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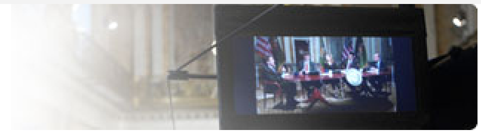

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Introduction

Good morning Chairman Neal, Ranking Member Tiberi, and other members of the Subcommittee. I appreciate the chance to appear before you today to discuss changes in Federal tax subsidies to lower borrowing costs to State and local governments.

State and local governments confront difficult challenges in the current economic environment. Their residents are losing jobs and consuming less. As a result, States and localities are facing declining tax revenues and having to cut services when more services are needed. The American Recovery and Reinvestment Act of 2009 (the "ARRA") provides a number of new and expanded bond financing subsidies to enable State and local governments to borrow at lower costs for capital projects and targeted programs for schools and energy projects. In general, these bond financing tools aim to promote critical public infrastructure investment, job creation, and economic recovery.

I commend this Committee for its work in leading the successful legislative efforts for these bond financing tools in ARRA.

Tax-preferred bonds, particularly tax-exempt bonds, are an important source of financing for State and local government infrastructure projects and other significant public activities. There are over $2.7 trillion in outstanding tax-exempt bonds. State and local governments have issued an average of about $340 billion of tax-exempt governmental bonds annually in the past five years (plus an average of about $30 billion annually in tax-exempt "private activity bonds" for the benefit of private entities subject to annual volume caps).

In my testimony, I will discuss several aspects of these State and local governmental bond programs. First, I will compare the different ways of providing Federal subsidies for State and local government borrowing. Second, I will focus on the broadest new bond program, called "Build America Bonds," and its early market reception. Third, I will touch briefly on the Recovery Zone Bond program aimed at areas hard-hit by unemployment and the tax credit bond programs for schools and energy. Finally, I will highlight Treasury Department's efforts to provide prompt guidance to implement these bond programs.

Different Ways to Deliver a Federal Subsidy to State or Local Governments for Lower Borrowing Costs.

First, I want to compare three general approaches to subsidizing State and local government borrowing that are provided for under current law: (1) traditional tax-exempt bonds; (2) bonds for which tax credits pay a portion of borrower interest costs; and (3) bonds for which direct payments are made to the issuer to subsidize interest payments.

<u>Traditional Tax-exempt Bonds: Tax-exempt Interest to Investors</u>

Tax-exempt bonds deliver an indirect subsidy for State and local government borrowing. Because the interest paid is exempt from investors' taxable income under Section 103 of the Internal Revenue Code ("Code"), investors are willing to accept lower interest rates on tax-exempt bonds than on conventional taxable bonds.

Tax-exempt bonds are an inefficient means of subsidizing State and local borrowing if the Federal revenue cost of tax-exempt bonds exceeds the benefit provided to State and local governments. This would occur if, in order to clear the market, interest rates on tax-exempt bonds are set high enough to attract investors below the top Federal marginal tax rate bracket. The interest rate paid in that event is such that investors with the lowest marginal tax rate among buyers receive the same after-tax return on tax-exempt bonds as they do on taxed bonds. For those so-called marginal investors, the value of the tax exemption is equal to the interest subsidy paid to State and local governments. But investors with marginal tax rates higher than that of the marginal investor would receive tax subsidies larger than the interest subsidy conveyed to the borrower. As a result, in this example, it costs the Federal government more than $1 to give State and local governments a $1 subsidy in terms of lower interest rates. This appears to be a common occurrence. As evidence, since 1986 interest rates on long-term tax-exempt bonds have been about 20 percent lower than the yields on high-grade taxable bonds whereas the Federal revenue cost has been large enough to finance a 25 to 30 percent reduction of interest rates.

"Tax Credit Bonds": Federal Tax Credits to Investors in Lieu of Interest

"Tax credit bonds" are potentially more efficient than tax exempt bonds for delivering a Federal subsidy to state or local governments with respect to their borrowing costs. Investors in new tax credit bonds provided for in ARRA receive a Federal tax credit equal to a set percent of interest received. The tax credit provides investors with a subsidy just sufficient to make them indifferent between the tax credit bond and an otherwise similar taxed bond. As a result, each dollar of Federal revenue foregone therefore benefits State and local governments by a dollar.

