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OFFICE OF THE COMPTROLLER
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April 15, 2015

United States Senate Committee on Finance,
Community Development and Infrastructure Working Group
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Comment Letter on Tax Reform and Municipal Bonds

Ladies and Gentlemen,

I appreciate the opportunity to provide comments to the United States Senate Committee on Finance's Community Development and Infrastructure working group on bipartisan tax reform. My comments will focus principally on the proposal to place a 28% cap on the tax exemption on municipal bonds. If enacted, even just on a prospective basis, this cap would fundamentally damage the municipal bond market and increase borrowing costs significantly for New York City and for state and local government entities across the country. I strongly urge you to exclude any alteration to municipal bond tax exemption that would diminish, complicate or impair the market for this critical infrastructure finance vehicle.

Background

The federal tax exemption on municipal bond interest was included in the United States' original income tax code in 1913 and has been a successful cornerstone of state and local infrastructure development for over a century. The municipal bond market functions effectively and enables state and local governments to finance projects to build schools; build and maintain the country's drinking and clean water infrastructure and its roads, bridges and mass transit; address healthcare and affordable housing needs; and provide public safety infrastructure to help ensure local and national security. Maintaining this market and the full tax exemption are essential to governments like New York City.

Impact of a Cap on Tax Exemption on New York City

In New York City alone, the tax exemption on municipal bonds has contributed to the advancement and completion of many thousands of infrastructure projects that have cost billions of dollars. The City only sells bonds for long-term capital projects. All of these projects created jobs and helped the City address critical needs such as educating our children, providing clean water, improving public health and safety and supporting economic growth.

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New York City has over $100 billion of bonds outstanding and plans to issue approximately $30 billion of bonds as part of its four-year capital plan for fiscal years 2016 to 2019. Holding that borrowing level constant over the City's 10 year capital strategy implies total borrowing of approximately $76 billion over the 2016-2025 period. These figures do not include the borrowing of other entities that provide critical services to City residents such as the New York State Metropolitan Transportation Authority, The Port Authority of New York and New Jersey, and City and State housing agencies.

A partial repeal of the tax exemption would change the demand landscape for municipal bonds and would require New York City and state and local governments across the country to incur higher interest costs on their bond issues. Higher costs would result from two factors. First, the reduced exemption would require issuers to pay higher interest rates to attract buyers. At current marginal tax rates, there would be an effective 11.6% income tax surcharge on municipal bonds held by investors in the top bracket, which would have to be compensated for by higher interest rates. Perhaps more significant would be the turmoil and uncertainty the cap would introduce. Overall demand and thus liquidity would likely fall as investors shunned the uncertain return levels. Investors would also – quite reasonably – fear additional intervention and require higher interest rates to compensate for the risk.

New York City would be negatively impacted in the following ways:

1. The City would be forced to pay higher costs when it borrows for capital projects. Looking just at the additional cost to compensate for the tax surcharge, and not trying to estimate the additional costs of market disruption, the City could expect to pay an additional $6 billion in interest over the life of the bonds on the estimated $76 billion 10 year capital program borrowing. This would force New York City to either raise taxes, reduce the capital budget or reduce expenditures elsewhere. To hold the City's debt service expense at the same level as with fully tax-exempt bonding, we would have to reduce our 10 year capital borrowing by 3.8% or $2.94 billion.
2. If the 28% cap is imposed retroactively, interest rates on the existing $15.6 billion of floating rate debt of New York City and its related issuing entities could increase immediately. The economics underlying our swap transactions would also be upended.
3. The City's ability to refund outstanding bonds for interest rate savings would be diminished. Bond refundings are an important contributor to the City's budget balance. In fact, since January 1, 2010, over $3.9 billion has been saved for future City taxpayers and water and sewer ratepayers though such refinancing.

Public Policy

Introduction of a cap on tax exemption would fundamentally alter the financial relationship between the federal and local and state governments. It would raise the borrowing costs of states and localities while increasing federal government revenues, thus transferring wealth from localities and states to Washington.

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Proposals to cap the exemption of all tax-exempt interest also overturn the historical practice of Congress to not change the taxability to investors of outstanding bonds. A retroactive tax change would immediately reduce the value of municipal bond investments, and because the majority of municipal bonds are held directly or indirectly by households, this drop in value would immediately hit families' pocketbooks.

Removing low-cost infrastructure funding through tax-exempt bonds has myriad costs besides the simple fact of higher interest rates. Limiting the exemption for state and local bonds would most likely lead to less investment in our nation's infrastructure due to higher borrowing costs, with a resulting loss in infrastructure-related employment and the support that infrastructure provides to economic growth. Further, if infrastructure-related projects are not repaired, maintained, and renewed as they approach their end of their useful life, the cost of renewal or replacement rises.

America Fast Forward Bonds

The Obama administration has also proposed the America Fast Forward bond program, which builds upon the successful example of the Build America Bonds (BAB) program created pursuant to the American Recovery and Reinvestment Act of 2009. The BAB program, which expired at the end of 2010, enabled state and local governments to sell taxable bonds in 2009 and 2010 and receive a 35% (since reduced) interest rate reimbursement from the federal government for the bonds' interest costs. The BAB program restored stability and enabled bond issuers across the country to broaden their investor base and benefit from a decreasing supply of tax-exempt bonds, thereby lowering borrowing costs in the tax-exempt bond market.

While I would welcome the ability to issue America Fast Forward Bonds as an additional tool in our bond-issuing tool kit, this program should not be enacted in coordination with a cap on the municipal bond tax exemption. The full tax exemption must remain in place, as it has been for over a century.

Conclusion

I urge you to leave the full municipal bond tax exemption unchanged so that New York City and thousands of other governments across the nation can continue to provide critical infrastructure and services to our residents. Thank you for seeking input on bipartisan tax reform and for your consideration of our request. My staff and I are available to work with you and welcome any questions that you may have for us.

Respectfully,

Scott M. Stringer
New York City Comptroller

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