Peter Coffin, President
Breckinridge Capital Advisors, Inc.
200 High Street
Boston, MA 02110
617-443-0779
pcoffin@breckinridge.com

Submission to House Ways and Means Committee hearing:

Tax Reform and Tax Provisions Affecting State and Local Governments

Tax reform should seek to maximize the effectiveness and efficiency of any federal subsidy, including the subsidy to municipalities through the exemption of municipal bond interest. The Federal Government forgoes tax revenue on municipal bond interest in order to reduce municipalities' cost of capital for financing important public infrastructure projects. The subsidy is effective as long as the supply of tax-exempt bonds is met with sufficient demand. When demand is insufficient, municipal bond yields rise and the benefit of the subsidy shifts to the bondholder/investor in the form of higher taxable equivalent yields.

In recent years, the supply of tax-exempt bonds has often exceeded demand, shifting much of the benefit of tax-exemption to investors rather than municipalities. Perhaps as a result, there has been a proposal to limit the benefit to investors by limiting the exemption to 28%. This proposal would do far more harm than good. A much better way to limit tax-exempt interest would be to reduce the size of the tax-exempt market. Doing so would allow policymakers to preserve the tax-exemption for those municipalities that truly need it: smaller issuers.

The proposal to limit the exemption to 28% would raise some additional revenues, but an even greater cost would be borne by state and local governments. The rise in municipal borrowing costs would almost certainly exceed the tax that high-income investors would pay on their bonds. Investors have little appetite for the complexities of partially taxable bonds. The sloppy trading history and poor liquidity of municipal Market Discount Bonds* provide ample evidence of that fact.

In fact, it's likely that limiting the tax-exemption for municipal interest would produce an even greater yield penalty than that for Market Discount Bonds. Investors will certainly be wary of future limits to the tax-exemption, and thus, a yield premium for heightened "tax risk" would result. Simply put, when the federal government's credibility with tax-exemption falls, the borrowing costs for state and local governments go up.

A much more straightforward approach that retains the credibility of the federal government and actually benefits the municipal market would be to limit the volume of new tax-exempt issuance to favor small issuers. Capping tax-exempt issuance by issuer at $100 million annually would cut annual tax-exempt issuance roughly in half. The vast majority of municipal issuers - probably well over 90% - would fall within the cap and continue issuing tax-free bonds. The tighter supply would immediately cause a significant drop in tax-free bond yields. Borrowing costs would fall, and state and local governments would then reap a far greater share of the benefit from the tax-exemption.

This solution would preserve tax-exemption for the small issuers who borrow too infrequently and in sums too small to entice institutional investors. These communities depend on retail demand, so tax-exempt financing is critical for their efficient access to capital. It enables them to prioritize local infrastructure spending from the bottom-up. This is important. It's why the Bank Qualified Program has been supported for over thirty years; to ensure small issuers have access to affordable capital. Top-down, central planning has its place, but our Country has always favored some local control.

Placing a per-issuer limit on annual tax-exempt issuance would redirect the largest municipal issuers to the taxable market. While their borrowing costs would rise, the increase would be relatively small. Over the last several years, high-grade corporate bond yields have been only slightly higher than yields on comparable tax-free municipal bonds. The taxable fixed income market would certainly welcome the added high-grade bond supply. Institutional investors have a strong appetite for the long duration bonds that finance the infrastructure projects that state and local governments routinely build. This demand would only grow stronger if a large and steady supply of taxable municipal issuance were made permanent.

Redirecting large issuers to the taxable market would raise federal revenue regardless of whether the new institutional buyers were untaxed pension or endowment funds. Every dollar of municipal debt that is redirected to the taxable market is one less dollar of tax-exempt issuance. There is not an infinite supply of tax-preferred investments, so somewhere down the line more federal tax will be paid. The Joint Committee on Taxation estimates that complete elimination of the tax exemption would generate $40 billion. While cutting new tax-exempt issuance in half would generate something less, it would also reduce tax-exempt yields, and in so doing, lower financing costs for important municipal infrastructure.

We all understand that getting serious about deficit reduction will require making some sacrifices. We also recognize the need for meaningful tax reform. To succeed on both fronts will require smarter tax policy - and tax-exempt policy, where the goal isn't just the amount of added federal tax revenue. Financial markets - and Americans - expect policymakers to strive for greater simplicity, more credibility and far less waste and inefficiency. By all three measures, a plan that limits tax-exemption to smaller issuers is vastly superior to what's currently being discussed in Washington.

**The Market Discount Tax requires Investors to pay ordinary income taxes on the accretion of tax-exempt municipal bonds purchased in the secondary market at a significant discount.*