utilities by the cities over the next several years. This legislation that I have would encourage communities to find willing partners in the private sector

to finance these infrastructure endeavors. It would in fact lift the cap for these types of ventures.

The bill has a total cost over 10 years of 187 million dollars, which is minute when you think about the gravity of the problem. The bill is supported by 45 organizations, including the U.S. Conference of Mayors, The National Association of Counties, The National League of Cities, The National Association of Towns and Townships. I think this is exactly the type of help that we should send to cities and that we do mandate these upgrades, and I yield back.

[The prepared statement of Mr. Shaw follows:]

Statement of The Honorable E. Clay Shaw, Jr., a Representative in Congress from the State of Florida

Mr. Chairman, I appreciate the opportunity to testify today about my Clean Water Investment and Infrastructure Security Act—H.R. 1708. I am glad that the Subcommittee is holding this hearing on tax-preferred bonds and their use to finance various public-private activities.

Our nation is facing a water infrastructure replacement challenge. In 2002, the Environmental Protection Agency (EPA) estimated that approximately $500—$600 billion will be needed through the end of this decade to replace, upgrade or expand water and wastewater infrastructure. This infrastructure is critical to the economic and public health of our communities and the nation.

Older towns and cities in the north and east, and growing towns and cities in the west and south are all facing major water infrastructure challenges. The reason for this large need is an accident of history. There have been several generations of water infrastructure put in place in the U.S. over the last hundred years. The oldest infrastructure was extremely long-lived but is now coming to the end of its useful life or does not fulfill the current needs of the community. Newer rounds of water infrastructure had shorter projected life spans and are also coming to the end of their lives or need upgrading.

As a former mayor of Fort Lauderdale, Florida, I understand the importance of rebuilding our infrastructure. Local governments are cost-strapped and are in need of help. We have a tremendous opportunity to impact our local municipalities on an issue of concern.

The challenge communities across the country are facing can largely be addressed with good management and creative thinking. Willing partners to finance these endeavors can be found in the private sector. The federal government can do its part to facilitate this by lifting the current volume cap on private activity bonds—which can be done through the Clean Water Investment and Infrastructure Security Act—H.R. 1708.

H.R. 1708 would bring water and wastewater projects out from under the state volume caps on private activity bonds (PABs), and thereby assist municipalities' accessing the private sector to responsibly address the water infrastructure challenge. This simple change will make capital both easier to obtain and less expensive for partnerships between the public and private sector on water projects, thus making such partnerships much more economically attractive to all concerned.

The goals of H.R. 1708 directly support and facilitate recent initiatives by the EPA and many states and cities to develop sustainable water and wastewater infrastructure systems based on sound economic and asset management principles. The new projects initiated by H.R. 1708 would benefit from innovative financing and project delivery methods, and cities and citizens would see their challenges met more efficiently and more quickly. Projects structured as public-private partnerships using newly available PABs would optimize development, construction and long-term operations—allocating and sharing risk and management.

The Tax Reform Act of 1986 clearly identified public-purpose water and wastewater facilities as two of only a few types of projects undertaken in the public good to be eligible for PABs. However, the 1986 Act and its federally mandated state volume caps on the PABs essentially force water projects to compete with other public projects, including public housing, school loans and others for PABs. Data shows that water projects generally lose this battle to more high-profile, politically attractive activities like housing.

All of the projects eligible to use PABs may be worthy endeavors that contribute to a community's growth and prosperity. Uniquely, however, the water and waste-

water infrastructure constructed is needed to comply with federal requirements under the Clean Water Act and the Safe Drinking Water Act.

My legislation would end this competition, bring water projects out from under the cap, and unleash the power of the private sector to assist our cities and towns water in meeting their infrastructure replacement challenge. It has been estimated in the first few years after H.R. 1708 is made law, $1 to $2 billion in water PABs would be issued annually, and could double or triple over time.

We can look to the solid waste sector for further indications of the potential of this simple change in the tax code. Municipal sold waste disposal projects were pulled out from under the volume cap in 1986 to address the then serious public solid waste disposal challenge. As a result, over $15 billion worth of PABs have been issued since, and the problem has largely been solved.

Chart 1 shows the impact that this move made in using PABs and innovative partnerships to create effective solutions to the nation's solid waste needs of that time.

Transaction Amounts Over Past 25 Years

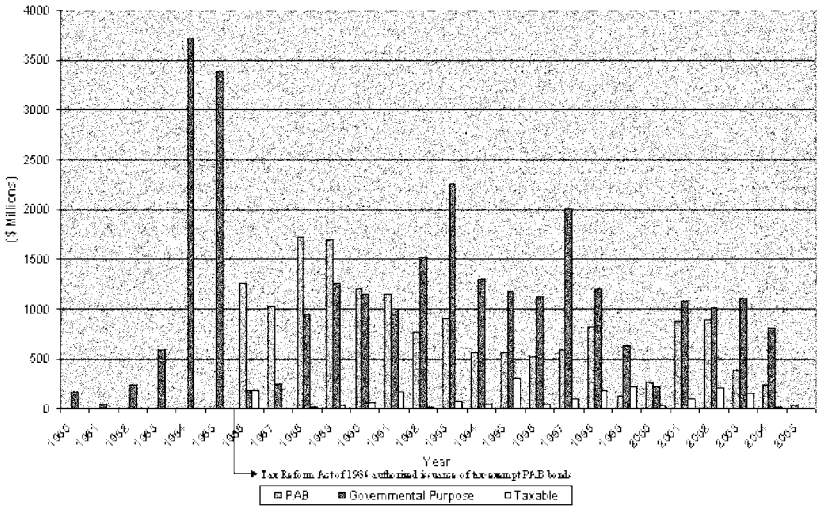


Chart 1. *Solid Waste Historical Data (Lehman Brothers)*

In contrast, **Chart 2** shows how little communities have been able to access PABs to finance construction of facilities to address their water and wastewater challenges. I believe we will see a response for water similar to solid waste with enactment of H.R. 1708.

Transaction Amounts Over Past 25 Years

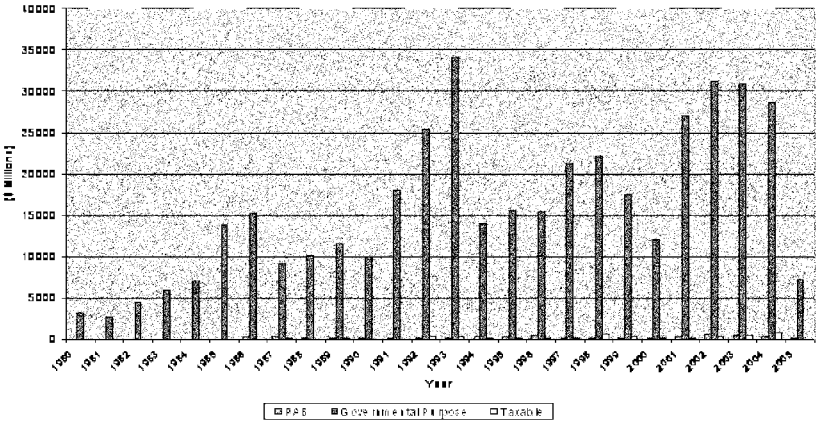


Chart 2. *Water/Wastewater Historical Data (Lehman Brothers)*

When you factor in the cost/benefit of H.R. 1708 to the federal government, it is easy to see that this is a correct path for Congress to take. Legislation identical to H.R. 1708 was scored by Joint Committee on Taxation in 2002, and was found to cost the federal government $147 million over ten years. That is $147 million that the federal government can invest over the next decade, and generate several billion dollars for critical public purpose water facilities in return every year.

I have requested that the Joint Committee on Taxation conduct a new score of this legislation and hope to have it in hand soon.

So far, H.R. 1708 has attracted over 25 co-sponsors; roughly equally from each side of the aisle including 6 Ways and Means Committee members. It is also supported by over 30 organizations including the U.S. Conference of Mayors, the National Association of Counties, and the National Association of Towns and Townships.

There are those who believe the federal government needs to establish a massive new grant program to address the water infrastructure challenge. They further believe that this new bureaucracy should be financed by a new "user fee" or tax of some sort; and they may be coming to the Ways and Means Committee to establish these new fees or taxes. I urge my colleagues to not go down this path but instead respond to the infrastructure funding challenge responsibly. H.R. 1708 is the preferred federal response because it:

1. Leverages limited federal resources;
2. Does not require massive reliance on scarce federal funds;
3. Does not require any new taxes or fees;
4. Does not subsidize utilities with a government handout, instead gives them the tools to handle their problems themselves;
5. Leverages the power of the private sector to address the problem with their proven efficiency and innovation, saving money for the government, taxpayers, and water customers;
6. Does not require the average taxpayer to pay for services he/she does not directly enjoy; and
7. Is far less likely to lead to over-built and wasteful projects often seen in projects heavily reliant on government grants.

Thank you again for this opportunity to testify before you today. I look forward to continuing to work with the Subcommittee on measures to strengthen and improve the financing of projects beneficial to all communities across the country.

Chairman CAMP. I thank the Gentleman, and I thank you for your testimony, and your full statement will be part of the record. Hon. Kevin Brady, another distinguished Member of the Committee on Ways and Means.

STATEMENT OF THE HONORABLE KEVIN BRADY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. BRADY. Thank you, Mr. Chairman and Ranking Member. I would say, Mr. Shaw, you set the bar a little to high on that brief statement. Let me try to be equally brief. I want to thank you for hosting this, Mr. Chairman. I would like to speak briefly about the tax-exempt financing for air and water pollution equipment. I have introduced again to this Congress the Clean Air and Water Investment Act to make these facilities eligible for tax-exempt financing bonds.

They used to—prior to 1986, when it was taken out of the Tax Act—but the problem is that more and more communities around the country are facing very stringent timelines for meeting clean air standards in America.

The deadline for most of our communities is 2010. Including Michigan and New York, 38 states have communities that are now out of compliance in one of those areas, ozone, carbon monoxide, particulate matter. It is very expensive to do the upgrades on this equipment for the community to meet these standards.

My district has two of those communities, Houston and Beaumont, both ozone related communities. For one of them, Houston, it is estimated those upgrades will be about 15 billion dollars throughout our community to meet those standards.

The solution is to give states additional tools, like air and water control facility bonds, which would be based on need and merit, to help them meet those standards on time and to do it affordably.

What our bill would do is simply restore the exact same language that existed in section 142 of the Internal Revenue Service (IRS) Tax Code. It would keep the existing state volume cap, so we wouldn't be adding activity levels. In fact, air and pollution equipment would have to compete against the other modern needs within the state, so we're not adding cost to the process. We're giving them these tools and restoring the category to the Code will allow states to prioritize their compliance issues by granting these bonds.

So, we would not increase the amount of private activity bonds, but we would provide that as a local tool. We know in Texas, for example—many states use this—but we have 15 different projects, air and water projects, very key to cleaning up our environment before 1986.

We also have a list of projects that we know would be available today. I'll close with this. The benefit to restoring the bonds is you accelerate the pollution improvements, bring them about faster. You do so at less cost, so the community and industries can use their dollars, whether it's for health care costs for the workers or research and development to stay competitive with other countries.

But we, in effect, reduce the costs of those facilities by 25 to 30 percent, while still meeting our clean air and clean water goals around this country.

I have, Mr. Chairman, two documents, the list of states that are in non-compliance, a list of the projects that are examples of it, and my thought is that America helps finance clean air and water projects all around the world. Why can't we do the same in our own local communities? Thank you, Mr. Chairman.

[The prepared statement of Mr. Brady follows:]

Statement of The Honorable Kevin Brady, a Representative in Congress from the State of Texas

Mr. Chairman and distinguished Members of the Subcommittee, I am delighted to be before you today to discuss a matter that is very important to me—restoring tax-exempt financing eligibility for "air and water pollution control facilities" to the United States tax code.

My district, and the entire State of Texas, need additional tools for compliance with non-attainment issues related to implementation of the Clean Air Act. In fact, communities on both the eastern and western borders of my district—Beaumont and Houston, respectively—are in non-attainment. I have been working hard for over five years on my own and as a part of coalitions to effectuate this change and truly believe that this hearing is a first important step toward making it a reality. And, I would like to acknowledge the hard work of the Gulf Coast Waste Disposal Authority whose General Manager, Board Chairman and Board Members are with us in this room today. It was this group that initially brought this provision to my attention and persuaded me of the need to move forward.

Air and water pollution control facilities, one of thirteen tax-exempt categories, were removed from the tax code in the Tax Reform Act of 1986. Remarkably, in all of time I have been trying to restore their eligibility status no one has ever been able to explain the reason for their removal. Airports, docks and wharfs, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste facilities, public water pollution control facilities and many other environment and infrastructure measures remained, but this one was removed. It was removed, notwithstanding the fact that, prior to l986, a large amount of the nation's progress in the reduction of the release of pollutants into our air and water was directly tied to projects that had been financed by private activity bonds for air and water pollution facilities.

In the 109th Congress, I have once again introduced the "Clean Air and Water Investment Act" to accomplish the objective of restoring air and water pollution control facilities as an eligible tax-exempt category. I have introduced this legislation in several forms over the past few Congresses, but in this instance, it is a simple restoration of prior tax code. The measure would restore the term air and water pollution control facilities to Section 142 of the Internal Revenue Code, but it would not in any way amend the provisions of Section 146 of the code relating to state volume caps on the use of tax-exempt financing. Under my bill, tax-exempt bonds issued for air and water pollution control would be under the existing caps and would not increase the total amount of private activity state and local bond issuance. They would, in fact, compete with other requests for tax-exempt financing and only be approved if they were successful.

What I am trying to do is add—restore, really—a tool for state and local governments to deal with the pressing needs demanded by increased environmental regulations particularly those pursuant to the Clean Air Act. The tool would aid in compliance through the construction of new, required pollution control facilities, and the repair of existing facilities, which, in Texas were severely damaged by hurricane activities.

Every year the President's budget includes the estimated losses to the federal government from all tax-exempt interest on municipal debt. The total nationwide for Fiscal Year 2006 is estimated to be $34.86 billion including all categories. However, the revenue loss on an annual basis for pollution control is estimated at $480 million or 1.4% of the total of all tax-exempt bonds. This loss will grow slightly over the next five years as populations increase and additional demands are placed on state and local governments for pollution control activities. The growth of bond issuance will occur whether or not this proposed legislation is approved because there will be an increase in state caps due to a natural increase in population.

But the demands are significant and the state and local governments are in need of additional tools. According to the U.S. Environmental Protection Agency, as of April 2005, there are 474 counties in thirty-two states that cannot meet clean air standards as measured by the 8-hour ozone criteria. Additional counties and states could be added to the list if one includes other standards, such as carbon monoxide

and particulate standards. States are increasing their enforcement of the total maximum daily loads (TMDLs) for water pollution creating more burdens on the private sector to further clean up water pollution discharges. This legislation would simply provide a financing tool not currently available to the private sector to construct needed facilities that will meet ever increasing air and water standards thus reducing the burden on small businesses and protecting the health of the general population.

In addition, we are all reading about the increasing demand for safe drinking water free from contaminants for our growing population. Much of the required infrastructure to meet the demand will come from private-public partnerships. The private activity bonds that I am proposing will provide an alternative that will reduce capital costs and, in turn reduce the cost of safe, clean water to consumers.

In conclusion, Mr. Chairman let me state my appreciation to you and to the committee for holding this important hearing. I stand ready to assist you in any way that I can to move this important legislation forward. Thank you. I will be happy to answer any questions that you may have.

Chairman CAMP. Well thank you very much and your full statement will be part of the record. Thank you both for your excellent testimony, and that concludes our first panel and the Committee will recess until we conclude votes on the floor. Thank you very much.

[Recess]

Chairman CAMP. The hearing will come to order again. We will begin with panel two, and we're honored to have Eric Solomon, acting Deputy, Assistant Secretary to Tax Policy of The U.S. Department of Treasury, and Donald Marron, Phd., acting Director to The Commission of The Congressional Budget Office (CBO). Thank you both for being here. You have 5 minutes, Mr. Solomon, to give your statement. Your full statement can be part of the record and you many begin.

STATEMENT OF ERIC SOLOMON, ACTING DEPUTY ASSISTANT SECRETARY OF TAX POLICY, U.S. DEPARTMENT OF TREASURY

Mr. SOLOMON. Thank you Chairman Camp and distinguished Members of the Subcommittee. I appreciate the opportunity to discuss with you today some of the Federal tax issues surrounding the use of tax-preferred bond financing. The Administration recognizes that tax-preferred bond financing plays a very important role as a source of financing to state and local governments for critical public infrastructure projects and other significant public purpose activities.

In talking about tax-preferred bonds, it is important to keep in mind the difference between governmental bonds, the proceeds of which directly finance the activities of state and local governments, and qualified private activity bonds, which typically benefit the private party in some way.

The cost to the Federal Government of tax-preferred bond financing is significant. Unlike direct appropriations, however, the cost often goes unnoticed, because it is not tracked annually through the appropriations process.

In addition to the direct Federal revenue cost of providing a tax-exemption or credit, there are also indirect costs, such as administrative burdens on issuers and the IRS, in part imposed by complex rules.

The steady growth in the volume of tax-preferred bonds and Congressional proposals to expand them reflect their great importance as incentives in addressing public infrastructure and other needs. At the same time, however, it is appropriate to review these programs to insure that they are properly targeted and to insure that the Federal incentive is justified in light of the revenue costs and other costs imposed.

Now, I would like to just highlight a few tax policy and administrative issues raised by tax-preferred bonds. First, as I previously mentioned in considering any expansion of any tax-preferred bond financing, it is important to target the Federal incentive carefully. When tax-preferred bonds are used to finance necessary projects that would not be built without a Federal incentive, the justification for the Federal incentive is apparent. Where projects would have been built even without a Federal incentive or where the broader public justification for a project is absent, the Federal incentive can result in a misallocation of capital.

Second, the allocation of the Federal incentive provided by tax-preferred bond financing is most efficient when it is provided for within the existing general framework of the tax-exempt bond rules, rather than with additional specialized bond regimes. The tax-exempt bond provisions have developed over the past 20 years to insure proper targeting of the Federal incentive.

Third, we have concerns about the Federal revenue costs associated with providing a deeper level of incentive to tax credit bonds than is provided to tax-exempt bonds. The deeper Federal incentive provided in the three existing tax credit bond programs is comparable to the Federal Government paying the entire interest coupon on Double-A corporate bonds, which is a larger Federal incentive provided to tax-exempt bonds.

In addition, tax credit bonds raise a number of difficulties that offset the fact that they may be more efficient than tax-exempt bonds in delivering a Federal incentive. Concerns with tax credit bonds include a small illiquid market, a less market driven pricing procedure conducted by The Treasury Department, and many new complexities. There is a complexity and awkwardness in having parallel regulatory regimes for the large longstanding tax-exempt bond program, and the various limited tax credit bond programs.

Fourth, we believe that the unified annual state volume cap on qualified private activity bonds generally has provided a fair, flexible, and effective constraint on the volume of tax-exempt private activity bonds. We have various concerns about other volume cap allocation methods.

Fifth, we have administrative resource concerns with special bond programs. The Treasury Department and the IRS are increasingly charged with responsibility to regulate, allocate, and audit unique special purpose bond issuances. They present many administrative challenges and they require a disproportionate allocation of administrative resources.

In conclusion, the Administration recognizes the very important role that tax-preferred bond financing plays in providing a source of financing for critical public infrastructure projects and other significant public purpose activities. When considering further expansions of tax-preferred bond financing, it is important to insure that

the Federal incentive is properly targeted and used for its intended purposes, and that the direct and indirect costs of the Federal incentive are carefully considered in light of the revenue costs and other costs imposed.

Thank you for the opportunity to appear before you on these important matters, and I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Solomon follows:]

Statement of Eric Solomon, Acting Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Chairman Camp, Mr. McNulty and distinguished members of the Subcommittee:

I appreciate the opportunity to discuss with you today some of the Federal tax issues surrounding the use of tax-preferred bond financing. There are two general types of tax-preferred bonds: tax-exempt bonds (including governmental bonds and qualified private activity bonds) and tax credit bonds. Tax-preferred bonds have long been an important tool for State and local governments to finance public infrastructure and other projects to carry out public purposes. The Federal government provides important subsidies for tax-preferred bond financing that significantly reduce borrowing costs for State and local governments, most notably through the Federal income tax exemption afforded to interest paid on tax-exempt bonds. While steady growth in the volume of tax-preferred bonds and Congressional proposals to expand them reflect their importance as incentives in addressing public infrastructure and other needs, it is appropriate to review these programs to ensure that they are properly targeted and to ensure that the Federal subsidy is justified.

The first part of my testimony today will provide an overview of existing types of tax-preferred bonds and summarize the current market for these bonds. The second part of my testimony will give a basic explanation of the Federal subsidy that is provided for each type of tax-preferred bond. The third part of my testimony will describe various technical rules in the tax law that ensure that the Federal subsidy for tax-preferred bonds is used properly. The fourth part of my testimony will summarize the recent growth in special purpose tax-exempt bonds and tax credit bonds. The fifth and final part of my testimony will highlight administrative and tax policy concerns that are raised by the recent growth in special purpose bond financing.

Overview of Tax-Preferred Bonds

Governmental Bonds

State and local governments issue tax-exempt bonds to finance a wide range of public infrastructure, including schools, hospitals, roads, libraries, public parks, and water treatment facilities. The interest paid on debt incurred by State and local governments on these bonds is generally excluded from gross income for Federal income tax purposes if the bonds meet certain eligibility requirements. There are two basic kinds of tax-exempt bonds: governmental bonds and qualified private activity bonds. Bonds generally are treated as governmental bonds if the proceeds of the borrowing are used to carry out governmental functions and the debt is repaid with governmental funds.

Under the general tax-exempt bond provisions of the Internal Revenue Code (Code), bonds are classified as governmental bonds under a definition that limits private business use and private business sources of payment for the bonds and also limits financing of private loans. Bonds that have excessive private involvement under this definition are classified as "private activity bonds," the interest on which is tax-exempt only in limited circumstances.

In order for interest on tax-exempt bonds, including governmental bonds, to be excluded from income, a number of specific requirements must be met. Requirements generally applicable to all tax-exempt bonds include arbitrage limitations, registration and information reporting requirements, a general prohibition on any Federal guarantee, advance refunding limitations, restrictions on unduly long spending periods, and pooled bond limitations.

The total volume of new, long-term governmental bonds has grown steadily since 1991, as shown in Figure 1. The Federal tax expenditures associated with the income exclusion for interest on governmental bonds has also grown over the years, as shown in Figure 3.

Private Activity Bonds.

Bonds are classified as "private activity bonds" if more than 10% of the bond proceeds are both: (1) used for private business use (the "private business use test"); and (2) payable or secured from private sources (the "private payments test"). Bonds also are treated as private activity bonds if more than the lesser of $5 million or 5% of the bond proceeds are used to finance private loans, including business and consumer loans. The permitted private business thresholds are reduced from 10% to 5% for certain unrelated or disproportionate private business uses.

Private activity bonds may be issued on a tax-exempt basis only if they meet the requirements for "qualified private activity bonds," including targeting requirements that limit such financing to specifically defined facilities and programs. For example, qualified private activity bonds can be used to finance eligible activities of educational and other charitable organizations described in section 501(c)(3). Tax-exempt private activity bond financing is also available for certain qualified facilities such as airports, docks, wharves, transportation infrastructure, utility and sanitation infrastructure, low-income residential housing projects, and small manufacturing facilities. Qualified private activity bonds may also be used to finance home mortgages for veterans and to facilitate single-family home purchases for first-time home buyers who satisfy income, purchase price, and other qualifications.

Qualified private activity bonds are subject to the same general rules applicable to governmental bonds, including the arbitrage investment limitations, registration and information reporting requirements, the Federal guarantee prohibition, restrictions on unduly long spending periods, and pooled bond limitations. Most qualified private activity bonds are also subject to a number of additional rules and limitations, in particular the volume cap limitation under section 146 of the Code.

Unlike the tax exemption for governmental bonds, the tax exemption for interest on most qualified private activity bonds is generally treated as an alternative minimum tax (AMT) preference item, meaning that the tax preference for these bonds is often taken away by the AMT.

The current private activity bond regime was enacted as part of the Tax Reform Act of 1986 and was designed to limit the ability of State and local governments to act as conduit issuers in financing projects for the use and benefit of private businesses and other private borrowers. Prior to enactment of this regime, States and municipalities were subject to more liberal rules governing tax-exempt "industrial development bonds," the proceeds of which could be used for the benefit of private parties. The dramatic impact that enactment of the private activity bond regime in 1986 had on the volume of tax-exempt bonds benefiting private parties is reflected in Figure 4.

The total volume of new, long-term qualified private activity bonds issued since 1991 is shown in Figure 1. In 2003, the most recent year for which the Internal Revenue Service Statistics of Income (SOI) division data are available, approximately $200 billion in tax-exempt bonds were issued, 22 percent of which were private activity bonds. Between 1991 and 2003, private activity bonds accounted for an average of 27 percent of total annual tax-exempt bond issuances.

Figure 2 shows the allocation of private-activity bonds among various qualified projects and activities. As can be seen, the largest issuance category in 2003 was tax-exempt hospitals, followed by non-profit education, rental housing, airports and docks, mortgages, and student loans. Tax expenditure estimates for tax-exempt bond issues between 1996 and 2005 are shown in Figure 3.

Tax Credit Bonds

Tax credit bonds are a relatively new type of tax-preferred bond that differ from governmental or qualified private activity bonds in that the economic equivalent of "interest" is paid through a taxable credit against the bond holder's Federal income tax liability. Tax credit bonds are designed to be "zero coupon" bonds that pay no interest. Recent programs for tax credit bonds encompass less than $5 billion in total authorized or outstanding issues. By comparison, the tax-exempt bond market (including governmental and qualified private activity bonds) encompassed over $2 trillion in outstanding issuances as of the end of 2005.

In general, the Federal subsidy provided to tax credit bonds is "deeper" than that provided to tax-exempt bonds. In simplified terms, the Federal subsidy to State and local governments on tax credit bonds is equivalent to the Federal government's payment of interest on those bonds at a taxable rate. By comparison, the Federal subsidy on tax-exempt bonds is equivalent to the Federal government's payment of the interest differential between taxable and lower tax-exempt interest rates as a result of the exclusion of the interest from income for most Federal income tax purposes.

Existing law provides for three types of tax credit bonds, Qualified Zone Academy Bonds ("QZABs"), Clean Renewable Energy Bonds ("CREBs") and Gulf Opportunity Zone Tax Credit Bonds ("GO Zone Tax Credit Bonds"), each of which is described in more detail below.

Federal Subsidy for Tax-Exempt Bonds and Tax Credit Bonds

A rationale for Federal subsidization of local public projects and activities exists when they serve some broader public purpose. The most straightforward means of delivering this subsidy is through direct Federal appropriations for grants to State and local governments. The tax exemption for interest paid on tax-exempt bonds, and the interest equivalent paid on tax credit bonds, are alternative means of delivering a Federal subsidy. The policy justification for delivering these subsidies, whether through direct appropriations, a tax exemption, or a tax credit, is weakened, however, as use of the proceeds gets further away from traditional governmental purposes.

Subsidy for Tax-Exempt Bonds

The Federal government's exemption of the interest on certain bonds from income tax lowers the rate of interest that investors are willing to accept in order to hold these bonds as compared to taxable bonds, thereby lowering State and local governmental borrowing costs. Governmental bonds also often have tax exemptions for various State tax purposes. The amount of the Federal subsidy enjoyed by State and local governments depends on the overall supply and demand for tax-exempt bonds and on the marginal tax bracket of the investor holding the bonds. For example, if taxable bonds yield 10 percent and equivalent tax-exempt bonds yield 7.5 percent, then investors whose marginal income tax rates exceed 25 percent will prefer to invest in tax-exempt bonds. On an after-tax basis, these investors will be better off giving up the extra 2.5 percent yield on a taxable bond in exchange for a greater than 25 percent reduction in their income tax liability for each dollar in tax-exempt interest they receive. At the same time, the State or local government issuing the bond will enjoy a 25 percent reduction in its borrowing costs.