The potential market for tax credit bonds is broader than for tax-exempt bonds. Potential buyers of tax credit bonds include anyone with Federal tax liabilities at least as large as the tax credits the bonds convey. This includes many taxpayers with marginal tax rates below the level that makes tax-exempt bonds a profitable purchase. A recent 2008 statutory change in Code Section 54A(i) authorizes the Treasury Department to adopt regulations that enlarge the market still further by allowing separation or "stripping" of tax credits from tax credit bonds and the sale of the bond cash flow and tax credits separately to different investors. This stripping provision may expand the market for tax credit bonds to include a broader set of investors than traditionally participate in the tax-exempt bond market. For example, entities without tax liabilities could purchase the bonds and sell the stripped tax credits.

At the same time, the potential market for tax credit bonds is limited in a way similar to tax-exempt bonds in that they also are tax-advantaged investments that compete with other tax-advantaged investments. Recent economic conditions and associated uncertainty have limited the demand for tax-advantaged investments further. Moreover, until this year, the total Congressional authorization for tax credit bonds was very limited (mainly, $400 million annually for qualified zone academy bonds since 1998 and some energy bonds beginning in 2006). As a result, the market for tax credit bonds has remained small, illiquid, and undeveloped.

Build America Bonds Providing Direct Federal Subsidy Payments to State and Local Governments

A third way to deliver a Federal subsidy to State and local governments to reduce their borrowing costs would be to make direct Federal subsidy payments to such State and local governments. Build America Bonds represent the first program that implements such a strategy. [1] Build America Bonds are similar to tax credit bonds, but the credit is paid directly to State and local governments rather than to investors. They are taxable bonds with "refundable tax credits" in which the Federal government makes direct subsidy payments to State and local governments for a portion of their borrowing costs.

Like tax credit bonds, Build America bonds that provide a direct subsidy are efficient--each dollar of revenue foregone by the Federal government benefits State and local governments by a dollar.

Because investors receive no direct tax benefits, these bonds will have yields comparable to taxable debt instruments and should be attractive to investors irrespective of their tax status or income tax bracket (such as pension funds and other tax-exempt investors, investors in lower tax brackets, and foreign investors). Therefore, direct Federal subsidy payment bonds should appeal to a broader market than either traditional tax-exempt bonds or tax credit bonds and thereby provide lower State and local governmental borrowing costs.

Differences in "Depth" of Federal Subsidy

One flexible aspect of direct Federal subsidy payment bonds and tax credit bonds is that these subsidies can be tailored to provide different levels of Federal support by adjusting the subsidy rate. The existing direct Federal subsidy payment programs and tax credit bond programs under current law reflect different subsidy rates for different programs.

Build America Bonds

Build America Bonds under new Code Section 54AA are the broadest and most innovative new bond financing tool for State and local governments included in ARRA.

There are two types of Build America Bonds. The first type, herein referred to as "Tax Credit Build America Bonds," provides a Federal subsidy for State and local governmental borrowing costs in the form of a Federal tax credit to investors for a portion of the coupon interest (excluding original issue discount) payable on the bonds similar to other tax credit bonds discussed herein. Tax Credit Build America Bonds can be issued to finance the same kinds of expenditures (e.g., capital expenditures and working capital expenditures) and may involve the same kinds of financings (e.g., original new money financings, current refundings, and one advance refunding) as tax-exempt governmental bonds (excluding private activity bonds under Code Section 141).

As noted above, the second type of Build America Bond provides direct subsidy payments to State and local governments. The subsidy payments equal 35 percent of the coupon interest (excluding original issue discount) on the bonds payable contemporaneously with debt service payments. For example, if a state or local government were to issue Build America Bonds at a 10 percent taxable interest rate, the Treasury Department would make a payment directly to the government of 3.5 percentage points of that interest, and the issuer's net borrowing cost would thus be only 6.5 percent.

