GFOA ISSUE BRIEF

Tax-Exempt Municipal Bonds and Infrastructure:

Over 100 years of building together

POLICY RECOMMENDATIONS

- → **Protect the full tax-exemption for municipal bonds,** a fundamental component of the federal/state/local partnership that develops the nation's infrastructure
- → **Restore advance refunding bonds,** a critical tool that allowed state and local governments to achieve substantial savings for taxpayers
- → **Adopt bond modernization provisions** to help state and local governments meet infrastructure challenges of the 21st century and beyond

Background: While the tax exemption for municipal bond interest remained intact despite threats of elimination during the tax reform debate in 2017, Congress may continue to look at changes to the tax code that impact public finance going forward. If state and local governments lose the ability to use tax-exempt bonds and are compelled to issue taxable bonds as an alternative, it is estimated that debt issuance costs would increase around 25%, and possibly more for smaller governments.

> Governments should continue efforts to educate their Representatives and Senators of the important role tax-exempt bonds play for financing essential infrastructure in their communities.

Tax-exempt Bond Issuance (thru 10/31/2018)

CATEGORY	Amount (in billions)	Percent of Total
Education	66.7	27%
General Purpose	66.0	26%
Utilities	31.7	13%
Transportation	29.8	12%
Healthcare	22.6	9%
Housing	13.8	5%
Public Facilities	9.4	4%
Electric Power	5.1	2%
Development	3.9	1%
Environmental Facilities	0.7	1%
Total	**$249.54**	**100%**

Source: GFOA analysis of Thomson Reuters data as of 10/31/18

Tax-exempt bonds are the primary mechanism through which state and local governments raise capital to finance a wide range of essential public projects. The volume of municipal bond issuance for the period from 2007 to 2017 amounted to **$3.6 trillion**.[1] Communities across the country would be negatively impacted if federal tax policy reduced the financial power of state and local governments to meet their capital needs. This further exacerbates the current situation faced by state and local governments in continued reductions or elimination of federal assistance of various kinds over the years, including categorical grants and general revenue sharing, and seeing a rise in costs due to federal mandates (legislative or regulatory requirements imposed by the federal government upon states and localities). No federal program has or would be able to finance all the capital needs across the country. For over 100 years, the municipal bond market has worked fairly and efficiently to address these needs, whether it is in our largest states and cities or the rural areas across the United States.

Current Status of Federal Tax Policy

The Tax Cuts and Jobs Act (*TCJA*) passed by Congress and signed into law by the President in 2017 made several changes to the tax code of interest to governments. Although the full tax exemption for municipal bond interest was successfully retained, other changes noteworthy to issuers of municipal bonds include:

- the elimination of advance refundings;
- the elimination of tax credit bond programs; and
- the reduction of the corporate tax rate and elimination of some corporate, bank and insurance tax incentives to purchase municipal securities.

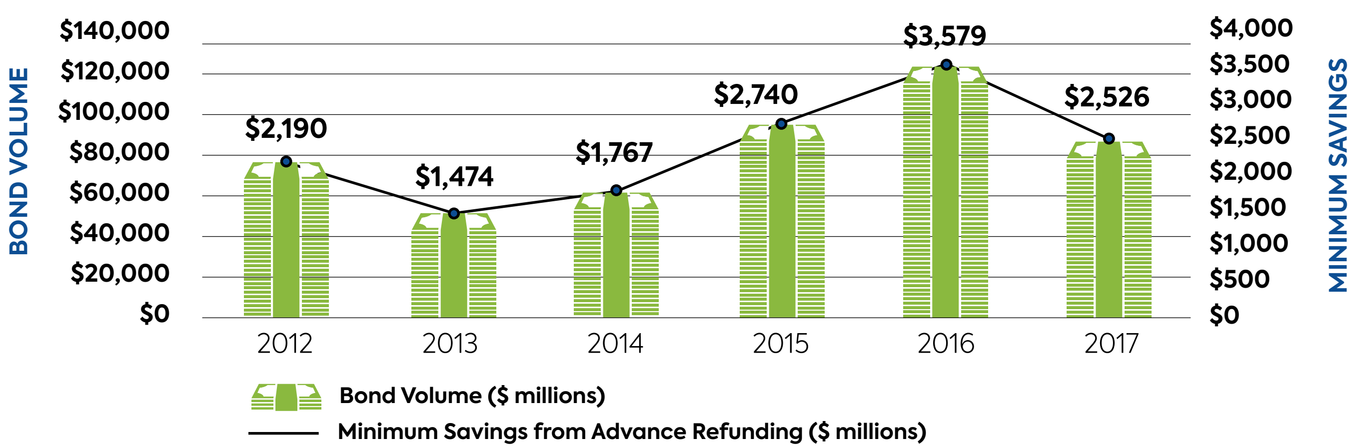
HOW HAVE THE CHANGES IMPACTED PUBLIC FINANCE?