This "tax wedge" between the tax-exempt and taxable bond interest rates highlights the inefficiency of the Federal subsidy provided by tax-exempt bond financing. Investors whose marginal tax brackets exceed the prevailing tax wedge (25 percent in the example above) reap a windfall from investing in tax-exempt bonds, because they would have been willing to accept a lower interest rate to hold tax-exempt debt. Therefore, although tax-exempt issuers spend less on interest than they would if they had to issue taxable debt, they nonetheless spend more on interest than they would if they were able to pay each investor just enough to make him hold tax-exempt debt. The size of the windfall to high-bracket investors can be large: since 1986, the average tax wedge between long-term tax-exempt bonds and high-quality corporate bonds has been about 21 percent, well below the top marginal personal income tax rates of 28 to 39.6 percent during that period. The Federal government pays this premium through a tax exemption.

Subsidy for Tax Credit Bonds

Tax credit bonds provide a Federal tax credit that is intended to replace a taxable interest coupon on the Bonds. Existing tax credit bond programs provide that the credit rate is based on a taxable AA corporate bond rate at the time of pricing. In theory, an investor who has sufficient Federal tax liability to use the credit will have a demand for a tax credit bond. Tax credit bonds are more efficient than tax-exempt bonds, although unlike tax-exempt bonds they shift the entire interest cost to the Federal government.

Instead of having cash coupons, tax credit bonds provide tax credits (at a taxable bond rate), which are added to the investor's taxable income and then subtracted from the investor's income tax liability. For example, if the taxable rate is 10 percent, a $1,000 bond would yield $100 in tax credits. If the investor were in the 35 percent tax bracket, he would include $100 in income and pay an extra $35 in tax (before the credit). He would then take the $100 credit against this total tax bill, for a net reduction in tax liability of $65. For investors with sufficient positive tax liabilities to utilize the full value of the credit, tax credit bonds are equivalent to Federal payment of interest at a taxable interest rate. Thus, an investor who received $100 in taxable interest and paid $35 in tax would have $65 in hand after taxes. Similarly, the holder of a tax credit bond who receives $100 in credits would, after paying $35 in tax on those credits, end up with $65 more in hand after taxes.

From an economic perspective, the Federal subsidy for tax credit bonds may be viewed as more efficient than the subsidy for tax-exempt bonds. This is because the Federal subsidy for tax credit bonds is based on taxable interest rates and an investor may have a demand for tax credit bonds so long as the investor has sufficient

Federal tax liability to use them. By comparison, the Federal subsidy for tax-exempt bonds may be viewed as inefficient in the sense that the tax-exempt bond market does not pass the full Federal revenue cost to State and local governments through correspondingly lower tax-exempt bond rates. As discussed in more detail below, however, tax credit bonds have a number of practical inefficiencies that may outweigh any economic advantage they have in delivering a Federal subsidy.

Rules Governing Tax-Preferred Bonds

Federal tax law contains a number of detailed rules governing tax-exempt bonds that reflect a longstanding, well developed regulatory structure. Additional rules provide detailed targeting and other restrictions for qualified private activity bonds. In contrast, the three existing tax credit bond programs provide disparate statutory rules with varying incorporation of the general tax-exempt bond rules.

Rules of General Applicability to Tax-Exempt Bonds.

Arbitrage Yield Restrictions and Arbitrage Rebate. In order to properly target the Federal subsidy for projects financed with tax-exempt bonds, the Code contains arbitrage rules that prevent State and local governments from issuing more bonds than necessary for a particular project, or from issuing bonds earlier or keeping bonds outstanding longer than necessary to finance a project. Subject to certain exceptions, these "arbitrage yield restrictions" limit the ability of State and local governments to issue tax-exempt bonds, any portion of which is reasonably expected to be invested in higher-yielding investments. The arbitrage rules also require that certain excess earnings be paid to the Federal government (the "arbitrage rebate" requirement).

Advance Refunding Limitations. The Code contains detailed "advance refunding" limitations designed to limit the circumstances in which more than one tax-exempt bond issuance is outstanding at the same time for the same project or activity. Refunding bonds are often issued to retire outstanding debt in an environment of declining interest rates. Limitations on the ability to "call" outstanding debt often lead to circumstances in which issuers seek to do advance refundings. In an advance refunding, the issuer uses proceeds from refunding bonds to defease its obligation on the original "refunded bonds," but does not pay off the refunded bonds until more than 90 days after the refunding bonds are issued.

Advance refundings are inefficient and costly to the Federal government because they result in more than one Federal subsidy being provided for the same project at the same time. In 2002 and 2003, when interest rates were falling, current refundings and advance refundings accounted for 40 percent and 36 percent of total governmental bond issuances, respectively. By contrast, in 2000, a year of relatively high interest rates, advance refundings accounted for 20 percent of total governmental bond issuances.

Prior to the Tax Reform Act of 1986, advance refundings were a greater concern because issuers could advance refund governmental bonds an unlimited number of times. The Code now generally permits only one advance refunding for governmental bonds and prohibits advance refundings entirely for qualified private activity bonds other than qualified 501(c)(3) bonds. Less restrictive rules apply to "current refundings" in which the refunded bonds are fully retired within 90 days after the issuance of the refunding bonds.

Prohibition Against Federal Guarantees. Under the Code, interest paid on bonds that carry a direct or indirect Federal guarantee is generally not excluded from income. The broad prohibition against Federal guarantees of tax-exempt bonds is designed to avoid creating a tax-exempt security that is more attractive to investors than Treasury securities because it has both the credit quality of a Treasury security and a Federal tax exemption. There are a limited number of exceptions to the prohibition on a Federal guarantee, most of which date back to enactment of the Federal guarantee prohibition in 1984.

Registration Requirement and Information Reporting. In order to ensure the liquidity of tax-preferred bonds in the financial markets and to prevent abuse through use of bearer bonds, most tax-exempt bonds are subject to registration requirements. In addition, issuers of these bonds must file certain information returns with the IRS at the time of issuance of the bonds in order for the interest to be tax exempt or for the holder of a tax credit bond to claim the credit.

Hedge Bond Restrictions. "Hedge bond" provisions generally prohibit the issuance of tax-exempt bonds in circumstances involving unduly long spending periods in which issuers cannot show reasonable expectations to spend most of the bond proceeds within a five-year period.

Pooled Bond Financing Limitations. "Pooled bond" financing limitations generally impose restrictions on the use of tax-exempt bonds in pooled bond financings involv-

ing loans of bond proceeds to two or more borrowers. These restrictions are designed to encourage prompt use of the bond proceeds to make loans to carry out ultimate governmental purposes.

Additional Rules Applicable to Qualified Private Activity Bonds

Qualified private activity bonds are generally subject to the rules described above and to additional limitations. Most significantly, with some exceptions, the amount of tax-exempt qualified private activity bonds that can be issued by each State (or its political subdivisions) is subject to a unified annual State volume cap based on population. Presently, the annual State volume cap is equal to the greater of $75 per resident or $225 million (increased for inflation for every year after 2002). In general, the unified State volume cap on qualified private activity bonds has provided a fair, flexible, and effective constraint on the volume of tax-exempt private activity bonds.

The Code also places limitations on the types of projects and activities that can be financed by qualified private activity bonds. For example, the proceeds from qualified private activity bond cannot be used to finance sky boxes, health clubs owned by an entity other than a Section 501(c)(3) entity, gambling facilities, or liquor stores. In addition, there are a number of more technical rules that apply to qualified private activity bonds, including limits on the tax exemption for bonds held by persons who are users of projects financed by the bonds. There are also limits on the maturity date of the bonds, which unlike governmental bonds is statutorily linked to the economic life of the financed property. Furthermore, conduit borrowers who use the proceeds of qualified private activity bonds are subject to penalties if they use the bond proceeds in an inappropriate manner.

Application of the Operating Rules to Tax Credit Bonds

The general operating rules for tax-exempt bonds are established in the Code and Treasury Department regulations. In theory, similar rules should apply to tax credit bonds in order to ensure that the proceeds from these bonds are being properly utilized, and to ensure that the Federal subsidy is properly targeted. The three existing tax credit bond programs, however, provide disparate statutory rules with inconsistent incorporation of the general tax-exempt bond rules. For example, the Code provides that the arbitrage rules and information reporting requirements apply to certain tax credit bonds but not to others. Similarly, remedial action rules are applied inconsistently to tax credit bonds. In addition, due to the novelty and limited scope and application of tax credit bonds, the rules otherwise applicable to tax-exempt bonds cannot be applied without statutory authorization or appropriate modification of existing regulations. Tax credit bonds also raise new issues and challenges, including those highlighted below:

- *Eligible Uses.* The projects and activities for which qualified private activity bonds can be used are articulated in the Code and defined in regulations that have been developed over time. While the statutory provisions authorizing tax credit bonds similarly describe eligible uses for the proceeds of these bonds, there is little guidance on the specific types of projects or activities that qualify. Moreover, because the permitted uses are often highly technical and differ from the uses authorized for qualified private activity bonds, entirely new sets of rules may need to be published.
- *Application to Pass-Through Entities.* The complex nature of tax credit bonds raises significant issues when those bonds are held by pass-through entities or mutual funds. Accordingly, new rules need to be developed to describe how the tax credit is both included in income for members of a pass-though holder of a tax credit bond, and to describe how the credit is ultimately used by the members or partners.
- *Credit Rate.* For tax-exempt bonds, the markets set the applicable interest rate. While there are some market inefficiencies that arise from the limited size of some issuances, the market can generally take them into consideration. In contrast, the Treasury Department sets the rates for tax credit bonds. While the credit rate-setting mechanism is designed to result in rates that permit the bonds to be sold at par, that objective has not always been achieved in practice and the Treasury Department may be less suited than the market in determining the appropriate rate.
- *Maturities.* For qualified private activity bonds, the Code generally requires that the weighted average maturity of the bonds be based on the economic lives of the financed projects or activities. In contrast, the Treasury Department is charged with determining the maturity date for all existing tax credit bonds at a level at which the present value at issuance of the obligation to repay the principal of the bonds is equal to 50% of the face amount of the bond. This rate-

setting methodology does not involve the typical consideration of the economic life of the financed projects.

- *Volume Cap.* The authorizing statutes for the three existing types of tax credit bonds each limit the aggregate amount of bonds that can be issued. Under the volume cap rules that apply to most qualified private activity bonds, the IRS is only required to determine the total amount of volume cap a State may allocate and States are given the discretion to allocate their volume caps among permitted types of projects in accordance with their specific needs. In contrast, for some tax credit bonds the IRS is required to make allocations to specific projects. This raises complex questions about how to allocate bond authority when demand exceeds supply and how to determine the technical merits of an application for bond authority. Although the Treasury Department and IRS are responsible for answering these questions, they often lack the non-tax expertise needed to do so and must make judgment calls on which projects will be allocated bond authority. Moreover, allocations of tax credits by the Federal government outside of State volume caps weighs against the flexibility and efficiency associated with allowing States to allocate limited volume cap in accordance with State and local needs and priorities.

Special Purpose Tax-Preferred Bonds

In recent years, a number of new types of qualified private activity bond programs have been created outside of the general volume cap rules for specific targeted projects or activities. In addition, three tax credit bond programs have been enacted for specific targeted projects or activities that would not otherwise be covered by the qualified private activity bond rules. A number of proposals for additional types of private activity bonds and tax credit bonds have been proposed, including recent proposals for high-speed rail infrastructure bonds, transit bonds and Better America Bonds.

Special Purpose Private Activity Bonds

Recently enacted special purpose qualified private activity bonds include those described below.

New York Liberty Zone Bond Provisions. The Job Creation and Worker Assistance Act of 2002 provided tax incentives for the area of New York City (the "New York Liberty Zone") damaged or affected by the terrorist attack on September 11, 2001. New York Liberty Zone tax incentives include two provisions relating to tax-exempt bonds: (1) $8 billion of tax-exempt private activity bonds that are excluded from the general volume cap rules and that are allocated by the Governor of New York and they Mayor of New York City in a prescribed manner; and (2) $9 billion of additional tax-exempt, advance refunding bonds. The dates originally established for issuing bonds under the New York Liberty Zone authority were extended by the Working Families Tax Relief Act of 2004. New York City has not used all of its allocated bond authority.

GO Zone Act Bond Provisions. The Gulf Opportunity Zone Act of 2005 (GO Zone Act) increased the otherwise applicable volume cap for qualified private activity bonds issued by Louisiana, Mississippi and Alabama. For each of these States, the GO Zone Act provided additional volume cap through the year 2009. The GO Zone Act also provided that interest paid on additional private activity bonds issued by under this provision would be exempt from AMT. The additional volume cap authority is estimated to be $7.9 billion, $4.8 billion, and $2.1 billion for Louisiana, Mississippi, and Alabama, respectively. These States collectively had over $1.8 billion in unused, carryover volume cap at the end of 2004, raising some question as to whether, as happened with the New York Liberty Zone bond authority, the additional volume cap authority will be used.

Green Bonds. As part of the American Jobs Creation Act of 2004, Congress authorized up to $2 billion of tax-exempt private activity bonds to be issued by State or local governments for qualified green building and sustainable design projects. "Qualified green building and sustainable design projects" are defined to mean any project that is designated by the Treasury Secretary, after consultation with the Administrator of the Environmental Protection Agency, to be a qualified green building and sustainable design project and that meets certain other requirements. The Treasury Secretary is responsible for allocating the dollar limit among qualified projects. Only four qualified applicants submitted applications for green bond authority. The IRS has made allocations among those qualified applicants. Because the demand for an allocation of the limit was greater than the limit, the allocation was made using a pro rata method.

Qualified Highway and Surface Freight Transfer Facility Bonds. The Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 authorizes the Sec-

retary of Transportation to allocate a $15 billion national limitation to States and local governments to issue bonds to finance surface transportation projects, international bridges or tunnels or transfer of freight from truck to rail or rail to truck facilities, if those projects receive Federal assistance. Bonds issued pursuant to such allocation do not need to receive volume cap under the normal bond rules. The statute generally requires proceeds to be spent within 5 years from the date the bonds were issued.

Special Purpose Tax Credit Bonds

The three existing special purpose tax credit bond programs are described below:

Qualified Zone Academy Bonds. Qualified Zone Academy Bonds (QZABs) were first introduced as part of the Taxpayer Relief Act of 1997. State and local governments can issue QZABs to fund the improvement of certain eligible public schools. Eligible holders are banks, insurance companies, and corporations actively engaged in the business of lending money. QZABs are not interest-bearing obligations. Rather, a taxpayer holding QZABs on an annual credit allowance date is entitled to receive a Federal income tax credit. The credit rate for a QZAB is set on its day of sale by reference to credit rates established by the Treasury Department and is a rate that is intended to permit the issuance of the QZABs without discount and without interest cost to the issuer. The credit accrues annually and is includible in gross income (as if it were an interest payment on a taxable bond) and can be claimed against regular income tax liability. The maximum term of a QZAB issued during any month is determined by reference to the adjusted applicable Federal rate (AFR) published by the IRS for the month in which the bond is issued. The arbitrage investment restrictions and information reporting requirements that generally apply to tax-exempt bonds are not applicable to QZABs.

Because issuers of QZABs are not currently required to file Form 8038 information returns, there is no reliable data on the volume of QZABs that have been issued. Total QZAB issuances of $400 million per year have been authorized since 1998, so the maximum aggregate volume would be $3.2 billion. Although data is not generally available, it is likely that a significant portion of this volume remains unused, since many States did not use their full allocation in the early years of the program, when the instruments were new to both issuers and investors.

Clean Renewable Energy Bonds. The Energy Tax Incentives Act of 2005 introduced a new tax credit bond for clean renewable energy projects. This provision provides for up to $800 million in aggregate issuance of clean renewable energy bonds ("CREBs") through December 31, 2007. CREBs are similar, but not identical, to QZABs in how they work. Like QZABs, CREBs are not interest-bearing obligations. Rather, a taxpayer holding CREBs on a quarterly credit allowance date (versus annual credit allowance dates for QZABs) is entitled to a Federal income tax credit. Unlike QZABs, there are no limits on who may hold these bonds. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate on the bonds is determined by the Treasury Department and is a rate that is intended to permit issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unlike QZABs, CREBs are subject to arbitrage rules and information reporting requirements.

Gulf Opportunity Zone Tax Credit Bonds. The Gulf Opportunity Zone Act of 2005 (GO Zone Act), authorized a third type of tax credit bond referred to as "GO Zone Tax Credit Bonds." These tax credit bonds can be issued by Louisiana, Mississippi and Alabama in order to provide assistance to communities unable to meet their debt service requirements as a result of the Hurricane Katrina. Gulf Tax Credit Bonds operate in much the same way as QZABs and CREBS, with the economic equivalent of interest being delivered through a Federal income tax credit that the holder can claim on its tax return. GO Zone Tax Credit Bonds must be issued by December 31, 2006, and must mature before January 1, 2008.

There have been other recent proposals for tax credit bonds as to which the Administration has expressed strong reservations.

Tax Policy and Administrative Concerns Highlighted by Tax-Preferred Bonds

Applying Generally Applicable Bond Rules to Special Purpose Bonds

In general, it would be preferable to subject any new or expanded programs for tax-preferred bond financing to the existing regulatory framework for tax-exempt bonds or to impose comparable general restrictions and targeting restrictions. The general tax-exempt bond provisions have well developed general restrictions. To

take one illustrative example, the tax-exempt bond provisions have extensive arbitrage investment restrictions that limit the investment of tax-exempt bond proceeds at yields above the bond yield and which require that excess earnings be rebated to the Federal government, subject to certain prompt spending and other exceptions. Similarly, the general tax-exempt bond provisions have an information reporting requirement to the IRS which assists Treasury and the IRS in analyzing use of tax-exempt bonds. The tax credit bond program for QZABs, however, does not impose arbitrage investment restrictions or information reporting requirements, raising targeting and administrability concerns. In this regard, various special other tax-exempt bond programs and tax credit bond programs outside the general tax-exempt bond framework present many administrability issues for Treasury and the IRS in assessing how or to what extent to impose comparable rules by analogy.

Liquidity Concerns

The tax-exempt bond market generally caters to tax-sensitive investors. Even in this large market, liquidity is low due to the small size of individual issues and the limited attractiveness of the Federal tax exemption. Low liquidity creates a number of problems that are magnified in the context of special purpose bonds, all of which have very small relative volume. Most notably, low liquidity requires the issuer to offer a higher tax-exempt interest rate in order to ensure a market for the bonds. This problem is magnified as the volume of tax-exempt and tax credit bonds increases, forcing issuers to offer higher rates in order to appeal to the same limited universe of holders. An increased interest rate, in turn, increases the Federal subsidy for the bonds.

Tax Credit Bond Considerations

For the three existing tax credit bond programs, the credit rate is set at a rate equivalent to an AA corporate bond rate with the intention that this pricing allow the bonds to be sold at par. In practice, however, this has proven to be difficult. Investors in tax credit bonds generally demand a discounted purchase price in comparison to similar interest-bearing bonds in order to account for a number of additional risks, including the possibility of not having sufficient tax liability in the future to use the credit and liquidity concerns.

While more efficient from a broader economic perspective in delivering a Federal subsidy, tax credit bonds have a number of practical inefficiencies. The tax-exempt bond market is a longstanding, established market with over $2 trillion in outstanding bond issues. The market generally operates independently to set appropriate interest rates. In addition, the general tax-exempt bond provisions under the Code reflect a well developed set of rules and targeting restrictions aimed at ensuring that the tax-exempt bonds carry out public purposes. By comparison, the existing tax credit bond market is limited and illiquid, and requires some inefficient, less market driven involvement by the Treasury Department in setting the credit rates. These rates are designed to allow zero interest tax credit bonds to price at par, although this often does not happen in practice. In addition, tax credit bonds introduce a number of new complexities, including issues involving the timing of ownership relative to eligibility for using the tax credits in the case of pass-through entities and other holders, the inflexibility of tax credit bond maturity rules that are not tied to project economic life considerations, and the inconsistent application of general restrictions (e.g., arbitrage investment limitations) and other restrictions comparable to those under the general tax-exempt bond provisions.

In general, tax-exempt bonds and tax credit bonds have the same fundamental purpose of providing a Federal subsidy as an incentive to promote financing of public infrastructure and other public purposes for State and local governments. That said, absent completely replacing the tax-exempt bond subsidy with a broad-based tax credit bond subsidy having carefully developed program parameters, the complexity and awkwardness associated with parallel regulatory regimes for the large tax-exempt bond program and the various limited tax credit bond programs raises concerns.

Targeting of the Federal Subsidy

Statutes authorizing special purpose bonds typically carry specific dollar amount authority, either as an exception to the normal volume cap rules or as a targeted amount for tax credit bond issuances. With bond financing, however, it is often difficult to predict the market for the issuance, raising questions as to whether the authorization can and will be utilized for its intended purpose. For example, the New York Liberty Bond provision overestimated demand for private activity bonds as a tool in rebuilding lower Manhattan after September 11th. Accordingly, the full intended Federal subsidy was not delivered. New York Liberty Bonds were seen as a model for delivering relief in the GO Zone Act through authorizations of additional

private activity bond authority. The original New York Liberty Bond authority was carefully targeted to a very small geographic area in lower Manhattan and, for this reason, could be targeted to the economic character of that area. Expanding the concept to such a large and economically diverse area as the Gulf coast region damaged by Hurricane Katrina may raise additional targeting concerns.

The experience with QZABs is also illustrative. While no statistics are available (because QZABs are not subject to the normal information reporting rules), we understand that many States do not use their allocated QZAB tax credit bond authority while others would, if able, use more. Thus, the incentive that was intended to be provided by QZABs appears to have been both over-inclusive (for those States that do not use the full amounts of their allocations) and under-inclusive (for those States that could use more bond authority). In both scenarios, targeting of the Federal subsidy has missed its mark.

Related to the problem of targeting the Federal subsidy is competition between tax-preferred financing and other forms of financing. This problem is exacerbated the further a bond-financed project is from traditional governmental activities. When tax-preferred bonds are used to finance necessary projects that would not be built without a Federal incentive, the justification for the subsidy is apparent. Where projects would have been built even without the subsidy, or where the broader public justification for a project is absent, the Federal incentive can result in a misallocation of capital.

Volume Cap Considerations

In general, the classification system for governmental bonds and private activity bonds effectively targets the use of tax-exempt qualified private activity bonds to specified exempt purposes with extensive program requirements and effectively constrains those bonds with the unified annual State volume cap. One structural weakness of this general classification system is that, under the definition of a private activity bond, a State or local government remains eligible to use governmental bonds in circumstances involving substantial private business use, provided that it secures the bonds predominantly from governmental sources. While political constraints generally deter State and local governments from pledging governmental sources of payment to bonds used for private business use, this is nonetheless a structural weakness of the definition of a private activity bond. A classic example is financing for a stadium in which a professional sports team uses more than 10% of the bond proceeds, but the State or local government is willing to subsidize the project with generally applicable governmental taxes and thus the stadium remains eligible for governmental bond financing.

The unified annual State volume cap on qualified private activity bonds generally has provided a fair, flexible, and effective constraint on the volume of tax-exempt private activity bonds. The unified State volume cap is fair in that it appropriately provides for allocation of bond volume based on population, with some additional accommodation for small States. In addition, the unified State volume cap is flexible in that it accommodates diverse allocations of volume cap within States to different kinds of eligible projects tailored to State and local needs. In general, the unified State volume cap has been an effective way to control private activity bond volume and Federal revenue costs. In this regard, it is important to recall that, in the early 1980s before the enactment of any volume caps, private activity bond volume grew at an unchecked, accelerated pace. Between 1979 and 1985, private activity bond volume grew from about $8.9 billion to $116.4 billion. While the unified State volume cap has been somewhat less of a constraint in the last several years since the volume cap was raised effective in 2002 (from the greater of $50 per resident or $150 million to the greater of $75 per resident or $225 million, with annual inflation adjustments thereafter), the unified State volume cap basically has been effective and is preferable to alternatives.

While the case appropriately can be made for separate volume caps for particular activities (e.g., New York Liberty Bonds) or for Federal involvement in allocations (e.g., the new private qualified highway and surface freight transfer facility bond program), as a general structural and tax policy matter, the private activity bond volume caps work best when imposed within the framework of the unified State volume cap under section 146.

Allocations

Under the general private activity bond volume cap rules, each State is required to allocate volume cap to the projects it deems most worthy of a Federal subsidy. Some recent special purpose bonds diverge from this historical State-based allocation system and require the IRS or other Federal agencies to allocate new bond authority. For example, the IRS has recently allocated the Green Bond national limit

and the Department of Transportation is responsible for allocating the volume cap on the new exempt facility category for highway and surface freight transfer facility projects

Requiring the IRS to make allocations raises a number of concerns. Historically, allocations have been made by the States on the theory that they are in a better position to understand local demands for Federally-subsidized financing. In addition, because allocations have historically been done by the States, there is no mechanism in place for the IRS to perform bond allocations among proposed projects. More significantly, with highly technical provisions such as Green Bonds and CREBs, the IRS is not in the best position to determine how to allocate a Federal subsidy to renewable energy projects or energy-efficient projects. Thus, tax administrators are placed in the difficult position of selecting between qualified applicants, without necessarily having the technical knowledge needed to make informed allocation decisions. While the Treasury Department and IRS do consult regularly with other agencies having technical expertise, coordination can be time-consuming and difficult. For example, tax administrators need to learn the intricacies of energy policy while energy administrators need to learn the nuances of tax-exempt bond law. It is questionable whether this approach represents the most efficient use of limited government resources.

Allocation problems also arise when a special purpose bond provision is over or under-subscribed. If over-subscribed, the Treasury Department and the IRS may have to pick among largely indistinguishable qualified applicants or reduce all allocations pro-rata, which may have consequences for the feasibility of a project. If under-subscribed, unless the volume cap goes unused, the Treasury Department and the IRS may need to reopen the application process for further submissions. Given the limited time frame over which special purpose bonds are generally authorized, additional rounds of applications are often precluded.

Illustrative of other problems that can arise with allocations is the American Jobs Creation Act provision authorizing Green Bonds as a new category of qualified private activity bonds subject to an exception to the normal volume cap rules. In providing an exception to the volume cap, the statute also mandated that at least one qualified applicant from a "rural state" be awarded an allocation of Green Bond authority. The Treasury Department and IRS published a notice specifically soliciting rural State applicants for Green Bonds, but no applications were received.

Administrative Resource Considerations

The Treasury Department and the IRS are increasingly charged with regulatory responsibility for writing rules for allocating and auditing unique special purpose bond issuances. Because these special bond programs are often created as independent programs outside the well-developed structure of tax-exempt bonds rules (including established volume cap rules), they present unique challenges in trying to ensure that the myriad technical rules governing tax-preferred bonds correctly apply. Uncertainty in the application of these rules can lead to delay in implementing guidance (and, in turn, delay in issuing the bonds) and can create uncertainty in the market, limiting the number of investors and the effectiveness of the special purpose bond program.

Special purpose bond provisions require the Treasury Department and the IRS to evaluate whether special rules are needed in order to implement them. Because these provisions have such limited scope and are highly complex, they require a disproportionate allocation of administrative resources. Further, to help issuers comply with interest arbitrage rules, the Treasury Department provides State and local government issuers with the option to purchase non-marketable Treasury securities known as State and Local Government Securities, or "SLGS." Administration of this $200 billion program adds to the cost to the Federal government in facilitating tax-exempt bond financing.

