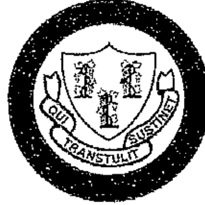
State of Connecticut



DENISE L. NAPPIER
TREASURER

April 3, 2013

The Honorable John Boehner
Speaker of the House
U.S. House of Representatives
The U.S. Capitol, Room H-232
Washington, DC 20515

The Honorable Nancy Pelosi
House Democratic Leader
U.S. House of Representatives
The U.S. Capitol, Room H-204
Washington, DC 20515

The Honorable Dave Camp
Chair
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Patty Murphy
Chair
Senate Budget Committee
624 Dirksen Senate Office Building
Washington, DC 20510

Dear Speaker Boehner, Democratic Leader Pelosi, Chairperson Camp and Chairperson Murphy:

As Treasurer of the State of Connecticut, I have responsibility for the State's issuance of debt obligations and management of its $19 billion debt portfolio. I also serve *ex officio* on the boards of many of the State's quasi-public issuers. It is in this capacity, as the elected Constitutional officer of the State most directly involved with the use of tax-exempt bonds for the financing of State activities, that I submit this letter to assist you in your consideration of tax reform and the Federal budget.

- First, we write to express our views regarding recent proposals that state and local bonds should no longer be treated as tax exempt for federal income tax purposes. In the strongest terms, we urge Congress not to alter the overall federal tax treatment of interest on state and local government bonds. This proposal would result in higher borrowing costs for state and local governments, estimated at as much as $1.9 billion for state and local governments in Connecticut alone over the next ten years. The increased cost of borrowing could result in fewer capital projects and infrastructure improvements necessary for our economy to function, while contributing little to overall federal deficit reduction -- estimated at only $9.3 billion or 0.2% of the current federal fiscal year budget.

- Second, we understand that Congress is weighing difficult choices. In the spirit of offering positive ideas, we also write to suggest the elimination of the market discount rule for tax-exempt bonds. We believe that this would result in a meaningful reduction of the budget deficit. We estimate that the overall principal amount of tax-exempt bonds might be reduced by 6% to 9%, saving the federal Treasury approximately $3.6 billion over five years once the change is fully phased into the market.

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Retain Tax-Exempt Status of State and Local Bonds

State and local government bonds are overwhelmingly issued to fund capital investment projects, such as roads, schools, and other infrastructure. Any proposal to limit or eliminate the tax exemption on municipal bonds would translate into higher interest rates on these bonds and will tend to deter these critical job-creating and -sustaining investments. Higher interest rates must be funded in state and local budgets and have the effect of crowding out other expenses, including pension contributions and education support. Changing the tax treatment of interest on state and local bonds, resulting in deterring capital investment and higher interest payments, is an unfortunate idea, particularly at this time when more job-creating and -sustaining capital investment is needed for aging infrastructure, and government budgets are being strained by a slow economic recovery. The net effect would be to further retard economic recovery.

A recent report of the Congressional Joint Committee on Taxation estimates the annual savings to the federal Treasury from elimination of the tax exemption to be $9.3 billion for the current fiscal year ($48.5 billion over the next 5 years), a drop in the bucket for the $3.54 trillion federal budget. However, the increased costs to state and local governments and the taxpayers that fund them are enormous. In Connecticut, about $4.8 billion of tax-exempt securities are issued each and every year. The cumulative increased interest cost on these debt issues over a ten year period is expected to amount to $1.9 billion based on current spreads between taxable and tax-exempt debt.

Moreover, the mere possibility that the tax treatment might change is disrupting the market for state and local bonds. During the December 2012 'fiscal cliff' discussions, municipal interest rates spiked and some offerings had difficulty in the market as investors considered the possibility that this tax treatment would change. We expect similar disruption in the coming weeks as Congress grapples with the issues before it.

We therefore urge you to make it known, clearly and promptly, that a change in the tax treatment of state and local bonds is not under consideration.

Consider Deficit Reduction Measure -- Eliminate Market Discount Rule for Tax-Exempt Municipal Bonds

In 1993, Congress extended the 'market discount' rule to tax-exempt bonds. This rule raises the possibility that under certain conditions, the holder of a tax-exempt bond would be taxed on a portion of the income from the bond. To minimize this possibility, the market has favored the issuance of bonds with above-market coupons, typically 5%, which are priced at a significant premium to reduce the yield to market rates, e.g., 3%, creating a distortion in the municipal bond market. More than half of outstanding municipal bonds -- some $1.55 trillion -- now carry 5% coupons.

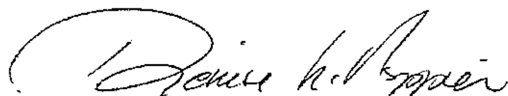
This distortion assures that an advance refunding will be economically attractive. An advance refunding involves the issuance of refunding bonds before the original bonds are retired, resulting in two sets of tax-exempt bonds being outstanding for one capital project for a period of time. Thus, the loss of federal tax revenue is greater than if bonds are issued at a coupon closer to a market rate of interest. Elimination of this 'market discount' rule for tax-exempt municipal bonds would avoid this.

Based on our internal analysis of Connecticut's own bond portfolio, we estimate the amount of tax-exempt bonds outstanding may be 6% to 9% higher due to these advance refundings of 5% coupon bonds. Applied nationwide, repealing the 1993 extension would, phasing in over the next ten years, reduce the amount of tax-exempt bonds outstanding, decreasing revenue loss for the United States Treasury. Using the estimated $48.5 billion five year estimated loss to the federal Treasury from the tax exemption on municipal bonds when fully phased into the market, savings to the federal Treasury could approximate $3.6 billion over five years.

There would be advantages to issuers as well. There would be fewer and smaller bond refundings, saving issuance costs and freeing funds for productive investment.

We realize this is a highly technical proposal, and my staff and I would be happy to explore it further with you. We believe it could be a real contribution to the financial health of the municipal bond market, removing current market distortions, while at the same time assisting in the goal of federal deficit reduction without requiring the damaging step of limiting or eliminating the overall tax exemption on municipal bonds.

Sincerely,



Denise L. Nappier
State Treasurer

cc: The Honorable Richard Blumenthal, United States Senate
The Honorable Christopher Murphy, United States Senate
The Honorable John Larson, United States House of Representatives
The Honorable Rosa DeLauro, United States House of Representatives
The Honorable Joe Courtney, United States House of Representatives
The Honorable Jim Himes, United States House of Representatives
The Honorable Elizabeth Esty, United States House of Representatives