# Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

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Mr. Scott Hodge
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Director of Economic Development and Commerce Committee, Office of Federal Relations, National Governors Association, Washington, DC

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## Hearing on Tax Reform and Tax Provisions Affecting State and Local Governments

U.S. House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met, pursuant to call, at 10:05 a.m., in Room 1100, Longworth House Office Building, Hon. Dave Camp [chairman of the committee] presiding. Advisory

Chairman Camp. Good morning. The committee will come to order. Good morning, and thank you all for joining us today.

As part of the committee's efforts to strengthen the economy, create more jobs, and increase wages for American families by making the Tax Code simpler and fairer, today's hearing allows stakeholders and members of the public the opportunity to share their perspectives on tax reform and tax provisions affecting State and local governments.

Several items in the Tax Code directly affect State and local governments. The most significant and widely known provisions include the exclusion of State and local government income from Federal income tax; the itemized deduction for State and local income, property, and sales taxes; and various benefits for State and local bonds; and special rules for State and local government employee pensions and benefits. Other provisions indirectly affect State and local governments as well, such as the exclusion for contributions to corporate capital.

Over the last several years, we have heard much about how the Tax Code might be changed in ways that could affect State and local government activity. Some such as President Obama argue that exclusions, such as those for State and local bonds, and deductions, such as those for State and local taxes, inappropriately provide larger subsidies for high-income taxpayers and have advocated limiting the value of deductions and exclusions or replacing them with credits. Other tax reform proposals have also proposed significant reform of Federal tax provisions that affect State and local governments. Generally those proposals reduce the tax expenditures associated with these provisions and use the money to finance either rate reduction or higher spending. Both Democrats and Republicans, including Bowles-Simpson, Domenici-Rivlin, and tax reform panels appointed by President Obama and then-President George W. Bush, have offered these proposals.

Because such a wide range of policymakers have concluded that reform of tax provisions affecting State and local governments should be part of the discussion, it is critical to understand why they have come to such a conclusion, and it is equally critical to make sure the committee hears all sides of the story. Thus, in the interest of fairness, it will be important for the committee to examine how these Federal tax subsidies impact individual States.

For example, with regard to the deduction for State and local taxes, consider the following: In terms of the total value of deductions claimed, taxpayers in just three States -- California, New York, and New Jersey -- claim over 36 percent, more than one-third in 2010. These same States have some of the highest combined State and local income tax rates. California's State income tax rate is 13.3 percent, New Jersey's is 9 percent, and New York's highest combined income tax rate, which is in New York City, is 12.7 percent. Those findings and many more that have been uncovered over the years raise significant concerns about the current Tax Code is being used to pick winners and losers.

But we are not writing a tax reform bill in some ivory tower. Changes to the Tax Code will have a real impact on State and local economies, and the committee needs to hear directly from these stakeholders before considering any proposals as part of comprehensive tax reform. In addition to this hearing, the committee's 11 separate working groups also serve as a way to gather information from these stakeholders about how current tax laws affect them. These reports will be important to have as we begin to explore what changes, if any, should be considered, and I am hopeful they will take the opportunity to share their thoughts.

I would like to thank all of you for being here today. We have assembled a panel of four witnesses, each of whom has a broad set of experiences in this area, and I am sure they will provide a unique perspective to the discussion, and we look forward to your testimony.

Chairman Camp. And I will now recognize the ranking member for the purposes of an opening statement.

Mr. Levin. Thank you very much, and welcome.

In the 11 tax reform working groups that we set up on a bipartisan basis, based on reports to date and my own participation, we are making progress toward understanding present laws and their pluses and minuses, and their possible implications for the policy challenges we face. In an important sense, the hearing today illustrates that challenge as we address tax reform.

Republicans in the budget to be voted on this week have once again reaffirmed their goal of collapsing the current rate structure to two brackets with a top rate of 25 percent. An analysis by the nonpartisan Tax Policy Center has indicated that the rate reduction and other specific tax policies in that budget would cost $5.7 trillion over 10 years, yet the budget gives no indication or any illustration as to how to address this huge gap, most of which would involve Ways and Means jurisdiction.

We are familiar with the President's proposal to cap deductions at 28 percent. Various proposals to limit deductions and tax preferences have been put forth in the past. I believe there is value in considering thoughtful proposals as we seek a balanced approach to deficit reduction. However, the differences of opinion in the testimony before us today on one set of tax policies, those relating to State and local government, illustrate the need to distinguish between rhetoric and reality in addressing the important issue of tax reform.

I yield back.

Chairman Camp. Thank you, Mr. Levin.

Chairman Camp. Now it is my pleasure to welcome our panel of experts, all of whom bring a wealth of experience from a variety of perspectives. Their experience and insights will be very helpful as our committee considers the impact of Federal tax reform on State and local governments.

First I would like to welcome Scott Hodge, president of the Tax Foundation here in Washington, D.C. Mr. Hodge has spent over two decades working in tax policy, and his organization has provided this committee with a host of valuable data and insight through the years.

Second we will hear from David Parkhurst, who joined the National Governors Association in 2007 and currently serves as its director of its economic development and commerce committee.

Third we will hear from Christopher Taylor, an independent consultant who spent nearly 30 years as executive director of the Municipal Securities Rulemaking Board and now works in Alexandria, Virginia, as a financial consultant.

And finally we welcome back to the committee and we will hear from John Buckley, the former chief of staff for the Joint Committee on Taxation and the former Democratic chief tax counsel here at the Ways and Means Committee, who is currently a professor of tax law at Georgetown University Law Center. And again, welcome back, Professor Buckley.

Thank you all for being with us today. The committee has received each of your written statements, and they will be made part of the formal record. Each of you will be recognized for 5 minutes for your oral testimony, and, Mr. Hodge, we will begin with you. You are recognized for 5 minutes.

Mr. Hodge. Well, thank you, Mr. Chairman, and Ranking Member Levin, members of the committee. I appreciate the opportunity to contribute to this really important discussion of fundamental tax reform. And I think, as all of you recognize, one of the obvious goals of tax reform is to eliminate those parts of the Tax Code that have unintended side effects that outweigh whatever sort of policy reasons motivated their original creation. At the top of this list, actually, should be the various tax provisions benefiting State and local governments.

In the same way that a mortgage interest deduction may encourage some families to purchase a more expensive home than they would otherwise afford, the taxes-paid deduction and municipal bond exemptions encourage many States to tax more, spend more, and borrow more than they otherwise would. Academic research indicates that the taxes-paid deduction leads to greater reliance on tax-deductible taxes, such as progressive income taxes and property taxes, and ultimately leads to increases in State and local spending of own-source revenues.

The States with the largest amounts of taxes-paid deductions currently spend $2,800 more per capita on average than States with lower amounts of those deductions. The taxes-paid deduction not only benefits higher-income individuals, but it also tends to benefit the wealthiest States. The wealthiest States, such as New York, New Jersey, Connecticut, Massachusetts, and Virginia, all have among the highest percentages of filers claiming the State tax deduction. Meanwhile the poorest States, such as Arkansas, Mississippi, New Mexico, West Virginia, all have among the lowest and fewest percentage of filers claiming the deduction. Is it fair to have a tax deduction that gives the biggest benefit to the wealthiest States?

As far as individuals, I think we all know that those claiming the taxes-paid deduction, 88 percent of the benefits of that deduction go to taxpayers earning over $100,000 a year. Does that seem fair?

Now let's turn to the debt question. In recent years local governments have taken on an enormous amount of new debt, which now does not seem to be financing a lot of new investment. In fact, since year 2000, State and local debt has increased by 152 percent, increasing from roughly $1.2 trillion to nearly $3 trillion, and meanwhile State and local investment has grown hardly at all after adjusting for inflation.

So we have to ask ourselves, where has all of that borrowed money gone? The municipal bond exemption may not be the sole cause of all that new borrowing, but the availability of this cheap source of financing does create a moral hazard that can only be cured by eliminating the exemption.

Now the question is what would be the economic effects of eliminating the taxes-paid deduction and the municipal bond exemption? We used the Tax Foundation's tax simulation and macroeconomic model to answer this question in two different ways. We ran two scenarios. In the first scenario we eliminated the taxes-paid deduction and used all of the increased revenues for deficit reduction. The model showed that this sort of revenue-raising plan would reduce the long-term level of GDP by 0.23 percent, it would reduce private business stocks by 0.45 percent, and it would reduce wages slightly.

Now, these are not major economic effects, I understand, but this sort of policy would reduce GDP by $1 for every $1 of tax revenues it would raise, and we have to question whether that is worth the trade-off.

Now, in the second scenario we modeled a revenue-neutral plan that eliminated the taxes-paid and the municipal bond exemption going forward, while lowering tax rates across the board, and we found that it had a very positive impact on the economy. It would boost future level of GDP by .26 percent, or about $41 billion, not a huge effect admittedly, but it would boost private business investment and wages as well, and enough to create about 240,000 new jobs.

While, in conclusion, Mr. Chairman, I applaud the committee for taking on this very challenging effort of reforming the Tax Code, I think we all know that the defenders of these kinds of provisions will put enormous pressure on Members of Congress to save them from reform, as was done successfully in 1986. However, the economic evidence is very clear that these provisions produce more harmful effects than benefits. They encourage higher taxes, higher spending, and more debt at the State and local level. And our simulation showed that eliminating these provisions while lowering tax rates across the board would lead to higher GDP, higher private investment, higher wages, and better living standards for all Americans.

I appreciate this opportunity, and I welcome any questions you might have.

Chairman Camp. Well, thank you very much, Mr. Hodge.

Chairman Camp. Mr. Parkhurst, you are recognized for 5 minutes.

Mr. Parkhurst. Chairman Camp, Ranking Member Levin, and members of the committee, thank you for inviting testimony from the National Governors Association, which is the only bipartisan organization of the Nation's Governors. My name is David Parkhurst, and I direct NGA's economic development and commerce committee, led by Pennsylvania Governor Tom Corbett and Kentucky Governor Steve Beshear.

Governors last year appointed a five-member tax reform task force, cochaired by Governors Corbett and Beshear, to explore the possible effects of Federal tax reforms on the States. Other members of the task force included Connecticut Governor Malloy, Michigan Governor Snyder, and U.S. Virgin Islands Governor de Jongh.

Let me begin with a few main points. Number one, Federal and State tax policies are intertwined and linked; two, the preservation of public financing, notably tax-exempt bonds, is necessary because it is the primary method for States and local governments to raise capital for a wide range of infrastructure projects; three, Federal laws and regulations should not increase costs States and local governments incur to issue municipal debt or decrease investor appetite to purchase those products; and number four, no Federal law or regulation should preempt, limit, or interfere with the constitutional or statutory rights of States and local governments to develop and operate their revenue and tax streams.

Tax reform is a complex and multipronged issue. Changes to deductions, credits, exclusions, and exemptions in the Federal code will have corresponding revenue and economic implications for the States because of the variations in each State's linkages to the Federal code.

In anticipation of comprehensive Federal reform, the Nation's Governors recently released guiding principles. They focus on Federal deductibility of State and local taxes and the interest exclusion on municipal bonds, because these topics are top priorities for all States. In addition, the principles address the broader issues of ensuring that Federal reform does not limit or preempt State authority over budget and revenue systems.