Examination Concerns

Special purpose bond provisions often contain unique rules defining the projects or activities for which their proceeds can be used. For example, with respect to CREBs, qualified projects are linked to the technical eligibility requirements for the renewable energy credit. Failure of a bond issuance to comply with eligibility requirements results in disallowance of the credit to a third-party holder who had nothing to do with operation of the bond-financed facility. The technical nature of many special purpose bond provisions, combined with the absence of historical rules and practices interpreting these provisions, compounds an existing problem for tax-exempt bonds. For tax-exempt bonds generally, the tax consequences of failure to comply fall on the holder, who generally is without the information necessary to determine whether the bonds comply.

Conclusion

The Administration recognizes the important role that tax-preferred bond financing plays in providing a source of financing for critical public infrastructure projects and other significant public purpose activities. The Tax Reform Act of 1986 enacted a number of important provisions such as the volume cap limitation that help to ensure that the Federal subsidy being delivered is properly targeted and used for its intended purpose. Over the past 20 years, a carefully structured set of general statutory and regulatory rules have been developed under the general tax-exempt bond provisions to further this goal. On balance, tax-preferred bond financing works most effectively to target uses to needed public infrastructure projects and other public purpose activities when it is provided for within the existing general framework of the tax-exempt bond rules, rather than within small independent special regimes.

The cost to the Federal government of tax-preferred financing is significant and is growing. Unlike direct appropriations, however, the cost often goes unnoticed because it is not tracked annually through the appropriations process. In addition to the cost to the Federal government that results from providing a tax exemption or credit, there are indirect costs, such as administrative burdens on issuers and the IRS, imposed by the complex rules. These more indirect costs are magnified in the context of special purpose tax-preferred financing.

When considering further expansions of tax-preferred bond financing, it is necessary to ensure that the Federal subsidy is properly targeted and used for its intended purposes, and that the direct and indirect costs of the subsidy are carefully considered.

Figure 1
New Money Long-Term Tax-Exempt Government Bonds, 1991-2003

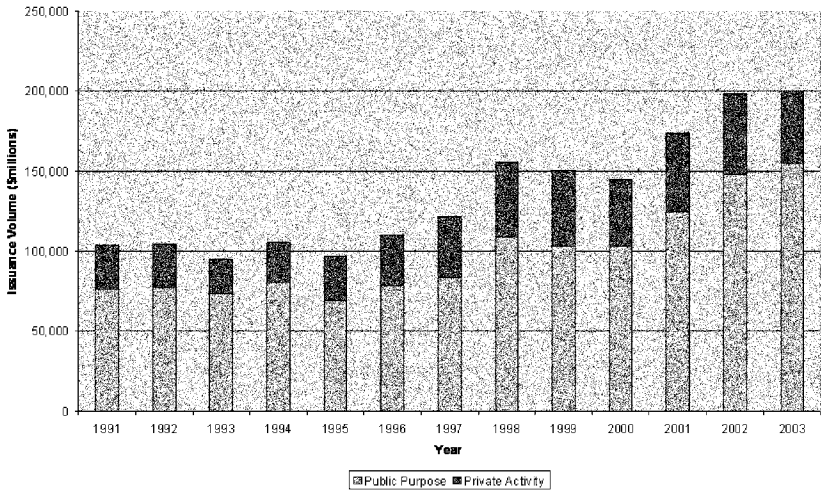
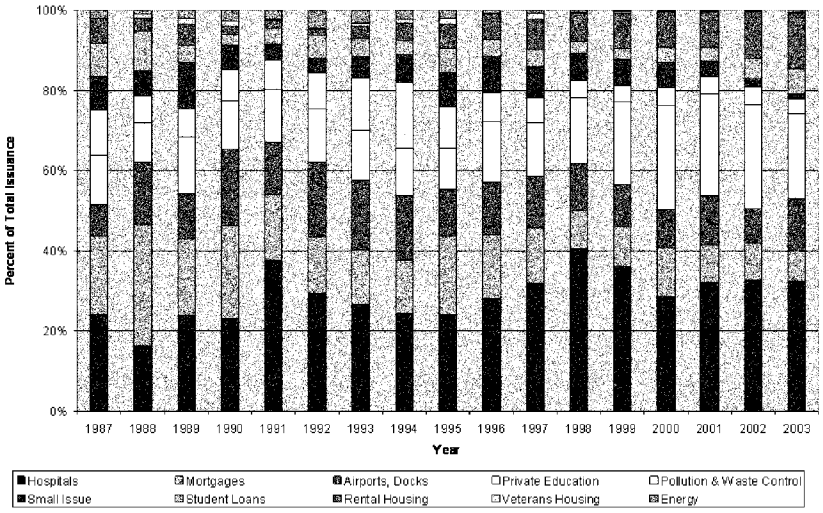
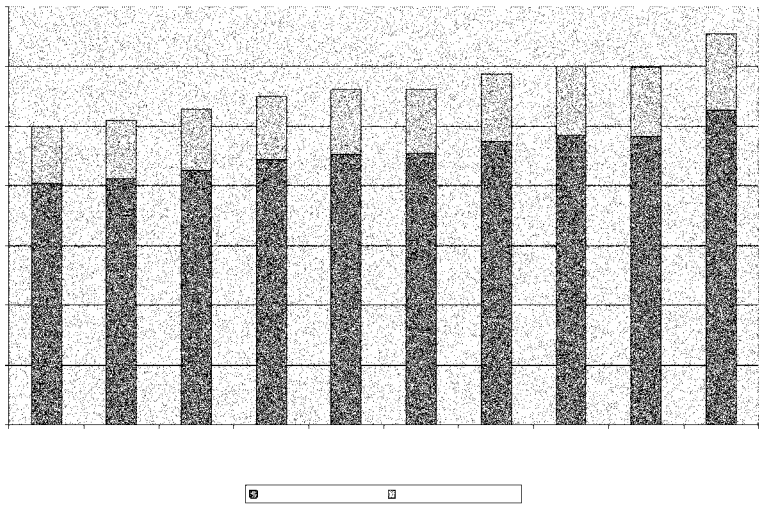
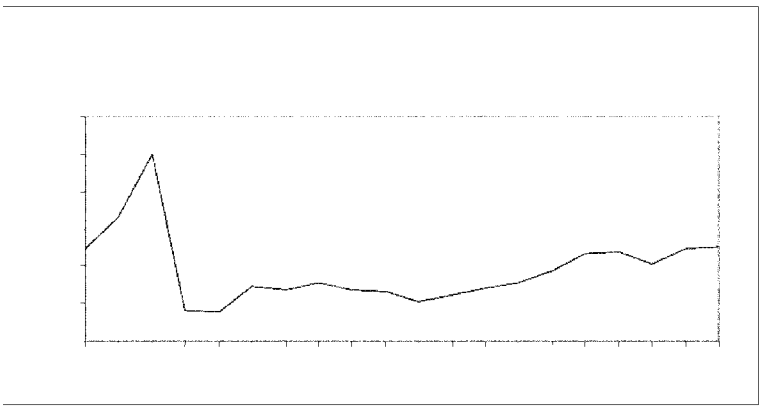


Figure 2: Uses of Private Activity Bonds, 1987-2003







Chairman CAMP. Thank you, Mr. Solomon. I appreciate your testimony very much. Dr. Marron, you may begin. You have 5 minutes.

STATEMENT OF DONALD B. MARRON, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. MARRON. Thank you, Mr. Chairman. It's a pleasure to be here today to address yourself and the Committee and give to give Congressional Budget Office's (CBO) perspective on tax-preferred bond financing. I guess what I'll be presenting is essentially the economist's view of these instruments of financing projects. Just a couple of quick points. First, if you look at traditional tax-exempt bonds, they clearly provide a significant and important subsidy to projects undertaken at the state and local level. Think of them in rough order of magnitude as subsidizing somewhere in the neighborhood of 25 percent of the interest costs on the debt of those projects.

The challenge, from an economist's point of view on those, in particular, is that the cost to the Federal Government and thereby to the taxpayer is larger than the subsidy that is received by the issuers. The reason that happens is the value of the tax-exemption that's provided with the bonds differs across different taxpayers based on the marginal tax rates that they face. That in order to sell a complete issue of municipal bonds, you need to price it in such a way and set the interest rates in such a way that is attractive to people who don't just have the highest margin of tax rates, but that have some of the lower marginal tax rates. As a result, the interest rate that is being set is one that's attractive, say, to someone who might be in the 25 percent marginal tax rate bracket, but some of those bonds will be purchased by people in higher marginal tax rates, and they'll essentially get a windfall from it.

So, if you look at them in the aggregate, what you have is that traditional tax-exempt bonds have a certain inefficiency in them, that the amount of money that the Federal Government and taxpayers are providing as a subsidy, some is going to a windfall to

people with higher marginal tax rates, and only a portion is flowing through to the issuers and helping them finance these projects.

In recent years, a separate and distinct way of providing tax preferences has arisen, the development of tax credit bonds. They work a little bit differently. As Eric hinted, they have a much deeper subsidy per project.

Typically, the tax credit is structured in such a way that it would be approximately 100 percent of the interest on the bond, rather than, say, 25 percent. However, they're structured in such a way that the tax credit is of the same value to essentially all of the investors who might purchase them, assuming they have enough taxable income to use the tax credit. You do not have the effect that exists with traditional tax-exempt debt.

So, on the one hand, tax credit bonds are more efficient, in that they do a better job of each dollar of subsidy that the Federal Government is providing, more of that dollar is getting through to the issuer. On the other hand, they provide a much deeper subsidy for the particular projects that qualify for it.

In my testimony, and some earlier reports that CBO issued, we discussed one implication of that. The proposal has been made by several folks, the one thing you might try to do is design a hybrid tax credit bond in which the size of the tax credit is more comparable to the interest rate subsidy that traditional tax-exempt debt provides, but would be structured as a tax credit in order to eliminate the inefficiency.

That's the financing side. Clearly, another significant issue is the use to which this financing is put, what types of projects are developed, what kinds of projects are financed in this way.

As Eric hinted, one problem arises when the financing is being used for projects that would have happened anyway. So, projects that could have gone to private capital markets, raised the money, and done what they needed to do. In that case, the subsidy that's being provided in this way is a windfall to the issuers of those bonds.

Secondly, there are some projects that wouldn't without this support. For those projects, the issue arises about, are you getting a misallocation of capital? Are you providing, basically, additional financing to help the projects that could not stand on their own in private markets. That could be bad, if that's the end of the story, but that could be justified if those projects provide other social benefits that warrant that subsidy.

One of the real challenges that you and your colleagues face—and that the state and local issuers face—is trying to distinguish between those that have those additional social benefits and are worthy, in essence, of this subsidy, and those that are not. One particular issue to keep in mind, I think, from Congresses' point of view is the extent to which these various projects have benefits that would be national in scope or national in importance, and not just a matter of providing benefits to one local area, at the expense of other local areas.

Wrapping up then, and this is something that Eric would have more expertise on, a third level of concern that arises with these financing mechanisms is the administration of them. In particular, giving the need to try to have roles that target the benefits on cer-

tain areas that provide social benefits. That places a burden on the Treasury and the IRS, in order to make sure that those targets, those desires, are implemented.

That's a challenge, just administratively, for folks to execute. Also, under the current rules, there are limitations in the degree to which they—the IRS in particular—receive information that might be necessary to monitor compliance with the various rules for these financing mechanisms.

So, there may be room for improvements along that front. Then just to wrap up, this entire set of issues raises a larger question of when you want to support projects through the Tax Code, and when it might make sense to do them by something through on the spending side. With that, I look forward to your questions.

[The prepared statement of Dr. Marron follows:]

Statement of Donald Marron, Ph.D., Acting Director, Congressional Budget Office

Mr. Chairman and Members of the Subcommittee, I am grateful for the opportunity to appear before you to talk about the economic effects of financing both public projects and private activities with tax-preferred bonds.

In today's testimony, I will discuss the following four points:

- The traditional form of tax-preferred financing—exempting from federal taxation the interest income earned on state and local bonds—is not a cost-effective means of transferring resources from the federal government to state and local governments. Because of the progressive structure of the federal income tax system, the revenue loss that the federal government incurs from tax-exempt bonds exceeds the debt-service savings that accrue to states and localities. More-direct means of transferring resources—for instance, through appropriations—could deliver equal or even greater amounts of aid to the states at a reduced cost to the federal government.
- Tax-credit bonds—a relatively new development in tax-preferred financing—pay a larger share of state and local governments' borrowing costs than do tax-exempt bonds. However, tax-credit bonds could be structured to pay the same share as tax-exempt bonds at less cost to the federal government.
- The expansion of tax-preferred financing to private activities raises additional concerns. State and local governments are permitted, within limits, to use tax-exempt financing to support a variety of activities, including aid to local businesses, the financing of housing, and even the construction of sports arenas. Subsidizing such endeavors, however, runs the risk of funding investments that would be made anyway and of displacing more-productive investments with less-productive investments, thereby reducing the value of overall economic production. A key question is whether subsidized investments provide social benefits to the nation as a whole or just to local areas.
- The tax-administration system is poorly equipped to monitor compliance with the various targeting rules that the Congress has adopted to achieve social objectives. That ability could be enhanced if the Internal Revenue Service (IRS) could make greater use of the information gathered by the issuers of state and local bonds. However, a larger question would still remain: whether it is appropriate or desirable to pursue certain societal objectives through the tax code.

Tax-Exempt State and Local Public-Purpose Debt

Traditionally, the interest income earned on debt issued by state and local governments has been exempt from federal income taxation. That exemption lowers the interest rate that state and local governments must pay on their debt and encourages investment in public facilities. Purchasers of tax-exempt bonds are willing to accept a lower rate of interest than they could receive on taxable bonds because they are compensated for that difference with lower tax payments.

The exemption, which has existed since the inception of the income tax in 1913, had its origins in the belief that such income was constitutionally protected from

federal taxation. Although the Supreme Court rejected that argument in 1988 in *South Carolina v. Baker,* the exemption has continued.[1]

The federal government imposes some limits on the amount of such debt that is issued. For example, a government could profit by borrowing at low tax-exempt rates and then investing in taxable bonds. Anti-arbitrage rules contained in the tax code regulate and limit such opportunities. Additional limits are imposed by state and local governments themselves and by the bond markets when questions of creditworthiness result in higher borrowing rates.

In 2005, the outstanding stock of tax-exempt state and local public-purpose debt equaled about $1.3 trillion. According to the Joint Committee on Taxation (JCT), the revenue loss associated with the exemption in fiscal year 2006 amounted to about $27 billion.

As alluded to previously, tax-exempt financing is not a cost-effective mechanism for encouraging the formation of public capital. Because of the progressive rate structure of the U.S. income tax system, taxpayers with lower marginal tax rates receive lower tax savings from the exemption than do taxpayers with higher marginal tax rates. When an issuer must sell bonds to purchasers with lower marginal tax rates, the issuer must set a higher interest rate on the bond issue to compensate those purchasers for their lower tax benefits. As a result, bond purchasers with higher marginal tax rates receive an interest rate greater than they require to induce them to buy the bonds. That windfall gain causes the federal government's revenue loss to exceed the reduction in state and local borrowing costs, perhaps by as much as 20 percent.[2] That excess tax benefit is received by bond purchasers with higher marginal tax rates.

In principle, it may be possible to deliver a higher amount of fiscal aid to state and local governments at a lower cost to the federal government if such aid is delivered as an outlay instead of as a tax preference. Such a mechanism, the taxable bond option (TBO), in which the federal government would pay a specified share of state and local borrowing costs, was reported favorably by the House Committee on Ways and Means in 1969 and 1976, and proposed by the Carter Administration in 1978. State and local governments prefer the tax exemption because it is available for any amount of borrowing they choose to undertake, making it operate more like an entitlement. By contrast, a TBO would be an outlay and subject to an annual appropriation process, which would impose a limit on its availability.

Tax-Credit Bonds

Tax-credit bonds are a new tax-preferred bond option. They are available as Qualified Zone Academy Bonds, adopted in 1997; Clean Renewable Energy Bonds, adopted in 2005; and Gulf Tax Credit Bonds, recently authorized as part of the Gulf Opportunity Zone Act of 2005. A number of other applications have been proposed, almost all of which are for activities that would have been eligible for tax-exempt financing.

Current tax-credit bond programs provide more-generous subsidies than do tax-exempt bonds. The purchaser of a tax-credit bond receives a taxable tax credit set by the Treasury that yields tax savings equivalent to the interest that would have been earned on a taxable bond. For example, if the taxable-bond interest rate was 7 percent, the bond purchaser would receive a taxable tax credit every year from the Treasury Department equal to 7 percent of the face value of his or her bond holdings. In essence, the federal government pays 100 percent of the financing costs on the bond issue through the tax system. By contrast, a tax-exempt bond pays only about 25 percent of borrowing costs. Nonetheless, the tax-credit bond is more cost-effective than the tax-exempt bond—every dollar of revenue loss is used to reduce state and local borrowing costs.

A variation on the tax-credit bond could be used as a cost-effective alternative to tax-exempt financing. Bond purchasers would receive two payments: taxable interest income equal to their current tax-exempt interest income, and a taxable federal tax credit equal in value to the tax benefits that a tax-exempt bond would have provided to the purchaser with the lowest marginal tax rate. Since the credit rate would be the same for all bondholders regardless of their tax bracket, there would

[1] 485 U.S. 505.

[2] The revenue loss and interest savings are determined, respectively, by the average marginal tax rate (estimated to be about 30 percent) and the lowest marginal tax rate (about 25 percent) of bond purchasers. If the taxable interest rate is 7 percent, for instance, the federal government loses $1.20 of tax revenue for every $1.00 reduction in state and local borrowing costs.

be no windfall gain to taxpayers and the full revenue loss to the federal government would be received as a subsidy by state and local governments.[3]

Private-Purpose Tax-Exempt Bonds

Prior to 1968, the Congress imposed few restrictions on the type of capital facilities that state and local governments could finance with tax-exempt bonds. Over time, state and local officials began to use such funding to finance more than just public capital investment. In essence, they began to perform commercial banking functions, relending borrowed funds to private entities for various purposes. As a result, the share of bonds used to finance business investments and loans to individuals grew. The Congress responded by imposing limits on the issuance of bonds for those "private activities"—restrictions that have gradually been relaxed since 1986.

Currently, the outstanding stock of private-purpose tax-exempt debt totals about $315 billion. According to the JCT, the revenue loss associated with the exemption—including state and local funding for housing (rental and owner-occupied), student loans, industrial development, transportation, nonprofit institutions, energy, and waste disposal—amounts to about $6 billion for fiscal year 2006. The Congress set the ceiling on the annual volume of private-activity bonds to rise gradually to a maximum of $75 per state resident in 2007. In addition, the Gulf Opportunity Zone Act of 2005 provided for increases in that ceiling for the areas affected by Hurricanes Katrina and Rita.

The expansion of tax-exempt financing to private activities raises additional concerns besides excess lost revenue. Private-activity bonds subsidize some investments that would be made without the subsidy—in effect, transferring resources to private investors. Private-activity bonds also distort the allocation of capital investment and thereby reduce the nation's economic output. They do so by subsidizing investments that would otherwise not be made, channeling scarce private savings into investments that have a relatively low rate of return.

Companies will not undertake investment projects unless they expect a return that is at least equal to the next best alternative use of their funds. If they can obtain bond financing at a lower rate, the profits (net of tax) that may accrue to the owners are increased. Thus, if they have a choice between two investments, one that can be financed with tax-exempt bonds and one that cannot, the one with tax-exempt funding does not have to be as profitable or productive. Because the tax-exempt subsidy does not increase the supply of funds in capital markets, investment in the economy may flow from activities that yield a higher private return to those that yield a lower return. As a result, the value of total economic output may decline unless the tax-subsidized activity has sufficient social or public value to compensate for the lower private return. Given financial returns in today's economy, a manufacturing firm that invests in a project made profitable by substituting a small-issue industrial-development tax-exempt bond for taxable bond financing might impose annual costs on the economy that average more than $22 per $1,000 bond.[4]

Most social benefits can be measured qualitatively, at best, so making judgments about whether such subsidies are worthwhile is difficult. Restrictions on private-activity bonds were implemented as a means to control the loss of federal revenue and national income from private projects lacking social benefits.

When considering limiting the scope of private-activity bonds, it is important to distinguish between local and national social returns. For example, bonds issued for a nonprofit hospital may have a presumption of providing social benefits to the community that can arguably be said to extend to the nation, such as contributions to the control of communicable disease and basic research in teaching hospitals. But some activities that are financed with tax-exempt bonds may lack such presumptions. That is particularly true when benefits are strictly local rather than accruing to a broader population.

For example, small-issue industrial-development bonds are used to finance investments by manufacturing companies. Since no presumption exists that those companies are providing goods that are materially different from other unsubsidized manufacturing competitors, nationwide social benefits of a conventional nature are unlikely. State and local officials' desire to subsidize those investments is based on their belief that the investments are effective tools to stimulate local economic development. However, the success of the bonds in achieving that goal is not necessarily beneficial to federal taxpayers. The subsidy might make the community

[3] The substitution of tax-credit bonds for tax-exempt bonds is discussed more completely in Congressional Budget Office, *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures* (July 2004).

[4] The annual loss of tax revenue would be more than $19 per $1,000 bond, and the reduction in national income might average slightly more than $3.

where the subsidized firm is located better off than it otherwise would have been, but other communities may be made worse off. Federal taxpayers as a whole would not necessarily gain. In effect, the social benefits may not be adequate to offset the loss of national income and the reduction of the federal tax base, unless federal taxpayers' objective is to reallocate investment within the United States.

Trying to restrict the use of tax-exempt borrowing authority for private activities may not prove successful in all instances, however. Even with limits on or elimination of tax-exempt private-activity financing, states and localities may find ways to continue funding those activities through their regular public-purpose bond issues. For example, the Congress prohibited the issuance of private-activity bonds for professional sports stadiums in 1986. Yet some communities consider the funding of those stadiums to be so important that they are willing to finance them with general-obligation debt, pledging their taxing power as security for the bonds. Because one community's successful acquisition of a franchise comes at the expense of all remaining communities without a franchise, the federal tax dollars provide no benefits to federal taxpayers as a whole. Similarly, states and localities can circumvent the limits on financing private activities by undertaking the activities themselves in partnership with private firms.

Administering Public Policy Through the Tax System

From an administrative perspective, much of the complexity in tax law that relates to tax-preferred financing stems from the use of that funding for private activities. The Congress limits the issuance of tax-preferred bonds by restricting ("targeting") private use to those selected activities and users that are enumerated in sections 141 to 150 of the Internal Revenue Code. For example, the issuance of mortgage revenue bonds and rental housing bonds requires that numerous provisions relating to income eligibility and housing prices be satisfied. Similarly, rules governing the issuance of small-issue industrial-development bonds require that the use of such bonds be restricted to companies with limited amounts of capital investment. Virtually every type of private-activity bond has similarly detailed targeting criteria.

Private legal counsel must certify that a bond issue complies with federal tax law. After issuance, most monitoring of a bond issue's tax-law compliance takes place at the state and local level. The extent of monitoring among state agencies that issue mortgage revenue bonds, hospital bonds, higher education bonds, small-issue industrial-development bonds, and so on, varies widely. No requirement exists for bond issuers or their support organizations to report on their compliance with targeting rules, and state and local information is not shared systematically with the IRS.

As a result, the extent to which compliance with federal eligibility rules is maintained over the life of a bond is unknown. For example, mobility and the changing income characteristics of tenants may render a rental housing project ineligible for continued use of multifamily rental housing bonds. Recipients of mortgages financed with owner-occupied housing bonds may sell the house at a time that triggers a requirement to repay the subsidy. And manufacturing companies that use small-issue industrial-development bonds may be acquired by firms whose capital-acquisition history makes them ineligible to use such bonds. Many other requirements could be cited.

To determine whether compliance problems exist, the IRS has established a program to sample bond issues for a particular private activity. The program is not comprehensive, however. Compliance could be enhanced if state and local organizations were required to monitor compliance and report their findings to the IRS.

The discussion of administrative difficulties associated with private-activity bonds raises a larger question, one that applies to tax preferences in general. It is not always clear from the perspective of public administration that the tax system is the best way to pursue certain social objectives. For some objectives—such as those that are means-tested—the tax system may lend itself to fulfilling social goals because of the information it compiles on taxpayers' income status. But in general, a bureaucratic apparatus designed to collect revenue may be poorly suited to administer what are essentially spending programs.

There are two reasons for that. First, the administration of social programs may serve to divert the attention of tax administration from its principal purpose. Goals as divergent as collecting revenue and regulating state and local support of certain private activities may be difficult to pursue simultaneously.

Second, many government programs are subject to periodic review and evaluation to determine how well they achieve their objectives and whether their benefits exceed their costs. That effort requires coordination within the executive branch to provide economic analysis and performance evaluation and provides a basis for regular Congressional oversight. Such efforts may be more effectively undertaken in

the context of similar programs and by agencies with specific programmatic missions.

Chairman CAMP. Thank you very much, Dr. Marron, and I do have a couple of questions. Mr. Solomon, there obviously has been over recent years, an increase in the categories of bonds that are allocated at the Federal level. Does the Treasury feel that they have adequate guidance, both statutory and the resources and expertise, to make the kinds of allocations that are headed your way in legislation?

Mr. SOLOMON. It does preset a challenge to the Treasury Department and the IRS to deal with the many new kinds of bonds. In the recent years, there have been an increase in the number of bonds. I have made a list. For example, in 2001, Educational Facilities, 2002, Liberty Bonds, 2004, Green Bonds, 2005, Gulf Opportunity Zone Bonds. It does present a challenge for the Treasury Department and the IRS in allocating its resources to provide guidance—and to provide guidance quickly -with respect to the new kinds of bonds, particularly when they have different rules.

That is to say, there is a general framework with respect to tax-exempt bonds, and there are general rules, for example, the arbitrage and the allocation rules. In some of the new bond issuances they have special rules. That is to say, they may be outside the volume cap and they may have other exceptions. So, it does present challenges to the Treasury Department and the IRS to quickly provide guidance to get these programs up and running. So, yes, it can present administrative problems. It can present challenges, particularly where it involves specialized areas that need technical expertise.

Chairman CAMP. Mr. Solomon, some of the recent bonds that qualified, the Qualified Zone Academy Bonds (QZABs), Clean Renewable Energy Bonds, and the Gulf Tax Credit Bonds, they're not subject to the arbitrage or rebate requirements of the Code. Does this inconsistent treatment impact the Treasury Department's ability to administer the rules applicable to tax-preferred bond financing?

Mr. SOLOMON. Having a proliferation of many different rules presents challenges.

One of the values of having a single framework, a single set of rules to deal with all the different kinds of bonds is that it helps target the bonds, more effectively. So, not only an administrative, but there's a policy question presented there. When you have many different rules to different kinds of bonds, it may affect targeting. Having one set of rules helps the subsidy to be targeted more efficiently.

So, yes, having different arbitrage rules, for one set of bonds than in others can present issues and it probably is better to have a single set of rules, a single framework to apply to all kinds of bonds.

Chairman CAMP. The bonds that I referred to earlier, there are different credit rates for those bonds and The Treasury Department sets those. Are there any concerns raised by that?

Mr. SOLOMON. Yes. You're referring to the tax-credit bond.

Chairman CAMP. Yes.

Mr. SOLOMON. With respect to tax credit bond, the Treasury Department is directed to set the credit rate. In fact the Treasury Department is directed to set the credit rate without discount, which imposes a challenge for the Treasury Department, because the Treasury Department has to pick a rate where there will be no discount. The Treasury, in picking its rate, does not take into account issuer-specific factors. For example, credit quality, industry sectors, frequency of pricing.

