



**Testimony of  
Carla Sledge  
President, Government Finance Officers Association and  
Chief Financial Officer, Wayne County, MI**

**On behalf of the Government Finance Officers Association**

**Before the  
Subcommittee on Select Revenue Measures  
Committee on Ways and Means  
U.S. House of Representatives**

**March 16, 2006**

Introduction

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

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

Purpose and Importance of Tax-Exempt Bonds

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

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

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

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

Some specific examples of infrastructure paid by bonds today include:

*Wayne County, MI*

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

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

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

*Hanover County, VA*

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

*Newington, CT*

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

*Montgomery County, MD*

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

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

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

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

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

## Need for Simplification

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

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

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

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

### *Arbitrage Rebate*

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

Unused monies from proceeds of tax-exempt bonds are generally invested until they are needed and, if invested at rates higher than the borrower’s rate of interest, they generate “excess” investment income. The differential is known as “arbitrage.” Under the arbitrage rebate requirement that has been in place since 1986, arbitrage must be rebated to the federal government. While some relief was provided in 1989, arbitrage compliance remains one of the largest administrative and costly burdens that governments face. Additionally current law, last updated in 1989, dictates various

spending requirements for bonds, including the need for 100% of available bond proceeds to be spent in a 24 month period for construction bonds. This is a short time frame for many projects to be completed, and many governments run into problems in order to comply with this stringent regulation.

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

**Two areas in particular require remedy. First, the amount of annual debt exempted from arbitrage rebate restrictions should be raised from \$5 million to \$25 million. This will help a vast majority of issuers from adhering to needless and costly requirements. Second, the spend-down exception should be extended from two years to three.**

#### *Advance Refunding*

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

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

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

#### *Bank Deductibility*

Prior to the 1986 Act, commercial banks were the largest investor in tax-exempt bonds. Pre-1986 law permitted banks to deduct all or portions of the interest costs they incurred to invest in municipal bonds. The 1986 Act placed a severe limit on the amount banks

could deduct – 80% of the costs of purchasing and carrying bonds of issuers that do not issue more than \$10 million of bonds annually. The result has taken away a major purchasing sector of tax-exempt bonds, which in effect hurts many governments.

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

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

#### *Alternative Minimum Tax*

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

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

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

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

#### *Expansion of Public-Private Partnerships*

In many aspects, Congress and various Administrations have encouraged greater public-private partnerships. Many vital economic development projects require significant public commitment combined with private investment. The ability to fund the public

share of costs with tax-exempt bonds allows these projects to proceed. Current tax laws limit the amount of private use of a governmental facility to ten percent. This inhibits the financing of facilities where private use could materially assist delivery of public services.

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

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

#### *Purchasers of Tax-Exempt Bonds*

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

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

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

#### Other Congressional Action that Impacts the Tax-Exempt Bond Market

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

## Conclusion

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

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

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

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

For almost 200 years, states and local governments have been able to access the capital markets by issuing bonds to fund their jurisdiction's public purpose infrastructure. This system has worked well for all parties involved, especially state and local governments. The authority to issue tax-exempt bonds at the state and local level allow local and state governments to determine the project needs of their jurisdiction and pay for them through the issuance of bonds, absent federal government interference. Without the ability to access the low cost, tax-exempt bond market, communities across the United States would suffer, and greater demands would be placed on the federal government to provide additional direct funding to local and state governments.

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