I want to highlight one point I think captures an important reminder. Federal tax policies and tax expenditures serve public policy purposes that aren't necessarily captured in revenue and spending numbers. To help avoid unintended consequences from Federal reform, Federal and State partners should work together to determine whether the policy benefits of a particular Federal tax expenditure exceeds its budgetary costs before making final decisions.

For nearly 200 years municipal bonds have assisted States, cities, and counties finance their infrastructure projects. Since its inception at the beginning of the 20th century, the Federal code included the exclusion from income for municipal bond interest. This was intentional and not a special-interest add-on.

Ending or capping this Federal exclusion would increase the cost of financing infrastructure. Investors would demand higher yields as compensation. Higher borrowing costs would chill infrastructure investments, lead to higher taxes on citizens to cover those increased costs, or some combination. Given constraints on direct Federal spending, and with the tremendous overhang of unmet infrastructure needs throughout the country, policymakers should encourage, not limit, State and local financing for those projects that create jobs and boost economic growth.

Finally, every State and local government has some combination of mandatory income, sales or property tax. Each of those combinations benefits directly or indirectly from the Federal deductibility that has long been in place. Ending this Federal tax deduction for State and local income and property taxes changes the rules. It would effectively mean marginal tax rates increase for taxpayers, and, absent an offset for equity purposes, it could create an economic drag and increase uncertainty and risk for bondholders.

The message to Congress from the Nation's Governors is clear: We are all in this together. States and local governments, as the principal owners and operators of our Nation's infrastructure and issuers of municipal bonds, will remain strong advocates for safeguarding municipal markets and supporting investment in infrastructure.

As Congress moves forward on comprehensive tax reform, NGA looks forward to working in partnership with this committee. Thank you.

Chairman Camp. Thank you very much, Mr. Parkhurst.

Chairman Camp. Mr. Taylor, you are recognized for 5 minutes.

Mr. Taylor. Thank you, Mr. Chairman, Ranking Member Levin. I am here to share my observations on the municipal debt market as an economist and as a regulator of the municipal dealer community from 1978 to 2007. In particular I want to focus my remarks both in my statement and in my opening remarks on the Tax Reform Act of 1986, which fundamentally changed the municipal securities market and did so overnight.

That act basically changed the groups that invested in municipal debt, and it did so in a way that destroyed the business models of many of the members of the municipal dealer community. It changed the structure of the market, and it changed the way in which those participants in the market adapted to the new tax law. It moved the dealer community away from a model of risk taking to one that was focused on obtaining fees for services. That led to a series of scandals and problems that the municipal market has wrestled with for nearly 20 years.

Up to date, in the early 1990s, the municipal market paid more than $250 million -- the dealer community paid more than $250 million in fines for yield burning that dealt with the reinvestment of bond proceeds for municipal bonds. For members of the committee, if you make a bond tax exempt for income tax purposes, the rate at which State and local governments borrow is less than what corporations borrow because of the tax exemption. This gives State and local governments and those that serve them, the dealer community and others, the chance to invest those monies at a higher taxable rate. IRS rules regulate that, and IRS rules were changed as a result and tightened supposedly as a result of the tax reform effort of 1986.

Despite that, and because of the changes in the market, we ended up with two sets of scandals and major rule changes that had to be enacted by the Municipal Securities Rulemaking Board to address problems in the market. The two scandals involved the reinvestment of bond proceeds, yield burning, as I mentioned; fines of about $250 million; and, ongoing today, an SEC, IRS, and Justice Department investigation which has led to the 13 individuals either pleading guilty or being found guilty of violating Federal tax and securities laws. Moreover, in the most recent one to date, the fines have reached the point of $650 billion on the part of the dealer community.

It raises the question about tax law changes; because tax law changes change markets, participants change their behavior. So whatever you do, please keep in mind how it is going to affect the markets and those that are participants in the market, be it State and local governments, the dealer community or investors. Those changes can have a dark side. So I would urge all of you to think very carefully about how you go about doing that so that these markets are not fatally damaged.

We do have one of the greatest sets of infrastructure in this country. In my role as the regulator of the municipal securities market, I had individuals come to my office on a regular basis from foreign countries, and their constant question is, how did you build all these roads, schools, buildings, and everything else? And most of it came out of the municipal securities market. So please look at that market from a point of view of maintaining its integrity and taking steps to maintain its integrity if at all possible.

With that, I will conclude my remarks, Mr. Chairman.

Chairman Camp. Thank you very much, Mr. Taylor.

Chairman Camp. Mr. Buckley, you are recognized for 5 minutes.

Mr. Buckley. Thank you, Mr. Chairman and Ranking Member Levin, for the opportunity to participate in your hearing today.

After completion of your hearings and working group process, this committee faces a fundamental choice as to the structure of the tax reform that it will pursue. Mr. Chairman, you, the work you and your staff have done outlining areas of the code that need structural reform and proposing options for changes in those areas, does offer one way forward. If you put your committee staff and the joint committee staff back to work, you could identify several other similar-type areas. Those areas plus the ones you have already done could be the basis for a fundamental tax reform, a reform that could pass this committee, in my opinion, with bipartisan support, and a reform that would compare favorably to the 1986 tax reform. So that is one way forward.

The other way is to pursue a plan with dramatic rate reductions and equally dramatic repeals or curtailments of existing tax benefits. That will be a very challenging task for this committee for several reasons. First, you, unlike everybody else in this tax reform debate, have to provide the details, something that almost everybody has avoided up to this point.

Second, in 1986, the Congress had the luxury of being able to eliminate rampant, abusive tax sheltering to finance the rate reductions. That does not appear to be present in today's situation. So to finance rate reductions today, you will have to go where the Congress was totally unwilling to go in 1986, and that is repeal or curtailment of long-standing tax benefits that are embedded in our society and in our economy. There are no tax benefits more long-standing than the exemption for interest on State and local bonds and the deduction for State and local taxes.

I think the best way to explain the benefits of State and local bonds is to simply look at how they have been used. Most tax-exempt bonds are borrowing for public infrastructure. Private activity bonds, where there is a private business use, are a relatively small part of the market. In the past decade tax-exempt bonds have financed $1.65 trillion of new infrastructure investment with very small cost to the Federal Government. A third of that infrastructure investment was primary and secondary school construction.

Repealing the exclusion will simply increase the cost of capital for State and local governments, reducing investments in infrastructure. It is that simple. To pretend that there are benefits from reduction in infrastructure spending, I think, is just demonstrably wrong. We have underinvested in our public infrastructure, and there are observable economic costs on account of that underinvestment. Tax reform should not make that problem worse.

You also should recognize the impact of tax reform on State and local governments. Repealing the deduction for State and local taxes will increase the burden of those taxes and make it more difficult for State and local governments to finance basic governmental services.

In the case of the deduction for real property taxes, I think the committee also has to be concerned about the impact of collateral consequences. Most people believe that the value of the mortgage interest deduction and the value of the deduction for State and local real property taxes is embedded in the price of our homes. Repealing those benefits could put further pressure on home values. Studies have indicated it will lead to further real declines in home values, threatening our already too-slow economic recovery.

Mr. Chairman, these issues were debated at great length in the process of formulating the 1986 Tax Reform Act. Substantial changes to these benefits were rejected in 1986, and I believe the reasons for that rejection remain valid today.

Thank you very much.

Chairman Camp. Thank you very much, Mr. Buckley.

Chairman Camp. And now we will go to questions.

Mr. Hodge, you stated that eliminating the Federal tax breaks for State and local taxes and bonds, and using that revenue to reduce rates across the board, would actually create nearly a quarter of a million jobs in America. Given the stubbornly high levels of unemployment that we have seen and we continue to face several years after the financial crisis, could you explain for the committee the economics behind why that trade-off would result in significant job gains?

Mr. Hodge. Sure. Well, what this sort of reform would do -- and this is revenue-neutral reform in which the proceeds from eliminating those deductions would go directly toward across-the-board rate reductions, and in our model it would allow all rates to be reduced by about 5 percent -- not 5 percent points, but 5 percent. But that is enough to spur a lot of new economic activity either through direct spending on the part of taxpayers or through new investment, and by lowering the cost of capital, we would see a considerable amount of new investment in the economy, which ultimately leads to increased wages and increased jobs. These sorts of effects don't happen overnight, but they do happen over time, and I think that is the critical point is to look at the long-term horizon of what the economy will look like once the reform is fully in place and fully working its way through the economy.

Chairman Camp. Also, I mentioned in my opening statement that three States are responsible for more than a third, almost 40 percent, of the total Federal deduction for State and local taxes, and they coincidentally happen to be the three States that also have the highest combined State and local income tax rates in the country. Does the State and local tax deduction, as some economists have claimed, does that really encourage bigger government at the State level, in your opinion?

Mr. Hodge. The research is pretty clear that there is a direct linkage between the State and local tax deduction and higher taxes, certain types of taxes at the State level, particularly those that are deductible, those being progressive income taxes and property taxes, and a number of States have, as you indicate, have dramatically increased those particular types of taxes. California has the highest State income tax, personal income tax. New York has some of the highest property taxes in the Nation.

And so those are the kind of taxes that are not only deductible, but then are more easily increased by State and local officials because they know that Washington is going to pick up as much as one-third of the tab through the State and local deduction.

Chairman Camp. All right. I have a question for everyone on the panel, if you could answer briefly. Do you believe -- and I will start with you, Mr. Hodge. Do you believe there is a policy difference between the Federal subsidies for government bonds, which obviously are used for a public purpose, and private activity bonds, which benefit private parties?

Mr. Hodge. I would eliminate both, Mr. Chairman. I don't think it is the proper role of the Federal Government to subsidize either one of those. Essentially what those policies are doing is saying that it is more important to build a sports stadium or some other public infrastructure than to build a private R&D facility, and I think that the Tax Code should be neutral to those kinds of decisions.

Chairman Camp. All right. Mr. Parkhurst?

Mr. Parkhurst. Mr. Chairman, the vast majority of tax-exempt bonds, whether they are, in this case, private activity bonds where you have a public wrap, or it is a clear tax-exempt bond issued by State and local is usually used for financing traditional purposes, it is helping with government, schools, roads, sewer systems, public power, airports, and other infrastructure.

It is interesting. I would say that some of the examples we have seen recently in the media, were addressing projects financed under special temporary authorities that were granted by Congress following natural disasters and other events like Hurricane Katrina or 9/11, and the authority for those bonds has largely expired. And I think that private activity bonds really do help focus in some areas around low-income housing and do help in certain particular areas.

Chairman Camp. All right. Mr. Taylor?

Mr. Taylor. I believe that --

Chairman Camp. Your microphone.

Mr. Taylor. I certainly believe that if you are going to give a benefit -- and that is a decision the committee has to make -- if you are going to give a benefit to the State and local government sector, limit it to true public purposes. I do not see a reason to -- for the same reasons that I have heard to my right -- see any reason to give any kind of public benefit to private corporations or private decisionmakers. I would probably go very strongly in favor of very sharply limiting even the public purposes that are out there.

