MINORITY STAFF
COMMITTEE ON GOVERNMENT REFORM
U.S. HOUSE OF REPRESENTATIVES
JANUARY 2003

Tax Cut Analysis | Prepared for Rep. Rush Holt

Tax Cuts Proposed by President Bush Would Hurt State and Local Governments in New Jersey

On January 7, 2003, President Bush proposed a $674 billion dollar tax cut. The major element of the tax cut plan is the elimination of taxes on income from dividends. Under this proposal, corporations that pay federal income taxes could pay tax-free dividends to their shareholders.

This analysis, which was conducted at the request of Rep. Rush Holt, analyzes one often-overlooked aspect of the proposal to eliminate taxes on dividends: its potential impact on state and local governments. The analysis finds:

- **President Bush's proposal would significantly increase the cost of borrowing by state and local governments.** Tax-free municipal bonds are the primary means used by governments to finance long-term investments such as highways and schools. Analysts estimate that President Bush's proposal would increase interest rates on tax-free municipal bonds by one-fourth to one-half of a percentage point.

- **This increase in interest rates could cost New Jersey taxpayers billions of dollars.** If current trends continue, state and local governments in New Jersey will issue almost $90 billion of bonds in the next decade. A half-point increase in interest rates attributable to the President's tax cut plan would mean that New Jersey taxpayers would pay an additional $7.8 billion in interest costs over the life of these loans.

- **An increase in borrowing costs could cause significant reductions in investments by state and local governments.** If borrowing costs increase, state and local governments may be forced to reduce the amount that they can borrow. A half-point increase in interest rates would mean that governments in New Jersey could lose an estimated $4.2 billion of borrowing capacity in the next decade. This is enough borrowing to finance building almost 400 new high schools, 50 new hospitals, or almost 900 miles of new highways.

BACKGROUND

States and cities typically pay for the cost of critical infrastructure improvements, such as schools and highways, by issuing long-term bonds. Like home mortgages, the bonds are generally repaid over a twenty- to thirty-year period. Nationwide, states and cities issued $285 billion worth of bonds in 2001.[1] Presently, the interest rate that states and cities pay for these bonds is approximately 5% annually.[2]

Experts have indicated that one consequence of President Bush's proposal to eliminate dividend taxes will be increased costs for borrowing by state and local governments. As one bond analyst noted, "President Bush's dividend tax exemption proposal may have profound effects on the tax-free municipal bond market."[3] If the proposal is passed, these municipal bonds, which are currently one of the few tax-free investment options, would have to compete with stocks that offer tax-free dividends. This would mean that in order to obtain buyers for the bonds, state and local governments would have to pay higher interest rates. Analysts have indicated that interest rates on municipal bonds could increase by one-quarter to one-half of a percentage point.[4]

The Impact of Increased Borrowing Costs in New Jersey

The state of New Jersey and its cities borrow billions of dollars annually. In 2001, state and local governments in New Jersey issued $9.5 billion in tax-free bonds.[5] Over half of the proceeds were used to pay for two big-ticket items: transportation ($2.7 billion) and education ($2.6 billion). Over one billion dollars worth of bonds were issued to pay for additional improvements in areas such as health care ($802 million), the environment ($259 million), and housing ($142 million). In the five years between 1997 and 2001, state and local governments in New Jersey issued an average of $8.7 billion in tax-free bonds each year.[6]

If state and local governments issue bonds at the same rate for the next ten years as they have for the past five, they will issue an estimated $87 billion in tax-free bonds over the next decade.[7] If President Bush's dividend tax cut proposal causes the cost of these bonds to increase, there will be serious financial impacts on state taxpayers.

Financial experts have indicated that the interest rates paid by state and local governments for bonds could increase by up to half of a percentage point. If this occurs, then the cost of borrowing will increase significantly. If $87 billion of bonds are repaid at a five percent interest rate over 25 years, borrowers will pay a total of $65.9 billion in interest charges over the life of the bond. But if interest rates increase by half a percentage point, then the total interest charges on these bonds will increase to $73.7 billion. This means that if interest rates increase by half a percentage point, New Jersey taxpayers will pay an additional $7.8 billion over the life of the bonds.

