Written Testimony of John Buckley

Committee on Ways and Means
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I. Introduction

Chairman Camp, Ranking Member Levin, I want to thank you for the opportunity to participate in this hearing. It is a pleasure to be back in a familiar room. I also want to thank a former employee of this Committee, Dallas Woodrum, who now is a student at Georgetown Law School. He provided research assistance for this testimony.

There is little doubt that our tax laws are in need of reform and the Committee did not have to conduct hearings to reach that conclusion. However, this and other hearings on various aspects of tax reform can provide information necessary for this Committee to make the fundamental decisions concerning the structure of the reform.

In my opinion, there are two possible approaches:

- The Committee could attempt to formulate a tax reform plan consistent with the plan contained in the budget proposed last week by Budget Committee Chairman Paul Ryan. Such a plan would have dramatic reductions in tax rates, coupled with equally dramatic repeals or limitations of current tax benefits. Unlike others in the tax reform debate, the Committee cannot avoid the painful details. There would be hard votes, perhaps on party lines, for legislation with highly uncertain prospects of enactment.

- Another approach would be a reform that identifies problematic areas and proposes structural reforms in those areas. The Chairman has already identified three such areas and released options for reform. I may disagree with some of the details, but agree with the choice of the areas where reform is needed and think that the proposed options were thoughtfully developed.

Mr. Chairman, with a little more work by your staff in identifying other areas in need of reform, you would have the framework for significant tax reform, a reform that could be enacted with bipartisan support.

If, as I expect, the majority on this Committee chooses the first approach, you will face a task far more difficult than the task faced by this Committee in developing the Tax Reform Act of 1986. In 1986, the Congress had the luxury of being able to finance much of the cost of rate reductions by eliminating rampant and abusive tax sheltering, a relatively easy target. Undoubtedly,

there are abuses today, but I have not seen any as widespread, with revenue consequences as large, as those targeted by the 1986 Tax Reform Act.

As a result, to finance rate reductions today, the Committee would have to go where the Congress refused to go in 1986; namely repeal or substantial curtailment of longstanding tax benefits that are embedded in the structure of our society and economy. The tax benefits that are the primary topic of today's hearing (tax-exempt bonds and the deduction for State and local taxes) are both longstanding and consistent with our federal system of government.

II. Tax- Exempt Bonds.

A. Overview

The Federal income tax exclusion for interest on State and local obligations has been part of the modern Federal income tax since it was first enacted in 1913. That exclusion is mirrored by a similar exclusion in all State and local income tax laws for interest on obligations of the Federal government.

The exclusion in State and local income taxes is not a voluntary, reciprocal, accommodation. It is required by Federal law.[1] This Committee needs to keep that limitation on the taxing powers of State and local governments in mind when it considers changes to the Federal income tax exclusion. It would be difficult to justify substantial limitations on, or repeal of, the Federal exclusion, while retaining the prohibition on State and local taxation of interest on Federal obligations.

The size and complexity of the rules governing tax-exempt bonds has increased dramatically over the last 100 years. However, almost all of that complexity has focused on limiting the use of the exemption for private purposes (private activity bonds) or limiting potential abuses such as arbitrage bonds (borrowing at low tax-exempt rates and investing the proceeds at higher taxable rates) or advance refundings.

When a State or local government borrows money today for traditional governmental purposes (general obligation bonds), the rules are not substantially different than they were many years ago. The main new limitation on the issuance of general obligation bonds is the requirement that they be issued in registered, not bearer, form. Otherwise, all major decisions concerning the structure of the financing and the public purpose being financed are the prerogative of the issuer. I would suggest that this is a fairly conservative method of providing Federal support for State and local investment in public infrastructure, minimizing the role of the Federal government, eliminating the possibility of earmarks, and leaving the decisions on public investments in the hands of issuers which will be responsible for all the principal repayments and the bulk of interest costs.

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[1] See section 3124, title 31, USC.

B. Tax-Exempt Bond Market

The debate over tax reform cannot be merely driven by tax policy concerns. This Committee has to take into account the possible collateral consequences of changes to longstanding tax benefits. Therefore, I want to briefly discuss the size of the tax-exempt bond market and the purposes for which those bonds are being issued.

According to data compiled by the JCT staff, the total issuance of tax exempt obligations averaged $400 billion over the period 2001-2010. Of that amount, $340 billion consisted of long-term bonds typically used for infrastructure financing and $60 billion were short-term obligations. As of the close of 2011, there were $3 trillion in outstanding tax-exempt obligations.

The JCT tax expenditure estimates suggest that the overwhelming portion of tax exempt obligations are general obligation bonds, not private activity bonds. The largest category of private activity bonds consists of bonds issued on behalf of private nonprofit educational institutions, followed by housing-related bonds. The recent press story concerning inappropriate use of private activity bonds may be worthy of Committee attention, but it is important to note that the examples cited in the article are an extremely small part of overall issuances and most were the result of limited relaxations of normal rules to provide disaster relief.

