American Bankers Association
Building Success. Together.

Frank Keating
President and CEO
202-663-5111
fkeating@aba.com

July 15, 2013

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Ranking Member Hatch:

As you start the process to reform the United States tax code, the American Bankers Association (ABA) strongly recommends that the tax-exempt status for credit unions – especially large, complex credit unions – be repealed. The credit union tax exemption has a significant cost. The Office of Management and Budget recently estimated the credit union tax exemption at almost $10 billion over the next five years. With large annual federal deficits, our country can no longer afford to subsidize the $1 trillion credit union industry, which increasingly operates like a tax-free banking system.

In your Dear Colleague letter, you wrote that the process of reforming the tax code would start as a blank slate – that is, a tax code without all of the special provisions in the form of exclusions, deductions, credits, and other preferences that some refer to as "tax expenditures." You stated that these tax expenditures should only be added back if the tax expenditures: (1) help grow the economy, (2) make the tax code fairer, or (3) effectively promote other important policy objectives. ***Based upon the evidence, the credit union tax expenditure does not meet these policy objectives and can no longer be justified.***

Credit Unions Were Never Intended To Be Tax-Exempt Banks, but This Is the Reality Today

Credit unions compete head-to-head with banks in communities across this country. They serve the same markets as banks – particularly community banks – and there is no practical limitation on who a credit union can serve. In fact, the public does not differentiate between banks and credit unions.

Basic economics tells us that this tax expenditure puts credit unions at a competitive advantage relative to other taxpaying financial institutions providing identical services, as it distorts economic behavior and the allocation of resources within the financial services sector. Over time, these bank-like credit unions will grow at the expense of taxpaying financial institutions and so will the tax expenditure.

The tax code should not be picking winners and losers, but that is exactly what the credit union tax exemption does. It has a particularly harsh impact on Main Street community banks. Continuing the credit union tax expenditure would violate the principle of making the tax code fairer.

The Credit Union Tax Expenditure Is Being Abused and No Longer Serves Its Original Purpose

This tax expenditure was originally provided to credit unions as a way to subsidize financial services for individuals with low and moderate income. However, the evidence shows that this tax expenditure is going to wealthy individuals and businesses and not going to people of modest means.

A 2006 study by the U.S. Government Accountability Office (GAO) found that "14 percent of credit union customers were of low-income and 17 percent were of moderate-income, compared with 24 percent and 16 percent for banks." Moreover, GAO found that 49 percent of credit union customers were of upper-income compared to 41 percent for banks.

Thus, the tax expenditure is subsidizing financial services to individuals who clearly do not need it. In fact, the credit unions' own surveys suggest that their image of serving moderate and lower income people is no longer valid. The typical credit union member has higher than average income, more years of education, and is more likely to own a home than non-credit union members.

Moreover, credit unions have never had to document that this tax subsidy was actually used as intended and there is no examination by credit union supervisors to assure compliance. With such a lack of oversight protecting taxpayer dollars, it is no surprise that the tax expenditure has grown and been directed to purposes Congress never intended**.**

If the tax expenditure is no longer conditioned upon the policy goal of serving low- and moderate-income individuals, it can no longer be justified and should be repealed.

The Credit Union Tax Exemption Does Not Help the Economy Grow

Credit unions will certainly say that their tax exemption allows them to make more loans helping to grow the economy. By this logic, ***banks should also be tax exempt***.

Community banks and credit unions compete for the ***same*** business and offer ***identical*** products and services. A loan to a creditworthy borrower made by a credit union is a loan that any bank would be happy to make. Thus, the tax exemption merely shifts the same business to tax-favored credit unions without adding to economic growth. It is patently unfair for community banks across all the Main Streets of America to compete with credit unions of equal (and often larger) size but without the enormous tax subsidy credit unions enjoy.

As discussed above, the tax exemption violates the principle of fair taxation because it distorts the allocation of resources away from taxpaying banks toward tax-favored credit unions offering identical services. This distortion has an economic impact. The economic theory is simple and straightforward: any misallocation of resources will lower productivity, which in turn harms economic growth. Leveling the playing field with regard to tax policy will ensure that financial resources in our economy will go to their highest and best use. This will lead to greater economic efficiency and higher productivity.

In addition, as economic activity moves from the taxable sector of the economy to the tax-exempt sector of the economy, it will add to the federal deficit and reduce long-term economic growth, because any added debt must be financed rather than used in other more productive ways.

The Credit Union Tax-Exemption Should Be Repealed

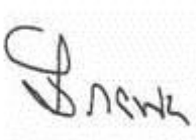
As you and your colleagues in the Senate debate reform of the United States tax code, consider the fact that 208 credit unions have assets over $1 billion. Each one of these credit unions is larger than 90 percent of taxpaying banks. ***More fundamentally to the tax debate, these 208 credit unions – three percent of the entire credit union industry – account for 62 percent of the tax expenditure.*** These large, fast-growing, and increasingly complex credit unions have diversified to the point that they bear no resemblance to the traditional credit unions that Congress envisioned to be worthy of preferred tax status. They often no longer use "credit union" in their names and advertise that they are just like banks.

This is not the first time that Congress has had to deal with different tax treatments in the financial services industry. In the 1940s and early 1950s, Congress faced a similar situation of tax-exempt financial institutions – mutual insurance companies and mutual savings banks – that had outgrown their original purpose and competed head-to-head with taxpaying institutions. What public policy decision did Congress make? It eliminated the tax exemption for mutual insurance companies in 1942 and for mutual savings banks in 1951. Importantly, removing this tax exemption did not drive mutual savings institutions out of business or even hinder their growth.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should thus be subject to tax on the same basis as other financial institutions.

In conclusion, the credit union tax exemption is a Depression-era tax break that for many credit unions has outlived its purpose. It no longer supports the public policy of providing financial services to low- and moderate-income consumers. Previous administrations – both Democratic and Republican – have recommended ending the credit union industry's tax exemption. The time has come for Congress to abolish this exemption. It would be a fiscally sound way to help reduce the U.S. debt and eliminate distortions in the financial services industry.

Sincerely,



Frank Keating

Cc: Members of the U.S. Senate