Another way to measure the impact of increased bond costs is in terms of loss of borrowing capacity. If interest rates increase, state and local governments may not be able to issue as many bonds. For example, the annual cost of repaying $8.7 billion worth of bonds (a typical year of borrowing by state and local governments in New Jersey) at 5% interest is approximately $610 million dollars.[8] But if interest rates increase by half a percentage point, this $610 million will only be able to pay interest on $8.28 billion worth of bonds, meaning that state and local governments will have lost borrowing capacity of approximately $420 million dollars. Over a decade, this represents a loss of borrowing capacity of $4.2 billion, which is equivalent to a 5% reduction in long-term investments by state and local governments in New Jersey.

This loss of borrowing capacity could have significant impacts on New Jersey citizens. The three largest uses of bonds in the state are to pay for education, health care, and transportation improvements. The $4.2 billion in lost borrowing capacity would be able to pay for 400 new high schools,[9] 50 new hospitals,[10] or almost 900 miles of new highways.[11]

Even a smaller increase in the cost of issuing bonds would have a major impact on New Jersey taxpayers. An increase in borrowing costs of one-quarter of a percentage point would mean that state and local governments would have to pay an additional $3.9 billion in borrowing costs over the life of the bonds they are expected to issue over the next ten years. Viewed in terms of lost borrowing capacity, an increase in interest rates of a quarter of percentage point would cause a loss of borrowing capacity of $210 million annually, or $2.1 billion over the next decade. This would be enough money to pay for approximately 200 new high schools, 25 new hospitals, or almost 450 miles of new highways.

CONCLUSION

This report analyzes the impact of President Bush's proposed tax cut plan on state and local governments in New Jersey. It finds that the proposal would increase the cost of borrowing for these governments, meaning either that taxpayers will have to pay higher costs for schools, highways, hospitals, and other projects or that these projects will suffer significant cuts. The analysis finds that taxpayers would have to pay up to $7.8 billion in additional costs for bonds that will be issued over the next decade. Measured in terms of borrowing capacity, state and local governments could suffer a loss in borrowing capacity of up to $4.2 billion.

Endnotes

1. Thompson Financial, *The Bond Buyer 2002 Yearbook* (2002).

2. Bloomberg.com, *Muni Bond Yields* (Jan. 22, 2003) (online at www.bloomberg.com/markets/pasmuni.html).

3. David Kotok, Cumberland Advisors, Inc., *Bush Plan and Tax Free Bonds: Impact Negative* (Jan. 13, 2003) (online at www.cumber.com/ comments/011303.htm).

4. *See* Bond Buyer, *Bush's Plan May Raise Muni Rates: State Tax Revenues Could be At Risk* (Jan. 8, 2002); Office of the California State Treasurer, *No Dividends: How Taxpayers Lose Under the Bush Plan* (January 2003).

5. Thompson Financial, *supra* note 1.

6. *Id.* In these five years, the state issued an average of $8.9 billion in bonds each year. Approximately 2% of these bonds, or $0.2 billion each year, were taxable bonds that would not be affected by President Bush's tax cut proposal. These bonds were not included in the calculations.

7. Because this assumption does not take inflation or the increasing population of New Jersey into account, the estimate of $8.7 billion in annual new bonds may be a conservative estimate.

8. This calculation assumes that the bonds are repaid over 25 years. *See, e.g.,* Office of the California State Treasurer, *supra* note 4. The methodology and estimation methods used in this analysis are the same as those used by the Office of the California State Treasurer.

9. This calculation is based on estimates that the average new high school costs approximately $10 million to build. *28th Annual Official Education Construction Report: Bucking the Trend*, American School and University (May 2002).

10. This calculation assumes that the hospitals each have 500 beds, and that the average cost of building a hospital is approximately $170,000 per bed. RS Means, *2003 Building Construction and Cost Data* (2003).

11. This calculation is based on estimates that a mile of highway construction in New Jersey costs $4.7 million. Washington State Department of Transportation, *Highway Construction Cost Comparison Survey: Final Report* (April 2002).