Mr. Parkhurst mentioned airports and public power. I am not sure, quite frankly, that you could have a good reason for doing either of those as a true public purpose. Limit it to roads, sewers, and those things that local governments and State governments do, not stuff that can be substituted by a private corporation.

Chairman Camp. All right.

Mr. Buckley?

Mr. Buckley. Well, first of all, I would say that most tax-exempt bonds are general obligation, traditional government financing of infrastructure. The term "private activity bond" picks up a whole wide range of activities, some of which I think have big public benefit: docks, wharves, airports. These are transportation facilities that are necessary for our economy, there are public purposes involved, and therefore I think it is appropriate to have private activity bond financing for that type of thing.

But if this committee is going to look at anything in this area, I would suggest they would look at the private activity bond rules. But let me firmly agree with the prior statement: The abuses that were outlined in that New York Times article are largely because of one-time disaster-related relief, and I would hope the Congress would not repeat that in the future.

Chairman Camp. Well, the New York Times article talked about the winery in North Carolina, the golf resort in Puerto Rico, the Corvette museum in Kentucky, obviously the Barclay Center in Brooklyn, as well as the Goldman Sachs and Bank of America towers or buildings in New York City. But my question is if those aren't appropriate for federally subsidized borrowing, are there any rules that we might change to help prevent those activities? You sort of touched on that, Mr. Buckley.

Just quickly if you each want to respond if you think there is any -- I mean, obviously some have said prevent that activity altogether, and narrowly focus. Any other comments, Mr. Parkhurst or Mr. Taylor?

Mr. Parkhurst. I would associate my remarks with Mr. Buckley. I think that that is an opportunity to obviously correct anomalies, to look very carefully at how private activity bonds are used, and make certain that the private portion is a de minimis amount, and that indeed private activity bonds are used for a public purpose.

I think we have had this discussion over the years around the use of eminent domain, and the Court had been very clear in how that issue was resolved. While State and locals may have won in the court, the court of public opinion, I think, led to some further discussion on the issue. I think we will have a similar discussion going forward with private activity bonds.

Chairman Camp. Mr. Taylor?

Mr. Taylor. Mr. Chairman, if you are going to confer a subsidy or a benefit or something to a State and local government, they should be actively involved and the only ones involved in that activity in terms of either using their taxing power, general obligations, raising sewer fees, whatever it is. But the minute you allow a melding of those things, then I think you open the door to potential abuses both in terms of the amount of issuance that is out there and also about how the funds are subsequently used and invested.

Chairman Camp. Okay. All right. Thank you.

Mr. Levin is recognized.

Mr. Levin. Thank you.

You know, I agree we should look at private activity bonds, remembering they are a small portion of the bonding that is going on, and I would hope, though it isn't clear within the jurisdiction of which of the working groups, Mr. Chairman. I would hope that the working groups --

Chairman Camp. This working group.

Mr. Levin. Well, but also I think we need -- I think the testimony today shows the need for much further inquiry into this issue, because, Mr. Hodge, I very much agree at least with what you say at the beginning. I don't agree with other parts of it perhaps. But when you say, contrary to conventional wisdom, not every tax expenditure is a loophole, that is really correct. And I think in this discussion of tax reform we need to press people when they say, let's resolve these huge gaps by looking at loopholes, we need to press them what they mean by that, because I think the issues before us today are not loopholes. There are loopholes, but these are policies that have been embedded in our Tax Code for a long time.

By the way, Mr. Hodge, the Tax Foundation is a nonpartisan entity. How is it financed?

Mr. Hodge. We are entirely privately financed. We are a nonprofit. We are a loophole for people who want to avoid taxation by giving us a charitable contribution, and if I --

Mr. Levin. But the funders aren't public, right?

Mr. Hodge. I am sorry?

Mr. Levin. The funders to your foundation aren't public?

Mr. Hodge. They are private individuals. We accept no government funds.

Mr. Levin. And it comes from individuals, corporations?

Mr. Hodge. Private foundations.

Mr. Levin. Private foundations. Okay.

Mr. Parkhurst, your testimony was approved by the association?

Mr. Parkhurst. Yes, Congressman.

Mr. Levin. So you are speaking on behalf of all the Governors, Republicans, Democrats?

Mr. Parkhurst. NGA is a bipartisan organization of the Nation's Governors, correct.

Mr. Levin. And when you testify, there is some clearance process, so when you speak on behalf of Governors, it is something that is appropriately said?

Mr. Parkhurst. Yes, there is.

Mr. Levin. Because I think that is important. There is a pointing here to three States that receive a substantial portion of the impact of the deduction for State and local taxes. I think when we look at that, we should look at the rest of the States. I think also we should look at what those three States do in terms of the use of their monies, and to simply say they are higher-tax States, I think we also need to look at their educational processes, their role in health care in this country as well as their State.

And, Mr. Buckley, I also think we need to take into account what is outlined in your testimony about the impact of long-term bonds. By the way, we tried to keep the other bonding program alive, and it now isn't in existence. The pages aren't numbered, but you indicate $340 billion of annual issuance. It goes this way according to estimates: $1.65 trillion in new infrastructure investments over the last 10 years in terms of school construction accounted for almost a third of the infrastructure investments. The other major categories were $288 billion in tax-exempt financing for acute care hospitals, $258 billion for water and sewer improvements, and $178 billion for roads, and $100 billion for mass transit.

Mr. Buckley. Yes, Mr. Levin, and let me go back to the discussion of the three big States, because I think the discussion is somewhat unfair to the three big States. They are large States; they are urban States. Urban areas have higher costs than rural areas. So it is unclear in my mind whether they have high tax rates because of the Federal deduction, or because it is much more expensive to have government in the area of an urban area.

They are also high-income States, so clearly the tax rates have -- the State and local taxes are being invested for reasons that have created wealth in those States. I think -- and they are among the largest populated States.

So there are whole reasons of factors why some States have higher tax burdens that have nothing to do with Federal deductibility. They have to do with some of the choices they have made about their educational system that have proved to be valuable to their citizens and because of the urban nature of the States.

Mr. Levin. Thank you.

Chairman Camp. Thank you.

Mr. Johnson is recognized for 5 minutes.

Mr. Johnson. Thank you, Mr. Chairman.

Mr. Hodge, last week the Dallas City Council came in to see me, and in that meeting they expressed strong opposition to doing away with the tax exemption for municipal bonds, which you referred to. According to the city's position paper, and I quote, Removing the tax exemption from municipal bonds could raise the city's borrowing costs substantially. The increased borrowing costs would disproportionately impact moderate- and low-income residents since higher borrowing costs for the city would mean either doing less or raising property tax or water and sewer fees to cover higher borrowing costs.

In your testimony you make the case for doing away with the tax exemption, and I am going to ask you about four questions if you would talk to them. In the interest of ensuring a full and fair debate, how would you respond to the council's concerns, one? And, two, is the council crying wolf? Three, would borrowing costs actually increase substantially? And, four, would property taxes have to go up?

Mr. Hodge. Well, and not necessarily in that order, to some degree, yes, they are crying wolf. They are enjoying a benefit, that is absolutely clear.

To the extent of how much interest rates would go up, well, that is up to the marketplace and how creditworthy that particular government is. But I think there should be parity between what that government borrows at and what a private-sector company in the same community would have to borrow at. Whether.

Or not it would lead to a direct increase in property taxes and other taxes to pay for it, it depends. It actually might encourage the city to reduce its overall amount of borrowing and be a little bit more prudent in what it goes about trying to build.

I think, more importantly, if you look at the overall issue, this is a very inefficient way of funding municipal projects because about a third of the benefit will go to bondholders, many of them who are upper income, and then a third of the benefit, yes, does go to the community. But when you are a Federal official looking at this, you are going, wait, we are paying a third extra essentially to finance this particular local project. So it is a very inefficient way to do it.

Actually, I wouldn't recommend this, it would be cheaper in a way to just give the cash to a State community or to a local community to build a project rather than giving a third to the bondholder and a third to the community.

Mr. Johnson. In that case New York would probably want more.

Mr. Hodge. It would certainly want more, yes.

Mr. Johnson. Thank you so much.

Thank you, Mr. Chairman.

Chairman Camp. Thank you.

Mr. Rangel is recognized.

Mr. Rangel. Thank you so much.

Very interesting, Mr. Hodge, your response to Mr. Levin in terms of your organization receiving tax exemption. I understand that from your testimony you believe that if we eliminate the subsidies given to local and State governments, we can take that money and lower the rates for taxpayers. And I assume that the contributors to your firm are wealthy taxpayers. I mean, it is not poor people that are doing it, right?

Mr. Hodge. I don't know the net wealth of my --

Mr. Rangel. No, you know your constituency.

Mr. Hodge. We have everything from little old ladies -- we have contributors who are little old ladies and wealthy people.

Mr. Rangel. Well, let me ask you, do you engage in fundraising?

Mr. Hodge. We do indeed.

Mr. Rangel. And you have no clue as to who makes the contribution to your --

Mr. Hodge. We do, yes, certainly.

Mr. Rangel. Are they wealthy people?

Mr. Hodge. There are some, and then there are some who aren't.

Mr. Rangel. Okay. But the whole idea is that you really want to lower tax rates as opposed to assisting States, especially the three that you mentioned, you think that is a give-away.

I ask you this: Do you have any idea as to the amount of Federal taxes that are paid to the Federal Government from these three States and how it relates to States that are less -- have less income? Do you ever take a look at it?

Mr. Hodge. We do. We annually rank the States in terms --

Mr. Rangel. And it is the highest in the country, isn't it?

Mr. Hodge. It is because of the progressive nature --

Mr. Rangel. It is the highest amount of revenue in the country.

Mr. Hodge. Right.

Mr. Rangel. Now, if an argument was made that because God has blessed these States with resources, and that they want to improve their education and their infrastructure and to be a place that is a symbol for American capitalism in this country and the world, just say like New York as an example, if we have to pay heavily for that in order to increase the revenue to turn back over to our Federal Government that makes it possible, don't you really believe that we should get a break for the contribution that we make to society and to your tax-exempt foundation?

Mr. Hodge. I think that people like Donald Trump and others on Wall Street can well afford --

Mr. Rangel. I wish you wouldn't have mentioned Trump's name. He is not relevant, he really isn't, to this discussion.

Mr. Hodge. He doesn't --

Mr. Rangel. Please don't do that.

Mr. Hodge. Wealthy people don't need that kind of subsidy.

Mr. Rangel. Okay. Well, I really would want you to think about whether you would want the lowest States that have the lowest educational areas, the lowest-paid people, the less productive thing, if you are comparing this as an example for fairness, do you think that makes any sense at all that you should compare the lowest States? Now, true, they need revenues, but that you compare them with a higher-paying tax State that has higher expenses than the rest? You don't believe in equality of the 50 States across the board between those that contribute to the Federal Government and those that are the beneficiaries of the Federal Government. Isn't there a difference that has to be considered?

Mr. Hodge. The economic research shows that all of those citizens would be better off with lower rates.

Mr. Rangel. But isn't it true that we contribute --

Mr. Hodge. Lower tax rates.

Mr. Rangel. A large amount of States that you mention in your testimony, they are not givers, they are receivers, and a lot of the part of that money comes from California and New York; isn't that true?

