Protecting Bonds to Save Infrastructure and Jobs

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In the United States, tax-exempt municipal bonds are the most important tool for financing investment in schools, roads, water and sewer systems, airports, bridges and other vital infrastructure. In 2012 alone, more than 6,600 tax-exempt municipal bonds financed over $179 billion worth of infrastructure projects.

As shown in the chart on the following page, state and local governments financed more than $1.65 trillion of infrastructure investment over the last decade (2003 to 2012) through the tax-exempt bond market.

As shown below, six categories represent 90 percent of the total amount of municipal bonds used to finance infrastructure between 2003 and 2012.

Category	$ in billions
Primary and secondary schools	$514
General acute care hospitals	$288
Water and sewer facilities	$258
Roads, highways and streets	$178
Public power projects	$147
Mass transit	$106

Infrastructure issuance volume by use

LONG-TERM, TAX-EXEMPT, $ MIL

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	totals
Airports	3,366.2	2,950.7	5,446.5	2,191.0	4,029.8	3,393.3	6,581.9	13,844.1	3,051.1	4,471.0	49,325.6
Bridges	2,721.7	1,213.4	706.9	3,228.2	1,957.7	2,471.0	1,698.1	1,362.0	1,424.2	3,380.3	20,163.5
Combined utilities	1,746.8	2,894.4	1,526.6	1,071.5	1,094.3	1,079.8	1,420.4	647.3	787.4	1,947.4	14,215.9
Fire stations & equipment	230.0	215.4	296.3	357.4	312.2	230.8	319.6	193.6	276.5	212.6	2,644.4
Flood control	6.2	0.0	0.0	0.0	1.0	0.0	1.6	4.4	5.4	0.0	18.6
Gas	0.7	352.6	397.7	515.2	2,957.2	3,477.3	2,210.6	1,322.5	186.8	2,176.6	13,597.2
General acute care hospitals	19,295.3	17,303.2	28,642.1	29,182.3	36,241.6	53,343.2	37,021.3	23,652.3	19,025.6	24,198.8	287,905.7
General purpose/public improvement	71.3	101.9	235.8	58.6	87.1	170.1	215.3	211.0	75.3	0.0	1,226.4
Government buildings	8.0	0.0	25.3	0.0	2.0	0.0	22.2	0.1	186.8	0.0	244.4
Mass transportation	9,011.7	9,922.6	11,627.9	13,775.1	8,405.5	12,635.7	8,348.2	5,607.3	9,143.2	17,146.0	105,623.2
Multifamily housing	7,055.1	3,585.1	2,923.6	1,826.1	952.3	2,357.5	3,216.7	3,141.3	2,539.0	3,439.7	31,036.4
Police stations & equipment	170.0	255.7	51.6	538.8	151.4	119.1	381.3	33.5	74.5	143.2	1,919.1
Primary & secondary education	51,432.5	54,059.4	72,570.7	59,218.1	62,631.5	47,084.3	40,915.7	34,221.0	37,375.3	54,548.3	514,056.8
Public power	15,834.3	6,524.2	12,983.8	21,190.4	19,717.1	19,762.0	11,743.8	17,137.1	9,905.7	12,194.2	146,992.6
Recycling	112.7	258.4	3.8	0.0	10.0	21.7	0.0	0.0	0.0	2.5	409.1
Sanitation	1,084.2	552.8	465.4	731.8	1,205.1	465.5	731.9	219.8	564.6	275.4	6,296.5
Seaports/marine terminals	1,062.8	276.4	328.6	790.0	1,889.4	1,211.4	719.7	1,821.7	943.6	100.1	9,143.7
Solid waste	1,091.2	815.8	522.7	755.5	819.2	1,724.1	703.4	1,602.2	846.2	387.6	9,267.9
Toll roads, highways, & streets	29,946.9	26,903.1	17,478.1	13,963.1	17,717.8	17,141.5	13,743.7	13,668.5	9,413.9	18,000.3	177,976.9
Tunnels	0.0	0.0	800.0	0.0	0.0	99.6	0.0	0.0	0.0	240.3	1,139.9
Water & sewer facilities	15,261.2	10,688.3	28,607.6	29,364.4	29,640.2	30,531.5	28,124.1	21,738.2	27,444.9	36,546.9	257,947.3
TOTALS	159,508.8	138,873.4	185,641.0	178,757.5	189,822.4	197,319.4	158,119.5	140,427.9	123,270.0	179,411.2	**1,651,151.1**

SOURCE: THOMSON REUTERS DATA, FEBRUARY 2013

The Impact of Proposals to Limit/Eliminate Tax-Exempt Financing

Under the federal tax code, investors are not required to pay federal income tax on interest earned from most bonds issued by state and local governments. The tax exemption for municipal bond interest has been in law since the federal income tax was promulgated 100 years ago, and tax-exempt bonds have financed trillions of dollars of infrastructure investment over that time. The effect of this tax exemption is that state and local governments receive a lower interest rate on their borrowing than they would if their interest was taxable to investors. In typical market conditions, the tax exemption can save states and localities up to two percentage points on their borrowing rates.