The $340 billion of annual issuances of long-term bonds reflect both new infrastructure spending and refinancing of previously issued bonds. Estimates by organizations representing State and local governments suggest that tax-exempt obligations financed $1.65 trillion in new infrastructure investments over the last 10 years. Primary and secondary school construction accounted for almost a third of those infrastructure investments, $514 billion. The other major categories were $288 in tax-exempt financing for acute care hospitals, $258 for water and sewer improvements, $178 billion for roads and $100 billion for mass transit.

C. Arguments for Change

There are three main policy arguments being presented for repeal or substantial limitation of the exclusion for State and local obligations.

First, there is the argument that the exclusion is inefficient. Inefficiency in this context means that the revenue loss from the exclusion is greater than the cost savings enjoyed by the issuers in the form of lower interest rates. I do not believe that is the real reason why the exclusion is "on the table" in the tax reform debate. In my opinion, the real reason is the potential $124 billion revenue increase over 10 years from repeal that could offset the cost of rate reductions. However, if inefficiency is the main objection, there is a simple

answer: restore the Build America Bond direct payment provisions with a dramatically lower payment rate. Such a restoration would create a new market for State and local obligations and increase the efficiency of the exclusion for issuers utilizing tax exemption, with little or no cost to the Federal government.

Second, there is the perception that the exclusion is merely a benefit for upper-income investors. That perception is fostered by distributional methods used by the JCT and Treasury which assume that all of the benefits of the exclusion flow to the investor. Those methods are simply wrong because they ignore the implicit tax borne by the investor in the form of a lower interest rate. Much of the burden from repeal would in fact be borne by State and local governments and their taxpayers.

Finally, there is the argument that the exclusion imposes economic costs by interfering with market allocation of resources. Implicit in this argument is the notion that as a country we have over-invested in public infrastructure on account of tax-exempt bonds. I believe that it would be hard to find an objective observer who does not believe that this country has under-invested in public infrastructure and that there are observable economic costs on account of that under-investment.

Repealing the exclusion will increase the cost of capital for State and local governments resulting in lower governmental investment in infrastructure. Market forces will not compensate for that lower governmental investment because market returns do not reflect the public benefits of infrastructure investments.

D. Caveat Concerning Indirect Limitations

The desire to avoid the political consequences of directly attacking specific tax benefits has led some to propose indirect, overall limitations. One example is the overall cap proposed by Mitt Romney in the recent presidential campaign. Another is a slightly different approach outlined by Martin Feldstein in an op/ed in last week's Washington Post. In both cases, tax-exempt bonds were subject to the overall limitation, but the application to previously issued bonds was not clear.

The Committee should understand that those proposals are equivalent to repeal of the exclusion, unless the overall limit is set so high that it would affect few taxpayers. They are potentially more draconian than total repeal because the case for exempting previously issued bonds is less clear.

Tax-exempt bonds are different from other deductions and exclusions because they come with a cost, an implicit tax in the form of a lower investment return. Another benefit with a similar cost is the charitable deduction. Faced with an overall limitation, taxpayers will fill the limit first with benefits that do not have a cost or are involuntary in nature, such as the exclusion for employer-provided health insurance, the mortgage interest deduction, or the deduction for State

and local taxes. Only if the limit is so high as to have no significant impact will there be room for tax-exempt bonds.

The only other form of indirect limit is the Obama Administration proposal to limit the exclusion and other tax benefits to the benefit realized at a 28% marginal rate. The proposal is a direct response to the inefficiency argument discussed above. This is the most difficult proposal to analyze. You could argue that the primary impact of the proposal would be a reduction in the "windfall" enjoyed by upper-income investors with marginal tax rates well in excess of the percentage reduction from taxable rates resulting from the exclusion. Others have argued that the proposal would increase tax-exempt rates and result in a 5% decline in the market value of existing tax-exempt bonds.

I am not in a position to know which argument is correct, but would simply note that the Obama Administration proposal would have a less adverse impact on tax-exempt rates and the market value of existing tax-exempt bonds than a tax reform plan that reduces the top marginal rate to 25%. That is true even if the reform retained the exclusion for tax-exempt bonds.

III. Deduction for State and Local Taxes

The deduction for State and local taxes has been part of the Federal income tax system since its very beginning. The deduction was one of only two deductions specifically provided for in the Income Tax Act of 1861. Every Federal income tax statute enacted since 1861 has continued that deduction, although there have been some restrictions on the types of taxes eligible for the deduction.[2]

A. Policy Rationale for the Deduction

The deduction for State and local taxes has been such a long-standing and accepted part of our Federal income tax that there was no official legislative history justifying its existence until 1964. The legislative history accompanying the Revenue Act of 1964, for the first time, set forth the Congressional rationale for the deduction.

1. Income Taxes

The legislative history of the Revenue Act of 1964 indicates that the policy rationale for the deduction of State and local income taxes is the most

[2] Harvey E. Brazer, "The Deductibility of State and Local Taxes Under the Individual Income Tax," submitted to the House Committee on Ways and Means, 86th Congress, 1st Session.

compelling: a combination of Federalism and preventing double taxation.