The Federal subsidy of 35 percent of the coupon interest on Build America Bonds is "deeper" than the implicit Federal subsidy for traditional tax-exempt bonds, where the tax exemption typically results in about a 20 percent reduction in interest rates.

Program Parameters

Build America Bonds can be issued by State and local governments during 2009 and 2010 to finance capital expenditures for the full range of capital project types for which they are eligible to issue traditional tax-exempt governmental bonds (excluding private activity bonds under Code Section 141). The range of capital projects includes, without limitation, public buildings, courthouses, schools, roads, bridges, public transit, transportation infrastructure projects, governmental hospitals, public safety facilities and equipment, water and sewer projects, environmental projects, energy projects, governmental housing projects, public utilities, and any other capital projects that are used primarily for state or local governmental use or payable primarily from governmental funds.

Build America Bonds are available for "new money" financings to encourage new investments in public infrastructure, as contrasted with refinancings for existing capital projects. Build America Bonds also may be used to reimburse capital expenditures made out of pocket or to refinance certain temporary financings for capital costs paid or incurred after the effective date of the 2009 tax legislation.

There is no volume cap on the amount of Build America Bonds that State and local governments can issue during 2009 and 2010. Build America Bonds cannot be issued with more than a *de minimis* amount of premium determined under rules similar to Code Section 1273(a)(3). The arbitrage investment restrictions under Code Section 148 apply in a tailored manner adopted to Build America Bonds.

Notably, there is a permanent, indefinite appropriation for the direct Federal subsidy payments on Build America Bonds under 31 U.S.C. Section 1324(b)(2) comparable to the permanent, indefinite appropriation authorizing the Treasury Department to make outlays that refund overpayments of tax of certain programs conducted through the tax code.

Early Market Reception for Build America Bonds.

The early market reception for Build America Bonds has been very positive. Based on reported data, between April 15 and May 20, 2009, approximately $9.5 billion in dollar volume and approximately 36 bond issues of Build America Bonds were issued since the first public sale in mid-April, which represents about 20 percent as large as the issuance of tax-exempt bonds during this same period. [2] Investor demand and sales orders for many of the initial transactions of Build America Bonds exceeded the available supply offered in the market.

The state of California sold a benchmark issue of Build America Bonds on April 22, 2009 in a principal amount of about $5.23 billion. This transaction was oversubscribed with about $16 billion in orders. In this transaction, about 97 percent of investors were institutional investors and about 90 percent of investors were domestic investors. [3]

As discussed above, the deeper Federal subsidies for Build America Bonds potentially offer significant savings to State and local governments as compared with traditional tax-exempt bonds. In the initial issuances of Build America Bonds, estimates of issuer savings over traditional tax-exempt bonds ranged from 40 to 60 basis points for issuances in the first week following the initial issuance to over 100 basis points more recently. [4]

Collateral Impact on Supply Potentially Lowers Tax-exempt Bond Rates

Build America Bonds are an additional State and local governments financing option that are intended to supplement, not replace, traditional tax-exempt bonds. One purpose of the new Build America Bond program is to reduce supply pressures in the traditional tax-exempt bond market through a new financing option that provides subsidized financing for State and local governments, but that can be readily sold into broader bond markets. The supply relief from the Build America Bond program should help to stabilize the tax-exempt bond market and to provide relief to State and local governments which are facing significant pressures in the current environment.

Preliminary indications suggest that the significant volume of early sales of Build America Bonds over the past month may have provided some relief to supply in the tax-exempt bond market and contributed to declining interest rates in the tax-exempt bond market. It is difficult, however, to separate out the effect of other factors that influence tax-exempt bond rates.

Comment on Market Impact, Future Prospects, and Administrative Challenges

The Build America Bond program has just begun. While it is premature to make any general statements about the program or its future prospects, the early signs are positive. The Build America Bond program offers potential for a broader and more efficient market for at least some portion of the State and local governmental debt sector as compared to the traditional tax-exempt bond market.