Several legislative proposals have been offered to curtail or eliminate the federal tax exemption for municipal bond interest. One proposal would impose a tax-benefit cap of 28 percent for certain taxpayers on many itemized deductions and exclusions, including tax-exempt interest. The effect would be a partial tax on interest that would otherwise be exempt from income tax. In effect, the tax-exempt bond market would no longer be entirely tax-exempt.

If the proposal to impose a 28 percent benefit cap on tax-exempt interest had been in effect during the last decade, it is estimated that this would have cost states and localities an additional $173 billion in interest expense for infrastructure projects financed over the past ten-year period.

For an investor in the 39.6 percent federal tax bracket, the tax benefit cap proposal would equate to an 11.6 percent tax on municipal bond interest income, the difference between the 39.6 percent tax rate and the 28 percent benefit cap. While it may appear that this tax would fall on high-bracket taxpayers, in effect, it would be borne almost exclusively by state and local governments in the form of higher interest rates on their borrowing. Market analysts have estimated that this proposed tax on municipal bond interest would raise state and local borrowing costs by up to 70 basis points (0.7 percentage points) or more. Because the tax would apply not only to new state and local borrowing but also to all outstanding bonds, investors would be taxed on investment which they reasonably expected would be tax-exempt as long as they are outstanding, an unprecedented form of retroactive taxation. As a result, investors would face the new risk that Congress could tax interest on outstanding bonds even more in the future, a risk that would raise state and local borrowing costs even more and create unprecedented uncertainty for investors in the municipal securities market.

“In the last decade, state and local governments financed more than $1.65 trillion of infrastructure projects through tax-exempt bonds.”

Some have proposed an even more onerous full federal income tax on municipal bond interest. For example, the National Commission on Fiscal Responsibility and Reform (the Simpson-Bowles Commission) in its 2010 deficit-reduction recommendations proposed full taxation for state and local interest for all newly-issued bonds. If this proposal had been in place during the 2003–2012 period, it is estimated that the $1.65 trillion of state and local infrastructure investment would have cost governments an additional $495 billion of interest expense.

Increased Costs to Select Jurisdictions

Partially or fully taxing the interest on municipal borrowing would have a direct effect on state and local budgets in the form of increased interest expense. Looking at interest expense incurred by some sample local governments in fiscal year 2012, it is estimated that individual cities and counties would have faced an increase of approximately 15 percent in interest costs in fiscal year 2012 if the 28 percent cap proposal had been in effect during the 15-year period from 1998 to 2012. This additional financial burden reflects the direct pass-through effect of the additional federal tax if it had been in place when the bonds were issued. Taxing the interest on municipal borrowing for investors would have the same effect as taxing state and local governments directly.

The Broad Use of Tax-exempt Financing

Tax-exempt financing is used widely across the country by communities large and small. The $1.65 trillion of infrastructure financed by state and local governments from 2003 to 2012 was spread across nearly 58,000 individual transactions, with an average transaction size of $29 million.

Bonds financed everything from large, multibillion transportation projects to school expansions of several hundred thousand dollars and are used by governments ranging from the largest states to the smallest towns and school districts. Because the interest on municipal bonds is usually exempt from state income taxation for residents of the states in which they are issued, investors tend to buy bonds issued within their states. In that manner, local investment is often financed to a significant degree by local capital.

In the last decade (2003–2012) state and local governments financed more than $1.65 trillion of infrastructure projects through tax-exempt bonds.

Conclusion

Tax-exempt municipal bonds are the country’s most important source of financing for infrastructure investment. Municipal bonds represent a partnership among the federal government, state and local governments, and private investors in contributing to public infrastructure which creates jobs and improves economic efficiency. The proposals to limit or eliminate the federal tax exemption for municipal bond interest would substantially impair the federalist system of government that currently exists and shift unnecessary cost burdens to local taxpayers. Tax-exempt bonds maintain decision making and project selection at the state and local level, where citizens and elected officials can best determine where needs are greatest and where investments will generate the maximum return. Finally, tax-exempt bonds force market tests of investment projects, since investors will not commit capital until they are convinced the credit behind the borrowing is financially sound. The default rate on borrowing by states and localities is near zero.

Congress should preserve the tax exemption for interest on municipal bonds. The tax exemption has successfully provided trillions in low-cost financing for infrastructure investment. Curtailing or eliminating the tax exemption would raise costs for financially-strapped state and local governments and would result in less investment in infrastructure at a time when jobs are scarce and the physical state of our public works is deteriorating.