Mr. Hodge. There is a considerable amount of redistribution.

Mr. Rangel. A lot of money comes from the high-tax States, and it goes to the lower-income States, and that is a fact. So when we ask you to consider that, then you should include that in your testimony that we are big givers, and we don't complain about it. They complain to me, but they don't complain to the Federal Government. We are so pleased that our State is able to do it with the support of our partners.

That is what Sandy Hurricane was all about. When one of the States get into trouble, we don't see who is a poor State and who is a rich State, we come in. So for you to single out these three States because we tried to be partners with them in rebuilding, when they rebuild for the city, when they rebuild for the State, I would like to believe that they are rebuilding for our great country as well.

Thank you, I yield back the balance of my time.

Chairman Camp. Thank you very much.

Mr. Reichert is recognized.

Mr. Reichert. Thank you, Mr. Chairman.

So I want to focus on Washington State now. Mr. Hodge, you talked about a couple of study models that you looked at in your testimony, and that those studies that you did suggested that by eliminating the itemized deductions for State and local taxes, that would result in a lowering of tax rates; is that correct?

Mr. Hodge. That is correct.

Mr. Reichert. In your study models did you look at those States -- and there are just a handful, Texas is one of those from Mr. Johnson's neck of the woods --

Mr. Hodge. Sure.

Mr. Reichert. -- did you look at the sales tax States? We don't have an income tax in the State of Washington. We have approximately a 9 percent sales tax. What would happen there?

Mr. Hodge. Well, we didn't look at every State specifically in terms of how it would change the mix of their tax base or their economy overall. We were looking at the national results. But generally speaking, the citizens of Washington State probably have far fewer State and local tax deductions than would be the citizens of other States because of the mix of your taxes. While you do have, certainly by some counts, some higher property taxes, you don't have a personal income tax nor a corporate income tax. You have the B&O tax, and some of that I don't think is deductible.

So to some extent the citizens, the taxpayers in your State would be far better off by giving up the deduction and taking lower Federal income tax rates, and they would be far better off as a result, I think.

Mr. Reichert. You don't have an opinion as to whether or not the sales tax might be reduced, the State might move that direction or --

Mr. Hodge. Well, since it is not -- well, it is deductible to some degree, but not like the personal income tax. I don't think that the State would necessarily reduce it. We would have -- I would have to give that some more thought.

Mr. Reichert. And this is for the panel, last question, Mr. Chairman. Do any of you see a policy reason for doing tax reform and not providing parity for State sales and income taxes, whether it be providing continued permanent deduction for both or eliminating both?

Mr. Buckley. I believe there should be neutrality among the States -- regardless of their choice of revenue sources, and that has been the underlying principle of the State and local tax deduction. It was violated somewhat in 1986 when they repealed the deduction for State and local retail sales taxes, but it was replaced, restored, and so I think the principle of neutrality among States is one that should be followed in this area.

Mr. Reichert. Appreciate that, Mr. Buckley.

Any other response?

Mr. Parkhurst. I would agree with the principle of neutrality, Congressman. Also one of the principles that the Governors have laid out is one of sovereignty. I think the discussion I have heard so far is a question that really rests at State capitols and between the executive and legislative branches of the States to make those decisions on the balance, if you will, of their respective State strategies on taxes, to create a competitive environment.

Mr. Reichert. Okay, thank you. I yield back.

Chairman Camp. Thank you.

Mr. Neal is recognized.

Mr. Neal. Thank you, Mr. Chairman.

I think I provide a unique perspective, because I think Mr. Pascrell and I might be the only two on this side who were formerly mayors of major municipalities, and I can tell you that tax-exempt municipal bonds are the most important tool in the United States for financing investments in schools, roads, bridges, water, and sewer systems. The reality is that these initiatives just wouldn't happen without muni bonds.

Bowles-Simpson in its 2010 deficit reduction recommendations proposed full taxation for State and local interests for all newly issued bonds. A recent report shows that if this proposal had been in place during the 2003 to 2012 period, it is estimated that $1.65 trillion of State and local infrastructure would have cost governments an additional $495 billion of interest expense. For Boston, the tax exemption loss over that period would have resulted in a $55 million cost increase. These numbers are staggering, and the reality is that State and local governments can't withstand those additional costs.

John, in our zeal to do tax reform here, which we all agree upon, there apparently are many options that we could consider to raise revenue. You and I have worked over the years on a number of proposals to close tax loopholes, and what do you think of eliminating or capping tax-exempt financing as it relates to good policy?

Mr. Buckley. I think you can pretend that there are economic benefits from capping or repealing the exclusion only if you believe this country will benefit by lower investment in public infrastructure. The exemption goes directly to the cost of funds for State and local governments, which you have experienced.

The answer to Mr. Johnson is governments will pay higher interest rates. I don't think there is anybody in this room will disagree with the proposition that repeal of the exclusion will increase interest rates to State and local issuers, increasing their cost of investment, reducing public infrastructure.

Mr. Neal. Mr. Parkhurst.

Mr. Parkhurst. Congressman, the question is a very interesting one. I would argue that capping this benefit, to your point, would indeed, I think, raise the cost by simply a percentage. I think we have seen estimates anywhere between 60 to upwards of 200 basis points. But interestingly, if the purpose of cap is to, you know, address revenue issues, it may be a challenge, given that, based on IRS data for 2010, itemizing taxpayers seem to fall primarily, who claim interest on muni bonds, are making less than $250,000, and I think going forward, if the cap is applied in particular to all taxpayers, you going to be effectively taxed twice.

As Professor Buckley says, obviously, going to taxed on the increased cost to infrastructure and we will see the direct tax here that you are referencing.

Mr. Neal. Let me turn for a moment to Build America Bonds. John Buckley and I, along with Alan Krueger, worked very hard on Build America Bonds. They were part of the 2009 stimulus legislation. BABs are taxable bonds for which the U.S. Treasury Department pays a 35 percent subsidy to the issuer to offset borrowing cost. They were a huge success around the country. Virtually everybody who had an airport expansion, they were done with Build America Bonds during that period of time. And I must tell you that the Accelerated Bridge Program was very successful, and across Massachusetts the Build America Bonds were a smash.

Now, I want to ask you, John, do you think that this would have happened without Build America Bonds?

Mr. Buckley. Build America Bonds were enacted at a time when the municipal bond market was in freefall. There was no market for tax-exempt bonds because of the economic downturn, so clearly it responded to a tremendous need at that time.

I also think it is the response to the argument that the exclusion is inefficient. You can dramatically lower the rate of the subsidy that was provided in Build America Bonds and still dramatically increase the efficiency of the market for tax-exempt bonds. So I think it is something that has to be looked at in the long run because State and local issuers are facing a shrinking market for tax-exempt bonds.

Mr. Neal. And New Markets Tax Credits was designed to stimulate investment in low-income communities. It has been overlooked by conventional capital markets, and it has generated more than $45 billion in capital for projects in low-income communities. In North Hampton, the Holyoke Public Library, the Colonial Theater in Pittsfield, cities across the country have used New Markets Tax Credits to incent certain behaviors. I have been a real champion from day one of New Markets Tax Credits. Again, very, very successful. And how might cities attract private investment into communities with high employment and deteriorated property without the use of these incentives?

Could we do that quickly, Mr. Chairman?

Chairman Camp. Very quickly, because time has expired.

Mr. Buckley. I believe that the New Markets Tax Credit and the Low Income Housing Tax Credit are important parts of encouraging redevelopment in low-income areas. The market does not allocate resources to those areas, so if you repeal those, you are relying on market allocations and you will see less development, less low-income housing as a result.

Mr. Neal. Thank you, Mr. Chairman.

Chairman Camp. Thank you.

Dr. Price is recognized.

Mr. Price. Thank you, Mr. Chairman. And I want to thank the panelists for their presentation.

Mr. Hodge, you make the case that the Federal Government ought to be agnostic as it relates to deduction for State and local taxes, municipal bonds and the like. Can you help me understand why, what the rationale was at the beginning for the providing for tax exemption for State and local taxes?

Mr. Hodge. Sure. Well, according to the principles of sound tax policy, we shouldn't pay taxes on income that has already been taxed by another level of government. The same way we have foreign tax credits where companies don't have to pay tax on -- or they get to deduct taxes paid abroad, a similar rationale applies here. And I think that that is true. As a tax purist, I would say we generally shouldn't have to pay taxes on taxes or income that has already been taxed at the local level. However, we ought to look also at the economic effects of that kind of policy, and in this case, the policy, the unintended consequences of this policy are more harmful, I think, in the long run and outweigh whatever benefit comes from that.

Mr. Price. Is that because of a difference in rates between States, so different citizens are paying different rates and therefore they are treated differently? Is that part of your rationale?

Mr. Hodge. Well, generally speaking, and this goes back to 1913 when the code was originally written, all State taxes were deductible, and then over time it has been whittled away in various fashion. Today it is further eroded because of the AMT and the Pease provisions, which already reduce the value of these deductions. So the Congress has already made this policy decision to limit these deductions in some fashion. The question is, do we take it to the next level and just eliminate it for all taxpayers? We already do it for high-income taxpayers, and the question is, do we do it for everyone?

Mr. Price. Yeah. Mr. Buckley makes the case, I think, that if this exemption were to go away for municipal bonds and the like, that it would drive up costs for infrastructure projects and the bonds that would then be let and that, therefore, I think is the argument, that then taxes would go up for the individuals in that municipality to pay for the increased cost for the project. That makes some sense to me. Tell me why that isn't the case.

Mr. Hodge. Well, no, it probably is the case because, you know, these projects are getting a federal subsidy. So more of the costs would fall on local taxpayers, which means that local officials would have to be entirely up front with local taxpayers about the cost and they couldn't shift part of the cost to the Federal Government.

Mr. Price. So the argument is that doing away with the exemption then becomes a much more transparent, much more honest way of governance.

Mr. Hodge. Absolutely, and brings more responsibility to local officials to maintain those costs and reduce those costs and ultimately reduce the long-term borrowing cost to future taxpayers, because you got to remember, this is an obligation on future taxpayers to pay off those bonds. So by essentially subsidizing it at the federal level, you are encouraging more and more of that activity at the local level, putting a greater burden on future taxpayers, and that is what we have seen in the recent data.

Mr. Price. Mr. Parkhurst, why doesn't that make any sense?

Mr. Parkhurst. I just want to highlight one key point here, Congressman. When we are talking about investments in infrastructure, we are talking about long-term capital assets that have a long lifecycle, so it makes eminent sense to be issuing long-term debt for infrastructure that is going to benefit --

Mr. Price. I think Mr. Hodge's argument was that the process gets more transport, more accountable, and the elected officials become more then responsive to their constituents. Why isn't that true?

Mr. Parkhurst. I would argue that given that for many States and municipalities that are issuing debt, many are doing it either through a public referendum where they have got to go to the voters to explain why they are going to be issuing bonds. There are caps that are held. Transparency is well addressed, I think, at the municipal level through that at this point right now. I am not certain what the delta would be on additional transparency from Mr. Hodge's point.

Mr. Price. Mr. Hodge.