It is uncertain the extent to which Build America Bonds can serve the diverse financing needs of State and local governments. Characteristics of the conventional corporate taxable bond market generally include large, well-known issuers with investment grade credits, large minimum issue sizes of about $250 million, institutional purchasers, and bond structures involving bullet maturities with "make-whole" calls. By comparison, the traditional tax-exempt bond market includes over 50,000 State and local government issuers, large numbers of bond issues (about 10,000 to 15,000 issues annually), small average size of bond issues (about $25 million), retail purchasers, and bond structures involving serial bonds and 10-year optional par calls.

One major administrative challenge for the Treasury Department and the IRS is serving effectively as paying agents for a significant portion of the State and local governmental bond market. The recurring Federal direct subsidy payments to State and local governments for Build America Bonds will require development of an efficient electronic payment system and tax compliance safeguards. Finally, because Build America Bonds treat the Federal subsidy payments to State and local governments akin to tax refund payments, this treatment will require development of new tax compliance procedures.

A tax policy goal will be to move in the direction of simpler and more uniform programs for providing Federal subsidies for State and local governmental borrowing costs in efficient ways that afford broad market access to State and local governments.

Other Targeted Bond Program Tax Incentives in the 2009 Tax Legislation

Next, I want to mention briefly a number of other targeted bond program tax incentives under ARRA.

<u>Recovery Zone Bonds</u>

ARRA provides a $25 billion authorization for two types of Recovery Zone Bonds targeted to areas hard-hit by unemployment in 2008.

A $10 billion authorization for Recovery Zone Economic Development Bonds involves a type of direct payment Build America Bond with a deeper Federal subsidy payment equal to 45 percent of the interest on the bonds for governmental use for a broad range of qualified economic development purposes in recovery zones.

A $15 billion authorization for Recovery Zone Facility Bonds involves a type of traditional tax-exempt bond which may be used by private businesses to finance depreciable capital projects for original use in active businesses in recovery zones, excluding residential rental housing.

<u>Tax Credit Bond Programs for Schools and Energy</u>

ARRA provides new or expanded authorizations for four targeted tax credit bond programs for schools and energy under national volume caps that are allocated based on statutory criteria that are unique to each program. These bond programs include:

(1) <u>Qualified School Construction Bonds</u>. A $22.4 billion authorization for 2009-2010 for Qualified School Construction Bonds, which provide a Federal subsidy in the form of tax credits to investors for 100 percent of the borrowing costs on tax credit bonds used for public school construction.

(2) <u>Qualified ZoneAcademy Bonds</u>. A $2.8 billion authorization for 2009-2010 for Qualified Zone Academy Bonds, which provide a Federal subsidy in the form of tax credits to investors for 100 percent of the borrowing costs on tax credit bonds used for public school renovation, repair, course materials, and teacher training.

(3) <u>Qualified Energy Conservation Bonds</u>. A $3.2 billion authorization for Qualified Energy Conservation Bonds, which provide a Federal subsidy in the form of tax credits to investors for 70 percent of the borrowing costs on tax credit bonds used for a broad range of qualified energy conservation purposes.

(4) <u>New Clean Renewable Energy Bonds</u>. A $2.4 billion authorization for New Clean Renewable Energy Bonds, which provide a Federal subsidy in the form of tax credits to investors for 70 percent of the borrowing costs on tax credit bonds used for a broad range of clean renewable energy projects.

In the current market, the demand for tax credits is limited and uncertain, and the issuance of these recently-authorized tax credit bonds has been very limited in 2009. One notable recent issue of tax credit bonds involved a $38.84 million issue of Qualified School Construction Bonds for the San DiegoUnifiedSchool District on April 21, 2009.

<u>Tax Incentives to Assist with Demand for Tax-exempt Bonds in 2009 Tax Act</u>

I also want to mention several provisions in ARRA that aim at improving demand in the tax-exempt bond market.

A new temporary two percent *de minimis* bank purchase exception and an expanded $30 million small issuer bank purchase exception to the Code Section 265(b) tax-exempt carrying cost disallowance rules applicable to financial institutions encourage banks to purchase tax-exempt bonds issued in 2009 and 2010.

