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GSEs:

Implications of Removing State and Local Tax Exemption

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GOVERNMENT-SPONSORED ENTERPRISES:
Implications of Removing State and Local Tax Exemption

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Except for real property taxes, GSEs are exempt from State and Local taxes. This is one of a set of advantages that GSEs receive in exchange for performing certain services. These services are meant to compensate for perceived market failures. For example, mortgages and student loans were (1) small, (2) not standardized, (3) difficult to evaluate, and (4) illiquid. GSEs by providing primary and secondary markets for these loans increased liquidity, efficiency, and reduced risk in the national market. In addition to the tax exemption, these GSEs have lines of credit to the federal Treasury that reduce their perceived riskiness to potential investors. As a result, GSEs pay interest rates only slightly higher than the federal government.

Removing the exemption to local income taxation in the District of Columbia will directly reduce federal corporate tax revenues. However, unlike an increase in direct spending or federal tax expenditures, there is no requirement under current budget rules to make up such a revenue loss.

If the exemption is removed for D.C. alone, the predominant effect will be on Fannie Mae. Because of its competition with Freddie Mac, Fannie Mae will have an incentive to reduce its tax bill by shifting activity out of D.C. The tax bill it pays will come from two primary sources: customers and shareholders. To the extent it can, Fannie may try to pass the tax on to financial institutions and the final borrowers. If Fannie cannot pass much of the higher costs on to borrowers, they may be forced to reduce payments to shareholders and prices for Fannie Mae's stock may fall.

Mr. Chairman and Members of the Committee:

One of the advantages that federally chartered Government-Sponsored Enterprises (GSE) enjoy is an exemption from state and local taxes. Mr. Chairman, you have introduced legislation that would give the District of Columbia the right to impose its corporate income tax on Fannie Mae, Freddie Mac, and Sallie Mae and have invited us here to talk about the original basis for the tax exemption and whether that basis holds today. We are also going to discuss some of the implications of imposing such a tax.

Without Congressional action, instrumentalities of the federal government are immune from taxation by state and local governments. This immunity is based on the supremacy clause of the Constitution, as originally interpreted in early Supreme Court decisions.[1] The Court determined that a state tax infringes upon the supremacy clause when it taxes an organization with federal supervision and a federal charter. Congress has exempted Fannie Mae, Freddie Mac, and Sallie Mae from state and local taxes, except for property taxes.

Removing the exemption will have the direct effect of reducing federal tax revenues somewhat because many state and local taxes are deductible in computing federal income taxes. However, the net revenue effect depends on what states and localities would have done if the exemption had not been removed. For example, if states and localities had raised income taxes, which are deductible from federal income taxes, federal revenues might have gone down anyway. Because it is not possible to know what states and localities would have done if the exemption had not been removed, the budgetary effect of removing the exemption is not "scored".

The effect of removing the tax exemption on the markets for home mortgages and student loans is also unclear. To the extent that the GSEs are unable to avoid the tax by shifting the location of their activities, removing the exemption would likely (1) increase the cost of funds to home borrowers, (2) reduce the price paid to financial intermediaries for loans, or (3) reduce the return to GSE shareholders to some extent.

GSES Were Established To Serve Social Goals

The three GSEs that are the subject of this legislation were established to ensure that reasonably priced credit would be available for borrowers in specific sectors of the economy: housing in the cases of Fannie Mae and Freddie Mac and education in the case of Sallie Mae. Each was created to correct what were

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[1] McCulloch v. Maryland, 17 U.S. (9 Wheat.) 316; Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 738.

perceived as failures in the relevant credit markets, at the time they were established. Mortgages and student loans were generally characterized by small principal amounts, loan contracts that were not standardized, loan quality that was not easily comparable, risks that were difficult to evaluate, and the lack of efficient and liquid national secondary markets for these loans.

GSEs have helped to overcome these perceived market flaws by operating nationally to make funds available in all regions of the country. They offer securities that are highly liquid, sold in large denominations, carry known maturities, and are considered relatively safe. In addition, they create liquid secondary markets so that loans can be sold or resold in good and bad times.

Federal Ties Constrain and Benefit GSEs

GSEs are subject to a number of federal controls that distinguish them from private sector corporations. Boards of Directors generally have some members who are appointed by the President. Directors have the responsibility to ensure that the enterprise operates within its charter. Freddie Mac and Fannie Mae are subject to programmatic oversight by HUD as well as prudential oversight by the Office of Federal Housing Enterprise Oversight (OFHEO). The Secretary of the Treasury is authorized to approve or disapprove the issuance of debt by the three GSEs.

The three GSEs are limited by their charters to engage in certain permissible types of activities: housing credit for Fannie Mae and Freddie Mac and education loans for Sallie Mae. These restrictions are meant to ensure that GSEs operate safely and soundly and devote energies to the public purposes embedded in their charters. However, such limitations also reduce the ability of the GSEs to enter more lucrative markets or to diversify and thus spread their risks over different economic sectors.

On the other hand, GSEs have many operating privileges that increase profitability and reduce costs to borrowers by both lowering operating and capital costs and increasing liquidity of GSE securities. For example, GSEs have access to federal funding should it ever be necessary. Each has a line of credit with the Treasury equal to $2.25 billion for Fannie Mae and Freddie Mac and $1 billion for Sallie Mae. This implicit backing has meant that capital markets treat most GSE debt as only slightly more risky than that of the federal government.