Mr. Hodge. I think that the more we can make this process transparent, the better. And if we look at the increase in debt over the last, say, 12 years relative to the amount of that debt that has gone to new infrastructure, there is a lot of money missing. There has been very little new investment in infrastructure relative to the tremendous amount of new debt that has been taken on.

Mr. Price. All right. Thank you, Mr. Chairman.

Chairman Camp. Thank you.

Mr. Doggett is recognized. After Mr. Doggett concludes, we will go two to one on this side.

Mr. Doggett. Thank you, Mr. Chairman.

There is probably no perfect way to ensure public input, public participation for a truly public interest revision of our complex tax laws, but I think what the chairman has done in terms of laying out proposals for public comment, last year on the international tax, recently on derivatives, is a step in the right direction, as is this hearing. I am less confident about how productive in assuring the public interest is represented in this revision, how the working groups are operating. In fact, one of them is meeting as we convene here now with groups that are interested in what is happening in the energy code, and many of these working groups are overlapping. All of them are done in private. And they do provide some insight, but they do not really provide an opportunity for all members of the committee to participate in all of these really important groups. And so I think that process is not quite as productive, and the more hearings like this we can have to explore all the implications of tax code revision, I think the better product we will get.

You have covered a lot of territory about how we finance infrastructure. I would like to return to a topic that the chairman asked you about, and that is on private activity bonds. While I realize that is a small portion of the overall municipal or bond market, the suggestion in the recent Times critique of the private activity bond market referred to a Bipartisan Policy Center study suggesting that the private activity bond market amounts to a cost to the Treasury of $50 billion over 10 years. Is that a fair analysis of what the cost of that program is?

Mr. Buckley. Let me say that their estimate makes the point that I was trying to make in my testimony, that it is an extremely small piece of the overall cost of tax-exempt bonds.

Mr. Doggett. Indeed, and I agree, but $50 billion is $50 billion.

Mr. Buckley. Right. Now, also, the term private activity bond picks up a whole wide range of activities. Bonds issued on behalf of private colleges are private activity bonds. Bonds issued for transportation infrastructure, wharves, docks, airports, where there is a mixed public-private are private activity bonds. So there is a wide range here.

Now, I do believe it is an area where the committee should look at.

Mr. Doggett. There were some standards set in the 1986 reform that have gradually been eroded or excepted so that while at that time you couldn't finance golf courses, now some of the subsequent disaster relief proposals have --

Mr. Buckley. What you absolutely should not do is not enact, you know, kind of scattershot disaster relief provisions that just simply waive all the limitations on private activity bonds.

Mr. Doggett. In our eagerness to respond to disasters, whether Texas, New York, Louisiana or anywhere else --

Mr. Buckley. The midwest, that is correct.

Mr. Doggett. -- sometimes those standards are forgotten, but isn't that the best way to ensure that doesn't happen to have strong clear, standards in the law about when private activity bonds can be used or to eliminate them entirely?

Mr. Buckley. Well, I think there are standards in the law. I would caution against eliminating them entirely because I think that will affect some types of infrastructure that are valuable and that you will desire. This is an area where I think the committee should look at.

Mr. Doggett. Why can't those other forms of infrastructure be, to the extent that they deserve any preference or Federal subsidy, be financed through general obligation bonds?

Mr. Buckley. Just because there is a mixed public-private use is the only reason.

Mr. Doggett. The Times article suggested that the largest beneficiary of private activity bonds had been Chevron.

Mr. Buckley. That was a disaster-related provision.

Mr. Doggett. And would be the kind of provision that while Chevron might get a benefit, Joe's Chevron station that is a small business in the same area is not accorded any benefit.

Mr. Buckley. They could have probably accessed it as well, but they did not.

Mr. Doggett. Mr. Taylor, Mr. Hodge, Mr. Parkhurst, I know you have raised questions pro and con on bonds generally, but specifically on private activity bonds, should they be limited? Are new standards necessary?

Chairman Camp. Just answer very briefly because time has expired.

Mr. Taylor. My answer is, yes, they should be eliminated. If you are going to give a benefit, give it to the State and local government directly. If they don't want to finance it, I don't see a reason that the private sector should benefit in any way.

Mr. Parkhurst. At this point, I think the Governors would want to examine all the options on the table before making any final decisions.

Chairman Camp. All right. Thank you very much.

Mr. Buchanan is recognized for 5 minutes.

Mr. Buchanan. Thank you, Mr. Chairman, for holding this important hearing today, and I would like to thank all our witnesses for taking their time out to be here. As a member from Florida, I am the only member on Ways and Means, but my district, we have 200,000 retirees, and I know that they count on municipal bonds as a stable investment.

Mr. Parkhurst, or any of you, I have got a sense of it myself, you know, as an investor over the years, but how safe are municipal bonds in terms of a sound investment for retirees?

Mr. Parkhurst. Municipal bonds are probably one of the, if not the safest investment that my parents, who are retirees, could invest in. I think, and I will defer to Dr. Buckley on the specific numbers, but I think it is well below 1 percent default rate.

Interesting point on retirees. Again, citing back to the 2010 tax date I referenced earlier, it is in my testimony, of those taxpayers that identify on their tax forms an exclusion for interest for muni bonds, 5 out of 10 of those taxpayers are 65 years or older. So seniors do comprise a large section of investors in muni bonds, either directly or through their mutual funds that invest in these products.

Mr. Buchanan. Mr. Buckley, do you have actually a number, a percentage or something? I mean, I assume 1 percent. I just wanted to kind of hear it.

Mr. Buckley. I do not have a specific number. The default rate has been low in this area.

Mr. Buchanan. Okay. The other thing was just in terms of this, do you have any sense of what percentage are owned by retirees in terms of these pension funds? Do you have any sense, 65 and older individuals?

Mr. Parkhurst. I don't have a specific answer for you, Congressman, I can look into that. I would say, though, just to give you a little more macro perspective, the market is made up of both retail and institutional investors, and the retail investors are who you are referring to at this point, individuals who are purchasing. They also include the individual investors who have been discussed here as well.

On the institutional side, the primary investors in municipal bonds are P&C, property and casualty insurance companies, as well as banks, not necessarily the large banks, but more regional and community banks that are reinvesting in infrastructure investments within their communities.

Mr. Buchanan. Mr. Buckley, the National Federation of Independent Businesses, NFIB, and I have seen that from our local chambers as well, they surveyed their members who make up the small business community across the country, and 85 percent of their members think that Congress should do tax reform, change the Federal Tax Code. However, they favor retaining the deduction for State and local taxes even in exchange for lower tax rates. They want tax reform, but they would like to retain the exemptions for State and Federal Governments. Why do you think that is, or do you have any sense of that?

Mr. Buckley. Well, first of all, as was mentioned previously, repealing the deduction effectively increases their marginal rate. So if you repealed the deduction for State income taxes and replace it with a lower rate, you really haven't done much. You have substituted one form of marginal rate increase for a marginal rate decrease.

Also, my guess is the small business community has to be very concerned about the question of whether corporations would have their deduction for State and local taxes repealed. It is hard, in my mind, to justify taking the deduction away from unincorporated businesses and continuing it for corporate businesses.

Now, in the corporate context, the rationale for the deduction is as strong as it is on the individual side, so my guess is they are worried about discrimination here.

Mr. Buchanan. One other thing. Bowles-Simpson and other groups, advisory panel for the President, want to eliminate the deduction, and why is that, do you think? Because at the end of the day you would think it would create more jobs, more opportunities, put more dollars into the Treasury in terms of people being employed, but why did they come up with that analysis?

Mr. Buckley. Revenue. Just revenue to finance rate reductions. That is all.

Mr. Buchanan. Thank you, Mr. Chairman. I yield back.

Chairman Camp. Thank you, Mr. Buckley. I do appreciate your comment that actually reducing the rate would have all taxpayers being treated more similarly as opposed to those taxpayers in those States that have high incomes and use the deduction more. But if you do eliminate that and lower the rate, there is not a marginal rate increase.

Mr. Buckley. There is a marginal rate increase depending --

Chairman Camp. Not if you lower the rate. Not if you lower the rate.

Mr. Buckley. Depending on the State in which you reside.

Chairman Camp. Yes, but you could lower the rate and there may not be a marginal rate increase and then you wouldn't have tax policy favoring certain States and certain constituencies in a way that they don't now.

Mr. Buckley. Mr. Chairman, I disagree with favoring notion here. You know, there are States that are urban in nature and therefore they have higher incomes and higher tax deductions. There are cities, Seattle in the State of Washington, where the tax burdens are higher than they are in the rest of the State. Using averages here, it doesn't really, I don't think, accurately reflects what is going on.

Chairman Camp. All right. Thank you.

Mr. Smith is recognized for five minutes.

Mr. Smith. Thank you, Mr. Chairman, and thank you to our witnesses today.

Mr. Buckley, you briefly touched on your assertion that higher taxes in various States are perhaps because of a higher cost of living. Shouldn't higher wages generate higher taxes per capita?

Mr. Buckley. That is correct. I mean, the reason some States have higher taxes than others is a combination both of higher incomes and of higher cost of government, I would argue, largely due to the urban nature of the State.

Now, those States also, as Congressman Rangel pointed out, are typically the donor States. They pay a far greater share of Federal income tax liability than other States for exactly the same reason, they are high-income States.

Mr. Smith. But that should also reflect on what their tax burden is at the State level and/or local level, correct?

Mr. Buckley. That is correct.

Mr. Smith. Okay. We have heard briefly about the public power and taxes on public power and perhaps different treatment than private power. Mr. Taylor, coming from a public power State, I am curious because I almost feel like there is more transparency in terms of, okay, there is tax free municipal bond advantages there, but then we know that in other States there are power generators in the private sector that enjoy a number, in fact, perhaps a smorgasbord of tax benefits. Is that accurate?

Mr. Taylor. I am not in a position to compare the States and the public power and private power in different States. I think my concern was that the Federal Government is providing a benefit or a subsidy or whatever, tax expenditure, for State and local governments, and I think it then behooves the committee to determine where that benefit is going.

I think Mr. Hodge said earlier, listen, you could essentially eliminate tax exemption on municipal bonds and then decide where you want the money to be spent. It might be a more efficient way to do that. It is not for me to sit here and say, okay, it should always go to A or B. That is really your decision.

That being said, if you are going to talk about State and local governments and those governmental bodies that are making decisions, they should be the ones getting a tax exemption, and it should be very clear.

In the case of Nebraska or other places where public power is a big issue, then you have to sit there and say, to what extent is the State controlling that, is it substituting for private power, at what point should you stop substituting for private power and let the private power companies come in? Those are governmental decisions that should be taken very carefully because you run the risk, with tax exemption, of it substituting for the private sector and it remaining that way even though the economy changes.

Mr. Smith. Okay. Anyone else wish to comment? No? Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman Camp. Thank you.

Mr. Blumenauer is recognized.

Mr. Blumenauer. Thank you, Mr. Chairman. I appreciate continuing this process of trying to dive into the Tax Code and the implications, and I appreciate the balanced presentation here. It gives us a range of concerns.

I want to go back to the infrastructure piece. I appreciate what my colleague Mr. Neal talked about. Mr. Buckley, you are providing some balance here. I find it --

Mr. Buckley. There are two of us, I think.