Therefore, it really is very difficult to set credit rates in a way that there will end up being no discount. In fact, it's our understanding for QZABs—which are a type of tax credit bond—which has a statutory requirement that the rate be set, that they sell without a discount. In that case we are told that nevertheless, they are selling at a discount.

Chairman CAMP. Dr. Marron, obviously we've seen over the last 20 years an expansion in the use of tax-preferred bond financing, to increases in the amount of private activity bonds that states can issue. Also the addition of activities that qualify for preferred financing. Has that expansion had an overall effect on the economy?

Dr. MARRON. As Eric and I indicated in our testimony, a principal concern with providing tax-exemption to private activities is concern about misallocation of capital. To the extent that this type of financing becomes available to more projects, you run a higher risk of projects occurring that, again, wouldn't be able to stand on their own in a private market, and can only survive because they get this assistance.

It is difficult to see that in the overall macroeconomic data. We have an enormous economy even with a trillion plus or minus in total tax-exempt debt, and 300 billion of these kinds of bonds out there. It's hard to see an overall effect on our enormous economy, but there's certainly the possibility that there is some misallocation of capital, and that therefore output is somewhat lower than it otherwise could be.

Chairman CAMP. Well, I was thinking particularly of the public benefit to some of these bonds, and other Members have referred to that. So, they may not have been decisions that were made in the private sector. What about the overall public benefit to some of these projects?

Dr. MARRON. Well, unfortunately, I have not seen anything that would be a systematic look at the public benefits that flow from these. I was talking to folks at CBO about this earlier, and this falls in the category of areas that are probably understudied in the community that does those sorts of things. There isn't really a clean answer to whether the public benefits that have been claimed are actually being provided.

Chairman CAMP. In your testimony, it may be suggested that there may be areas where direct appropriation may be preferable or more cost efficient. Do you think we can make modifications that can improve the efficiency of tax-exempt bonds and tax credit bonds?

Dr. MARRON. Certainly. As I hinted in my testimony—certainly with traditional tax-exempt bonds—there is an issue of this inefficiency that I mentioned. In essence, that the amount of the money

that the taxpayer and the Federal Government are giving up in order to provide this support is larger than the amount that's received by issuers. To the extent that it's possible to move in the direction of making the tax benefits look more like the tax credits, which don't have that inefficiency, there may be an opportunity—essentially you can have a win-win in the sense of delivering the support in a more cost effective and less expensive manner.

Chairman CAMP. All right. Well, I want to thank you both for your testimony. Thank you for your patience. I don't know if there's anything you want to add at the end, to sum up, but I appreciated your waiting through all that delay and the series of votes that we had. Thank you for your excellent testimony, both of you. You're welcome to make any closing comments that you wish.

Dr. MARRON. I just want to go back to the question that you asked Eric earlier, about to what extent it's important to have a single set of rules or a finite set of rules. I think it's important administratively, and as the economist, I'd also want to point out I think that's very helpful for the capital markets. To the extent that capital markets can begin to have a sense that there's a large stock of bonds that operate under simpler operating rules, it becomes easier to have a deeper market. It's easier for the markets to understand and price those.

Chairman CAMP. Okay. Thank you, Mr. Solomon, thank you, Dr. Marron. That concludes panel number two. We'll now move to panel number three. I will introduce to the Subcommittee Carla Sledge, who is President of the Government Finance Officers' Association, Walter St. Onge, III, President of the National Association of Bond Lawyers, and Micah Green, President and Chief Executive Officer of the Bond Market Association. We'll start with Carla Sledge. Ms. Sledge, welcome. It's always good to see a person from Michigan here. Everyone will have 5 minutes to summarize their testimony, and then we'll have some questions afterward. You may begin, and your full statement will be made part of the record, of course.

STATEMENT OF CARLA SLEDGE, PRESIDENT, GOVERNMENT FINANCE OFFICERS ASSOCIATION AND CHIEF FINANCIAL OFFICER, WAYNE COUNTY, MI

Ms. SLEDGE. Thank you and I bring greetings from Michigan. Chairman Camp, my name is Carla Sledge, and I am the President of Government Finance Office Association, (GFOA) and also the Chief Financial Officer of Wayne County, Michigan.

The GFOA is a professional association of over 16,000 plus state and local finance officers, and has served the public finance profession since 1906. Wayne County is the 11th largest county in the United States, with a budget of about 2.2 billion. I certainly appreciate the opportunity to speak before you and this Subcommittee today on the important matter of municipal bonds. This is a subject matter that is vital to state and local governments across the United States, and this statement reflects the policy statements of the GFOA as they relate to the tax-exempt bond market.

Borrowing through access to the tax-exempt bond market is the primary way in which states, cities, counties, towns, and other governmental entities fund capital improvements to provide utilities,

housing, roads and bridges, airports, health care, education, and other public services to the citizens.

Every one of us, at almost every turn, relies upon the infrastructure provided by the financing of projects through tax-exempt bonds. The ability to sell debt with interest exempt from Federal income tax has been a significant benefit to state and local governments, directly reducing the tax burden that citizens would otherwise have to shoulder to finance essential public services.

The importance of allowing state and local decisionmakers, and the public at large, to evaluate what is needed within their own communities cannot be emphasized enough. Decisions to improve communities and build infrastructure should be done from the ground up rather than the top, in order to best serve the needs of citizens. Any attempt to curtail this essential tenant of state and local government operations should be abandoned.

Let me just give you some examples of infrastructure paid for by bonds in my own backyard. In 1992, 33.6 million limited tax general obligation bonds were issued for a medical examiner facility that was built in 1996. This award winning state of the art facility is approximately 48,000 square feet.

Over a billion dollars in bonds were sold in 1998 for the Wayne County Metropolitan Airport, which serves the Greater Detroit Area. This project included construction of a new Midfield passenger terminal, renovation of an existing terminal, and construction of a fourth parallel runway.

Finally, between 1994 and 2004, over 300 million in bonds were issued for sewer improvement projects in our 32 downriver communities. Of the 13 plus issues of debt in 2005, 85 percent of those governments represent small and midsize communities.

Without efficient economic incentives to access the market, governments would have to pay substantially more in interest rate costs, which could limit the scope of the projects, or deter projects from being done in the first place.

The need for thousands of governments to access the bond market with even more hurdles than already in place would cause grave disruption to the operations and the 2.7 trillion dollar bond market.

Changes in inter-government relations over the past several years has caused the financing needs of state and local governments to increase not decrease. This is shown by the reductions or elimination of various Federal assistance, including grants and general revenue sharing, and an increase in Federal mandates.

In 1999, the Congressional Budget Office issued a study which concluded that total Federal spending on infrastructure dropped from a little over 1 percent of Gross National Produce in 1977, to about.57 percent in 1998.

Total Federal spending for infrastructure also declined as a percentage of total Federal spending during the same period, from 5.1 percent to 2.84 percent. Since most of the cost of building and renovating the Nation's public infrastructure is, and will be, borne by state and local governments, continued use of tax-exempt financing will be vital if they are to meet these needs in an efficient and economic matter.

We believe that to foster long-term growth in The United States economy, Federal, state, and local governments must act in concert rather than at odds with each other. The 1986 Tax Reform Act and other tax legislation that has moved forward over the past 20 years has imposed greater restrictions on state and local governments who issue municipal bonds.

The consequences have caused less flexibility and greater administrative and issuance cost to governments who need to fulfill their responsibilities to provide necessary public services and to meet Federal standards and mandates without additional funds from the Federal Government.

In order to help a vast majority of state and local governments, we have submitted tax simplification proposals that include the need for additional refunding of debt, changes in arbitrage rebate restrictions, repeal of the Alternative Minimum Tax (AMT) on tax-exempt interest, eliminating restrictions on bank interest deductions, and finally expanding the ability for governments to enter into public-private partnerships.

For almost 200 years, state and local governments have been able to access the capital markets by issuing bonds to fund their jurisdiction's public purpose infrastructure. The system has worked well for all parties involved, especially state and local governments.

The authority to issue tax-exempt bonds allow state and local governments to determine the project needs of their jurisdictions and pay for them through the issuance of bonds without undue Federal Government interference. Without the ability to access the low cost, tax-exempt, bond market, communities across the United States would suffer, and greater demands would be placed on the Federal Government to provide additional direct funding to state and local governments. I thank you once again for this opportunity to present this testimony.

[The prepared statement of Ms. Sledge follows:]

Statement of Carla Sledge, President, Government Finance Officers Association

Introduction

Chairman Camp and Ranking Member McNulty, my name is Carla Sledge and I am the President of the Government Finance Officers Association and the Chief Financial Officer of Wayne County, Michigan. I appreciate the opportunity to speak before you and this Subcommittee today on the important matter of municipal bonds. This is a subject matter that is vital to state and local governments across the United States, and this statement reflects the policy statements of the GFOA as they relate to the tax-exempt bond market.

The Government Finance Officers Association (GFOA) is a professional association of state and local finance officers, and we are very proud to be celebrating our 100th year in 2006. Approximately 16,400 GFOA members are dedicated to the sound management of government financial resources. Our members are state and local government finance officials that have many responsibilities, including—the issuance of tax-exempt bonds to finance public infrastructure; preparing operating and capital budgets; managing public funds; and the financial management of cities, counties, states and special districts including school districts.

Purpose and Importance of Tax-Exempt Bonds

Tax-exempt bonds provide local and state governments access to the capital markets and the ability to fund projects based on decisions made at the level of government closest to citizens. The importance of allowing state and local decision makers, and their constituents, to make decisions about the infrastructure needs in their own communities can not be emphasized enough. Decisions to improve communities

and build infrastructure should be done from the ground up, rather than the top down in order to best serve the needs of citizens.

Borrowing through access to the tax-exempt bond market is the primary way in which states, cities, counties, towns and other governmental entities fund the capital improvements to provide utilities, roads and bridges, airports, health care, education, housing and other public services. Every one of us at almost every turn, relies upon the infrastructure that is provided by the financing of projects through tax-exempt bonds. The ability to sell debt with interest exempt from federal income tax has been a significant benefit to state and local governments, directly reducing the tax burden that citizens would otherwise have to shoulder to finance essential public services.

State and local debt financing has been in existence since the early 1800's, allowing states and then cities to finance infrastructure that was and still is essential to communities and the economic well-being of the United States. Two of the earliest projects funded by bonds are the Erie Canal and creating rail systems in the states, which promoted great economic prosperity for the United States.

Some specific examples of infrastructure paid by bonds today include:

Wayne County, MI

In 1992, $33.6 million limited tax general obligation bonds were issued for a medical examiner facility that was built in 1996. This award winning, state of the art facility is approximately 48,000 square feet.

Over $1 billion of bonds were issued in 1998 for the Wayne County Metropolitan Airport, which serves the greater Detroit area. This project included construction of a new midfield passenger terminal, renovation of an existing terminal, and construction of a fourth parallel runway.

Between 1994 and 2004, over $300 million of bonds were issued for sewer improvement projects in 32 Downriver communities.

Hanover County, VA

The Kersey Creek Elementary School that will open in September was built with $20 million of bonds that assisted the county in meeting the federally mandated No Child Left Behind Act. Additionally, last year voters approved with an overwhelming majority (79%) a $95 million bond referendum that will be used for projects over the next five years including: public safety/interoperability infrastructure so that Hanover County fire and police officers can share the same frequency with the City of Richmond and Henrico County; a new Mechanicsville library; three new fire stations in Ashland, Farrington and Black Creek; and a trades-based learning center.

Newington, CT

In 2005, $7.5 million in bonds were issued to expand the Newington Police Station and over the past couple of years, $24 million of bonds were issued to implement improvements to many Newington Public Schools.

Montgomery County, MD

Over $20 million on bonds were issued by Montgomery County that will be used for a Community Recreation Center in North Potomac, Maryland. This center will contain a gymnasium, exercise room, social hall, senior/community lounge, conference room, and an extensive outdoor recreation area. The community recreation center facility will serve the needs of over 30,000 residents where currently no community center exists.

To serve the needs of eastern and northern areas of Germantown, MD, nearly $10 million of bonds have been issued to complete a new Class I fire/rescue station.

For a Civic Building in Silver Spring, MD, the county has issued $8.5 million of bonds to construct a building that will serve as a focal point for County services and community events. This is part of a multi-project effort by Montgomery County to support the redevelopment of the Silver Spring Business District.

Changes in intergovernmental relations over the past several years have caused the financing needs of state and local governments to increase not decrease. This is shown by the reductions or elimination of various federal assistance programs including grants and general revenue sharing, and an increase in federal mandates. In 1999, the Congressional Budget Office released a study which concluded that total federal spending on infrastructure dropped from 1.06% of GNP in 1977 to.57% in 1998 (*Trends in Infrastructure Spending,* CBO, May, 1999). Total federal spending for infrastructure also declined as a percentage of total federal spending during the same period from 5.1% to 2.84%. Since much of the cost of building and renovating the nation's public infrastructure is and will be borne by state and local gov-

ernments, continued use of tax-exempt financing will be vital if they are to meet these needs in an efficient and economic manner.

Of the 13,000-plus issuers of debt in 2005, 85% of the governments represent small and mid-sized communities where the average amount of debt issued was $9.5 million. Without efficient and economic incentives to access the market, governments would have to pay substantially more in interest rate costs, which could limit the scope of the projects, or deter projects from being done in the first place. The need for thousands of governments to access the bond market with additional hurdles beyond those already in place, would cause grave disruption to their operations and the $2.7 trillion bond market.

Need for Simplification

The Tax Reform Act of 1986 ("The Act") affected the ability of states and local governments to finance public capital investment with tax-exempt municipal bonds. The Act had major consequences limiting the purposes for which tax-exempt debt could be issued, the procedures to be followed, and the ultimate value of such investments to investors.

Congressional actions resulted in the enactment of far-reaching proposals that have imposed restrictions that burden state and local governments in their traditional government financings. The consequence has been less flexibility and greater administrative and issuance costs to governments who need to fulfill their responsibilities to the public and to meet federal standards and mandates without additional funds from the federal government.

We believe that to foster long-term growth in the United States economy, federal, state and local governments must act in concert—rather than at odds with each other. The 1986 Act and other regulations operate to prevent abuses in the bond market, but they have gone too far, thus increasing bond issuance costs and forcing many governments to hire more finance professionals in order to ensure compliance with current laws. Thus, simplification measures are needed rather than additional limitations on tax-exempt bonds. Simplification of the tax-exempt bond provisions in the Internal Revenue Code would help increase flexibility and reduce costs for state and local governments—and taxpayers—and expand the positive characteristics of the tax-exempt bond market for the future.

Specifically, we would encourage members of the Subcommittee, and Congress at large to look at the following proposals when addressing tax-exempt bond issues in future legislation:

Arbitrage Rebate

There is no greater burden to issuers of tax-exempt debt than complying with federal arbitrage rebate rules. This is true both for smaller, less frequent issuers of public debt who often do not have the staff to comply with the rebate requirement and more regular issuers of debt who find themselves bearing enormous administrative costs in complying with the rebate rules as they apply to multiple bond issues. Moreover, these compliance costs are disproportionate to the potential arbitrage benefit involved.

Unused monies from proceeds of tax-exempt bonds are generally invested until they are needed and, if invested at rates higher than the borrower's rate of interest, they generate "excess" investment income. The differential is known as "arbitrage." Under the arbitrage rebate requirement that has been in place since 1986, arbitrage must be rebated to the federal government. While some relief was provided in 1989, arbitrage compliance remains one of the largest administrative and costly burdens that governments face. Additionally current law, last updated in 1989, dictates various spending requirements for bonds, including the need for 100% of available bond proceeds to be spent in a 24 month period for construction bonds. This is a short time frame for many projects to be completed, and many governments run into problems in order to comply with this stringent regulation.

A special hardship is for small issuers of debt. Eight-five percent of debt issuers in 2005 contributed to only 15% of the entire volume of bonds sold. Since 1986, the small issuer exception has been in place that allows governments who issue less than $5 million of debt annually to not adhere to arbitrage compliance. The $5 million limit set in 1986 is equivalent to $9,046.00 today (according to the Bureau of Labor Statistics). Although the amount has doubled in twenty years, there has been no willingness to increase the small issuer exception amount, nor index it to inflation. Increasing the amount will help a vast majority of small issuers, without affecting 85% of the bond market volume.

Two areas in particular require remedy. First, the amount of annual debt exempted from arbitrage rebate restrictions should be raised from $5 million to $25 million. This will help a vast majority of issuers from adhering

to needless and costly requirements. Second, the spend-down exception should be extended from two years to three.

Advance Refunding

In order to provide state and local governments with the tools and flexibility to face changing circumstances, they need the ability to refund their debt and reduce borrowing costs so that more financial resources are available. Issuers currently have only one opportunity to take advantage of favorable market conditions and achieve lower borrowing costs, before the original bonds mature or are callable. Somewhat similar to homeowners being able to refinance their mortgage to take advantage of lower mortgage payments, the same opportunities should be available to state and local governmental entities.

Following the 9/11 attacks as well as the Katrina aftermath, Congress wisely allowed for outstanding bonds in these areas to take advantage of an additional advance refunding. This helped governments lower their debt service payments so that they would have funds available for other necessities. In the case of the Gulf Coast region, this helped bonds to be restructured so that governments could extend debt service payments in order to keep their credit intact while not suffering from an inability to pay their obligations.

We ask that Congress provide a second advance refunding for all current and future tax-exempt bonds issues.

Bank Deductibility

Prior to the 1986 Act, commercial banks were the largest investor in tax-exempt bonds. Pre-1986 law permitted banks to deduct all or portions of the interest costs they incurred to invest in municipal bonds. The 1986 Act placed a severe limit on the amount banks could deduct—80% of the costs of purchasing and carrying bonds of issuers that do not issue more than $10 million of bonds annually. The result has taken away a major purchasing sector of tax-exempt bonds, which in effect hurts many governments.

The bank deductibility limitation harms many small governments that have regular capital needs higher than $10 million. Governments often defer needed projects until a subsequent calendar year in order to comply with the $10 million limit in any one-year. Additionally, in the face of rising compliance costs that did not exist when the $10 million limit was set, bank eligible financing would be an attractive and vastly more efficient vehicle for these smaller entities to finance their projects, but unfortunately current law deters them from doing so. Additionally, indexed to inflation, the $10 million amount set in 1986 equals nearly $18 million today.

We strongly recommend that the bank deductibility limit be raised from $10 million to $25 million and indexed for inflation thereafter.

Alternative Minimum Tax

As the AMT is capturing more individuals and businesses than ever imagined at its conception over 30 years ago, there have been unintended consequence placed on the tax-exempt bond market. Some bonds have AMT exposure, and thus the market demands a higher yield for these bonds.

Due to changes in the 1986 Act, many bonds for public purposes must be issued as private activity bonds. Governmentally owned facilities, such as public airports, solid waste facilities, ports, and water and sewer facilities, are defined as "private activity bonds" due to operation or other participation by private entities.

An example of the hardship that is placed on the mischaracterization of these governmental bonds is most notably airport bonds. In 1998, the Albany County Airport Authority, NY issued $30,695,000 of Airport Revenue Bonds to finance two capital projects. Due to the complicated tax laws, two separate bond issues, one governmental and one AMT had to be issued, causing the Authority to pay additional bond issuance costs due to the higher yield for the AMT bonds.

We ask that Congress repeal the Alternative Minimum Tax on tax-exempt bonds. Issuers of these bonds would benefit from lower borrowing costs and this would help restore demand from those individuals and corporations that are subject to the AMT. We also recommend that all bonds issued for governmental purpose be classified as governmental bonds.

Expansion of Public-Private Partnerships

In many aspects, Congress and various Administrations have encouraged greater public-private partnerships. Many vital economic development projects require significant public commitment combined with private investment. The ability to fund the public share of costs with tax-exempt bonds allows these projects to proceed. Current tax laws limit the amount of private use of a governmental facility to ten

percent. This inhibits the financing of facilities where private use could materially assist delivery of public services.

For example, publicly funded parking structures integrated with private retail establishments ensure safe and easy access to facilities. Such projects are difficult to fund with tax-exempt bonds, however, because of restrictive private activity bond rules.

We recommend that the threshold test for acceptable private business use be increased and that more flexible allocation rules be developed to facilitate private participation in public projects.

Purchasers of Tax-Exempt Bonds

As noted above, after the 1986 Act, banks went from being the largest group of tax-exempt bond purchasers to one of the smallest. Similar rules are in place for corporate and property & casualty insurers who need and want to purchase tax-exempt bonds for a variety of reasons, most notably their secure standing as a financial product.

Various proposals have been brought forward over the past twenty years that would place additional requirements on corporations and property & casualty insurers who are purchasers of tax-exempt debt. Such proposals would not harm these private sector entities themselves, but would directly hurt state and local governments if these entities stopped purchasing tax-exempt bonds. As an example, in 2005, property & casualty insurers held 16% of outstanding tax-exempt debt. If these purchasers were to leave the market, there would be a significant impact on state and local governments who would have to pay a great deal more in interest costs, as the purchaser pool becomes more limited.

Do not decrease, but instead increase the incentives for corporations, insurers, and the banking community to purchase tax-exempt bonds.

Other Congressional Action that Impacts the Tax-Exempt Bond Market

Congress also acts in indirect ways that influence the tax-exempt bond market. For many bonds, governments must use tax revenues to make payments to bondholders. When those revenue streams are in jeopardy, governments face greater pressure to meet their current and future obligations. Oftentimes when Congress makes decisions to limit state and local governments' revenue collecting capabilities—through legislation that bans taxation of internet access; disallows state and local taxation of remote sales; places restrictions on the taxation of communications services and franchise fees; and restricts the deductibility of state and local income, sales and property taxes—it adversely impacts the financial management of state and local governments.

Conclusion

As Congress looks at past and proposed municipal bond proposals we ask that Members recognize the continued need for tax-exempt bonds as a way to provide essential services to our citizens. World-class infrastructure has been and continues to be provided because of the tax-exempt bond market. Municipal bonds serve as a good illustration of a true partnership between the levels of government, as they are used to pay for the capital projects that serve as the delivery mechanism for federal priorities—including the *No Child Left Behind Act* and greater public safety needs following 9/11.

In 1989, the final report of the Anthony Commission on Public Finance—*Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing,* provided suggested changes that were apparent after the 1986 Tax Reform Act went into effect. Many of these conclusions remain valid today and should be reviewed when deliberating on tax-exempt bond issues.

A review of the tax simplification needs made in this testimony as well as in the Anthony Commission Report may best be summarized as follows:

1. Change arbitrage rebate restrictions;
2. Eliminate restrictions on bank interest deductions;
3. Repeal the AMT on tax-exempt interest;
4. Create new rules distinguishing between governmental and private-activity bonds and reclassify truly governmental purpose bonds as such; and
5. Allow for an additional refunding of tax-exempt debt.

For almost 200 years, states and local governments have been able to access the capital markets by issuing bonds to fund their jurisdiction's public purpose infrastructure. This system has worked well for all parties involved, especially state and local governments. The authority to issue tax-exempt bonds at the state and local level allow local and state governments to determine the project needs of their jurisdiction and pay for them through the issuance of bonds, absent federal government

interference. Without the ability to access the low cost, tax-exempt bond market, communities across the United States would suffer, and greater demands would be placed on the federal government to provide additional direct funding to local and state governments.

Thank you very much for the opportunity to provide this testimony.

Chairman CAMP. Thank you very much for your testimony. Mr. St. Onge, you have 5 minutes.

STATEMENT OF WALTER J. ST. ONGE III, PRESIDENT, THE NATIONAL ASSOCIATION OF BOND LAWYERS

Mr. ST. ONGE. Thank you, Chairman Camp, for inviting me to speak to you today. I am Walter St. Onge, a partner in the law firm Edwards, Angel, Palmer, and Dodge, of Boston Massachusetts. I am here today as President of the National Association of Bond Lawyers, or NABL.

The NABL is a professional association with more than 3,000 who specialize in the municipal bond area. The NABL's original statement of purpose provided in part that it shall promote the public good by educating its members and others in the law relating to state and municipal obligations, improving the state of the art in this field, and providing advice and comments with respect to matters affecting state and municipal obligations.

The NABL Board of Directors reaffirmed this commitment when it adopted a vision statement in 2005, stating that NABL exists to promote the integrity of the municipal market by advancing the understanding of, and compliance with, the law affecting public finance.

The municipal bond market is an important part of The U.S. economy, providing financing for governmental functions and for the infrastructure essential to economic growth and job creation and state and local self-government and fiscal autonomy. This public financing mechanism underpins our unique Federal system of state and local self-government.

Each year, thousands of issuers and borrowers, ranging from the largest state governments to the smaller school or fire district, decide what their capital needs are and how to best meet those needs.

The municipal bond market enjoys high levels of consumer confidence, based on its long history of economic strength, low default rates, and the integrity of the market's participants. The role of bond counsel is a cornerstone of the efficient operation of the market. The NABL's educational efforts promote the continued high standards of practice of its members. These efforts include annual seminars and periodic teleconferences on a full range of topics, including active participation by government officials, particularly from the Treasury, the IRS, and the Securities and Exchange Commission. Other NABL efforts include comment projects and guidance requests.

In 2002, for example, NABL submitted a lengthy report to the Treasury Department regarding tax simplification recommendations. A shorter version of this report was submitted to your Subcommittee in 2004.

Another recent project was a letter sent last September to the Treasury Department regarding the role municipal bonds in the

historic rebuilding efforts required in the wake of Hurricane Katrina. This letter identified potential administrative and legislative actions that could be taken to help alleviate the dramatic effects of Katrina in the affected region.

The function of bond counsel originated in the 19th century in response to growing investor concern regarding the validity of debt instruments issued by state and local governments. Today, the essential components of bond opinions address not only validity, but also the Federal tax treatment of interest on the bonds.

In most cases, bond counsel renders an unqualified opinion, which essentially means that the bond counsel is firmly convinced that the highest court of the relevant jurisdiction would agree with those legal conclusions. The unqualified bond opinion has become a required feature of most municipal bond issues.

While the opinion is not a guarantee, the high standard under which it is issued essentially allows investors to factor out any special risks regarding validity or tax-exemption in pricing the bonds.

The wide range of permitted purposes and issuers of municipal debt also insures a wide range of complexity in transactions. However, many aspects of the tax laws applicable to tax-exempt debt generally apply to all transactions, or reflect longstanding requirements. This allows bond counsel and other market participants to analyze and structure issues efficiently, and permits more effective administration and oversight of transactions.

New forms of tax favored financing commonly result in increased transaction costs, at least in the short term, as bond counsel and other participants must familiarize themselves with the new product, analyze new questions, and educate investors. Existing tax laws have allowed the municipal market to grow and prosper. While the 1986 Tax Reform Act imposed significant new restrictions on the market, it nonetheless preserved access to capital at less expensive rates.

The NABL believes that any tax reform proposal should promote a more efficient municipal bond market, but should also preserve the ability of local governmental units to make independent decisions regarding the most effective way to serve the needs of their citizens and to promote their economic development.

The municipal market remains a vital component in the Federal-state relationship by providing infrastructure to the Nation through local decisionmaking and access to the capital markets.

The NABL is dedicated to insuring that the market remains confident in the value of the opinions that we render. We intend to continue to promote the municipal bond market to insure that it remains a safe, liquid, and transparent market for all of its participants. Thank you very much.

[The prepared statement of Mr. St. Onge follows:]

Statement of Walter St. Onge, III, President, National Association of Bond Lawyers

Good morning. I am Walter St. Onge, a partner in the law firm of Edwards Angell Palmer & Dodge of Boston, Massachusetts. I am here today as President of the National Association of Bond Lawyers.

I would like to thank Chairman Camp and Ranking Member McNulty for inviting me to speak to you today on behalf of our Association.

The National Association of Bond Lawyers (NABL) is a professional association with more than 3,000 members who specialize in the municipal bond area.