> "In the case of State and local income taxes, continued deductibility represents an important means of accommodation where both the State and local governments on one hand, and the Federal government on the other hand, tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case, could mean that the combined burden of State, local and Federal income taxes might be extremely heavy."[3]

The deduction for State and local income taxes is not the only feature of the Federal income tax designed to coordinate with income taxes imposed by other governmental entities. The Federal income tax system also includes the foreign tax credit which reduces the U.S. tax on foreign source income by the amount of income taxes paid on that income to other countries. The foreign tax credit is a dollar for dollar reduction in U.S. tax, a benefit much greater than a deduction. That credit has never been attacked as a subsidy for foreign governments. It is designed to avoid double taxation. Similarly, the deduction for State and local income taxes is an accommodation for taxes imposed by State and local governments, a far less generous accommodation than is accorded to income taxes imposed by foreign countries.

One of the principal reasons for adopting and maintaining an income tax is the concept that tax liability should be based on the individual's ability to pay. State and local income taxes are involuntary and are the unavoidable cost of earning the income. The case for their deductibility in an income tax is compelling, particularly since the amount of an individual's liability for State and local income taxes bears no direct relationship to the amount of government services received by the individual.

Repeal of the deduction for State and local income taxes would be equivalent to an increase in Federal marginal tax rates. For example, assume an individual resides in a State with a 10% income tax rate and assume for ease of calculation that the top Federal marginal rate is 40%. If the individual is subject to the top rate and earns an additional $100, he or she would pay tax of $10 to the State. With the Federal deduction for the tax, the individual would pay a tax of $36 (40% of the individual's actual economic net income of $90). Without the deduction, the individual would pay $40 in Federal tax (approximately 44.4% of the individual's actual economic net income).

It would be difficult to justify a repeal of the individual deduction for State and local income taxes while retaining the deduction for corporate taxpayers. Concerns for small businesses not organized as a corporation would seem to require an "all or no one" approach.

2. Real Property Taxes

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[3] Report of the Committee on Ways and Means accompanying the bill, H.R. 8363, September 13, 1963.

The Revenue Act of 1964 legislative history justified the continuation of the deduction for real property taxes on the grounds that it is an explicit incentive for home ownership. Denial of the deduction would result in a shift of the Federal tax burden between home owners and non-home owners, a shift that the Congress was unwilling to entertain in 1964.

In this area as in the case of the mortgage interest deduction, the Committee must take into potential collateral consequences. Many believe that the value of the mortgage interest deduction and real property tax deduction is embedded in the price of homes. Withdrawal of those benefits could threaten the slow recovery that we are now experiencing in home values. Indeed, some studies suggest that it would result in a further real decline in home values.

3. *Retail Sales Taxes*

The legislative history behind the Revenue Act of 1964 states that the deduction for State and local retail sales taxes was continued so as to avoid discrimination among States.

There are three major sources of revenue for State and local governments: income taxes, property taxes, and retail sales taxes. In 1964, Congress chose to continue the deduction for each of those major revenue sources, because "it is important for the Federal government to remain neutral as to the relative use made of these three forms of State or local revenue sources."[4]

In 1986, Congress rejected the rationale for deductibility of retail sales taxes. That rejection was reversed in 2004 when Congress responded to the call for neutrality of the deduction among States using different revenue sources.

B. Why Repeal is "On the Table"

There are two reasons why repeal of the deduction for State and local taxes could be part of a tax reform plan with dramatic rate reductions. The first reason is obvious. The revenue from repeal will be necessary to offset the cost of the rate reductions. Also, some see repeal as consistent with their goal of shrinking government at all levels.

In the early 1980's, the Reagan Administration originally argued for repeal of the deduction on ideological grounds. The 1984 Treasury Tax Reform Report explained "the current deduction for State and local taxes in effect provides a Federal subsidy for public services provided by State and local governments, such as public education, road construction and repair, and sanitary services."[5] One columnist stated the rationale more clearly, "The whole point of eliminating the deduction is to change government behavior by encouraging State tax cuts,

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[4] Report of the Committee on Ways and Means accompanying the bill, H.R. 8363, September 13, 1963.
[5] Tax Reform for Fairness, Simplicity, and Economic Growth, 1984.

contracting out and the privatization of government services, and the shrinkage of the public sector."[6]

Many may disagree with the goal of shrinking government at the State and local level, but it is clear that repeal of the deduction for State and local taxes would further that goal. Repeal effectively would increase the burden of those taxes. It would make it more difficult for States to finance government services, such as education, law enforcement and transportation. It would create pressure to reduce government spending at the State and local level, at the same time as the Federal government is reducing its spending in support of State and local governments.

III. Conclusion.

Quite simply, dramatic reductions in marginal tax rates should not be financed by changes that could reduce needed public infrastructure investments unless the Congress is prepared to finance those investments with appropriated funds.

Dallas Woodrum 3/13/13 9:35 PM
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Also, the reasons the Reagan proposal to repeal the deduction for State and local taxes was rejected in 1986 remain valid today. The Federal deduction for State and local taxes is an important part of our Federal system of government. It is consistent with a tax system based on ability to pay

[6] Bruce Bartlett, "The State and Local Deduction," November 2, 2004, Townhall.com