Mr. Blumenauer. I find it interesting that we are having this hearing today when the American Society for Civil Engineers is putting out its update of its scorecard, which it has been doing over the years. We are still D's, F's, I think a C minus may be in there, and the cumulative deficit, by their estimate, is $3.6 trillion necessary for the standard between now and 2020.

It is interesting to me that the era of highest economic growth and productivity increase, and, by the way, dramatic reduction in Federal debt after World War II, occurred when we made the investments in our returning veterans for their education and enabled them to buy a home. The Interstate Highway System is an obvious example, but we had other infrastructure investments, in higher education, in aviation, in water, in sewer, in areas that now communities are looking at skyrocketing rates -- by the way, rates that are not tax deductible at the local level for utilities -- at a time when we are scaling back the Federal infrastructure investment.

And looking at the bill that we just passed that expires this Congress for transportation, we are really kind of stuck here. It strikes me that looking at adjusting the interest exemption in these tax deductible bonds is one of the few areas where the Federal Government is actually stepping up and providing support for infrastructure investment.

Do you want to --

Mr. Buckley. I would agree entirely and also state that it is the only stable source of Federal support for local infrastructure spending. It is there. It is not subject to an extension of the highway bill. It is something that State and local governments can plan on. And also it is a form of Federal support that has the least amount of Federal involvement in. All of the decisions about what infrastructure to invest in, how to structure the debt are questions that are left to the prerogatives of State and local government with no Federal interference. It is a fairly conservative way of delivering support here.

Mr. Blumenauer. And I know time is short, Mr. Chairman, so I will just prepared to yield back my time, but I think this is a very important concept that the committee should consider as we move forward.

I hope that we are spending a little more time looking at infrastructure, but the consequences of this investment in areas that have tended to be more productive, that have created more wealth, that have challenges and opportunities, that people have the choice, it is the amount of benefit to the communities is commensurate with decisions they have made locally. But I think the multiple effects that the entire country benefits from in terms of increased economic activity, and frankly, reduced pressure for other types of Federal investment bears our being careful with how we move forward with this.

Mr. Taylor.

Mr. Taylor. Yes, I would like to comment on that. While I actually agree with both of you on this, in terms of the fact that the decisions are made locally, that the infrastructure is very much needed, the question is, is this the most efficient way and are you getting the bang for your buck? And I think as an economist and someone who has been involved with this area back to 1975, there is no doubt in the economic literature that some program like BABs, maybe not at 33 percent or 20, maybe it is 28, make it is 25, BABs is a much more efficient way to say where the money goes. And I am all for State and local governments defining it, but let's make it efficient.

Mr. Blumenauer. And I appreciate the opportunity that we can fine tune the way that some of the programs are administered. We have had this conversation in the past with Mr. Buckley when we were factoring other things. But I just stand by my point that I would be very careful about monkeying with this.

Mr. Tiberi. [Presiding] The gentleman's time has expired.

Mr. Blumenauer. Thank you.

Mr. Tiberi. The gentleman from Texas is recognized for 5 minutes.

Mr. Marchant. Thank you, Mr. Chairman.

I, too, have heard from every one with of my school districts, my cities, counties in my district. I have a very unique district. The center of my district is the Dallas/Fort Worth Airport, and over the last 50 years that airport has spurred growth both in industry as well as population. And I started my political career as a city council member and a mayor, so I am someone that has sat in meetings and looked at water projects, road projects, school projects, projects to bring infrastructure to major industry that wanted to locate in our town, and made those decisions based on the fact that the municipal bond rate was a rate that we could take advantage of and expand our infrastructure.

I don't think there is any mistake that if Congress decides to do away with the exemption for municipal bonds, for school district bonds, for county bonds, that every single taxpayer in my district will have an increase in their taxes. The cities have to provide infrastructure. They have to provide water, sewer. They have to provide that because they are trying to attract the industry, the very industries that are going to bring the jobs to that town.

Now, it might be, for instance, we have in our local town, we have Amazon is bringing a 1 million square foot distribution warehouse because of its proximity to the airport. Could not have done that without a major road project, could not have done that without adequate water, without adequate city sewer, without an adequate workforce who need schools.

Our goal to simplify the tax code, I agree with. Our goal to lower taxes across the board, I agree. But for us to think that we are going to be lowering tax rates for our citizens in this case, all we are going to be doing is passing that tax down to a different level. Municipal bonds provided the major catalyst for us making those decisions in school districts, in cities, in counties across the nation. In every council meeting, every school board meeting, every county supervisor meeting, almost every week they are making those decisions to create jobs, create the infrastructure for that.

And so my point today is that maybe we need to look at private activity bonds, maybe we should take a very close look at the entire spectrum, but the core deductibility of municipal bonds, of tax-exempt bonds, all it will do is create a pure tax shift. And I would like to have each of yours opinion on that comment.

Mr. Hodge.

Mr. Hodge. Congressman, I know that property tax issue is a very hot issue in Texas these days, and there has been a lot of attempts to try to control the growth of property taxes. But I would suggest that it is possible that it is the availability of municipal bonds and the ability to borrow that has in some way contributed to those higher property taxes because of the communities and school districts that are over-borrowing and thus taxing their local taxpayers. So it is a circular thing. And so, you know, it is a chicken-and-egg situation.

But I would suggest that the evidence shows that if you were to eliminate these bonds, it would actually end up lowering property taxes overall because communities would not borrow as much and spend as much. And so over time I think that those property taxes and local taxes would come back down. That is what the economic evidence shows.

Mr. Marchant. Mr. Parkhurst.

Mr. Parkhurst. Congressman, I think your comments are in accord with the Nation's Governors. I appreciate those thoughts.

I would like to leave you with an interesting data point that I think will help you the next time you have visitors from back home. There are proposed next year of $43 billion in lost revenue to the Federal Government from the interest exclusion. There is also a projected increase, a sale of $400 billion in new issuances of muni bonds, about a 10:1 ratio. That is a pretty good leverage ratio for the dollars.

Chairman Camp. [Presiding] All right. Thank you. The gentleman's time has expired.

Ms. Black is recognized.

Mrs. Black. Thank you, Mr. Chairman.

I think that my colleague from Texas certainly does make a valid argument related to the investment and infrastructure, but as we read in the New York Times, they reported recently that the tax-exempt bonds had been used, as the chairman said, for things like a winery in North Carolina and a golf course in Puerto Rico, a Corvette museum. I probably should temper my comments on that since my husband is a big Corvette person.

But when we look at these, do you think that this is, first of all, an appropriate use for these kinds of projects, as my colleague talked about infrastructure, questioning these as infrastructures, and then in addition to that, what kind of rules could be changed to prevent these types of activities from happening in the future?

So why don't we start with you, Mr. Buckley, and work down the other way?

Mr. Buckley. Well, first of all, I think it is entirely appropriate for this committee to examine the rules for private activity bonds, and they were tightened in 1986. Now, a lot of the examples in the New York Times articles were in response of one-time liberalizations of the rules as part of disaster relief measures, and I would suggest the committee ought not to do that again in the future. I mean, they should tighten the rules.

Now, a lot of what was previously talked about are private activity bonds. When you were talking about the airport development and all of that, those are private activity bonds. And so they do serve, I believe, bona fide public purposes of development, helping, you know, as you say, Amazon would not have come but for the railroad development.

The highways in that circumstance may well be considered private activity bonds because of disproportionate use by one taxpayer. So I believe you should examine those rules. You should tighten them, if necessary. But don't use those, you know, anecdotal stories in the New York Times to justify repeal of a provision that I think has proved to be quite effective.

Mrs. Black. Mr. Taylor.

Mr. Taylor. In some ways I would agree with Mr. Buckley, but I would also add that any time you give, and I hate to pick on DFW again, if you are going to use the tax exemption there, it benefitted certain airlines over other airlines in terms of allocation of landing slots and the whole kit and caboodle. You had a corporate purpose that was involved in this.

I have absolutely no problem with the Congressman's discussion, the previous Congressman's discussion about water and sewer and schools and things like that. I think it is imperative that the committee decide to what activities does this benefit flow to. Personally, I have a question in my mind of any kind of benefit flowing down to one particular corporation or another without it being available to everyone, and that is what the markets are for.

So if you limit tax exemption to standard governmental purposes that we all could probably agree on here, fine. But once it gets into anything that flows to the private sector, you should be very, very careful.

Mrs. Black. Mr. Taylor, I want to just tag onto that for just a second because you mentioned Build America Bonds. And I don't know that much about them. Would they be any different than, in making these kinds of determinations, than --

Mr. Taylor. Well, I will go back to a comment that Mr. Hodge made earlier on, that the way the tax exemption is structured right now a certain portion of the dollar that you are providing goes to the investor. And so is that really what you want to do? The answer usually is no, and there isn't an economist, heck, I have read -- when I first got involved with munis, the studies were going back to 1963 saying do it, a la BABs, do it that way because it is the most efficient way to give the money, and let the decision making be at the lower level.

I think the real question is, what is that rate? Is it 28, which I have heard bandied about, or 25, that is your decision. But it is a much better way to get the bang for the buck.

Mrs. Black. Okay. Mr. Parkhurst.

Mr. Taylor. Rather than tax exemption

Mr. Parkhurst. Briefly, I would concur with Mr. Buckley's comments that working to review the rules would make eminent sense to correct anomalies, and I would offer up an opportunity for this committee to reach out to States and local governments that have the direct hands-on experience with many of these private activity bonds -- to work in partnership in that.

Mrs. Black. Mr. Hodge, I am out of time, so if you have any remarks pertaining to that, if you will submit it, that would be great. Thank you.

Mr. Hodge. I certainly will.

Chairman Camp. Thank you. Thank you very much.

Mr. Pascrell is recognized.

Mr. Pascrell. Thank you, Mr. Chairman, to the panelists.

Good to see you back, Mr. Buckley. I don't see you, but I am here. You stated that 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. Just give me one sentence of summary in your own mind.

Mr. Buckley. I would use two examples. Home values. I don't think there is any economist in the country that doesn't think the price of our homes have embedded in them the value of the deduction for mortgage interest and real property taxes. I really think the Congress has to be very careful about removing those benefits. I think it would be quite destructive to have further decline in housing prices by reason of what action is taken by Congress.

Employer-provided health care. Almost all of us get our health care through our employer. If you repeal the exclusion for employer-provided health care, you will see a decline in the level of healthcare coverage provided by the employer. I think that is a bad thing.

Mr. Pascrell. So in solving one, we will create another problem.

Mr. Buckley. You will have to respond with appropriated funds if people lose their health insurance.

Mr. Pascrell. We discussed it, as you remember, during the debate on Obamacare.

Mr. Buckley. That is correct.

Mr. Pascrell. Mr. Hodge, if we follow, if we pursue your path, what you are suggesting, we will never ever repair our infrastructure for water and sewers in this country. We lose 25 percent of our water that is already being treated because of the antiquated system that we have and will not repair it, and the municipalities do not have the money, the States do not have the money to do this. So they might as well just wait till they have the money. Well, you know what happens in that circumstance.