The original statement of purpose of the Association provided, in part, that: "the purpose of the Association shall be to promote the public good by:

- Educating its members and others in the law relating to state and municipal obligations,
- Improving the state of the art in this field, and
- Providing advice and comments with respect to legislation, regulations, rulings and other action, or proposals, affecting state and municipal obligations."

The NABL Board of Directors reaffirmed NABL's commitment to improving standards in the municipal bond market when it adopted a vision statement in 2005 to the effect that NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance.

The municipal bond market is an important element of the United States economy, providing financing for general governmental functions and for the infrastructure that is essential to economic growth and job creation in a manner that promotes state and local self-government and fiscal autonomy. The United States is the only nation that permits autonomous state and local governments direct access to the capital markets to finance state and local infrastructure.

This public financing mechanism underpins our federal system of state and local self-government. Year in and year out, thousands of municipal bond issuers and borrowers across this country, ranging from the largest state governments down to the smallest school or fire or sewer district, decide what their capital needs are and how to best meet those needs. The cumulative effect of those decisions is reflected in the annual issuance of municipal bonds, including over $400 billion in 2005. The economic impact of these expenditures is obvious and significant. The municipal bond market benefits all of its disparate borrowers by providing them equal access to funding on favorable terms.

The municipal bond market enjoys high levels of investor confidence based on its long history of economic strength, extraordinarily low default rates and the integrity of the market's issuers and professionals. The role of bond counsel is a cornerstone of the efficient operation of the market. The integrity and professionalism of bond lawyers are key to maintaining the high level of investor confidence in the municipal bond market.

NABL educational efforts promote the continued high standards of practice of its members and assist practitioners and regulators in advancing the state of the law. These efforts include annual seminars and periodic teleconferences on a full range of topics. These events include meaningful participation by federal government officials and other market participants.

Other significant NABL efforts include comment projects on regulatory and legislative matters and guidance requests on particular topics pertaining to the municipal bond area. In 2002, for example, NABL submitted a lengthy report to the Department of the Treasury regarding tax simplification recommendations for tax-exempt bonds. In 2005, NABL resubmitted these recommendations to the President's Advisory Panel on Federal Tax Reform and to the Department of the Treasury for review and consideration for inclusion in any tax reform proposals.

Another notable project was a letter submitted on September 7, 2005, to the Department of the Treasury regarding the role of municipal bonds in the historic rebuilding efforts required in the wake of Hurricane Katrina. This letter identified potential administrative and legislative actions that could be taken to help alleviate the dramatic effects of Hurricane Katrina in the affected region. We were mindful that the immediate task was emergency assistance for the citizens of that area, but we also recognized the disastrous effects on the state and local governments and their ability to provide not only immediate services, but also longer-term reconstruction activity and normal governmental services. Some of our suggestions were subsequently incorporated in action taken by the administration and in the Gulf Opportunity Zone legislation enacted by Congress.

The function of bond counsel originated in the 19th century in response to growing investor concern regarding the validity of debt instruments issued by state and local governments. Adverse court decisions led underwriters and bond purchasers to seek legal opinions to provide assurance as to the validity of the debt.

By the early 1900s, the practice of engaging bond counsel to provide an expert and objective legal opinion with respect to the validity of bonds was widespread. Today, the essential components of bond opinions address the validity of the bonds and the tax treatment of interest on the bonds, particularly, the federal tax aspects.

The bond opinion facilitates the sale of the bonds and thereby assists the issuer in carrying out the public purpose for which the bonds are issued.

In most cases, bond counsel renders an "unqualified opinion" which essentially means that bond counsel is "firmly convinced that the highest court of the relevant

jurisdiction, acting reasonably and properly briefed on the issue, would reach the legal conclusions stated in the opinion.

The "unqualified" bond opinion has become a well-accepted, and in most cases, a required feature of municipal bond issues. While the opinion is not a guarantee, the high standard under which it is issued essentially allows investors to factor out any special risks regarding validity and tax exemption in pricing the bonds. The favorable bond opinion, delivered by recognized bond counsel, promotes the efficiency of the municipal bond market (since bond purchasers rarely feel the need to retain separate, additional counsel) and contributes significantly to the overall successful workings of the market.

To date, public financing has resulted in over $2 trillion of valuable state and local infrastructure and other capital projects. Without the municipal bond market, state and local governments would have to look to the federal government to bear a greater share of the infrastructure costs or forego the infrastructure entirely if federal financing were not available.

The municipal bond market serves the needs of state and local governments, educational institutions, charitable organizations and certain qualified private entities by providing efficient access to capital, and addresses the needs of the bond purchasers by providing efficient access to liquid investments. The types of debt issued include traditional general obligation and revenue bonds, so-called private activity bonds for certain purposes and more recently, tax credit bonds for particular, special programs.

The wide range of permitted purposes and issuers of municipal debt also ensures a wide range of complexity in the structure of transactions. However, many aspects of the tax laws applicable to tax-exempt debt generally apply to all transactions or reflect long-standing requirements. This allows bond counsel and other market participants to analyze and structure issues efficiently and permits more effective administration and oversight of transactions. It also enhances the market's liquidity by allowing investors to effectively take tax risk out of their pricing decisions—assuming, of course, that an "unqualified" bond opinion is being offered as part of the transaction. New forms of tax-favored financing commonly result in increased transaction costs, at least in the short term, as bond counsel and other market participants must familiarize themselves with the nuances of the new product and analyze new legal and financial issues that may arise, as well as educate investors about the new types of projects.

Existing tax laws have allowed the municipal bond market to grow and prosper. While the 1986 Tax Reform Act imposed significant new restrictions on the municipal bond market, it nonetheless preserved the fundamental access to capital at less expensive rates. NABL believes that any tax reform proposal should promote a more efficient municipal bond market, but should also preserve the ability of local governmental units to make independent decisions regarding the most effective way to serve the needs of their citizens and to promote their growth and economic development.

Simplifying and improving the efficiency of the municipal bond market is critical to enable state and local governments to perform their role in providing cost-effective financing for ever-expanding public infrastructure needs and other public purposes.

Last fall, the President's Advisory Panel on Federal Tax Reform issued its final report on a wide range of possible tax reforms, including provisions that would adversely affect the municipal bond market. If enacted, the proposals would significantly reduce demand for tax-exempt bonds by corporations and thus dramatically increase interest costs for state and local governments. The proposals would also adversely affect individual investors who hold the remainder of the over $2 trillion of outstanding tax-exempt bonds, as the value of their bonds will decline in response to a decline in their attractiveness to business.

The municipal bond market has been and remains a vital component in the federal-state relationship by providing infrastructure to the nation through local decision-making and access to the capital markets. Our members have served over the years as advisors to various market participants to develop successful financing programs that meet the needs of the state and local governments and their constituents and, where appropriate, incorporate innovative financing techniques to assure the most effective capital program for each issuer across the country.

NABL is dedicated to assuring that the market remains confident in the value of the opinions we render. We intend to continue to promote the municipal bond

market to ensure that it remains a safe, liquid and transparent market for all of its participants, issuers and investors alike.

Thank you.

Chairman CAMP. Thank you very much, Mr. St. Onge. Mr. Green, you have 5 minutes and your full statement will be part of the record, as well.

STATEMENT OF MICAH S. GREEN, PRESIDENT AND CEO, THE BOND MARKET ASSOCIATION

Mr. GREEN. Thank you, Chairman Camp. It's a great pleasure to testify before you today on tax-preferred bonds. The Bond Market Association represents underwriters and dealers of all bonds and related products, and most particularly the over two trillion dollar outstanding municipal bond market. We have a longstanding tradition of working very closely with this Committee on Ways and Means, and have appreciated your leadership over the years on these issues.

Our members firmly believe in the value and efficiency of the tax-exemption for municipal bonds which illustrates inter-governmental relations at its very best.

Since association members underwrite and trade both taxable and tax-exempt securities, we could theoretically be indifferent toward the tax treatment of state and local government bonds. However, in that regard, our comments here today reflect our interest in seeing the most efficient municipal bond market possible, that work best for taxpayers, state and local governments and investors, and the Federal Government in meeting national interests.

In sum, our comments are these. The Federal tax-exemption for municipal bonds is longstanding and has been affirmed by the courts and maintained by Congress for the past nine decades. It is complimented by a prohibition on the taxation Federal Government bonds at the state level.

The ability of local voters and their elected officials to make decisions on local infrastructure finance eliminates a layer of bureaucracy that is associated with Federal appropriations that can lead to wasteful misallocation of resources.

The capital markets, because of their capacity to finance infrastructure projects, and the inherent market discipline that provides, that they enforce on borrowers, is the best funding source for the capital needs of the state and local governments. The tax-exemption links thousands of state and local governments to the capital markets that would otherwise have no access.

In many ways, the municipal bond market reflects the simple genius of our Founding Fathers. It is essentially a federalist system of public finance. It's designed to meet local needs by making municipal bonds attractive to investors at below market rates. It's those below market rates that reduce the cost of borrowing for states and localities.

The decisions these governments make to issue bonds to investors brings with it a promise to pay timely interest and principle back. The default rate, as a previous witness said, in the municipal bond market is close to zero. Since the tax-exemption was explicitly

adopted as part of the first Internal Revenue Code 1918, Congress has monitored it closely. At various times, lawmakers have proposed to revoke the tax-exemption or replace it altogether.

These efforts have always failed, largely out of a recognition that the municipal bond market constitutes the most efficient means available for state and local governments to finance public infrastructure. The market today, as a result, is a well functioning system that efficiently provides Federal assistance for governmental and other public purposes. Congress has recognized the financing needs of state and local governments are unlike those of corporations and other private borrowers.

Consider that there are more than 50,000 separate municipal bond issuers that have over one million separate bond issues outstanding, most in amounts of less than one million dollars. For these very small issuers, the municipal market is the only realistic source of low-source capital. Banks would be unwilling to lend under the same terms and the same small size and unique characteristics of each municipal bond. It would prevent their broad acceptance by investors in taxable securities.

No other system can offer the low cost financing that tax-exemption provides, combined with the local control over financing decisions. Municipal issuers would face significantly higher borrowing costs if the tax-exemption were eliminated. Direct appropriations by Congress, invariably at a level of bureaucracy that would distort the allocation of that Federal assistance.

If such appropriations were unlimited and came with no strings attached and no bureaucratic overlay, it would simplify the issue of infrastructure finance.

This is obviously not possible. The tax-exempt municipal bond market creates the appropriate partnership needed to meet National needs at the local level.

Congress turned to such partners in the wake of the 9/11 terrorist attacks, and more recently the destruction wrought by Hurricane Katrina in the Gulf Coast zone, devastation at a scale that demands a capital market solution.

I'd also note that Congress exempted these special bond programs from the individual AMT. This is a policy we strongly endorse, and would encourage Congress to extend to all tax-exempt private bond interests.

Congress has thoughtfully reviewed the municipal bond market over the last several decades and shaped a system that provides critical but limited Federal assistance, quickly, directly, and efficiently. We thank you for the opportunity to testify today and look forward to answering your questions.

[The prepared statement of Mr. Green follows:]

Statement of Micah Green, President and Chief Executive Officer, The Bond Market Association

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.

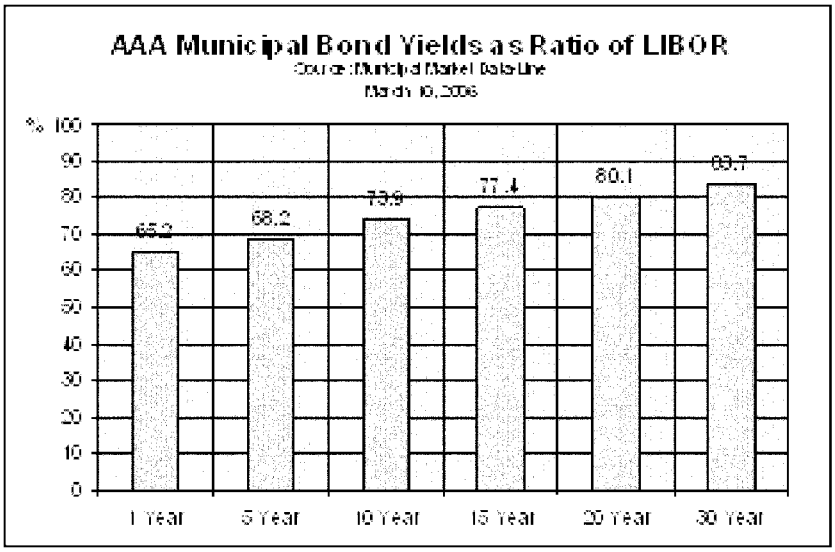
Once a project is authorized and appropriated, it faces a different set of obstacles associated with the federal bureaucracy tasked with its implementation. This usually takes the form of a lengthy review meant to ensure the project conforms to an agency's rules.

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

[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.

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.

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 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.

---

[2] *Report on Transactions in Municipal Securities* (page 19), 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.

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 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 quali-

[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.

fied 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 Con-

gress 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.

---

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

Municipal bonds benefit all Americans.

Chairman CAMP. Thank you very much. Thank you for your testimony, Mr. Green. We had a pretty active day on the floor today, legislatively, and a Subcommittee Member, Congressman Doggett, asked me if I would ask a question for him for Mr. St. Onge. His question is, what are the highlights of your tax simplification report?

Mr. ST. ONGE. We submitted two reports, as I said in my earlier remarks. In 2002, it was a lengthy report, detailing a number of specific recommendations. In 2004, a shorter version of that report was submitted to this Subcommittee. A couple of the highlights; one area would be to modify and simplify various arbitrage requirements, particularly those related to rebate requirements, in order to make it simply easier to administer those rules. We don't believe these recommendations would fundamentally change the requirements of meeting the rebate rules.

For example, one of the changes proposed would be to have a simple, 3 year, spend down period for being exempt from the rebate—rather than what is in place—which is a more complicated process.

The other area that we recommended changes would be to simplify the standard for what is a private activity bond. The basic test is 10 percent private business use and 10 percent private payments. We'd prefer to have that be the standard. There are a number of subsidiary requirements that currently exist, and impose additional requirements and complexity. Given, in particular, the volume cap, we don't think that those other rules are necessary to achieve the objectives.

The third item that I would mention would be we also recommend repealing the AMT as it applies to private activity bonds. We think that creates a distortion in the marketplace that isn't warranted in this case.

Chairman CAMP. Thank you very much. I have a question for Mr. Green, and then I'd ask Ms. Sledge to respond to the same question, which is about the categories of bonds that have been in recent legislation that have been allocated at the Federal level. Do you think it would be more appropriate for that bonding to be allocated at the state and local level, or if you have any opinion on how the mechanism should be structured in that situation?

Mr. GREEN. Well, if you hearken back to the 1986 Tax Reform Act, where there were significant limitations put on the issuance of private activity bonds, it is a much more limited program—and that hearkens to the previous panel—and it's much more controlled by two reasons. Number one, the definition of what bonds can be issued for, and the overall volume caps.

As you look at specific problems, catastrophic problems, like 9/11 and Hurricane Katrina, the ability to define an allowable use of bonds for private activity purposes that was not allowed under the existing law and allowing an additional volume cap, or even a more open volume cap insures that the Federal Government is meeting the national interest of helping those areas rebuild after a catastrophic event.

By putting a limitation on it, I suppose you could say from a Federal Government revenue standpoint, you're putting a limitation on the revenue outflow, or the revenue expenditure. From the standpoint of encouraging the activity and encouraging the access to the capital markets to meet that national need, you could almost argue that it's an arbitrary cap.

The decisionmaking of how you allocate it should be put down on the local level. They are closer to it. They are the ones putting their credit on the line. They are the ones promising to pay back interest and principle, and that is what defines as a partnership.

One could argue whether some uses should be without a cap. One should argue whether some uses should be handled differently to recognize they are clearly state and local benefits.

Chairman CAMP. All right, and Ms. Sledge, do you have any comment on that?

Ms. SLEDGE. Well, I certainly agree with the comments made by my colleague, but I think you can tell from my testimony that I am very passionate about the fact that the state and local governments need to have the ability to issue their tax-exempt bonds at that level.

They certainly need the flexibility to be able to respond as quickly as they need to respond when they have to deal with issues like Katrina or any other such natural disasters. To put it on the Federal level, I think, would inhibit that flexibility.

Chairman CAMP. You touched on this in your testimony, but obviously the expansion over the last 20 years tax-preferred bond financing through the private activity bonds. To what extent has that expansion—what effect I guess—has that had on state and local governments to finance what our traditional government functions, bridges and roads and items like that.

Ms. SLEDGE. I think that the ability to enter into a private partner relationship certainly enhances, in some cases, the ability for state and local governments to build some of the infrastructures that they need to build. Certainly the state and local governments without private partner relationships, but on the other hand, that relationship is needed in order to build some of the infrastructures that the public so much benefits from.

Chairman CAMP. Do you see this financing having an effect on businesses' decision to locate or expand their facilities in an area? Has that been your experience?

Ms. SLEDGE. It has especially been my experience. I can tell you that, currently, as we speak, the ability to enter into private-public relationships has enhanced our ability, in some cases, to help build some more infrastructure. We are currently speaking with several, well, a couple, at least, private companies that are interested in coming and expanding in the Wayne County area just for that reason.

Chairman CAMP. Thank you. Mr. St. Onge, in terms of compliance, what procedures are in place to make sure that bond proceeds are used as they are intended to be used?

Mr. ST. ONGE. Each bond issue that is done has in it a series of covenants and promises to use the bond proceeds in the appropriated manner. There is a variety of diligence that is done prior to the actual issuance of the bonds by bond counsel and the other

market participants to insure that what is being financed will, in fact, be financed. As I said, there are covenants in place for the issuer and other participants in the transaction to monitor that going forward.

In addition, the IRS has an active enforcement program in place. It's been in place for about 10 years. The NABL actually encouraged that, in part simply to help address what were perceived to be some abuses in the market. That program has also helped to identify and highlight particular problem areas.

One of the efforts that NABL has undertaken is to educate our members and to work with the IRS to help identify what are the areas of concern that they have on particular projects or types of bond issues, and make sure that our members are made aware of that as quickly as possible, so that they can help also monitor those issues and deal with them in an appropriate fashion.

Chairman CAMP. So, there are covenants when they enter into the agreements. After the bonds are issued, are there any procedures in place? Obviously you have an education program in place. Are there any other follow up procedures that they have, or that you're aware of?

Mr. ST. ONGE. Well, it will vary from transaction to transaction, issue by issue. Most issuers are repeat borrowers in a municipal market. It's rare that someone actually does a single bond issue and you never hear from them again.

So, in fact, the continuing process of working with the issuer for subsequent transactions often leads to follow-up questions as to what's going on, what has happened to that earlier project.

There are also opportunities to refund transactions, refinance them for interest rate savings. In that context, it also opportunities to follow up as to what's going on with those projects.

Chairman CAMP. Mr. Green, you wanted to comment?

Mr. GREEN. Yes. Mr. Chairman, I would add that the municipal bond market is both a primary market when bonds are issued and a secondary market where bonds, once they're issued, can be bought and sold. When an investor needs to sell a bond, there has to be a liquid market out there for to buy that bond. That involves constant market discipline and analysis and review of outstanding issues and how they're performing under the covenants that my colleague mentioned.

Also there are now, under the Federal Communications Commission rules, significant and ongoing disclosure requirements by state and local issuers to inform the marketplace of the continued viability of the revenue stream, or whatever the project was issued for.

So, there is an ongoing check in the system, and that's called the capital marketplace. Now, with so many of the bond issues that are now credit enhanced, in other words insured, the bond insurers help insure, too, that the viability of the underlying project continues on.

Chairman CAMP. I have a question. Thank you for that. Mr. St. Onge, in 1986, Congress prohibited the use of private activity bonds for sports stadiums, but most of those are being built now with tax-exempt government bonds. Are these current use limitations effective if state and local governments can issue bonds to fi-

nance that type of facility anyway? Did you have any comment on that?

Mr. ST. ONGE. I think that in most cases where a governmental entity issues bonds for a sports facility, it's doing so as a governmental bond. While there may be private use, it's a fairly complicated analysis to determine whether or not that is going to far over the line, and therefore creates an impermissible private activity bond.

However, this involves an area where, frankly, the purposes of the governmental entities, the economic development activities that governments undertake today is very different from what it was 20 years ago, 30, 50 years ago; in terms of the range of activities that governments are expected to provide and the sorts of services that their citizens want them to provide or to help develop as part of the overall economic development activities.

Fifty years ago, for example, in Massachusetts, there were questions as to whether affordable housing projects were a permissible public purpose. Today, there's no question that that is the case. It is pretty settled. The same thing is true with urban renewal projects and other economic development.

Initially there were questions raised, is that the proper function of government. I think today those questions are settled. The sports area presents another example of that. However, those particular projects also require careful analysis by the tax lawyers in the particular transactions to insure that they do comply with the appropriate rules.

Chairman CAMP. Well, thank you all very much. I'm about ready to conclude the hearing, if anyone had any closing comments that they'd like to make. Mr. Green.

Mr. GREEN. Not enough to prolong the hearing, but just to make one statement about the efficiencies of the markets, because the prior panel, particularly the gentleman from CBO, talked about that.

Frankly, we feel very satisfied, that when you look at the total picture—not just the efficiency of the interest rate subsidy as it relates to other like price securities in the marketplace—the cost of the administration of the program, the lack of a Federal bureaucracy to support that program, the pushing down of local decision-making, and the speed with which local governments can act, compared to a Federal appropriations allocation process. That when you take that all together, it really is an efficient program.

On the interest rate side, those who say it's inefficient are comparing it with the U.S. Treasury market, which is the largest, most global, most liquid, largest investor-based marketplace in the world. When you compare the municipal bond interest rate with other similarly situated indexes for similar types of securities on the taxable side, it actually is a very efficient market.

Chairman CAMP. Well, I really appreciate all of your patience as we had this long delay this morning. I want to thank you all for your excellent testimony. This is very helpful to the Subcommittee. I appreciate it very much.

At this time, the Subcommittee on Select Revenue Measures is adjourned.

[Whereupon, at 1:09 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Aeration Industries International
Chaska, Minnesota 55318
March 23, 2006

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

I am writing on behalf of our company in support of H.R. 1708, the Clean Water Investment and Infrastructure Security Act. Aeration Industries International, Inc. (AIII), founded in 1974, is a Minnesota-based corporation that solves a variety of water treatment problems. The Company introduced aspirator aeration technology into the water treatment market under the trademark, "AIRE–O_2®". Today, Aeration Industries is a world leading manufacturer of aeration equipment and wastewater treatment systems serving the municipal and industrial wastewater treatment industry and aquaculture market. The Company has solved the most challenging water treatment problems using superior, proprietary technologies and engineering expertise based on 30 years of field experience. Aeration Industries has more than 4,000 installations located in all 50 states and in more than 85 countries around the world.

We should all be concerned about the deteriorating state of our nation's water and wastewater infrastructure. Nearly $1 trillion dollars needs to be invested over the next 20 years to repair, rehabilitate, replace and upgrade our nation's network of water and wastewater treatment plants, collection systems and distribution lines. Failure to stem this looming crisis will cause significant public health and economic harm to our country.

H.R. 1708 will allow communities across the nation to partner with the private sector in funding critical water infrastructure activities by removing water and wastewater projects from the state volume caps for private activity bonds. This is the least expensive option for addressing a growing national crisis and ensuring that all Americans are guaranteed a safe, reliable water infrastructure system. We urge Congress to move expeditiously on this proposal and thank you for your leadership in this matter.

Sincerely,

Dan Durda
President and CEO

American Forest & Paper Association
March 28, 2006

Subcommittee on Select Revenue Measures
Committee on Ways and Means
Room 1135
Longworth House Office Building
Washington, D.C. 20515

Dear Sir or Madam:

On behalf of the Tax Exempt Bonds Recycling Coalition ("Coalition"), I am pleased to submit the following testimony for the record in the Subcommittee hearing related to tax-preferred bond financing held on March 16, 2006. The Coalition thanks the Subcommittee for this opportunity to provide its views on the importance of the use of tax-exempt bonds to finance solid waste recycling facilities. The Coalition is committed to working with Congress, the Treasury Department and the Internal Revenue Service in the establishment of fair and appropriate laws, regulations and rules promoting recycling through the issuance of tax-exempt bond financing for these facilities.

Sincerely,

David Koenig
Director, Tax Policy

The American Forest & Paper Association ("AF&PA") on behalf of the Tax Exempt Bonds Recycling Coalition ("Coalition") thanks Chairman Camp, Ranking

Member McNulty, and the other Members of the Subcommittee on Select Revenue Measures, Committee on Ways and Means for the opportunity to submit testimony for the record on tax-exempt financing for paper-related solid waste disposal facilities. This tax-exempt financing is crucial to achieving the Nation's recycling goals. The Coalition commends the Subcommittee for holding this hearing on the critical topic of tax-exempt bond financing.

The Coalition is comprised of companies, trade associations, environmental groups, and state and local governments all having a common interest in promoting public policy that supports recycling. The AF&PA, the national trade association for the forest products industry, represents more than 200 companies and related associations that engage in or represent manufacturers of pulp, paper, paperboard and wood products. AF&PA member organizations employ approximately 1.3 million people and rank among the top ten manufacturing employers in 42 states.

Recycling of paper and paperboard is a vital component of the Nation's recycling efforts. The AF&PA estimates that paper comprises nearly 80 percent of the materials recovered in community recycling programs. In 2004, the United States recovered for recycling nearly 50 percent of the paper consumed, breaking the 50 million ton mark for the first time. Paper and paperboard recovery has increased by 73 percent since 1990. Successful recycling efforts to date have resulted from effective legislation enacted by Congress to encourage and facilitate recycling, considerable investment and effort by private and public stakeholders in the paper recycling process, and dedication on the part of millions of Americans who recycle at home, work and school. In 2003, the amount of paper recovered for recycling averaged 339 pounds for each person in the United States. To keep up with growing demand for high quality recovered fiber, the industry has set an aggressive goal to increase recovery to 55 percent by 2012. This recycling activity helps protect the environment, provides a substantial number of jobs, and results in economic stimulus in many communities throughout the United States.

Congress has enacted a series of measures over the years to strongly support recycling policies (such as the Solid Waste Disposal Act of 1965 and the subsequent Resource Recovery Act of 1970), encourage the preservation of our natural resources, and reduce the amount of land needed for landfills.

In addition, the tax law provides very important incentives for financing of recycling facilities, and specifically authorizes issuance of tax-exempt bonds to promote recycling though the financing of solid waste disposal facilities. Over the years, these tax rules have provided a critical financing tool for the development of recycling facilities, and Congress has shown strong support for these rules.

Bonds issued to finance solid waste disposal facilities must meet a number of technical requirements to qualify as tax-exempt. For example, these bond issuances are subject to the unified State volume cap applicable to qualified private activity bonds. Additionally, existing Treasury Department regulations define the term "solid waste" as property which is useless, unused, unwanted or discarded material that has no market or other value at the place where it is located. (Treasury Regulation sec. 1.103–8(f)(2)(ii)(b)).

Regrettably, a 1998 Technical Advice Memorandum ("TAM") issued by the Internal Revenue Service ("Service") has created substantial uncertainty as to the availability of tax-exempt financing for solid waste recycling facilities, resulting in a severe "chilling affect" on the issuance of such financing. In TAM 199918001, the Service held that a payment to a supplier for solid waste material will deny classification of the material as solid waste for purposes of the tax-exempt bond financing requirements. The TAM did not reflect the fact that the material at issue was useless, unused, unwanted or discarded at the point of collection (for example, in a community waste collection stream). Additionally, the TAM did not allow for service costs involved in handling, collecting, separating, sorting, baling, and transporting the solid waste material to the recycler.