New financial products

Assuming an average savings of 3% of par, issuers have saved substantial sums over time through advance refundings, which freed up capital to use for other infrastructure needs. New market-borne financial products intended to achieve savings similar to those found previously have come to market. GFOA reminds members to carefully review alternative proposals and ensure that they are allowed within the parameters of their debt management policies.

> Governments should consult with outside professionals, such as municipal advisors and bond counsel, to determine if these products are suitable and beneficial to your entity.[2]

ADVANCE REFUNDING ISSUANCE



Source: GFOA analysis of Thomson Reuters data

Issuing Bonds in a Dynamic Market

Advance refundings represented 27% of municipal bond market activity in 2016 and 19% in 2017.[3] Additionally, the TCJA decreased the overall corporate tax rate from 35% to 21% and eliminated other tax incentives that could impact overall demand for municipal bonds. Market experts are keeping a keen eye to see how the market will react to possibly reduced supply, reduced demand due to corporate tax changes, or perhaps increased demand by individuals who are looking for tax exempt products to help alleviate tax exposures due to new state and local tax deduction limits. **Governments should be aware of these market dynamics as they consider going to market and determine appropriate action with consultation of outside professionals.**

COMPARISON OF Q1-Q3 ISSUANCE DATA

	2017		2018		
	Volume ($ Millions)	Number of Issues	Volume ($ Millions)	Number of Issues	% Change (Volume)
Total	293,254.7	9.479	252,234.1	7,063	-13.99%
Tax-Exempt	257,626.2	8,498	217,122.3	6,212	-15.72%
Taxable	25,391.0	868	21,963.8	768	-13.50%
Minimum Tax	10,237.4	113	13,148	83	28.43%

Source: GFOA analysis of Thomson Reuters data available as of 9/30/18

WHAT ABOUT INFRASTRUCTURE?

The country's infrastructure needs continue to grow. According to the 2017 Infrastructure Report Card by the American Society of Civil Engineers (ASCE), our nation's infrastructure earned a cumulative grade of D+.[4] **The ten-year funding gap between the $4.6 trillion in infrastructure needs and public spending necessary to achieve a state of good repair is $2 trillion.** With direct federal support to state and local governments continuing to decrease, and the lack of a clear vision from Congress or the Administration on a path forward for infrastructure, the importance of the municipal bond market cannot be overstated.

Action Items for GFOA Members

With the start of the 116th Congress, there will be several freshman members in addition to new staff in personal offices and on committees. GFOA members are encouraged to reach out – email, tweet or call – and educate your federal representatives about the role tax-exempt bond financings have in your communities. Provide them with specific examples of projects that are supported by municipal bonds and how they are meeting the needs of your communities.

WHAT PUBLIC FINANCE ISSUES COULD SEE ACTION IN THE NEW CONGRESS?

RESTORE ADVANCE REFUNDING BONDS

Brief Description:

In the previous session of Congress, bipartisan legislation was introduced to reinstate the availability for governments to use advance refundings. Advance refunding bonds allow states and localities to refinance existing debt with the greatest flexibility, resulting in substantial reductions in borrowing costs. The elimination of advance refundings in the TCJA as a cost-savings tool for state and local governments has limited the options to refinance debt, especially since interest rates will certainly fluctuate over the lifetime of outstanding governmental bonds (which in many cases is 30 years). As a result, state and local governments are now paying more in interest, a cost that must be paid by state and local residents.

