DEFICIT REDUCTION: A THREAT TO TAX-EXEMPT STATE AND LOCAL GOVERNMENT OBLIGATIONS

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In the third quarter of 2011, the total national debt was approximately 100% of the gross domestic product of the United States for the first time since 1947. Recent estimates of the budget deficit of the United States approached $1.28 trillion. The Congressional Budget Office anticipates that this amount will more than double in the next few years without significant budgetary reform. Needless to say, strong bipartisan support for the reduction of the budget deficit and the national debt continues to grow.

Each year, the federal government provides certain exclusions, exemptions and deductions from gross income for federal tax purposes and foregoes tax revenues that it would otherwise collect, generally referred to as tax expenditures. Tax expenditures are rooted in various political and policy considerations such as encouraging certain economic behavior and/or providing benefits to certain individuals and entities. Examples of tax expenditures include the exclusion of interest on certain governmental and private activity obligations from gross income, the exclusion of pension contributions from gross income, reduced tax rates for dividends and long-term capital gains, the exclusion of Medicare benefits from gross income and the deduction of charitable contributions from gross income, just to name a few. Eliminating certain tax expenditures may be viewed as either increasing federal tax revenues or decreasing federal spending. Both the President and certain members of Congress have proposed eliminating or reducing the exclusion of interest from gross income on obligations issued by state and local governments (hereinafter referred to as "tax-exempt obligations") for public and certain private activity projects as a way of reducing the budget deficit and/or the national debt.

Tax expenditures have a measurable impact on the nation's budget. For example, topping the list of the 10 largest tax expenditures[1] of the federal government is the exclusion of employer contributions for health care and insurance premiums from gross income, an exclusion which is projected to total $725 billion for the period 2011-2015. Although the interest exclusion for tax-exempt obligations is not among the 10 largest tax expenditures, over the same time period, the Joint Committee on Taxation anticipates that the interest exclusion for tax-exempt obligations issued for traditional governmental purposes will total $177.6 billion and such exclusion for tax-exempt obligations issued to benefit private entities will total $54.5 billion, with an additional cost for direct-pay obligations (including Build America Bonds) in the amount of $24.4 billion.

Notwithstanding political and policy considerations, it is clear that the elimination and/or modification of these tax expenditures may provide the federal government, either directly or indirectly, with significant additional sources of taxpayer liability or revenue, to be applied to deficit reduction.

Recent Legislation

2008 - 2009

Recently, a number of alternatives to the traditional interest exclusion for tax-exempt obligations have been enacted to provide for a lower net borrowing cost to state and local governments, 501(c)(3) entities and other exempt facilities. Many of these alternatives are the result of policies enacted (or continued) in 2008 and 2009, seeking to encourage immediate economic activity in a prolonged national recession. Alternatives have generally included either tax credit obligations, which provide a tax credit for the beneficial holder of the obligation, or direct-pay obligations, which provide a direct-pay subsidy from the federal government to the governmental entity issuing the obligations or other obligor. Federal legislation has provided for the issuance of such obligations in the form of Build America Bonds, New Clean Renewable Energy Bonds, Qualified School Construction Bonds, Recovery Zone Economic Development Bonds, Recovery Zone Facility Bonds (generally providing for the exclusion of interest for certain private activity projects) and Qualified Zone Academy Bonds.[2]

2010 - 2011

Although the policy driving the legislative enactments in 2008 and 2009 was primarily focused on stimulating the economy by lowering borrowing costs through the allocation of subsidy dollars in a manner that delivered such benefits to bondholders, issuers and obligors regardless of their marginal tax rates, there have also been a number of recent legislative enactments and proposals focused on deficit reduction rather than economic stimulus. Although economic development and job creation are still extremely important to lawmakers, legislative enactments in 2010 and 2011 demonstrate that deficit reduction is paramount.

A few of the well-known legislative enactments and proposals in 2010 and 2011 include the following:

1. On November 17, 2010, the Bipartisan Policy Center issued a report providing for the elimination of the interest exclusion from gross income for new private activity bonds, including bonds for single- and multi-family housing, airports, water and sewer facilities, hospitals and small manufacturing facilities in favor of tax credit bonds.[3]

2. On December 1, 2010, the National Commission on Fiscal Responsibility and Reform issued a report, "The Moment of Truth," outlining its ideas on reducing deficit spending. It proposed restructuring the Internal Revenue Code of 1986, as amended, and eliminating certain tax expenditures. The report proposed a simplified income tax for individuals and corporations and stated that any income tax, including tax expenditures not included in its model income tax, would require the levy of higher marginal tax rates. The Commission treated the exclusion of interest on tax-exempt obligations from gross income as a tax expenditure and eliminated it from its model income tax. This Commission failed to obtain the requisite supermajority of votes necessary to move forward with the substance of the report.[4]

3. On April 5, 2011, Senators Wyden (D-OR) and Coats (R-IN) introduced a bill that would eliminate the exclusion of interest on state and local obligations and would

give holders of such obligations, other than corporations, a nonrefundable credit of 25% of the amount of interest payable by the issuer of such obligations.[5]