Members of Congress and numerous industry groups have expressed concern to the Treasury Department and the Service that the uncertainty created by the TAM inappropriately restricts the use of tax-exempt bonds for financing solid waste recycling facilities in direct contravention of Congressional intent. For example, a bipartisan letter dated June 12, 200l, signed by 31 Members of the Committee on Ways and Means, was sent to then Treasury Department Secretary Paul H. O'Neill and then Internal Revenue Service Commissioner Charles O. Rossotti stating ". . . the policies articulated in the TAM undermine congressional intent." The letter further states that the TAM effectively would thwart solid waste disposal policies by denying tax-exempt bond financing for recycling facilities while allowing such financing to landfills and municipal waste incinerators.

In 2002, the Treasury Department and the Service requested public comments on the existing regulations and rules governing tax-exempt financing for solid waste

disposal facilities. After receiving public comments, the Treasury and Service in 2004 issued proposed regulations (REG–140492–02) ("Proposed Regulations") that would make numerous revisions to the existing regulations. The Proposed Regulations delete the requirement that qualifying solid waste have "no value." The preamble to the Proposed Regulations states that in light of the changes that have occurred in the waste recycling industry since the existing regulations were issued in 1972, the no-value test is eliminated for determining whether material is solid waste. The Proposed Regulations, however, contain numerous provisions which the Coalition and other commentators believe must be modified in order to provide fair and appropriate guidance on these important matters.

The Coalition has been very active throughout this period in providing comments and recommendations to assist the Treasury Department and the Service in the analysis of these issues. The Treasury and Service have placed this regulatory project on the 2005–2006 Guidance Priority List. Recently, the Coalition submitted a comprehensive set of comments to the Proposed Regulations. The Coalition is committed to working with the Treasury and the Service to analyze these vital regulatory issues to assist in the issuance of fair and appropriate guidance. The Coalition's recommendations for modifications to the Proposed Regulations may be briefly summarized as follows:

1. *Definition of Solid Waste.* The Coalition agrees with the Treasury and the Service, that the "no-value" element of defining qualified solid waste should be eliminated. The Coalition recommends that the appropriate definition of solid waste should include garbage, refuse, or discarded solid materials that are useless, unused, unwanted, or discarded.
2. *Solid Waste Disposal Function.* The Coalition recommends revising the definition of a solid waste disposal function to insure that future scientific and technological developments created to process solid waste will be covered by the new regulations. The Coalition notes that one shortfall in the Proposed Regulations is the "lock-in" effect limiting qualifying solid waste disposal functions to four types of processes, which definition soon could become obsolete from both scientific and technological standpoints.
3. *Definition of Solid Waste Disposal Process.* In the case of a procedure designed to process the solid waste into a useful product, the Coalition recommends defining the process of implementing the solid waste disposal function as beginning at the collection, separation, sorting, treatment, disassembly, or handling of the solid waste and ending at the point at which the solid waste material has been converted into a material or product that can be sold in the same manner as a comparable product produced from virgin material (regardless of whether the product is actually sold at that point in the process). The Coalition recommendation contains several examples of the application of this important standard and we believe is consistent with existing rules.
4. *Deletion of the Concept of "Preliminary Function."* The Coalition believes that if an appropriate definition of the entire solid waste disposal process is crafted, there is no need for a separate category defining a class of preliminary activities. The Coalition recommendation alleviates the need for the concept of a preliminary function, thereby simplifying significantly the structure of the regulations.
5. *Treatment of Mixed Input Facilities.* The Coalition recommends retaining the current law rules related to the treatment of mixed input facilities and the safe harbor as provided under current law and practice. The Proposed Regulations would set standards that are overly harsh and very difficult to administer in practice.
6. *Effective Date.* The Coalition recommends that for the appropriate administration of the tax law, taxpayers should be able to elect to apply the new regulations on a retroactive basis.

The Coalition's recommendations to modify the Proposed Regulations as summarized above would set standards for the issuance of these tax-exempt bonds that are reasonable, fair and administrable, and would effectuate Congressional intent to provide appropriate economic incentives in support of recycling policies. The Proposed Regulations as so modified should be finalized as expeditiously as possible, in order to end the current "chilling affect" on tax-exempt financing of solid waste recycling facilities, and to restart the tax-exempt financing of these vital projects.

The Coalition thanks the Subcommittee for this opportunity to provide its views on this very important aspect of the Nation's recycling policies. The Coalition is committed to working with Congress, the Treasury Department and the Service in the establishment of fair and appropriate laws, regulations and rules promoting re-

cycling through the issuance of tax-exempt bonds to finance solid waste disposal facilities.

Statement of the American Public Power Association

The American Public Power Association (APPA) appreciates this opportunity to submit comments for the record in the above-referenced hearing. APPA is the national service organization representing the interests of the more than 2,000 state and locally owned electric utilities collectively serving over 43 million Americans. As not-for profit units of state and local government, these public power utilities are authorized to issue tax-exempt bonds to construct and improve the infrastructure necessary to provide electricity and other essential services, such as advanced communications services. Electricity is the oxygen of the nation's economy; vital to its continued health. Continued access to, and flexibility in the use of, tax-exempt bonds is of huge importance in allowing public power utilities to continue to provide these services, and to do so in a cost-effective manner.

Our comments will briefly focus on the following points:

- The infrastructure benefits derived from both continued access to tax-exempt bonds and allowance of a certain level of private activity;
- The impact of continuing, dramatic changes in wholesale electricity markets on infrastructure needs and financing flexibility; and
- The increase in proposals to use taxable-tax-credit bonds.

Tax-Exempt Bonds Finance Essential Utility Infrastructure

To address societal needs, increase productivity, and make our nation more competitive in the global marketplace, we must invest in America's infrastructure. Tax-exempt municipal bonds are the basic tool used by states, cities, counties, towns, school districts and other governmental entities to fund the capital improvements necessary to provide needed facilities and services. The ability to sell debt with interest exempt from federal income taxes has been a significant benefit to state and local government borrowers, including public power utilities, in providing essential public facilities.

The nation's public power utilities are units of state or local government created to provide essential services subject to local control. Their historic and current day focus is on providing their citizens with the best possible electric service at the lowest possible cost. They have financed their electric utility infrastructure-generation, transmission and distribution facilities—just as local governments have financed other municipal activities: through the issuance of tax-exempt bonds. Public power utilities currently have over $80 billion in outstanding tax-exempt bonds.

Traditionally, our federalist system of government has respected the right of state and local governments to pursue activities that are in the public interest and the interest of the citizens they serve. Congress has promoted and protected the right of government to issue municipal bonds for "government owned and operated projects and activities." Public power systems are just that—governmentally owned and operated systems similar to other local infrastructure projects such as water systems, prisons, libraries, schools, hospitals, and transportation lines.

In addition to continued access to tax-exempt bonds to finance electricity infrastructure, it is important that Congress provide adequate flexibility in the ability of public power utilities to partner with private entities in the financing and use of certain facilities. High-voltage transmission lines and large generating plants, for example, are often constructed to serve multiple producers and users based on their economies of scale. Moreover, they can be difficult to site given the substantial land use involved and frequently cited environmental and aesthetic concerns. Furthermore, generation facilities, which are typically constructed to last 30 years or more, are often sized to meet both current and future electricity demand. That means surplus power may be available in early years for sale to other utilities. Some ability to make that power (or transmission capacity) temporarily available to other suppliers without running afoul of the private use restrictions on tax-exempt bonds used to finance the relevant facilities provides multiple benefits to all parties, without transferring the benefits or burdens of the bond financed facilities to private parties.

Congress has recognized this necessary flexibility by allowing a certain amount of "private use" from output facilities financed with tax-exempt bonds. Prior to the 1986 Tax Reform Act, the limitation on private use was set at 25 percent for all

governmental bond issues. However, in 1986 Congress amended the Internal Revenue Code (the "Code") to reduce the amount of permissible private use to no more than 10 percent. In addition to the reduction of the private use limitation from 25 percent to 10 percent, the Code also provides that for certain output facilities—which include public power generation, distribution and transmission assets—the private use limit per output project is further limited to the lesser of 10 percent of the issue or $15 million per project. Private use restrictions limiting the benefits available to private entities from publicly financed facilities are based on sound and appropriate public policy considerations. However, we believe that the private use restrictions should apply equally to all governmentally financed and operated facilities.

The special $15 million private-use limitation is not supported by any public policy justification and causes undue burden and complexity. It may force local governments that provide generating and transmitting facilities to have their surplus capacity sit idle rather than having it sold to others in order to avoid the private use limitation. This provision should be repealed because it is discriminatory and it encourages practices that are neither environmentally nor economically sound.

Another important element of flexibility in the use of tax-exempt bonds is the ability to advance refund bonds in order to take advantage of more favorable interest rates. This ability has saved public power utilities and their customers hundreds of millions of dollars over the past twenty years. It has also allowed public power to maintain more stable rates, even as electricity markets continue to suffer from ill-conceived de-regulation efforts and high price volatility. Proposals have been advanced that would eliminate the ability to advance refund bonds. We urge the subcommittee to reject such proposals because they would simply increase the cost of electricity. Instead, we urge the subcommittee to support the ability of issuers to have an additional opportunity to advance refund outstanding bonds in order to lower electricity infrastructure costs and ultimately the rates to consumers.

APPA is also aware that there has been some concern expressed in recent years by the Internal Revenue Service, the Joint Committee on Taxation, and others about alleged abuses of tax-exempt bonds. APPA and governmental issuers in general do not condone abuses or illegal use of tax-exempt bonds. However, while we have seen expressions of concern about such abuses and heard some discussion, frankly, we have yet to see any evidence of such abuses. Congress should not act to impose additional restrictions or requirements in the absence of verifiable evidence of abuse. Tax law changes that were made in the 1986 Tax Reform Act and other changes thereafter have placed many limitations on the tax-exempt bond market in the name of "curbing abuse." Yet the outcome has been an overreaching impact on the overwhelming majority of the marketplace where abuses do not exist. As importantly, Congress should provide the necessary resources to the Treasury and Internal Revenue Service to vigorously enforce the law using the considerable and effective tools already available to them in the tax code.

Significant Changes in Wholesale Electricity Markets Highlight the Need for Continued Access to, and Flexibility in the Use of, Tax-Exempt Bonds

As mentioned above, electricity markets, especially wholesale markets, are continuing to experience significant problems in market design and function, as well as extreme price volatility. In particular, wholesale markets run by centralized Regional Transmission Organizations or Independent System Operators (RTO-run markets) are experiencing major flaws in market design and operation that are resulting in increasing, and increasingly volatile, wholesale prices for electricity. Increases in rates for wholesale power are also occurring as a result of increases in the price of fuels used to generate electricity, primarily natural gas and coal. Natural gas prices have increased as a result of supply shortages, and coal prices have been driven up through monopoly practices by the railroads that deliver the coal to power plants. However, while fuel prices affect the cost of electricity in all regions of the country, not just those with RTO-run markets, prices in regions with RTO-run markets are higher than those in non-RTO regions.

RTO market design features such as "locational marginal pricing" for managing transmission congestion and single bid clearing auctions for short term sales of electricity are not meeting their intended objectives. Instead, they are increasing the cost of wholesale power and serve as a disincentive for investments in new power plants and transmission lines. In addition, these factors and other policies of RTO-run markets converge to severely limit the ability of electric utilities, including public power, to secure long-term power supply arrangements or transmission service. This situation is of critical importance to public power utilities since they, unlike many investor-owned utilities, have not relinquished their legal obligation to serve

all customers in their communities in the states that have adopted retail competition in electricity.

As the states, like Maryland and Virginia, and the District of Columbia, that imposed retail rate caps as part of retail electricity competition programs begin to see the term of those caps expire, retail customers are experiencing rate shock. Recent articles in the *Wall Street Journal, Baltimore Sun* and *Washington Post* chronicle these problematic developments in detail. And the situation is likely to get worse before it gets better.

In response to this market dysfunction and the resulting price increases, public power utilities are placing a much greater emphasis on self-reliance. They are increasingly building their own power plants and, where they can, bulk transmission lines to ensure their ability to meet their legal obligation to serve all customers and to do so at reasonable prices. This new infrastructure will be financed with tax-exempt bonds. Thus, it is imperative that public power utilities continue to have access to and flexibility in the use of, tax-exempt bonds.

Tax-Credit Bonds Can Be an Appropriate Additional Financing Tool for Limited, Targeted Purposes

We understand that one issue of concern to the subcommittee is the proliferation of proposals to use taxable-tax-credit bonds. There are only two existing programs for tax—credit bonds, the Qualified Zone Academy Bond program and the Clean Renewable Energy Bond (CREB) program. Both are relatively small programs, $400 and $800 million respectively. Additionally, because the CREB program was authorized as part of the Energy Policy Act of 2005, there is little context with which to review its successes and challenges. However, as qualified issuers under the CREB program, public power utilities are enthusiastically looking forward to using these new bonds to substantially increase the amount of energy produced from renewable sources. APPA believes that the CREB program is a good example of the appropriateness of using taxable-tax-credit bonds in limited, targeted circumstances.

At the same time we want to be perfectly clear that tax-credit bonds are not, and should not be viewed by Congress, as an alternative to tax-exempt bonds for financing state and local government activities and related infrastructure, but should instead be used in a targeted way to achieve specific public policy goals—like increasing renewable energy production that will result from the use of tax-credit bonds in the recently-enacted CREB program. CREBs were authorized for a very specific purpose—to provide public power utilities with an incentive for renewable energy production comparable to the incentive provided to private energy developers through the production tax credit under Section 45 of the Code. Moreover, these are new, relatively untested financial instruments for which there is currently a limited market. This program needs some experience and maturity in order to evaluate its overall benefits. In addition, it is already clear to APPA that some refinements and streamlining of the CREB program would improve its effectiveness and we look forward to discussing those matters with the subcommittee in the future.

APPA does share some concern as well regarding over-proliferation and inappropriate use of tax-credit bonds. One clear example is Section 569 of S. 2020, the Senate tax reconciliation bill now pending in conference. This provision would allow non-governmental entities (in this case, electric cooperatives and their wholly-owned financing institutions) to issue tax-credit bonds to build facilities such as police and fire stations, wastewater treatment plants, low-income housing units, and other facilities and services provided by state and local governments. Cooperatives are private businesses, thus the entire benefit of this proposal is for private activity. This does not strike us an appropriate use of this benefit.

Conclusion

- Congress should not limit the continued access to tax-exempt bonds by public power utilities to finance electricity infrastructure because tax-exempt municipal bonds are the basic tool used by public power to provide their citizens with the best and most economical electricity and other essential services, such as advanced communications services.
- Additionally, Congress should provide adequate flexibility in the ability of public power utilities to partner with private entities in the financing and use of certain facilities. APPA urges that Congress repeal the special $15 million private use limitation that applies only to publicly-owned electric and gas facilities utilities and is not supported by any public policy justification.
- Congress should reject proposals to eliminate the ability to advance refund bonds because they would simply result in increasing the cost of electricity. APPA urges the subcommittee to support the ability of issuers to have an addi-

tional opportunity to advance refund outstanding bonds in order to lower electricity infrastructure costs and ultimately the rates to customers.

- Because electricity markets are continuing to experience significant problems in market design and function, as well as extreme price volatility, APPA urges Congress to allow public power utilities to be able to increase self-reliance through the development of new infrastructure financed with tax-exempt bonds.
- Finally, APPA strongly believes that the use of tax-credit bonds should not be viewed by Congress as an alternative to tax-exempt bonds for financing state and local government activities, but should instead be used in a targeted way to achieve specific public policy goals—like increasing renewable energy production that will result from the use of tax-credit bonds in the recently-enacted CREB program.

Environment One Corporation
Niskayuna, New York 12309
March 23, 2006

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

I am writing on behalf of our company in support of H.R. 1708, the Clean Water Investment and Infrastructure Security Act. Employing 180 constituents, Environment One Corporation is an operating company of Precision Castparts Corp. (NYSE: PCP), a worldwide manufacturer of complex metal parts and industrial products. With corporate headquarters in New York and regional offices and distribution throughout the industrialized world, E/One is a manufacturer and provider of products and services for the disposal of residential sanitary waste.

We should all be concerned about the deteriorating state of our nation's water and wastewater infrastructure. Nearly $1 trillion dollars need to be invested over the next 20 years to repair, rehabilitate, replace and upgrade our nation's network of water and wastewater treatment plants, collection systems and distribution lines. Failure to stem this looming crisis will cause significant public health and economic harm to our country.

H.R. 1708 will allow communities across the nation to partner with the private sector in funding critical water infrastructure activities by removing water and wastewater projects from the state volume caps for private activity bonds. This is the least expensive option for addressing a growing national crisis and ensuring that all Americans are guaranteed a safe, reliable water infrastructure system. We urge Congress to move expeditiously on this proposal and thank you for your leadership in this matter.

Sincerely,

Philip Welsh
President

Flowserve
Taneytown, Maryland 21048
March 27, 2006

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

I am writing on behalf of Flowserve in support of H.R. 1708, the Clean Water Investment and Infrastructure Security Act. Flowserve has been a leading manufacturer of equipment for the Water and Wastewater market for over 100 years. Our company employs thousands of people worldwide and is committed to the people and communities we serve.

We should all be concerned about the deteriorating state of our nation's water and wastewater infrastructure. Nearly $1 trillion dollars need to be invested over the

next 20 years to repair, rehabilitate, replace and upgrade our nation's network of water and wastewater treatment plants, collection systems and distribution lines. Failure to stem this looming crisis will cause significant public health and economic harm to our country.

H.R. 1708 will allow communities across the nation to partner with the private sector in funding critical water infrastructure activities by removing water and wastewater projects from the state volume caps for private activity bonds. This is the least expensive option for addressing a growing national crisis and ensuring that all Americans are guaranteed a safe, reliable water infrastructure system. We urge Congress to move expeditiously on this proposal and thank you for your leadership in this matter.

Sincerely,

James Sivigny
Water Resources Marketing Manager

Hach Company
Loveland, Colorado 80539
March 30, 2006

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

I am writing on behalf of the Hach Company in support of H.R. 1708, the Clean Water Investment and Infrastructure Security Act. Hach has manufactured water analysis instrumentation and has been active in addressing water and wastewater issues for over 40 years.

We at Hach believe the deteriorating state of our nation's water and wastewater infrastructure is a significant issue that that needs to be addressed at both the local and Federal level. Nearly $1 trillion dollars need to be invested over the next 20 years to repair, rehabilitate, replace and upgrade our nation's network of water and wastewater treatment plants, collection systems and distribution lines. Failure to stem this looming crisis will cause significant public health and economic harm to our country.

H.R. 1708 will allow communities across the nation to work with the private sector in funding critical water infrastructure activities by removing water and wastewater projects from the state volume caps for private activity bonds. This can be a cost effective option for addressing a growing national crisis and ensuring that all Americans are guaranteed a safe, reliable water infrastructure system. We urge Congress to move expeditiously on this proposal and appreciate your leadership in this matter.

Sincerely,

Jonathan O. Clark
Vice President

JWC Environmental
Costa Mesa, California 92626
March 23, 2006

The Honorable Bill Thomas, Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

I am writing on behalf of our company in support of H.R. 1708, the Clean Water Investment and Infrastructure Security Act. Our company, JWC Environmental, has been active in the wastewater industry for 33 years. Although a small company, with annual sales of about $45 million and 150 employees, we are very important in our local Southern California community, which features very few manufacturing companies in today's climate. All of our manufacturing is done locally here in Orange County.

We should all be concerned about the deteriorating state of our nation's water and wastewater infrastructure. Detailed industry studies have shown that nearly $1 trillion dollars need to be invested over the next 20 years to repair, rehabilitate, replace and upgrade our nation's network of water and wastewater treatment plants, collection systems and distribution lines. Failure to stem this looming crisis will cause significant public health and economic harm to our country.

H.R. 1708 will allow communities across the nation to partner with the private sector in funding critical water infrastructure activities by removing water and wastewater projects from the state volume caps for private activity bonds. This is the least expensive option for addressing a growing national crisis and ensuring that all Americans are guaranteed a safe, reliable water infrastructure system. We urge Congress to move expeditiously on this proposal and thank you for your leadership in this matter.

Please do not hesitate to contact me for further information.

Sincerely,

Fritz Egger
Director of Sales & Marketing

Large Public Power Council
March 30, 2006

Congressman Dave Camp
Subcommittee on Select Revenue Measures
Committee on Ways and Means
1100 Longworth House Office Building
Washington, D.C.

Dear Congressman Camp:

I am writing on behalf of the Large Public Power Council (the "LPPC") to provide comments for the record of the Subcommittee's March 16, 2006 hearing on the use of tax-preferred bond financing. As described in detail below, the LPPC supports the appropriate use of both tax-exempt bonds and tax credit bonds.

The LPPC is an association of 24 of the largest governmentally owned electric utilities in the United States. Our members include not only the largest governmentally owned retail systems in the country but also a number of wholesale sellers of electricity that serve municipally owned retail systems. Our members serve approximately 18 million retail customers and own and operate electric generation facilities that produce over 11,610,000,000 megawatt hours of generation annually. In addition, the members of the LPPC own and operate approximately 26,000 circuit miles of transmission lines. Our members are located throughout the country, including California, Colorado, Arizona, New York, Texas, Washington, Florida, Georgia, Nebraska, and South Carolina.

LPPC members have approximately $50 billion of tax-exempt bonds outstanding. Our members use tax-exempt bonds to finance electric generation, transmission, and distribution facilities for use to serve their customers. The LPPC's members are political subdivisions and other governmental entities that have always been authorized to issue tax-exempt bonds, provided that the Internal Revenue Code's private activity, arbitrage, and other limitations are satisfied. Our members are traditional governmental entities who have, for many years, provided critical electric infrastructure facilities which, in recent years, have only grown in importance. As the Subcommittee's announcement states, the Tax Reform Act of 1986 (the "1986 Act") made significant modifications to the rules for tax-exempt bonds in an effort to limit the use of tax-preferred bond financing to support private activities. The LPPC's members issue "governmental bonds" rather than private activity bonds and, as a result, are permitted to finance all of their capital needs as long as the amounts of private business use do not exceed permitted levels. The 1986 Act substantially reduced the amount of permitted private business use for all governmental bonds and there has been no liberalization of these rules. Moreover, no other issuers of governmental bonds were restricted to the extent that public power systems—particularly large public power systems—were limited. Generally, the 1986 Act reduced the amount of permitted private business use from 25 percent to 10 percent (and, in certain instances, to 5 percent). For public power issuers, the amount of permitted private business use is the lesser of 10 percent of the proceeds of the issue (or 5 percent in certain instances) or $15 million per project. This means that for any public power project with a cost greater than $150 million, the private business use limitation is $15 million. Since many electric generation projects cost hundreds of millions of dollars, the private business use limitation for public power issuers

can be as little as 2 or 3 percent. Although this $15 million for private use limitation was aimed at preventing abuse, as a practical matter it is inconsistent with energy policy and the realities of constructing large new generation and transmission projects. Given the long useful life of these projects, their large, costs, and economics of scale, these generation projects are built to serve a public power system's customers both today and long into the future. As a result, it is necessary to size these projects to take into account the expected growth in the needs of the owner's customers; to build a facility large enough for today but not tomorrow would be foolish and wasteful. As a result of this, it is often necessary for public power systems to sell relatively small portions of the output of their new facilities to other utilities as the owner grows into those facilities. As a result, the $15 million rule imposes additional costs on customers during the early years of the facility's life or compels the system to keep the electricity unavailable to other utilities who need it to satisfy the needs of their customers. Clearly, this makes no sense from an energy policy perspective. No other issuer of governmental bonds is subject to this $15 million limitation, and as a result, it impacts only those governmental entities (and their customers) where it makes the least sense. We urge that Congress repeal the $15 million private use limitation on public power financing.

In addition, subsequent to the 1986 Act, Congress enacted Section 141(d) of the Internal Revenue Code, which further restricted public power's use of tax-exempt bonds by generally prohibiting the use of tax-exempt bonds to finance the purchase of privately owned electric facilities. Further, the deregulation and restructuring of the electric industry have resulted in additional difficulties for public power's use of tax-exempt bonds under the private activity bond limitations enacted as part of the 1986 Act. The need to comply with the private use rules in a deregulated market has, at times, limited public power's participation in the deregulated market or forced public power systems to forgo the use of tax-exempt financing for their faculties.

In short, although the private activity bond restrictions limit the ability of public power systems to use tax-exempt bonds to benefit private activities as intended, they also prevent public power from engaging in legitimate transactions that further national energy policy. We are unaware of any suggestion that public power systems have used tax-exempt bonds in connection with any abusive transactions. Based on this, we believe that Congress should not impose additional limitations on public power's use of tax-exempt bonds. In fact, we believe that it is appropriate for Congress to consider simplification of the private use and other limitations to achieve a better balance between complexity and preventing abuse.

The electric industry is capital-intensive and, as a result, public power systems in general, and the LPPC in particular, are substantial issuers of tax-exempt bonds. Despite this fact, the volume of tax-exempt bonds issued by public power issuers has not increased dramatically over the past 10 years.

There is another aspect to public power's use of tax-exempt bonds to finance electric generation and transmission facilities that should be recognized. In recent years, the problems with the supply of electric generation and transmission capacity in the United States have been well documented. It has been repeatedly recognized by both government and industry officials that the United States is in drastic need of additional transmission and generation. More than any other industry sector, it is public power that has been responding to this need and building the new generation and transmission that the country requires. It would be counterproductive to introduce new limitations on how public power finances these facilities given the critical need for additional generation and transmission.

We also will address two points made by the Congressional Budget Office ("CBO") in its testimony. First, CBO stated that governmental entities can circumvent the limitations on private activity through partnerships with private entities. This is incorrect. The applicable IRS rules contain extensive limitations on every means of private entity involvement, including partnerships and management or service contracts. If anything, these rules go too far in limiting governmental entities from accessing private entity expertise in operating their facilities. CBO also suggested that there is a lack of IRS efforts to monitor compliance with the rules for tax-exempt and tax credit bonds and, as a result, Congress should impose monitoring requirements on issuers. Again, we disagree. Although relatively new, the IRS has an effective, growing audit program for tax-exempt bonds. As in other areas, the IRS relies on audits of a portion of the bond market to achieve its compliance goals. In the tax-exempt bond area, levels of noncompliance have been relatively low and seem to involve relatively discrete, non-traditional financings such as blind pools and not public power. At the same time, issuers of tax-exempt bonds must comply with the tax rules to protect the bondholders, with whom the issuers covenant to protect tax-exempt status. As a result, imposing tax compliance monitoring requirements or the

tax-exempt bond market would needlessly impose substantial costs on every issuer in order to deal with the noncompliance of a small percentage of the market. This suggestion should be rejected.

Clean renewable energy bonds. The Subcommittee's hearing announcement indicates that it would like to examine the use of tax credit bonds to provide tax-preferred bond financing for new activities. The first tax credit bond enacted was for qualified zone academy bonds ("QZABs"), which are designed to provide low cost financing for certain educational facilities. As part of the Energy Policy Act of 2005 (the "Energy Policy Act"), Congress provided for the issuance of clean renewable energy bonds ("CREBs"), a tax credit bond for renewable energy facilities. The Energy Policy Act contained an extensive set of tax provisions designed to provide tax benefits to a wide variety of energy-related projects, including a number of new and expanded tax credits.

For many years, the Internal Revenue Code has provided a production tax credit (Code section 45) for renewable energy projects with no corresponding provision to assist public power systems and cooperatives in building renewable generation. Congress could have permitted renewable energy projects of public power systems and cooperatives to obtain federal funding by making the production tax credit tradable or by adequately funding a more direct form of subsidy for these projects through the Department of Energy's Renewable Energy Production Incentive ("REPI") program. Under the REPI program, DOE provided direct payments to public power systems and cooperatives. However, this program was subject to appropriation and since its creation in 1992 was never adequately funded. As a result, Congress chose to create CREBs to provide public power and cooperatives with a subsidy that is relatively comparable to the production tax credit through the issuance of tax credit bonds. Given that public power systems have been in the forefront of the movement to greater use of renewable energy, with many public power systems voluntarily adopting their own renewable portfolio standards, the LPPC was extremely gratified by the enactment of the CREB provisions.