That is not acceptable. That is not acceptable. And I agree with the gentleman from Texas that these things will not get done unless these bonds exist, unless these private equity bonds exist. We have had legislation before us for 10 years, passed in this House 3 times, 3 times, and stalled in the Senate. Right, Mr. Camp, Mr. Chairman?

Chairman Camp. Very familiar with it.

Mr. Pascrell. We need to keep the collateral consequences that Mr. Buckley refers in mind, as well as the policy goals we wish to accomplish through our Tax Code. One big collateral consequence I am concerned about is in the area, and you have heard about it, the State and local tax provisions, is what would happen to high-cost States like New Jersey if we eliminate the deduction for State and local taxes. According to the National Association of Home Builders, the average New Jersey property owner has $7,398 in real estate deductions. I think Texas is close to $5,500 a year. That is more than double the national average, the New Jersey number. I believe that eliminating this deduction could have a real devastating impact on my State and many other States. We need to think long and hard about the effect it would have. We have a long way to go to get to the $6 trillion the Tax Policy Center says we need to find to finance the Ryan-Camp tax reform proposal, and these are the kinds of issues we need to examine in depth.

Mr. Buckley.

Mr. Buckley. Yes.

Mr. Pascrell. Can you describe how impact of eliminating the capping of deduction for State and local taxes would be different for high-cost regions of the country? And the second question is, isn't repealing this deduction just a covert marginal rate hike that would double tax individuals' income, and how is this different how we treat foreign source income, Mr. Buckley?

Mr. Buckley. Well, you raise the interesting point. We do provide a foreign tax credit, a dollar-for-dollar reduction in U.S. tax liability for the amount of foreign taxes you pay. Nobody has ever asserted that that is a subsidy for foreign countries. It is an appropriate measure of reducing the potential for double taxation

We provide a far less generous accommodation for the State taxes, an accommodation that I believe is appropriate to prevent double taxation. Now, it will have particular impact on States with high incomes, but those States typically are net donors to the Federal Government.

Mr. Pascrell. Thank you, Mr. Buckley.

Oh, my time is up. Mr. Chairman, yield back.

Mr. Johnson. [Presiding] Thank you.

Mr. Young, you are recognized.

Mr. Young. Thank you, Mr. Chairman. I thank all our panelists for a very interesting conversation today and for your appearance here today.

I represent Indiana's 9th Congressional District, and the communities throughout my 13-county district rely heavily in various ways on tax-exempt bonds. But the question, I think, for many of us policymakers here is, of course, the issue of unintended consequences, which has been brought up a number of times, sometimes called collateral consequences. I see that always as a potential consequence of acting in the Federal sphere. You are going to have unintended consequences. What is incumbent upon us is to fully weigh all the evidence before us and try and mitigate those consequences before we act.

We also tend to be risk averse here in Washington. So we will hear a lot of qualifying language from my colleagues, perhaps occasionally from myself about this could happen, we need to weigh things very heavily before acting. But at some point there is a risk to not changing policies towards a more optimal public policy approach of tax-exempt bonds here if one exists

So, you know, I come back to the theme that people really don't fear change so much as they fear loss, and if we can prove that adopting a new mechanism of funding these infrastructure projects and bonding out various projects is better, then it ought to be adopted. I am not persuaded as yet entirely, but there are some things that I want to explore here.

Mr. Hodge, you said for each million dollar in tax-exempt bonds, the Federal government foregoes $21,000, so that is a potential benefit to the Federal coffers at least, could conceivably have what is called collateral consequences at the local level.

And you, yourself, Mr. Hodge, have conceded that at least initially there might be property tax implications on changing the tax status of these bonds. But you alluded to something very interesting. You said in the longer term, and you said absent this deduction, State and local governments would have lower overall taxes and would have smaller budgets.

I can think of a couple of dynamics that might lead to this. Greater project scrutiny at the local level, conceivably, might be one reason. Another reason would be greater competition for capital between communities and across States. Is that a potential thing that would drive the lower overall taxes and smaller budgets?

Mr. Hodge. Yes.

Mr. Young. Okay. So that is the positive side of the ledger.

The negative side, Mr. Parkhurst, you listed off a number of concerns, and I would like to go through those. An increase in direct taxes on citizens. So this is the burden-shifting concern, right? Do you disagree with the notion, though, that in the longer term you might actually see lower overall taxes and smaller budgets as a result of changing the tax-exempt status, and if so, why do you disagree with that notion?

Mr. Parkhurst. I think given the dynamics of the country's economics, conditions, regions, it is hard to give you a definitive answer on a hypothetical at this point right now. I would argue that what we can see happening or what we could perceive happening is just that point, is that shift in projects that either don't get done because the State and local officials make a rational decision that with limited dollars we can only do X and not Y, or if the decision is made that we must pursue a particular infrastructure project either because it is crisis driven or the public has made a decision, either through referenda or other by electing individuals who are making these decisions, to increase their taxes. I think then that is the response that I am looking at in the short term. But long term, at this point, I don't think I could give you a definitive answer to your question.

Mr. Young. Okay. There are various academic studies supporting this idea that there will be long-term benefits to changing the tax-exempt status. Doug Holtz-Eakin and Larry Lindsey, for example, have studies that the National Governors Association may consult to get further clarity on this.

Mr. Hodge, got about 10 seconds left, I think. You have any thoughts about this?

Mr. Hodge. No, the economic evidence is very clear, that if you were to remove these subsidies, then overall spending at the State and local level would decline and taxes would reduce overall as well.

Mr. Young. Okay. We will continue to explore this. I yield back.

Mr. Johnson. Thank you.

Mr. Davis, you are recognized.

Mr. Davis. Thank you very much, Mr. Chairman. And I was thinking one of the good things about being near the end is you get a chance to hear all of those things that have been said before you. And when the question arose, came up about Build America Bonds, I just happened to have six pages of projects that were either done or completed or underway in the State of Illinois, most of which, I suspect, would not have been on the table unless these bonds were available.

Also, I thought about the article in the New York Times. I grew up in rural America, and people often used containers to take a bath. They didn't all have indoor plumbing. And when they got ready to throw out the bathwater, there was an old saying that don't throw out the baby with the bathwater. I mean, there are some components of some things that may not be as effective or as good, but that doesn't mean the whole concept is not worthy.

Like my good friend from Texas, Mr. Bishop, I think many of us have had some experiences with local government, and I also think that many of us are firmly convinced that many local infrastructure projects would never get done if the bonds were not available, that they would just simply lay flat, nothing would happen, and the need would continue to exist. So I think that they have been lifesavers for infrastructure development in these communities all over America.

But let me ask, there are some proposals -- and, Mr. Buckley, let me ask you -- there are proposals to reduce the tax exemption on municipal bond interest, such as one to cap the exemption for certain taxpayers at 28 percent, would have severely detrimental impact on national infrastructure development and the municipal market, raising costs for State and local borrowers and creating uncertainty for investors. These investors' fears translate into investor demands for higher yield from State and local governments issuing the bonds. If these entities are unable to satisfy investor yield demands, then isn't it true that either, one, these much-needed infrastructure projects would not move forward, or the cost of these projects would be passed directly to State and local taxpayers?

Mr. Buckley. You have two problems, I think, when you legislate in this area. First is the uncertainty that you are talking about. Just the fact that this hearing is going on is creating uncertainty in the market about the long-term viability of the tax exemption, thereby demanding higher yields.

The question whether it is going to increase cost and reduce infrastructure that higher yields, I think that is absolutely correct. You can assert that there are economic benefits from repealing the exemption only if you believe that it is in the best interests of this country to have lower investment in public infrastructure.

You know, when Mr. Hodge talks about lower spending at State and local levels, it is all infrastructure. So if you believe we have overinvested in infrastructure, which I don't think anybody does, then you should entertain proposals to repeal this benefit. If you believe that infrastructure is very valuable, then you should not.

The cap has some impact on tax-exempt rates. I have seen a lot of different estimates and I am really not in a position to judge which one is right. I mean, some show it as fairly low. Some show it as fairly high.

Mr. Davis. In your written testimony you also indicated a need to maintain a balance between individual exemptions or deductions and corporate deductions. Why do you think that is --

Mr. Buckley. Well, I think it goes back to my answer about small businesses. I don't know how you could deny individuals the deduction for State and local taxes and at the same time permit corporate taxpayers to deduct those items. I just think it is not a politically viable solution.

Mr. Davis. Thank you very much. I yield back.

Mr. Johnson. The gentleman's time has expired.

Mr. Paulsen, you are recognized.

Mr. Paulsen. Thank you, Mr. Chairman. This actually is a very, very good hearing, and I heard from a number of folks back home.

I want to follow up on what Mr. Davis was actually asking, because when the President came out with his budget proposal, I think it was last fiscal year's budget proposal, just a year ago, he actually recommended that cap, you know, at the 28 percent level for that exclusion on municipal bond or, you know, State and local bond deductions. And I am curious, what would be the effect -- you know, aside from the trade-offs of the policy issue we have been having about whether you allow it or don't allow it -- what would be the effect if that was -- if that policy went forward as a part of, you know, a budget plan this year or next year in the near term? What is the average length of these bonds that are let out right now; is it 20 years, is it 30 years? What is the effect of these sort of -- these existing contracts that are in the market right now? What would be the effect versus, you know, phasing it in or not phasing it in? I am just -- in terms of the actual, it is more of a technical question, but what happens specifically to the market, Mr. Parkhurst?

Mr. Parkhurst. Some of the estimates that I have seen, I think they are rather conservative depending upon the percentage cap you are talking about. Anywhere, as I said earlier, from six-tenths of a point to, you know, 1-1/2 points in a bump-up in your yield.

You are back to the key issue here, which is risk and certainty, and obviously investors are looking for low risk and high certainty. When you are talking about any type -- just as Mr. Buckley said, the mere fact that this hearing is being held today is creating uncertainty in the market about what changes may happen, and that is going to have an impact on the market going forward.

Mr. Paulsen. Mr. Taylor?

Mr. Taylor. Yes. Let me kindly point out that this focusing on capping individual interest rates, the deduction for State and local interest is really looking at the problem the wrong way. If your concern, and Mr. Davis' concern, Mr. Marchant's concern is for financing infrastructure, you should be looking at ways in which to expand the market of potential investors, and right now because tax exemption exists for the interest on State and local bonds, you are limiting it to people who are in, by definition, higher-income tax brackets.

I think everyone who has ever been in the market -- and one of the reasons BABs were somewhat, from my vantage point, very successful was because it suddenly expanded the number of potential investors. What that does is eventually lower interest rates for people. It means the Federal subsidy is a little lower. That sort of thing is what you should be looking at, from my vantage point as an economist, and looking at markets rather than the reverse.

Mr. Buckley is absolutely right. In 1986, when tax reform was going through, the market froze because of discussions about how you should tax individuals.

Mr. Paulsen. Mr. Hodge, maybe you can comment. I mean, obviously we have got uncertainty in the marketplace on the healthcare law right now that is not giving predictability to the business community, but, I mean, just give a perspective of what the existing market would be like from a bond transition.

Mr. Hodge. Well, I think we have to be very careful about overdoing the uncertainty element. That would mean that we would never talk about tax reform --

Mr. Paulsen. Right.

Mr. Hodge. -- because somebody might be uncertain.