4. On September 12, 2011, President Obama submitted the American Jobs Act of 2011 to Congress. In this legislation, the President proposed to limit the value of the interest exclusion, other tax preferences and itemized deductions to 28% for individuals with incomes of more than $200,000 and families with incomes above $250,000.[6]

5. The Budget Control Act of 2011 created the Joint Select Committee on Deficit Reduction (the "Super Committee"). Given the recent failure of the Super Committee to enact a bill that achieved $1.5 trillion in spending reductions, Section 302 of this legislation requires sequestration beginning in 2013, resulting in $1.2 trillion in spending cuts divided equally between defense and domestic programs, excluding entitlement programs.[7]

2012 Outlook

Senior White House economic advisors have recently commented that proposals affecting the interest exclusion from gross income for tax-exempt obligations will not be altered by a proposal from the White House in the short term, yet President Obama's proposed 2013 budget, which was released on February 13, 2012, provides a 28% ceiling on the value of the interest exclusion to single taxpayers with income over $200,000 and to married taxpayers filing a joint return with income over $250,000, as well as other tax preferences and itemized deductions, similar to the President's proposal set forth in the American Jobs Act of 2011.[8] Although it is unlikely that legislation affecting the interest exclusion for tax-exempt obligations would be enacted in a presidential election year, this outlook could be impacted by President Obama's 2013 budget plan and the expiration of the Bush-era tax cuts at the end of 2012.

Beyond 2012

Although the scope of future legislation to alter or eliminate the benefits of the interest exclusion from gross income accompanying certain obligations for state and local governments, hospitals, small issuer manufacturing facilities and other organizations is presently unknown, it is nearly certain that deficit reduction will remain a high priority in Washington for years to come. In addition, there are a number of issues that will continue to fuel the debate as to the value of tax-exempt obligations, such as (i) whether higher taxes are needed to provide additional revenue to reduce the budget deficit and/or the national debt and whether the resulting marginal tax benefit provided to taxpayers should be limited when compared to the federal government's opportunity cost of capturing additional tax expenditures that result from such higher taxes and (ii) the cause-and-effect relationship between capping the marginal tax benefit of tax-exempt obligations below the highest marginal tax rate and decreased demand for tax-exempt obligations, which is expected to result in increased borrowing costs for state and local governments. Governmental advocacy groups and their constituents are sure to convey the perspective that the interest exclusion accompanying tax-exempt obligations should not be viewed as a tax expenditure, but rather as a partnership between the federal government and state and local governments designed to facilitate critical public projects. Considerations as to the full

consequences of altering or eliminating this tax expenditure will continue to be inextricably tied to the broader debate over the most efficient means by which to allocate this nation's resources and the appropriate tax policy by which to implement fiscal and monetary policy.

ENDNOTES

[1] *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015*, Joint Committee on Taxation, dated January 17, 2012.

[2] American Recovery and Reinvestment Act of 2009, §1531, 26 U.S.C. §54AA (2009) (Build America Bonds); Emergency Economic Stabilization Act of 2008, §107 26 U.S.C. §54C (2008) (New Clean Renewable Energy Bonds); American Recovery and Reinvestment Act of 2009, §1521, 26 U.S.C. §54F (2009) (Qualified School Construction Bonds); American Recovery and Reinvestment Act of 2009, §1401, 26 U.S.C. §1400U-2 (2009) (Recovery Zone Economic Development Bonds); American Recovery and Reinvestment Act of 2009, §1401, 26 U.S.C. §1400U-3 (2009) (Recovery Zone Facility Bonds); Emergency Economic Stabilization Act of 2008, §313, 26 U.S.C. §54E (2008) (Qualified Zone Academy Bonds).

[3] The Bipartisan Policy Center, The Debt Reduction Task Force, *Restoring America's Future*, November 17, 2010. Jennifer DePaul, "JCT: $178B For Public Muni Debt," *The Bond Buyer*, Vol. 379, No. 33649, 19 January 2012: 1, 4.

[4] President's National Commission on Fiscal Responsibility and Reform, The Moment of Truth (2010), December 2010.

[5] Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112th Cong. §111 (2011).

[6] American Jobs Act of 2011, S. 1549, 112th Cong. §401 (2011).
Lynn Hume and Jennifer DePaul, "Tax-Exemption Threats Are Still on the Radar," *The Bond Buyer*, Vol. 379, No. 33641, 3 January 2012: 1, 4.

[7] The Budget Control Act of 2011, S. 365, 112th Cong. §401 (2011).

[8] Jennifer DePaul, "Munis Spared from Cap," *The Bond Buyer*, Vol. 379, No. 33654, 30 January 2012: 1, 9. Jennifer DePaul, "Obama Still Wants a Muni Cap," *The Bond Buyer*, Vol. 379, No. 33656, 1 February 2012: 1, 4.