From a public policy perspective, it is clear that the nation needs greater use of renewable energy. In fact, the President in his State of the Union address this year stated that the development of alternative sources of energy is a top priority of this country. There are, however, restrictions on the CREBs program that substantially reduce its effectiveness. In particular, the CREBs program sunsets in two years and has a volume cap that ensures that only a small fraction of the qualifying projects will benefit from CREBs. In contrast, there are no volume limitations on the projects that are eligible for the production tax credit. In addition, Treasury has decided to allocate the volume cap in a manner that will result in small projects getting a substantially disproportionate benefit from the program. The manner in which Treasury establishes the credit rate for CREBs is also problematic. Finally, the CREBs legislation contains maturity limitations on CREBs that will limit the effectiveness of CREBs as a financing tool. Treasury has acknowledged its difficulties in allocating the limited amount of CREBs and in setting credit rates for CREBs. Although still a new program, Congressional input on the CREBs program, particularly regarding Treasury's methods of allocating CREBs volume cap and setting credit rates, is needed. Given the size of the program and limits on Treasury's resources, creative solutions are needed to address these problems.

Although CREBs did not exist prior to the Energy Policy Act, we do not believe they should be viewed as providing a new subsidy. First, for public power systems, these projects have always qualified for tax-exempt bond financing and have been financed with tax-exempt bonds in the past. Second, Congress had already recognized renewable energy facilities as worthy of federal subsidies when the production tax credit and REPI programs were enacted. Unfortunately, neither the production tax credit nor the REPI program was structured in a way that provided an effective federal subsidy for public power systems and cooperatives. Thus, the enactment of CREBs should be viewed as a modification of existing federal programs for renewable energy facilities to provide a viable subsidy for the renewable energy projects of public power systems and cooperatives. While economists can argue that tax credits and direct subsidies are more efficient, those forms of assistance have not been made available to public power for renewable energy projects. At the same time, we recognize that, compared to the tax-exempt bond market, tax credit bonds are an imperfect method of financing projects. While to economic policymakers tax credit bonds may appear to be more efficient than tax-exempt bonds, in practice, the tax-exempt bond market has proven to be very efficient and must continue to be the method that the vast majority of governmental projects are financed.

For the reasons described above, we believe that public power's use of tax-exempt bonds and tax credit bonds are more than adequately limited. Given the present state of the nation's electric infrastructure, we can think of no greater public benefit

from the use of tax-preferred bond financing than the improvement and expansion of the electric generation and transmission system.

Sincerely,

Noreen Roche-Carter
Chair, Tax and Finance Task Force

National Association of Higher Educational Facilities Authorities
Omaha, Nebraska 68124

National Council of Health Facilities Finance Authorities
Pierre, South Dakota 57501
March 30, 2005

The National Association of Higher Educational Facilities Authorities (NAHEFA) was incorporated in 1988 for the purpose of promoting the common interest of issuers of tax-exempt financing for non-profit educational institutions and to enhance the effectiveness of such organizations and their programs. The Association's members focus on issues that directly influence the availability of tax-exempt financing for non-profit educational institutions.

The National Council of Health Facilities Finance Authorities (NCHFFA) was incorporated in 1987 for the purpose of promoting the common interest of the governmental issuing authorities that provide tax exempt financing for not-for-profit hospitals and health care facilities and to enhance the effectiveness of its member institutions. The Council focuses on issues that directly influence the availability of tax-exempt financing for health care.

32 states have these authorities, and we also represent 4 local, specialized authorities.

In their states, NCHFFA/NAHEFA members operate a variety of programs to assist non-profit, educational institutions and health care providers in gaining access to the lowest interest rates available, thereby saving for each project tens of thousands of dollars annually which can then be used for faculty, staff, nurses and providing greater assistance to students or patients. Members have financed projects such as academic buildings, new dormitories, science laboratories, libraries and elementary and high schools as well as hospitals, facilities for the aging and community centers. Due to the activity of NCHFFA/NAHEFA member authorities, there is approximately $100 billion in capital project financing outstanding for nonprofit, charitable, educational and healthcare institutions throughout the United States.

Tax-exempt bond financing is crucial to the success and enhancement of many charitable, higher education and healthcare facilities. Every increase in capital costs decreases the services available to students and patients. The key role of charitable healthcare and not-for-profit education was recognized when the Internal Revenue Code provisions on tax-exempt bonds were revamped in 1986, by the Anthony Commission on Public Finance Report in 1989 and in actions by Congress and the Administration since then, including special provisions for 501(c)(3) financings in Katrina relief legislation.

NCHFFA and NAHEFA have supported legislative and regulatory provisions that prevent abuses in tax-exempt bond financing, including in our sectors. However, we strongly support the continued use of tax-exempt bond financing by legitimate charitable, healthcare and higher education institutions. Any significant limitations on bond financing in these sectors would create adverse consequences for higher education and healthcare providers and their students and patients. These organizations require regular and major amounts of capital and their vital role in the nation's economy would be threatened by undue restrictions.

Not-for-profit organizations are unable to access the equity markets, private contributions are unable to satisfy all of their needs, and government grants are extremely limited for capital projects. Therefore, much of the capital needs for not-for-profit healthcare and higher education organizations must be financed with debt. There is no question that the federal government and the states provide support and incentive to the enhancement of these institutions by allowing tax-exempt rather than taxable debt but we believe that such support is a wise policy choice. Tax-exempt debt means that institutions confront interest rates which are substantially lower and maturities significantly longer. These factors make much needed projects affordable due to lower debt service payments.

Arguments about appropriations and other direct financing of projects now financed by tax-exempt bonds are interesting intellectual speculation, but the reality is that the federal appropriations process is far from efficient and rational. Many of the appropriations and grants for charitable activities have been significantly re-

duced over time. We commend to the Committee the excellent analysis by the Bond Market Association on the efficiency of tax-exempt bonds as compared to taxable and other methods of financing projects.

The combination of state authorization and rules for the governance of issuers plus federal regulation provides an appropriate balance within our system of federalism. Basic decisions about whether projects should be financed should be made at the state and local level while Congress and the IRS protect against abuses of tax-exempt bonds. We believe that, as prior to 1986, qualified 501(c)(3) bonds should not be considered private activity bonds (even with the present exemptions) but rather as public purpose bonds when the 501(c)(3) organization's use of tax-exempt bonds is exclusively for charitable exempt activities. 501(c)(3) organizations, when operating appropriately, provide public services that are broad based in nature and that would otherwise have to be provided by a governmental entity, particularly in healthcare and education.

Concerns raised about the qualifications of certain 501(c)(3) organizations for tax exemption and the proper roles and activities of organizations, such as charitable hospitals, should be dealt with directly by the Congress and the IRS and not through the indirect and artificial means of limitations on tax exempt-bond issuances. To the extent that there is Congressional concern with the scope or operation of certain exempt purpose organizations, Congress should impose restrictions directly on such activities rather than amend the tax-exempt bond provisions. In connection with its current review of Section 501(c)(3) issues, Congress should satisfy itself that the criteria under Section 501(c)(3) are appropriate to assure that qualifying organizations operate in a manner consistent with Congress's view of proper public purposes.

NCHFFA and NAHEFA support the enhancement of the marketplace for tax-exempt bonds for healthcare and higher education. We are strong supporters of Mr. Nussle's legislation, H.R. 1140, which would amend the Internal Revenue Code to liberalize existing rules which greatly restrict "bank deductibility" of tax exempt bonds for smaller charitable healthcare and educational institutions. This legislation is aimed at focusing the existing exemption at the level of the institution's borrowing rather than at the level of the unrelated issuers' total issuances in a calendar year.

With respect to new forms of tax-preferred financing, such as tax-credit bonds, NCHFFA/NAHEFA view this development with some skepticism. Although some of these mechanisms are creative and interesting, it is unclear that they serve any purpose that is not fully satisfied by traditional tax-exempt bond financing. It is undesirable to create a system of non-uniform federal restrictions on various bonds. These bonds also divest state and local authorities and their citizens of control over what financing should occur. Rather than make an already complicated system much more complicated without clear commensurate benefit, we do not support an extension of this type of financing without clear demonstration that they create benefits that cannot be accommodated by the present public finance system.

We appreciate the Committee providing this opportunity for NCHFFA/NAHEFA to submit testimony and will be glad to provide further information as requested.

Respectfully submitted,

Linda Beaver
President NAHEFA
Donald A. Templeton
President NCHFFA
Robert Donovan
NCHFFA/NAHEFA Advocacy Chairman
Charles A. Samuels
Counsel to NCHFFA/NAHEFA

Statement of the National Association of Local Housing Finance Agencies

The National Association of Local Housing Finance Agencies (NALHFA) appreciates the opportunity to present its views to the Subcommittee on Select Revenue Measures, House Committee on Ways and Means regarding its comprehensive review of tax-preferred bond financing. NALHFA is a non-profit association of city and county government agencies, and their private sector partners, who finance affordable housing using a variety of sources, including federal tax code incentives, to attract private investment in affordable homeownership and rental housing opportuni-

ties for low-and moderate-income families. NALHFA strongly urges the Subcommittee to preserve and protect these incentives discussed in more detail below.

Affordable Housing Tax Code Incentives—Tax-Exempt Bonds

Local housing finance agencies (HFAs), and their state agency counterparts, utilize the authority provided under the Internal Revenue Code to issue several types of tax-exempt bonds to expand affordable housing opportunities for low-and moderate-income households. Among these are Mortgage Revenue Bonds (MRBs), which provide mortgage financing for first-time homebuyers; and, on the rental housing side, through tax-exempt multifamily bonds which are either private activity bonds, essential function bonds, or 501(c)(3) bonds.

In order to issue tax-exempt private activity bonds, issuers must receive an allocation of bond authority from the unified state volume cap. The volume cap is calculated as the greater of $75 per capita or $225 million per state per year (indexed for inflation), and may be used for a variety of purposes including affordable housing, "small issue" industrial, student loans, solid waste, and qualified redevelopment bonds.

Mortgage Revenue Bonds (MRBs) and Mortgage Credit Certificates (MCCs)—Local housing finance agencies issue tax-exempt MRBs under the authority of Section 143 of the Internal Revenue Code of 1986 to provide first mortgage assistance to low-and moderate-income first-time homebuyers—the people that the conventional market often leaves behind. Typically, the tax-exempt bond-financed interest rate is as much as 1.5 percent below the convention interest rate, although the spread has been much less for the past several years as the nation has enjoyed very low interest rates for conventional loans. In addition to being a first-time homebuyer, i.e. not having owned a home in the previous three years, to be eligible for MRB assistance, borrowers must have incomes no higher than 115 percent of the area median for households of three or more or 100 percent for households with less than three persons. There is an exception to these limits in certain targeted areas. In addition, the homes financed must have a purchase price no greater than 90 percent of the average area purchase price. Should a homebuyer sell the residence in which he/she lives within the first ten years, a recapture of the imputed subsidy is required to be paid to the Treasury.

In addition to providing first mortgage assistance, MRBs are also issued for qualified home improvement loans and qualified rehabilitation loans. Qualified home improvement loans cover repairs or improvement to an existing home by the owner to improve basic livability or energy efficiency of the residence. The amount of the loan may not exceed $15,000 (although this ceiling was increased to $150,000 for areas affected by last year's hurricanes).

Local housing finance agencies use MRBs for one or more public purposes:

- Providing homeownership opportunities for targeted households;
- Promoting new affordable housing construction through builder set-asides;
- Stimulating housing rehabilitation and home improvements;
- Promoting substantial rehabilitation, thereby encouraging neighborhood revitalization;
- Stabilizing and improving neighborhoods through homeownership; and
- Attracting residents to, and retaining them within, inner cities.

Local housing finance agencies may also elect to exchange all or part of their annual unused bond authority to issue mortgage credit certificates (MCCs) in lieu of MRBs. MCCs entitle qualifying individuals to a credit against their federal income tax liability for a specified percentage of the annual interest paid on a mortgage to purchase, improve or rehabilitate a home. Issuers may offer a rate from 10 to 50 percent. However, for credits in excess of 20 percent the amount of the credit is capped at $2,000. MCCs generally are subject to the same eligibility and targeting requirements applicable to the MRB program, including income, purchase price and target area set-aside. Credits are usable for the life of the mortgage so long as the mortgagor maintains the home as his/her principal residence. In order to maximize the value of an MCC, the mortgagor has to have sufficient tax liability. MCC programs tend to work best in areas with high housing costs.

Congress worked very hard in both the 1986 Act, as well as subsequent statutes, to limit the amount of issuance of MRBs and other tax-exempt private activity bonds by use of a volume cap as well as sharply targeting both the households assisted and the cost of the housing that can be purchased. In 2004 (the latest year for which data is available), local housing finance agencies issued an estimated $3.7 billion of the $14.9 billion used for MRBs through out the nation. This essential tool for expanding homeownership and assisting in neighborhood revitalization must be preserved for low-and moderate-income American first-time homebuyers.

Multifamily Housing Bonds—Local and state housing finance agencies use tax-exempt bonds to stimulate construction and substantial rehabilitation of rental housing meeting certain targeting requirements set forth in the Internal Revenue Code. They may issue private activity bonds pursuant to Section 142 (d) of the Code for residential rental projects. To qualify for such financing, a project must have at least 20 percent of the units set-aside for those households whose incomes do not exceed 50 percent of the area median income, adjusted by household size, or at least 40 percent of the units set-aside for households whose incomes do not exceed 60 percent of the area median income, adjusted for household size. The balance of the units may be rented to households paying market-rate rents.

Multifamily bonds may also be combined with Low-Income Housing Tax Credits. The Low-Income Housing Tax Credit program was created by Congress in the Tax Reform Act of 1986 to generate equity capital for the construction and rehabilitation of affordable rental housing for lower income households. They are usually used with other forms of subsidy because no one subsidy is sufficient to produce an affordable rental housing project. The credit replaced traditional tax incentives for investment in low-income housing (passive losses) that were eliminated by the same Act. The credit is a reduction in tax liability for an individual or corporate taxpayer each year for ten years that is based on the costs of development and the number of low-income units. The tax credit rate is approximately 4 percent for acquisition costs, 9 percent for rehabilitation and new construction costs, but only 4 percent if a project has federal subsidies (other than Community Development Block Grant or HOME funds) or tax-exempt financing. Properties qualifying for the tax credit (for a minimum 15-year compliance period) must have set-aside 20 percent of the units at or below 50 percent of area median income or 40 percent of the units at or below 60 percent of the area median income, with residents paying no more than 30 percent of their incomes for rent. The tax credit program is subject to a statewide volume cap set at the greater of $1.75 per capita or a minimum of $2 million. Housing credit allocating agencies must develop plans on how they will allocate credits, giving preference to projects that serve the lowest income households for the longest period of time. They must also evaluate and underwrite projects carefully to insure that they award them the least amount of credits to ensure financial feasibility. Projects that are tax-exempt bond-financed do not require a separate allocation of tax credits. Tax credits are typically syndicated to investors who may claim credits against taxable income. The amount of tax credits that individual investors may claim is $9,900 per year due to passive loss restrictions. Corporate investors may claim an unlimited amount of tax credits. Fannie Mae and Freddie Mac are the two largest purchasers of Low-Income Housing Tax Credits.

In 2004, local housing finance agencies issued an estimated $5.7 billion of the $7.7 billion in tax-exempt multifamily private activity bonds. Local and state housing finance agencies may also issue other types of tax-exempt multifamily bonds including "essential function" bonds in which the agency issuing the bonds is the owner of the project. Housing finance agencies may also issue tax-exempt bonds under Section 145 of the Code on behalf of non-profit entities qualifying for tax-exemption under Section 501 (c)(3) of the Internal Revenue Code, subject to a limitation of $150 million in bonds outstanding for any single non-profit entity at any one time. Under current law, both types of bonds [essential function and 501(c)(3)], if not used solely to acquire existing properties, are exempt from the targeting requirements and volume cap applicable to private activity bonds. None-the-less, issuers usually require some type of income restrictions for a portion of the units.

In addition to the types of bonds mentioned above, general obligation bonds are occasionally used for affordable housing. These bonds are backed by the full faith and credit of the issuing governmental entity and are not subject to federal restrictions as to targeting or the amount that may be issued. They may, however, be subject to state restrictions. Often it is necessary to obtain voter approval before issuing such bonds.

Tax-exempt private activity bonds are subject to the Alternative Minimum Tax.

These tax-exempt multifamily housing bonds serve a public purpose by expanding rental housing opportunities for lower income renters.

Recommedations

NALHFA strongly urges the Subcommittee and the Congress to preserve the tax-exemption applicable to single and multifamily housing bonds. In an era of shrinking federal domestic spending, these tax code incentives are essential for local housing finance agencies to expand affordable ownership and rental housing opportunities for low-and moderate-income families. This housing bond program does not require a large federal bureaucracy to administer and thus minimizes the administrative cost to the federal government.

In addition, NALHFA strongly urges the Subcommittee and the Congress to remove tax-exempt private activity bonds from the Alternative Minimum Tax. This tax code requirement increases issuance costs for tax-exempt private activity bonds by as much as 50 basis points, diverting resources that local housing finance agencies could otherwise use for expanding affordable housing activities.

Finally, NALHFA urges the Subcommittee and the Congress to preserve the so-called "two-percent de minimus rule" which currently encourages corporate investment in tax-exempt housing and other bonds. Under this safe harbor rule, corporations which invest in tax-exempt housing bonds may deduct the interest costs, in an amount up to two percent of their assets, associated with such investments without having to demonstrate that they did not use borrowed funds for the purchase. Preservation of this rule is necessary to maintain the corporate market for housing bonds. Fannie Mae and Freddie Mac in particular are active purchasers of state and local housing finance agency bonds and in 2004 constituted an estimated 36% of the market for housing bonds. Their private placement purchases result in issuance cost savings that local housing finance agencies can otherwise use to assist in expanding affordable housing opportunities.

Thank you for the opportunity to present NALHFA's views.

Statement of National Association of Water Companies

Mr. Chairman, on behalf of the National Association of Water Companies (NAWC) I would like to thank you for providing us the opportunity to submit testimony regarding the federal tax treatment of private activity bonds (PABs) for water and wastewater facilities.

NAWC is the only national organization exclusively representing all aspects of the private and investor-owned water industry. The range of our members' business includes ownership of regulated drinking water and wastewater utilities and the many forms of public-private partnerships and management contract arrangements. NAWC has more than 150 members, which in turn own or operate thousands of utilities in 38 States around the country.

NAWC endorses H.R. 1708, the Clean Water Investment and Infrastructure Security Act, introduced by Representative Clay Shaw (FL) and supports its earliest possible enactment.

H.R. 1708 would remove water and wastewater from under the state volume caps on PABs. This simple change would make capital both easier to obtain and less expensive for partnerships between the public and private sector on water projects, thus making such partnerships much more economically attractive to all concerned.

The Need for Increased Investment

According to recent reports by the Environmental Protection Agency and the Congressional Budget office the annual estimated need for investment in water and wastewater investment ranges from $20 to $40 billion a year. The specific projects vary from locality to locality, but the magnitude and downside for inaction is staggering.

According to EPA's data, 880 publicly owned treatment works receive flows from "combined sewer systems" which commingle stormwater with household and industrial wastewater and frequently overload during heavy rain or snowmelt. EPA estimates that such overflows discharge 1.2 trillion gallons of stormwater and untreated sewage every year. Even "sanitary" systems with separate sewers for wastewater can overflow or leak because of pipe blockages, pump failures, inadequate maintenance, or excessive demands. According to a draft EPA report, overflows from sanitary sewers alone result in a million illnesses each year. Moreover, according to industry experts, many urban and rural drinking water systems lose 20 percent or more of the water they produce through leaks in their pipe networks.

In part, those problems result from the aging of the nation's water infrastructure, particularly its pipes. Though less visible than treatment facilities, pipes actually account for the majority of both drinking water and wastewater systems' assets. According to estimates, drinking water systems have 800,000 miles of pipes, and sewer lines cover more than 500,000 miles.

The rule of thumb is that a sewer pipe lasts 50 years (although actual useful lifetimes can be significantly longer, depending on maintenance and local conditions), and a 1998 survey of 42 municipal sewer systems found that existing pipes averaged 33 years old, suggesting that many are, or soon will be, in need of replacement.Similarly, a study by the American Water Works Association that analyzed 20

medium-sized and large drinking water systems concluded that the need to replace pipes will rise sharply over the next 30 years as previous generations wear out.

Although treatment plants represent a smaller share of water systems' assets than pipes do, they too are aging. Equipment in many plants built under the Clean Water Act and Safe Drinking Water Act will need to be replaced in the next decade or two. Moreover, many drinking water systems will have to make additional investments in treatment equipment to satisfy forthcoming regulations under the Safe Drinking Water Act. A future but growing investment need is for large desalination plants in the South and West. In short, costs to construct, operate, and maintain the nation's water infrastructure can be expected to rise significantly in the near future.

The Problem with Current Law

While traditional methods for financing water and wastewater facilities are available, the growing magnitude of the problem dictates that public officials seek out a wider range of solutions including financing tools that encourage private-public partnerships. These partnerships allow the development of more cost-effective projects using non-recourse financing while minimizing project risk to taxpayers.

Unfortunately, under the current volume cap restrictions for PABs, less politically attractive long-term water and wastewater infrastructure needs are not being met. In most cases, states have allocated only a small fraction of their volume cap to such infrastructure needs, with the vast majority going to education and housing. (See the Department of Treasury testimony chart entitled "Figure 2: Uses of Private Activity Bonds, 1987–2003) In a number of key states, such as California, no PABs have been authorized for water and wastewater infrastructure in recent years. By discouraging innovations in financing, current policy places a greater burden on local, state and federal governments to provide direct funding for infrastructure.

The volume cap on the use of PAB's forces states to make tough choices concerning important infrastructure investments. Privately owned facilities are most often short-changed in the decision-making process because public officials choose to use their volume cap for more short-term politically attractive activities. If privately owned water facilities were removed from the cap, states could make more rational decisions on providing public financing based on the need to upgrade or modernize an infrastructure asset essential to future economic development and health for its citizen.

If Congress takes the private activity bonds for water and wastewater infrastructure outside the state volume cap, the financing tool would unleash untapped resources to meet this emerging crisis. Over the last two decades, policymakers were able to avert a similar crisis in the solid waste management field by removing solid waste facilities from the cap, resulting in the generation of over $20 billion in financing.

The cost of H.R. 1708 to the Federal Government is negligible; according to the Congressional Joint Tax Committee, removing the volume cap for water and wastewater projects will cost the government only $187 million over ten years. That limited investment, however, could leverage billions of dollars in much needed water project financing.

Some commentators have suggested that instead of removing the volume cap for water and wastewater just raising the cap for all qualifying bonds would suffice. Increasing the amount of the volume cap has been helpful in certain states. But, it is not enough in most situations. Many of the infrastructure projects in need of public-private partnerships are huge, multi-year undertakings. From the perspective of many states theses spikes in investment would often absorb too large a commitment in any given year. Additionally, many private sector investors are not willing to commit to multi-year projects without some guarantee that future volume cap will be there when they need it.

These same commentators point out that many states currently do not use their entire volume cap and therefore question the need for removing water and wastewater all together. In many instances, these water projects are large enough to absorb most, if not all of a state's cap. As discussed earlier, these types of projects include desalination plants, solving storm water/sewerage overflow issues, and large scale water main replacement needs. While a particular state may have some small amounts of volume cap left over at the end of a particular year, such an amount may not be large enough to address many of these problems.

Conclusion

In sum, lifting the state volume cap for water and wastewater infrastructure will result in lower cost financing that is passed on to ratepayers, will encourage private

sector partnerships to spread risk and encourage innovation, and will relieve all levels of government from the need to fund these much needed investments.

Statement of the National Council for Public-Private Partnerships

The National Council for Public-Private Partnerships (NCPPP) is a non-profit, non-partisan educational organization founded in 1985 for the purpose of providing a forum for the innovative ideas and best practices for public-private partnerships. Members of the Council are from both the public and private sectors. NCPPP wishes to respectfully submit this testimony for the March 16 hearing by the Select Revenue Subcommittee on HR 1708, the Clean Water Investment and Security Act, to remove the cap on Private Activity Bonds (PABs) for water/wastewater projects.

Private Activity Bonds (PABs) are an important tool in the financing of critical water/wastewater infrastructure. However, current federal tax law imposes caps on PABs for these projects despite the dramatic needs of the nation for the construction and restoration of its water infrastructure.

The "unified volume cap" that restricts the amount of PABs that states and localities may issue in any given year hampers their ability to address budget shortfalls in providing the public with critical water infrastructure. While other activities have been exempt from such caps, the alternative method for investment using PABs for water related projects continues to be limited by current federal tax laws.

By removing the unified volume cap on PABs, communities can gain access to more affordable interest rates as well as an important financial tool to deal with substantial funding shortfalls for the construction of critical water and wastewater treatment facilities. Through the exemption of water infrastructure projects from the bond cap, state and municipal governments would have greater flexibility and additional options to partner with the private sector in the developing, financing, owning and operating water and wastewater infrastructure, should they choose to do so.

This is also a step towards enabling state and local governments to obtain sustainable funding for the construction and operation of water infrastructure on a full life-cycle basis. This is as opposed to the limited and sometimes untimely availability of public program funds, which has been anticipated to be over $11.4 billion dollars short in the FY06 budget.

In summary, NCPPP encourages Congress to extend the list of tax-exempt private activity bonds volume cap exemptions to include water and wastewater projects as proposed in H.R. 1708.

Statement of the National Council of State Housing Agencies

Mr. Chairman, Representative McNulty, and members of the Subcommittee, thank you for the opportunity to submit testimony on the use of tax-preferred bond financing. The National Council of State Housing Agencies (NCSHA) urges Congress to preserve and strengthen the tax-exempt private activity housing bond (Housing Bond) programs in any tax legislation it undertakes.

NCSHA provides this testimony on behalf of the housing finance agencies (HFAs) of the 50 states, Puerto Rico, the U.S. Virgin Islands, the District of Columbia, and the hundreds of thousands of lower-income families these agencies house each year with the help of the Housing Bond and Low Income Housing Tax Credit (Housing Credit) programs. HFAs administer the Housing Credit and issue Housing Bonds in every state to finance affordable ownership and rental housing in thousands of communities nationwide.

The Housing Bond and Credit programs are by far the most effective tools states have to respond to their enormous affordable housing needs. With these programs, HFAs have provided millions of working families affordable ownership and rental housing and improved the quality of neighborhoods across the country.

NCSHA is deeply grateful to Congress for its steadfast support of the Housing Bond and Credit programs. Just three months ago, Congress recognized the value of these programs when it passed legislation turning to them as crucial tools to assist in the recovery of the Gulf Region from the devastation of Hurricanes Katrina, Rita, and Wilma. Over 85 percent of the Congress, including most members of this Subcommittee, cosponsored legislation enacted in 2000 to increase Housing Bond and Credit authority by 50 percent and 40 percent, respectively, and linking the authority to inflation.

NCSHA also recommends Congress make the already successful Housing Bond and Credit programs work even better for America with a few changes, many at low or no cost to the federal government, to make them even more flexible and responsive to state housing needs. Specifically, NCSHA urges you to pass H.R. 4873, sponsored by Representative Jim Ramstad, which would strengthen the Housing Bond program by exempting Housing Bond investments from the alternative minimum tax to attract more investors and reach even lower-income families, exempting single parents and families whose homes are destroyed by disaster from the first-time homebuyer requirement, and allow HFAs to recycle more resources by providing relief from the Mortgage Revenue Bond Ten-Year Rule.

