TESTIMONY OF ED LAZERE, EXECUTIVE DIRECTOR
At the Public Hearing
On the FY 2014 Budget Support Act of 2013
District of Columbia Committee of the Whole
May 3, 2013

Chairman Mendelson and other members of the Council, thank you for the opportunity to testify today. My name is Ed Lazere, and I am the executive director of the DC Fiscal Policy Institute. DCFPI engages in research and public education on the fiscal and economic health of the District of Columbia, with a particular emphasis on policies that affect low- and moderate-income residents.

I am here to testify in opposition to the proposal to restore the tax break on out-of-state bonds. I understand that this is a sensitive issue and that it affects DC residents who have builit their retirement portfolios around these bonds. I have communicated with them extensively and do not take their concerns lightly.

That said, I support maintaining current law, which continues to exempt all investments made prior to 2013 and therefore slowly phases out this tax break. As I will discuss, tax exempt bonds are used as a tax shelter by some of DC's wealthiest residents, who earn the lion's share of tax exempt interest in DC. If the intent in reinstating the tax break is to protect retirees relying on municipal bond income, that can be accomplished by limiting the tax exemption to residents below a specified income level. Doing so woud allow the District to keep most of the expected revenue from eliminating this tax break, and it also would maintain the incentive for residents to buy DC bonds, which helps lower their costs.

There are solid public policy reasons that every state with an income tax limits their municipal bond tax break to in-state bonds. This creates an incentive for residnets to purchase their state's bonds, which helps reduce the interest rate paid on that debt. It is the same reason jurisdictions work hard to improve their bond rating. DC's Chief Financial Officer found that the number of DC buyers of DC bonds, and the amount purchased, increased dramatically in 2012, after the initial legislation to limit the tax break to DC bonds was passed. While this shift could have been affected by many factors, there is no doubt that narrowing the tax break to DC bonds will increase demand for them among DC residents.

It is important to note that the FY 2014 budget includes several proposals to help retirees in need that are not funded. This includes $5.8 million through the Office of Aging to fund services for older residents, and $5 million to implement reforms to the Schedule H tax credit, which offsets property taxes when they are consume a large share of a household's income. Schedule H is especially important to lower-income seniors living in areas where property taxes are rising faster than their fixed incomes, such as in gentrifying areas. Both the Office of Aging proposal and Schedule H reforms are on a contingent priority list with no guarantee they will be funded. While

some will argue that it would be good to fund all of these, including the out-of state bond tax break, the reality is that budgets require choices and it is unlikely that all three of these will be fully funded.

It is worth exploring the impact of phasing out the tax break for out-of-state bonds on DC residents. Some advocates for the tax break state that 75 percent of those with income from this source are retirees, but this is based on unsubstantiated estimate. Only 26 percent of DC residents with tax-exempt interst have pension income, and while this understates the retirees who invest in out-of-state bonds, it is clear that many residents with tax-exempt interest are not retirees.

There is little doubt, however, that most of the benefit of this tax break goes to investors with substantial incomes. Over three-fourths of the interest on out-of-state bonds in 2010 was earned by residents with $200,0000 or more in income *beyond what thy get from tax-exempt interest.* In fact, there are 81 DC tax filers who on average earn $2 million from tax-exempt interest. These 81 households account for nearly half of all tax-exempt interest earned by DC residents. Households with income below $50,000, by contrast, account for just 6 percent of tax-exempt interest earned by DC residents.

This provides clear evidence that tax-exempt bonds are in many ways a tax shelter for very wealthy residents who would otherwise pay the highest federal and DC income tax rates if they invested in taxable investments.

Under current law, the District will collect $1.7 million in taxes in FY 2014 on income from out-of state bonds. That equals less than one percent of the out-of-state bond income received by DC residents. This limited impact reflects the fact that the District has grandfathered the tax break for current investments and will collect tax only on new investments. As the tax break phases out, the income tax collected will grow to $30 million per year.

To understand the longer-term impact, consider the example of a DC resident whose sole source of income is out-of-state bonds, which is likely to be rare, who decides not to alter her investments at all in response to the phaseout of the tax break, which also is likely to be rare. Even in this extreme case, someone whose income placres them in the federal 25 percent tax bracket will lose 6.5 perent of income.

Yet this example is extreme for two reasons. First, very few residents rely heavily on tax-exempt bonds. Only 656 residents city-wide received more than one-third of their income from these bonds in 2010, and only 338 with adjusted gross income below $50,000 relied to this extent on tax-exempt bonds.

Second, it is unlikely that residents investing in out-of-state bonds will keep all of their investments in place. Many residents will start buying DC bonds and others will switch to other investments, such as corporate bonds, which are taxable but have higher interest rates. In general, the after-tax return of corporate bonds is likely to be comparable to tax-exempt municipal bonds with similar bond ratings, except perhaps for residents in the highest federal income tax bracket. The fact that only a small number of DC residents rely on tax-exempt bondssuggests that retirees and other investors already are investing in a range of other investments. Indeed, investment in corporate bonds nationally far outweighs investments in municipal bonds. While changing investment strategies may be a challenge for some retirees, it is a viable way to help maintain the income earned currently from out-of-state bonds.

In conclusion, it is clear that tax-exempt bonds serve as a tax shelter for some of our wealthiest residents. There is no reason to create more opportunities for these residents to find tax-free investments, by allowing them to invest in out-of-state bonds. DC should thus continue with the current law that phases this tax break out. That said, there also are a number of DC residents who have built their retirement portfolios around safe municipal bonds. While I believe that the grandfathering of the existing tax exemption will protect many residents and that there are investment alternatives to municipal bonds, DCFPI would support changes to ensure that low- and moderate-income retirees are protected. We support maintaining a full or partial tax exemption for low- and moderate-income households, such as those below $100,000 of total income, as well as changes to clarify that purchases of mutual fund shares prior to 2013 are considered investments that retain the grandfathered tax exemption.

Thank you for the opportunity to submit this testimony.