Fannie Mae, Freddie Mac, and Sallie Mae are exempt from state and local taxes except real property taxes. Sallie Mae has an additional advantage resulting from the fact that investors in its securities are also exempt from state and local income tax.

In addition, none of the three GSEs are required to register their securities with the Securities and Exchange Commission. Financial institutions find GSE debt attractive because it can be used as collateral when borrowing from the Federal Reserve Banks.

GSEs Can Act as Portfolio Lenders, Guarantors, or Both

Sallie Mae operates as a portfolio lender. It raises funds by selling debt securities or equity to private investors. These funds, in turn, are used to purchase student loans from financial institutions, make loans to financial institutions to free up funds for them to make additional student loans, guarantee student loan revenue bonds, and invest in educationally related liquid assets.

Fannie Mae and Freddie Mac operate as portfolio lenders and as poolers and guarantors of mortgage backed securities (MBS). Fannie Mae operates as a portfolio lender and MBS guarantor earning profits from both interest income and fees. It raises funds for portfolio purchases primarily by selling debt securities. Freddie Mac operates primarily as an MBS guarantor but also has a portfolio of loans.

State and Local Tax Exemption of GSEs May Benefit Federal Treasury

While all GSEs are now exempt from state and local income taxes, Fannie Mae, Freddie Mac, and Sallie Mae are subject to federal corporate income tax. Because state and local income taxes are deductible in calculating federal income tax, the exemption of GSEs means that federal tax revenues may be higher than they would be without the exemption. Whether or not they are actually higher depends on whether and how the forgone state and local revenue is replaced. For example, if the revenue is replaced by sales taxes, which are not deductible under the federal individual income tax, federal revenues are higher with the exemption than without. However, if it is replaced by other income taxes that are deductible at the federal level, federal revenues may be similar with or without the exemption.

The direct cost to federal corporate income tax collections of removing the exemption depends in part on the state and local income tax rate. The higher the rate, the more the federal government loses of the revenue it would have collected. For example, in fiscal year 1993 Fannie Mae earned over $3 billion in income and paid about $1 billion in federal income taxes. If that entire $3 billion had been subject to D.C.'s 10 percent corporate tax rate, the district would have received about $300 million in revenue. However, deducting this tax bill from the federal tax base would reduce federal revenues by about $105 million. The federal rate would be reduced from 35 percent to an effective rate of 31.5 percent.

While the amounts involved for Freddie and Sallie are not nearly so large, the potential total federal revenue loss from removing the exemption for all three GSEs could still be significant. If an equivalent federal revenue loss had resulted from the introduction of a new tax expenditure, current budget rules would require that the revenue loss be made up by some offsetting tax increase or expenditure reduction. In the case of removing the state and local exemption, the budget rules do not require such an offset because it is not known what the District of Columbia would have done if the exemption had not been removed. For example, if the District chose to raise an equivalent amount by raising its individual or corporate income taxes, federal revenues would also fall, but there would be no need to account for the fall. For consistency's sake, removal of the tax exemption is not counted either.

Tax Exemption Is an Advantage for GSEs

Being exempt from state and local taxes in general is clearly an advantage for GSEs. Other private companies who are subject to these taxes and compete with GSEs either as portfolio lenders in the primary market or in the secondary market may be placed at a disadvantage. While GSEs clearly benefit, it is not clear exactly who captures the benefits--customers or owners. If the exemption is seen as a cost reduction, it could be (1) passed on to borrowers, either financial institutions or the final customers, in the form of lower borrowing costs, (2) passed back to GSE owners in the form of higher profits, or (3) shared by borrowers and owners.

Even if the amount of Fannie Mae's income that would be subject to D.C. tax is substantial, it is not clear how much of that income and revenue would remain if only GSEs in the District are subject to tax. The long term revenue impact will depend on the ability of GSEs to move employment and revenue outside of the District. Because Fannie Mae has a substantially larger presence in D.C. than its main competitor, it has more to lose and a correspondingly larger incentive to shift activity.

If the exemption is removed, shareholders of GSEs would prefer to pass the higher taxes on to borrowers, but market conditions may preclude such a pass through. Should GSEs offer tougher terms for purchasing or pooling loans, potential customers may look to alternatives. For example, because Fannie Mae would be hit harder by removing the exemption from District taxes, Freddie Mac could become relatively more attractive. Even if Freddie Mac does not offer better terms than Fannie Mae, financial institutions may decide to hold on to more of the loans they originate than they would otherwise.

Competition with Freddie Mac may put limits on how much of the tax Fannie Mae can pass onto customers. If Fannie cannot pass much of the higher costs on to borrowers, they may have no alternative but to reduce shareholder after tax income. This could come in the form of reduced dividends, lower retained earnings, and lower share prices.

In conclusion, subjecting GSE income to tax in the District of Columbia has the potential to generate substantial revenue for the D.C. government, although the revenue may be greater in the short run than in the long run. This revenue will come from three primary sources: the federal government, mortgage borrowers, and GSE shareholders. All of this adds up to a difficult tradeoff to make.

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Mr. Chairman, that concludes my statement. I will be pleased to respond to any questions you or other members of the committee may have.

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