The Nation's Affordable Housing Crisis

America's need for affordable housing is great and growing. More than 14 million working families of modest means in this country spend at least 50 percent of their income on housing. Hundreds of thousands more live in substandard housing or are homeless. Meanwhile, according to a recent report from Harvard University's nationally renowned Joint Center for Housing Studies, we are losing 200,000 affordable housing units annually to conversion, disrepair, and abandonment, exceeding the current rate of affordable housing production using existing resources, such as the Housing Bond and Credit programs. The Center for Housing Policy also has documented in a recent study that the homeownership rate for working families with children has actually declined since 1978.

Federal funding for housing programs is insufficient to make headway against this affordable housing crisis. Since 2001, the funding for HUD programs as a percentage of total federal discretionary spending has declined by 20 percent. Even the scarce housing resources we have are in jeopardy. The Administration has proposed a 5 percent inflation-adjusted cut in overall FY 2007 HUD discretionary funding, including a $1.1 billion cut for Community Development Block Grant programs, which often used in conjunction with Housing Bond and Credit programs to create affordable housing. While the crucial funding for housing programs has been declining, many Americans are left waiting for help. Three quarters of those eligible for federal housing assistance today do not receive it.

Creating Homeowners With Tax-Exempt Bonds

To help make homeownership affordable to working families each year, the federal government allows state and local governments to use tax-exempt single-family housing bonds, also known as Mortgage Revenue Bonds (MRBs) to finance low-interest mortgages for lower-income first-time homebuyers. MRBs have made first-time homeownership possible for more than 3.5 million lower-income families—more than 100,000 every year.

Congress limits MRB mortgages to first-time homebuyers who earn no more than the greater of area or statewide median income. Larger families can earn up to 115 percent of the greater of area or statewide median income. In 2004, the average MRB homebuyer earned $41,431—less than 60 percent of the national average family income. Congress also limits the price of homes purchased with MRB mortgages to 90 percent of the average area purchase price. The average purchase price of an MRB-financed home was $118,561—less than 65 percent of the national median home purchase price.

Investors purchase MRBs at low interest rates because the income from them is tax-free. The interest savings made possible by the tax-exemption is passed on to homebuyers by lowering their mortgage interest rates.

Each state's annual issuance of Housing Bonds and other so-called private activity bonds—including industrial development, redevelopment, and student loan bonds—is capped. Congress in 2000 increased the private activity bond cap by 50 percent and indexed it to inflation. The 2006 limit is $80 times state population, with a minimum of $246,610,000.

Multifamily Bonds—An Effective Supplier of Affordable Rental Housing

In addition to the proven effectiveness of MRBs, HFAs also issue multifamily Housing Bonds to provide financing for the acquisition, construction, and rehabilitation of affordable rental housing for low-income families. Multifamily Housing Bond-financed properties are dedicated over the long term at restricted rents and must set aside at least 40 percent of their apartments for families with incomes of 60 percent or less of median area income (AMI)—on average, families earning $34,800 or less—or 20 percent of their apartments for families with incomes of 50 percent or less of AMI.

The multifamily Housing Bond program has financed over 1.2 million apartments to respond to the severe shortage of decent, safe, and affordable housing for low-

income families—working families, seniors, people with disabilities, homeless families and individuals, and people with special needs all across the country.

Multifamily Housing Bonds are often combined with Housing Credits to provide affordable rental housing targeted more deeply to more low-income families. More than 40 percent of apartments that receive Housing Credits are financed with multifamily Housing Bonds. The Housing Bond and Credit programs have financed over 2.7 million apartments since 1986 and 160,000 apartments each year. Together, they are the only significant producers of affordable rental housing.

Promoting Economic Growth and Job Creation

The Housing Bond programs are not just good for housing; they are good for the economy. In 2004, the MRB program generated over 71,000 jobs, $921 million in wages and salaries, and over $1.7 billion in government revenue, while 2004 multifamily Housing Bond issuance generated nearly 68,000 jobs, $2.9 billion in wages and salaries, and $1.6 billion in government revenue.

Impact of Tax Reform Proposals on Housing Bonds

Several tax reform proposals put forward by members of Congress and the President's Advisory Panel on Federal Tax Reform would eliminate or diminish the impact of the Housing Bond programs. As you consider these proposals, NCSHA urges you to preserve the Housing Bond programs in any tax reform legislation you undertake. If any of the damaging proposals were to be enacted, the private market would not make up for these losses.

The Housing Bond programs help finance affordable housing production that would not otherwise occur. Land and other residential development costs far outstrip inflation in many areas of the country. The increased housing costs resulting from these increased land and residential development expenses severely impact the ability of lower-income families to meet monthly payments. Conventional mortgages are not as affordable as MRB-financed mortgages. Average rents in the unsubsidized rental housing market are far greater than rents of apartments financed with multifamily Housing Bonds.

Importantly, direct spending programs cannot replicate what the Housing Bond programs achieve through their private-sector discipline. Housing Bond investors risk losing the primary economic benefit of their investments (i.e., through the loss of the Bonds' tax-exempt status) if the programs fail to achieve their public purposes. This threat provides a performance incentive unmatched by direct spending programs that has helped make the Housing Bond programs an effective federal mechanism for providing affordable housing.

On the other hand, tax reform could greatly enhance the Housing Bond programs by eliminating tax code provisions that inhibit their effectiveness. For example, proposals to eliminate the Alternative Minimum Tax (AMT), or at least exempt Housing Bonds from it, would lower bond yields, increasing affordability.

Since 1986, the interest income on new money private activity bonds, unlike general obligation and 501(c)(3) bonds, has not been exempt from the AMT. As a result, demand for private activity bonds is weakening. To the extent potential Housing Bond investors are or fear becoming subject to the AMT, they either demand higher yields on the Housing Bonds they buy, reducing the dollars available for housing, or decline to buy Housing Bonds. Higher bond yields lead to higher mortgage rates, decreasing affordability for lower-income homebuyers and renters. AMT relief will lower bond yields and improve housing affordability.

An Opportunity to Strengthen the Housing Bond Programs

NCSHA also calls on Congress to improve the Housing Bond and Credit programs and make them even more responsive to today's affordable housing needs in any tax legislation it undertakes. By enacting a handful of changes—many at low or no cost to the federal government—Congress could make these programs more effective and efficient. H.R. 4873 contains such program improvements.

In consultation with all state HFAs and every major national housing industry group, NCSHA helped Representative Ramstad develop the Housing Bond proposals in H.R. 4873. These include:

- Exempting Housing Bond investments from the alternative minimum tax (AMT) to attract more investors and reach even lower-income families;
- Exempting displaced homemakers, single parents, and families whose homes are destroyed or made uninhabitable by presidentially declared natural disasters from the MRB program's first-time homebuyer requirement so HFAs will have greater flexibility to use the MRB program to assist in disaster recovery and serve vulnerable populations;

- Providing relief from the MRB Ten-Year Rule so states can recycle more MRB mortgage payments into new mortgages for first-time homebuyers; and
- Make technical changes to the Housing Bond programs to simplify their administration and allow them to serve more populations, such as homeless individuals.

We would be happy to provide the Subcommittee with more information on the rationale for and details of these recommendations.

Thank you for your attention. NCSHA is available to assist you in any way.

Statement of Steven Simons, Wellesley, Massachusetts

My name is Steven Simons. In 2004, I retired as a partner at Ropes & Gray LLP, where I practiced municipal bond law for thirty years, principally in the revenue bond area.

My statement reflects my own views and should not be considered to be the views of Ropes & Gray or any lawyer now or at any time in the past practicing law at Ropes & Gray.

I would like to address what I consider to be a substantial inequity in the treatment of educational and cultural institutions under IRC Section 145, which has led to the easier issuance of revenue bonds for wealthy 501(c)(3) institutions, while not really addressing the needs of less fortunate institutions. I believe that Congress recognized this inequity in part when it imposed a $150 million limitation on the issuance of non-hospital bonds, which in my view was unfortunately repealed by the Tax Reform Act of 1986.

There are several factors that contribute to this inequity. First is what I would refer to as the "knowledge" factor. The wealthier 501(c)(3) institutions not only know of the existence of tax-exempt financing but they know how to "play the game." With the assistance of legal counsel and financial advisors, they are smart enough to adopt an all-inclusive inducement resolution before spending any money on a capital project so that they can make internal advances which can later be reimbursed from bond proceeds. Additionally, and of more significance, is the manner in which the issuance of tax-exempt debt and contemporaneous capital campaigns is handled. Since tax-exempt debt for a capital project cannot be issued if the institution has funds on hand "earmarked" for that project (or the debt must be repaid when the earmarked funds are received), the institution simply does away with the concept of earmarking by soliciting pledges and accepting gifts for unrestricted endowment instead of bricks and mortar. I have personally seen examples of capital campaigns in which a particular dollar amount is to be raised. Four or five specific capital improvements were to be made (with estimated dollars next to each, or better yet no reference to the cost of such improvements), together with additional targets for financial aid for students, additional money for faculty salaries and general endowment purposes (again with or without specific dollar amounts). The fundraising literature will note that large gifts for whatever purpose will be recognized by naming rights, and the pledge cards do not specify which part of the campaign is to be benefited from the gift. Frequently, donors have a particular project in mind but are told that the ability of the institution to issue tax-exempt debt is dependent upon the gift being unrestricted. On occasion, I have been asked if pledges for a specific project (generally, a building) can be rescinded. I have not permitted this practice, although I am aware of other bond counsel that do. I have even heard anecdotally of instances in which a restricted gift, prior to its use, was changed to an unrestricted gift with the consent of the donor.

The end result: the capital campaign is successful, tax-exempt bonds are issued and debt service is paid from unrestricted endowment. This works particularly well for institutions with large endowments prior to the capital campaign, since the institution can argue that even without the campaign, there would be enough money to pay debt service on the bonds. (Of course, there might be barely enough money to pay current expenses of the institution in addition to debt service, let alone expenses five years down the road, including operating expenses for the new facilities.) At a presentation by a financial advisor for independent schools that I once attended, the principal speaker described this situation as a way for borrowers to legally "arbitrage" funds, a pronouncement that still causes me to cringe.

Contrast this situation to a local YMCA or Boys and Girls Club that wants to build a new facility. Since the capital campaign is for a single purpose, the amount of tax-exempt debt issued must be redeemed by funds already raised and further reduced as pledges are paid. Should these institutions have added an endowment

component to their capital campaign, even though they did not intend to fundraise for endowment, simply to place them on the same footing as the wealthier institutions described above? I am concerned that these smaller institutions are beginning to do just that and that this activity will haunt them in the future if the bond issues are audited by the Service.

Additionally, consider some additional differences between a tax-exempt bond issue for WG University ("WGU"), with an endowment of more than $1 billion, and the PoorFolks Boys and Girls Club ("PoorFolks"), with a minimal endowment and a much smaller bond issue. First, consider, the source of financing. Many national underwriters would not consider either a public offering or a private placement of tax-exempt debt of an amount under $40 million. This is no problem for WGU, which wishes to raise $250 million (and whose prestige will rub off on the underwriter. However, a $2 million bond issue for PoorFolks will likely have to be sold to a local bank which, because it cannot deduct the cost of purchasing or carrying tax-exempt debt, is offering a considerably higher interest rate and a shorter term for PoorFolks' bonds than WGU is receiving. Sure, WGU is on a much sounder financial footing and a combination of its financial condition and its reputation will certainly generate a lower overall interest rate. But if its financial condition and reputation is so good, why is the federal government subsidizing its debt?

Second, the wealthier the institution, the fewer financial covenants are required. WGU may issue substantial amounts of tax-exempt debt with no (or few) covenants and with no underlying security. The bank purchasing the PoorFolks bonds may insist upon a lien upon the borrower's entire campus and stringent covenants, including financial covenants that, directly or indirectly, will require the institution to maintain a sufficient amount of money on hand to ensure that there will be some money available to pay debt service. I am constantly astonished that the Internal Revenue Service has not issued a letter ruling or made another pronouncement that such arrangements create impermissible replacement proceeds. I am also somewhat dismayed that many transactions for the neediest institutions will not go through without such covenants, giving wealthier institutions a distinct advantage in issuing tax-exempt debt.

In between WGU and PoorFolks, we may have bond issues in the range of $20 million to $40 million, which are underwritten or privately placed with a bond fund by a regional underwriter and supported by a letter of credit. (This approach appears to be common now in financings for independent secondary schools.) PrepSchool may wish to build a new gymnasium or classroom complex. It is savvy enough to structure a contemporaneous capital campaign that avoids "earmarking." Depending on its PrepSchool's financial condition, the issuer of the loc may require the type of covenants that a bank would require of Poorfolks (again raising the spectre of replacement proceeds) and either a lien or a negative pledge of the borrower's campus.

At the end of the day, what do we have? Inexpensive, trouble-free borrowing by wealthy institutions and expensive, cumbersome borrowing by its less wealthy cousins. It doesn't take a rocket scientist to see who is getting the benefit of the revenue loss to the federal government. In an era of scarce resources and burgeoning deficits, is this really the most efficient method of assisting those non-profit entities that need the interest rate subsidy the most? I think not, and I urge the Committee to address the inequity here.

Thank you.

Smith & Loveless, Inc.
Lenexa, Kansas 66215
March 23, 2006

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

We here at Smith & Loveless, Inc. and its affiliated companies, are very supportive of H.R. 1708, the Clean Water Investment and Infrastructure Security Act. We have been supplying equipment and services to the water and wastewater market for sixty years. We employ on a direct basis more than 400 employees from PHD's and graduate environmental, civil, mechanical, chemical, electrical, and in-

dustrial engineers to highly qualified unionized personnel, as well as a full compliment of support personnel.

I personally have been involved in this industry for more than forty years and had the pleasure of representing our industry as Chairman of the Water & Wastewater Equipment Manufacturers Association. I currently chair the Presidents Council, made up of the leading manufacturers in this industry representing thousands of employees and several billion dollars of taxable revenues.

We are very aware of the nation's needs in regards to the environmental sector and we are all keenly aware of the shortfall of available funds to meet the nation's infrastructure needs. The funds needed are mind-boggling and we recognize that this shortfall cannot be made up by Grants from the Federal Government, or State and local funding. User fees would have to be increased to a level that would seriously impact those who least can afford them as well as have a serious effect on inflation and our ability as a country to compete.

We as a nation are becoming more and more aware of the need to upgrade our environment to safeguard our health and those of future generations. It is one thing to mandate higher standards and another thing to actually get them in place. The funding question is paramount. No constituent wants to pay higher taxes, as well as very few politicians want to raise taxes. We know that taxes remove from the economy the options that create our GNP.

That is why I believe the approach taken by H. R. 1708 is a very sound approach. While the bonds issued will be for the most part tax exempt, they will not effect the Federal Deficit, as would a grants program. The funding will be generated from the private sector. The equipment and services generated by the bonds will create thousands of high-paying construction and manufacturing jobs. All of which will give a return at the Federal level in the form of taxes and increased GNP. In addition, the profits of the companies supplying the equipment and services will further enhance the Federal and State treasuries. Another benefit of this program will be by upgrading the health of the environment and lowering in current and future generation the cost of health care. How much is that worth?

H. R. 1708 is a win win situation. We support this bill without equivocation.

Sincerely,

Robert L. Rebori
Chairman and CEO

Statement of the U.S. Conference of Mayors and the Urban Water Council

Chairman Camp, Ranking Member McNulty and Members of the Subcommittee, The United States Conference of Mayors (USCM) appreciates this opportunity to express our support for H.R. 1708 introduced by Representatives E. Clay Shaw and Jim Davis. H.R. 1708 is a bill that would strengthen the intergovernmental partnership and provide a much needed boost to local government investment in public-purpose water and sewer infrastructure in America.

A 2005 Survey conducted by the Conference of Mayors revealed that rehabilitating the aging water infrastructure is the highest water resource priority of the nation's principal cities. While local government is committed to sustaining major capital investment in water and wastewater infrastructure it has become clear that the $500 billion plus "Needs Gap" in investment needed to comply with the unfunded mandates imposed by the Clean Water and Drinking Water laws will not be closed. The need for capital investment is so great that traditional use of tax-exempt municipal bonds (revenue bonds and general obligation bonds), public water and sewer user fees and charges and Federal low interest loan programs combined will have the effect of helping cities run-in-place, but not make substantial progress in closing the "Needs Gap."

Cities will continue to use these financing tools to rehabilitate and expand public-purpose water and sewer infrastructure, but they are also implementing greater levels of asset management expertise and the use of Public-Private Partnerships to control or reduce costs for operations and maintenance as well as construction and reconstruction. Cities continue to seek ways to maximize public benefits in the most cost-efficient ways.

The Conference of Mayors adopted policy in support of changing the tax code to eliminate state caps on private activity bonds for public-purpose water and sewer infrastructure investment. It is painfully clear that increasing user rates, and the continued use of tax-preferred bonds and low interest loan programs, combined, are necessary but insufficient to satisfy the investment needs to comply with Federal

and state law. Hence, it makes good economic and quality of life sense to turn to private sources of capital through the increased use of private activity bonds. Local government has the ability to harness private capital for public benefit by using private activity bonds to fund water and wastewater infrastructure development, as the Shaw-Davis bill would allow. While the caps stay in place the use of these tax-preferred instruments are limited due to competition for investment in other worthy public benefit programs. By eliminating the state volume caps for this limited purpose the Federal tax code would help rather than hinder local government efforts to meet Federal environmental and public health mandates.

Concern was expressed at the March 16, 2006 Ways and Means Subcommittee on Select Revenue Measures Hearing by the Witness from the U.S. Department of the Treasury that the use of tax-preferred bonds be properly targeted, and ensure that the Federal subsidy is justified. The U.S. Conference of Mayors shares these concerns. The use of tax-preferred bonds as an incentive to finance public-purpose infrastructure and projects should meet the critical litmus test of broad public benefit. The use of private activity bonds for public-purpose water and sewer infrastructure projects provides an excellent example of how both of the concerns expressed by Treasury are satisfied.

A fundamental underpinning of Congressional adoption of the Clean Water Act was that it would provide broad public benefits to the American people by improving and protecting the quality of interstate waters. Despite vast improvements in public sanitation in the early to mid-1900s through the development of modern sewage collection infrastructure public health was adversely impacted by the direct and untreated or under-treated discharge of sewage into the very rivers and water bodies that were used for drinking water supplies. Congress established the publicly-owned sewage treatment works (POTW) construction grant program specifically to protect the public health of the American public from polluted interstate waters. While the construction grants program has been abolished, the public health threat remains very much alive.

Congress reconfirmed their commitment to help protect the interstate waters and public health by replacing the construction grant program with the Clean Water State Revolving Fund loan program (CWSRF) in the late 1980s, and establishing the Safe Drinking Water State Revolving Fund loan program (SDWSRF) in the 1990s. This policy shift signaled the recognition that local government still required financial assistance to help protect the integrity of the nation's interstate waters and public health; and the recognition that the cost to accomplish this goal was so great that the Federal government could no longer afford grants but would employ financial incentives through low interest loans, and continue to allow the use of tax-preferred bonds for this purpose.

It is important to point out that the benefit to the American people from investment in clean and safe water is not limited to protecting public health. Clean water policies help to protect natural species as well. Further, the provision of a clean, safe and reliable water supply creates certainty in our markets and our institutions, and that is a prerequisite for local and regional economic health. While there is much left to be done to close the water infrastructure "Needs Gap," the historical and current level of water infrastructure investment in America is one of the distinguishing characteristics of our nation. It is one of the reasons why we continue to have a strong economy and stay globally competitive. The Federal government should expand the use of tax incentives to sustain our public health, strong economy and natural resources.

The United States Conference of Mayors

The U.S. Conference of Mayors is the official nonpartisan organization of cities with populations of 30,000 or more. There are approximately 1,200 such cities in the country today. Each city is represented in the Conference by its chief elected official, the mayor. The primary roles of the Conference of Mayors are to:

- Promote the development of effective national urban/suburban policy;
- Strengthen federal-city relationships;
- Ensure that federal policy meets urban needs;
- Provide mayors with leadership and management tools;
- and Create a forum in which mayors can share ideas and information.

Urban Water Council

The Urban Water Council (UWC) is a Task Force of The U.S. Conference of Mayors (USCM). The UWC is open to all Mayors, and provides Mayors with a forum

for discussion of issues impacting how cities provide and protect water and wastewater services to the community. Some of the issues that the UWC focuses on include: watershed management; water supply planning; water infrastructure financing; rehabilitation of surface and sub-surface water infrastructure; water conservation; wetlands construction and education programs; water system program management and asset management; etc. The UWC develops local government positions on Federal legislation, regulations and policy. The UWC acts through the USCM Environment Committee, and other Committees, as appropriate, to propose and adopt resolutions on water related matters that benefits the nation's principal cities.

The U.S. Conference of Mayors

Resolution Adopted in Boston
June 2004

INCREASING INVESTMENT FOR WATER AND WASTEWATER INFRASTRUCTURE THROUGH REMOVAL OF PRIVATE ACTIVITY BONDS FROM THE STATE VOLUME CAP

WHEREAS, the projected costs for capital improvement and projects in water and wastewater infrastructure are projected to exceed $1 trillion over the next 20 years in order to comply with the Clean Water Act and the Safe Drinking Water Act; and

WHEREAS, the U.S. Conference of Mayors adopted policy in the year 2000 in Seattle to seek out innovative ways to help cities finance the construction of new water and wastewater treatment facilities, collection systems and distribution systems; and

WHEREAS, the Urban Water Council has reviewed federal impediments to financing water and wastewater infrastructure including existing environmental and tax policy, and

WHEREAS, the Urban Water Council adopted a resolution to support similar legislation in June of 2001 that would exempt Private Activity Bonds for water and sewage facilities from the state volume caps, but that legislation is no longer under consideration by congress, and

NOW, THEREFORE, BE IT RESOLVED that The U.S. Conference of Mayors hereby endorses and urges Members of Congress to support legislation which would exempt Private Activity Bonds for water and sewage facilities from the state volume caps in order to increase investment in water and wastewater supply infrastructure.

Statement of the Water and Wastewater Equipment Manufacturers Association

On behalf of the nation's producers of water and wastewater technologies used in municipal and industrial applications, worldwide, the Water and Wastewater Equipment Manufacturers Association (WWEMA) is pleased to present its views on H.R. 1708, the "Clean Water Investment and Infrastructure Security Act." Our organization considers this legislative proposal to be of utmost importance in helping to finance the nearly $1 trillion in needs facing our nation's water and wastewater infrastructure over the next 20 years.

As stated, the purpose of H.R. 1708 would be "to provide alternative financing for long-term infrastructure capital investment that is currently not being met by existing investment programs, and to restore the Nation's safe drinking water and wastewater infrastructure capability and protect the health of our citizens." It would do this by removing public-purpose water and wastewater facilities from the state volume caps on private activity bonds (PABs).

Due to their 'hidden' nature, water and wastewater facilities have been unable to compete to date under the state volume caps with the more politically-attractive, high-profile housing, health and educational facilities that receive the majority of PABs. Only 1% of tax-exempt bonds have been issued for water projects since 1986. The time has come to remove pubic-purpose water and wastewater facilities from these state volume caps and unleash the full potential of private sector capital to help communities meet their critical water infrastructure needs.

It would be difficult to find a more worthy use for PABs today than to invest in our nation's water and wastewater infrastructure. As was the case in the 1990s when the country faced a solid waste crisis and PABs were effectively used to stimulate private sector investment in that sector, today we face an even greater crisis with the need to repair, rehabilitate and replace our deteriorating water and wastewater infrastructure now in order to stave off a national public health epidemic in the not-too-distant future.

For various reasons, including a past reliance on the federal government to subsidize water and wastewater infrastructure projects, our industry has failed to charge the true cost of providing water and sewerage services and maintain sufficient reserves to meet future capital investment needs. This has led to an untenable funding gap. Though user fees are now on the increase, it will take time to build up sufficient capital reserves to meet future needs. We cannot afford to further postpone needed investments in our nation's water infrastructure. H.R. 1708 will leverage private capital to close the funding shortfall.

By partnering with the private sector, communities throughout the country will be able to avoid dramatic rate increases by having access to low-cost financing, while benefiting from the efficiencies and innovations commonly associated with private sector involvement in public works projects. The private sector already plays a pivotal role in providing services to the water and wastewater industry by operating over 2,400 municipally-owned water utilities. H.R. 1708 will provide an invaluable tool by encouraging private sector investment in water and wastewater projects.

Conservatively, $1 to $2 billion in new funds could be invested annually in the nation's water and wastewater infrastructure as a result of this legislation. The nominal loss in tax revenue to the federal government will be more than compensated by the billions in taxes generated from the jobs that will be created and the products that will be procured as a result of the infusion of additional capital into the marketplace.

While others may call for a new massive federal grants program to revitalize the nation's critical water infrastructure, during this period of constrained federal spending, lifting the current state volume caps on PABs for public-purpose water and wastewater facilities is the least expensive option for addressing a growing national crisis and ensuring that all Americans are guaranteed a safe, reliable water infrastructure system. We urge Congress to move expeditiously on this proposal.

The Water and Wastewater Equipment Manufacturers Association is a Washington, D.C.-based, non-profit trade organization founded in 1908 to represent the interests of companies that manufacture and provide water and wastewater product and services to municipal and industrial clients, worldwide. Its member companies employ over 50,000 individuals and generate in excess of $3 billion in sales globally.

Statement of the Water Partnership Council

Chairman Camp, Ranking Member McNulty, Members of the Committee:

The Water Partnership Council is pleased to provide this statement for the hearing record in support of legislation to eliminate the volume cap on tax-exempt private activity bonds for financing water and wastewater improvements.

Communities, municipalities, water management districts, river authorities, and water districts nationwide are confronted with the need to replace and maintain outdated infrastructure and provide service to additional customers. Nationwide, industry assesses these needs for water and wastewater at $23 billion annually. Meeting this infrastructure challenge requires the participation of all levels of government and the private sector. Alternative management measures such as public-private partnerships can provide communities with greater flexibility in performing needed repairs and maintenance to their systems. Public-private partnerships draw on the unique strengths of both the public and private sectors, ensure a business-like approach to asset management, and provide effective risk management.

A significant impediment to broader use of public-private partnerships is the severely limited availability of tax-exempt financing for partnerships. Currently, the tax code imposes a volume cap on the amount of bonds that may be issued to finance capital improvements to systems undertaken by the private partner. Many interests compete under the volume cap for the limited amount of tax-exempt financing in each state, and the allocation of these funds is determined annually. Both of these factors contribute to uncertainty of the availability of private bond funding for multi-year water and wastewater infrastructure projects.

In 2001, the United States Environmental Protection Agency's Environmental Financial Advisory Board recommended that private activity bonds for water and wastewater facilities be exempted from the state volume caps to allow more communities to more aggressively pursue projects that reduce capital and operating costs. HR 1708, introduced by Representatives Clay Shaw and Jim Davis, would do just that, eliminating the need for communities that are engaged in public-private partnerships to pick and choose between financing much-needed water infrastructure and other activities eligible for private activity bonding.

The Water Partnership Council strongly supports HR 1708 and urges the Committee to act promptly to ensure this much-needed legislation is enacted.

The WPC is a non-profit organization established by the leading providers of operational services for water and wastewater systems in the United States. The Council seeks to partner with citizens, local governments, and organizations committed to strengthening this country's water and wastewater infrastructure. Council members are American Water, OMI, Inc., Severn Trent Services, Southwest Water Company Services Group, United Water and Veolia Water North America.

For more information about the Water Partnership Council, please call (202) 466–5445 or visit www.waterpartnership.org.

○