In addition, a temporary repeal of the alternative minimum tax preference on certain tax-exempt private activity bonds encourages purchases of these bonds in 2009 and 2010.

The Treasury Department's Priority Efforts on Prompt Implementing and Reporting Guidance

Before concluding, I want to highlight the Treasury Department's commitment to provide prompt guidance to implement the new bond financing tax incentives so that State and local governments can use these tools for public infrastructure and economic recovery, as well as the Department's commitment to report on those benefits. _

Early April Implementing Guidance

A major part of guidance was issued through five IRS Notices released publicly on April 3, 2009 and April 6, 2009. This guidance implemented the direct payment procedures on the Build America Bond program and provided volume cap allocation guidance on each of four targeted tax credit bond programs for schools and energy (including Qualified School Construction Bonds, Qualified Zone Academy Bonds, Qualified Energy Conservation Bonds, and New Clean Renewable Energy Bonds). Set forth below are references to early April guidance and citations to where it can be found in the Internal Revenue Bulletin.

Build America Bonds--Notice 2009-26, 2009-16 I.R.B. 833 (April 20, 2009). This guidance covers the direct Federal subsidy payment procedures regarding the following:

- how (on new IRS Form 8038-CP available now) and when (by 45 days before an interest payment date) to request these payments;
- when the IRS will begin making these payments (July 1, 2009);
- how to make necessary elections to issue these bonds (in writing in an issuer's books and records);
- how to satisfy the information reporting requirement for these bonds (modified IRS Form 8038-G);
- future implementation plans (electronic platform in 2010); and
- a solicitation of public comment on all aspects of this program.

Qualified School Construction Bonds--Notice 2009-35, 2009-17 I.R.B. 876 (April

27, 2009).

Qualified ZoneAcademy Bonds. Notice 2009-30, 2009-16 I.R.B. 852 (April 20, 2009).

Qualified Energy Conservation Bonds. Notice 2009-29, 2009-16 I.R.B. 849 April 20, 2009).

New Clean Renewable Energy Bonds. Notice 2009-33, 2009-17 I.R.B. 865 April 27, 2009).

Near-Term Priority Guidance on Recovery Zone Bond Allocations

In the next several weeks, we expect to provide priority guidance on the bond volume cap allocations for the $25 billion Recovery Zone Bond programs. The Bureau of Labor Statistics released unemployment data needed for this purpose in mid-April 2009.

The Treasury Department wants to encourage use of Recovery Zone Bonds and to make this program as administratively easy as possible for State and local governments.

Near-Term Priority Guidance on Indian Tribal Economic Development Bond Allocations

Also in the next several weeks, we expect to provide priority guidance on the bond volume cap allocation process for the $2 billion authorization for Indian Tribal Economic Development Bonds. We solicited public comment on this program. We are consulting with the Department of the Interior on this matter.

Future Priority Guidance on "Stripping" of Tax Credit Bonds

We also have a longer-term priority project to provide guidance on "stripping" of tax credits to broaden the investor market for tax credit bonds. This project will require careful consideration of accounting rules for tracking tax credits and appropriate tax compliance safeguards.

Reporting

The ARRA brings with it an unprecedented commitment to transparency and accountability in the application of taxpayer resources. To meet these high standards, Treasury and IRS are undertaking an extraordinary effort to provide data to the public on the benefits these bond programs deliver to the American people.

Conclusion

The Administration recognizes that tax-preferred bond financing plays an important role as a financing source for State and local governments and public agencies to provide for public infrastructure projects and other significant public purposes, which will help create and save jobs and expand our economy. In the coming years as we move forward beyond the current economic challenges, the Administration is committed to working closely with the Congress to determine how best to provide Federal subsidies for lower borrowing costs to State and local governments in the most efficient, workable, uniform, simple, and sustainable way possible.

[1] As is explained in the next section, there are two types of Build America Bonds--one type that pays direct subsidies to State and local governments, and the other type that is structured like a tax credit bond. This testimony refers to the first type as simply "Build America Bonds," and the second type as "Tax Credit Build America Bonds."

[2] Source: Thomson Financial.

[3] Source: Barclays Capital.

[4]Ibid.