Well, let's look at the certainty here, and that is State and local governments this year are spending $120 billion a year on the interest on their debt, their accumulated debt. That is more than they spend on police protection, twice as much as what they spend on parks and recreation, twice as much as they spend on sewerage, on fire protection, et cetera. They have loaded themselves with debt to the detriment of other elements of their budget. So while they are crying poor and poverty now, that they can't afford to do certain things, a lot of is because they are crowding out their own budgets with the amount of debt they have taken on.

That is not our fault, but it can be attributed to the municipal bond exemption, which affords them the opportunity to overborrow and thus crowd out the things that they think are most important.

Mr. Paulsen. Okay. Mr. Parkhurst?

Mr. Parkhurst. Just a quick note on that. I can't speak to the interest amount, but I can tell you that the current outstanding bond market is $3.7 trillion. So, again, the leverage ratio is pretty good.

Mr. Paulsen. Okay, that is good.

Thank you, Mr. Chairman. I yield back.

Mr. Johnson. Thank you.

Dr. McDermott, you are recognized.

Mr. McDermott. Mr. Reed? I believe Mr. Reed is next.

Mr. Johnson. I had McDermott, I think.

Mr. McDermott. Thank you, Mr. Chairman.

I am listening to this whole thing, and, Mr. Buckley, you tell me that Seattle has a higher tax rate or pays higher taxes than other places in the State of Washington, and that is true, because we do these bonds for housing and all sorts of things in the city, and we tax ourselves for them, and it seems what -- I am having trouble figuring out what the upside of getting rid of municipal bonds is, because all I hear is Mr. Hodge, who says that, well, we will get a smaller government out of this, and people, they will do it with their own money or something.

I am not -- I am trying to figure out, does the Federal Government have this pot of money which we dole out, and we bring back earmarks so that we can get certain money, or since we are not using the tax-exempt status and let the local areas do their own thing, then I guess we have got to come here and try to get some earmarks back. Is that -- or how are we going to get the infrastructure built is really what I am having a hard time. I hear that BABs are good. All three of you.

Mr. Buckley. Right.

Mr. McDermott. Mr. Parkhurst, Mr. Taylor, Mr. Buckley, you all say they are good, right?

Mr. Taylor. It is a better way to do it than to do it as you currently do it.

Mr. Parkhurst. I want to at least be clear that what the Governors would support is an all-of-the-above strategy, building activity bonds together with existing tax exempts need to be part of the tool kit, not looking to substitute for the existing market.

Mr. Buckley. Let me also agree. I think Build America Bonds are a complement to tax exemption. It gives the issuer a choice, and it does make -- even for the issuers that choose to use traditional tax exemption, it means that they will receive much more of the Federal revenue cost because it makes the whole market more efficient.

Mr. McDermott. So taking -- getting rid of the tax-exempt municipal bonds, the only upside is that we would then have some money we could use to make a revenue-neutral reduction in rate on corporations to 25 percent; is that correct?

Mr. Buckley. It is essentially the debate that this committee is having is do you repeal these more targeted tax benefits to finance rate reductions. And this is where I will continue to disagree with Mr. Hodge. The only economic benefits that can come from repealing the exemption are based on the fact that this country will be better off with less public infrastructure. And I would argue our problem is inadequate public infrastructure, and if you don't subsidize infrastructure this way, which has no earmarks, no Federal involvement basically, you will be forced to find another way.

Mr. McDermott. We will be forced back to our old habits of appropriated earmarks?

Mr. Buckley. Appropriated funds.

Mr. Taylor. If I might, you are right in some ways in saying there is no Federal involvement in the initial decision of what infrastructure projects go forward and the like, and while I subscribe and agree with that, the fact of the matter is by issuing tax-exempt bonds, you create the possibility of arbitrage on the part of the issuer, and then I tried to lay out in my prepared statement that has led to a significant amount of abuse. And so if the committee wants to do what you have suggested, Mr. Buckley, which is have both, then I think you have to look at solutions to dealing with the arbitrage, forcing issuers to invest in State and local government securities at the Treasury rather than having it done in the free market, or some other steps to maintain the integrity of that market.

Mr. Buckley. I don't disagree there have been problems in the tax-exempt bonds; that is clear. That means that this committee should take targeted responses, and then perhaps what you just suggested is the right response to those abuses. You should not let the abuses nor the New York Times article to be used as an excuse to eliminate a fairly valuable support for local and State investment in infrastructure.

Mr. McDermott. That, I think, is sort of like medicine. You can find an individual case one place or another of a problem, but that really doesn't deal with the fact you have to deal with all the people. And when you are looking -- you talk about a significant amount of abuse. Could you put a number around that? Are you saying 2 percent, or 25 percent, or 50 percent is abuse?

Mr. Buckley. I will let -- I think it is de minimis, but I will let --

Mr. Taylor. Well, I think it is all in the eye of the beholder. Personally, where financial firms have paid since 1986 almost a billion dollars in fines and penalties for abusing the arbitrage restrictions, engaging in collusion, pay-to-play schemes and the like in order to take advantage of this, that, to me, is not the right way to promote, you know, national infrastructure programs that will make this a healthy market. That is, in fact, why I was very strong in my remarks about supporting BABs, because it does away with all of those potentialities.

Mr. Johnson. The gentleman's time has expired.

Mr. McDermott. Thank you, Mr. Chairman.

Mr. Johnson. Mr. Reed, you are recognized.

Mr. Reed. Thank you, Mr. Chairman, and thank you, Mr. McDermott, for the attempt at courtesy, but you were here first, so I appreciate that.

You know, I found this conversation very interesting as a former mayor and now a Member of Congress, and I have seen firsthand the benefits of municipal financing and municipal investments through local and State capital bonds.

And, Mr. Hodge, I want to give you an opportunity, because I think you are eager to have that opportunity, in response to Mr. Buckley's conclusion that what this will lead to by removing this exclusion is less of an investment in infrastructure, because I think we have broad support that our infrastructure needs are significant, they need to be made in America, our investments there. And so I want to give you an opportunity to directly respond to Mr. Buckley's conclusion that you are in error.

Mr. Hodge. Sure.

I think we have to be very careful about being sort of one-column accountants here, and what we hear a lot of is just the benefits of these particular programs, and we hear none of the downside. And I think that equalizing the financing of a public infrastructure and a private investment will lead to a better economy in the long run.

I don't think that the person who wants to borrow money in order to invest in a new factory should have to compete with a local community that wants to borrow the same amount of money in order to build a sports stadium. I don't think that that leads to positive outcomes in the economy; I think it leads to a negative. And, as the economic research shows very clearly, it shows it leads to overborrowing, overspending, and ultimately overtaxing at the local level.

And I think to turn that around, we need to equalize the treatment, the borrowing costs, for both private borrowers and the public, and that way you get the best economic efficiencies, and you get an equal rationalization of these kinds of investments, an equal trade-off in -- or the balance between public investment and private investment.

Mr. Reed. But to follow up on that, though, would that still provide adequate financing for the necessary infrastructure? Because you touched on a thing when you referenced the sports stadium, because one thing I am hearing in this conversation is -- and potentially on abuses and in the written material that I read -- is there an issue of definition of infrastructure? Because as a mayor, when I was dealing with issues of water system replacements, sewage replacements, there was no way I was going to be able to pay for that based on my tax revenue coming in. I had to have a capital plan 20, 30 years out, and part of that capital plan was not only the year-to-year tax revenue that was coming in, but it was also the leveraging of the dollar that I could get from the municipal financing market to build that capital. And a lot of these projects, as you know, are not 1-year projects. They are 30-, 20-year projects.

So would your proposal still allow for an adequate funding stream for local -- I am really talking about local, not so much on the State -- local and county level to do the necessary investments that our infrastructure demands outside of sports stadiums and all that? Because I do believe there is a question of what is a definition of a qualifying infrastructure that is worthwhile to take a look at.

But get beyond that, do you still see that you would have the revenue streams coming in?

Mr. Hodge. Well, I am not saying that local governments shouldn't be able to borrow for the long term, absolutely not. They should just pay the same interest rate as a company that wants to build a wafer-fabrication plant, or a pharmaceutical plant, or some other sort of private investment that is also going to have a huge impact on a local community. Those rates should be the same. There shouldn't be a subsidy, an interest rate subsidy, for the public just simply because it is public.

Mr. Reed. Mr. Parkhurst, please?

Mr. Parkhurst. Congressman, I am struck by your remarks because I think you are inviting a subsequent discussion about questions around public-private partnerships as an innovative tool to finance.

I think that your conversation lends to a great discussion, because there is a great model here of outcome-based-value-for-money analysis where the public sector is looking to get something built, but they don't have the front-end capital to do it. The private sector is looking for a stable revenue stream in the long term, and the way, for instance in the U.K., how this has been perceived -- and let me be clear, in the U.K. when you are looking at public-private partnerships, or as they are calling it Private Finance 2, going forward here, that is only 10 percent of their finance. And so it is back to the argument that I have made about everything needs to be in the tool kit that is available here.

But you are looking at a situation where the public-private partnership provides for front-end capital for the construction costs that the private entity is contributing; the public sector, in your case, your home community, doesn't pay a dime until that infrastructure is online, and it meets all of the obligations and outcomes that you as one of the parties negotiating this deal expect. Then going forward you have a long-term relationship with the operator, where the local government or community or State is paying regular operational costs going forward.

So it is an interesting option that I think would really benefit discussion going forward.

Mr. Reed. I appreciate that.

My time has expired. I yield back.

Mr. Johnson. That was a great closing comment. Thank you all. I know you recognize the problems down at the local level, and I hope we do, too. This is a difficult program that we are embarking on, and I thank you for your help. Each and every one of you made good comments. Thank you for being here.

The committee stands adjourned.

[Whereupon, at 12:14 p.m., the committee was adjourned.]

Public Submission for the Record

American Hospital Association

American Public Power Association, Large Public Power Council, and Transmission Access Policy Study Group

Bond Dealers of America

Breckinridge Capital Advisors, INC

Center for Fiscal Equity

City of Boerne

City of Coconut Creek

City of Dallas

City of Lincoln Nebraska, Lincoln Public Schools, Lincoln Electric System

City of Manteca

City of Rancho Cucamonga

City of Seattle Municipal Bonds

City of St. Petersburg

Clean Water Services

County of Newaygo Board of Commissioners

CTIA The Wireless Association

Eastern Municipal Water District

Education Finance Council

Government Finance Officers Association

Hon. Stephen K. Benjamin, Mayor of Columbia, South Carolina

Institute on Taxation and Economic Policy

Laura Morgan

Lofgren Franks

Louis Jambois

Marco Lowe

Missouri River Energy Services

Moran and Company

National Association of Bond Lawyers

National Association of Health and Educational Facilities Finance Authorities

National Conference of State Legislatures

National Governors Association

National Organization of Social Security Claimants' Representatives

Public Utility District No. 1 of Chelan County, Washington

Sheila Tucker

Statement of the National Association of Realtors

Sustainable Water Infrastructure Coalition

Tacoma Public Utilities

The Associated General Contractors of America

The Minnesota Service Cooperatives

Washington Public Utility Districts Association