Proposed Legislative Change:

Reinstate authority to issue tax-exempt advance refunding bonds.

- Call for and support legislation, similar to H.R. 5003 in the 115th Congress that sought to amend the Internal Revenue Code of 1986 to reinstate advance refunding bonds. H.R. 5003 would have fully reinstated tax-exempt advance refundings, including private activity bonds and qualified 501(c)(3) bonds.
- 10-year revenue effect estimated at ~$17 billion.[5]

SMALL ISSUER EXCEPTION

Brief Description:

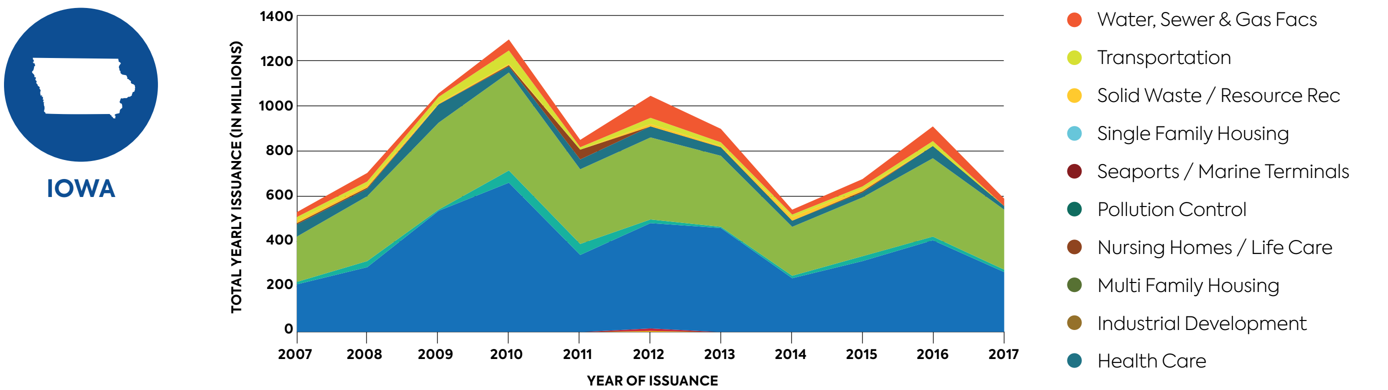
The bank qualified provision offers a proven incentive for local banks to purchase the tax-exempt debt of small local governments and borrowers such as small colleges, health care facilities and other charities. During the two years in which it was liberalized (late 2000s), it created a market for thousands of small borrowings that stimulated the economy as well as cash strapped small governments and nonprofits.

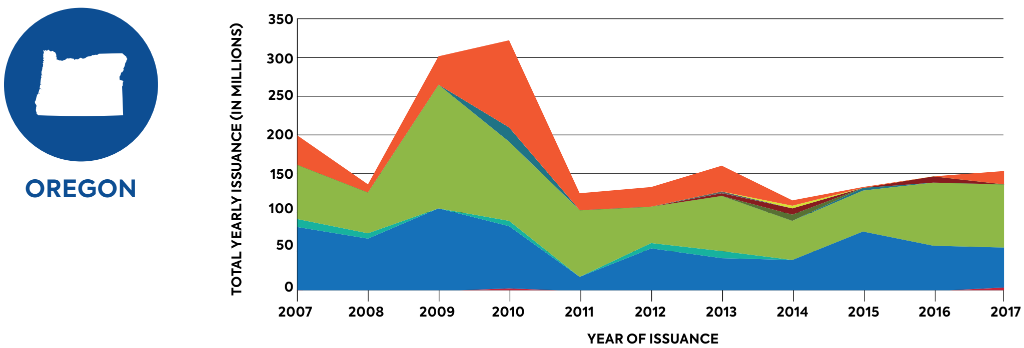
Governments issuing $10 million or less in bonds per calendar year can have those bonds designated (or qualified 501(c)(3) bonds) as bank-qualified, which allows them to bypass the traditional underwriting system and sell their tax-exempt bonds directly to local banks at a cost savings for taxpayers.

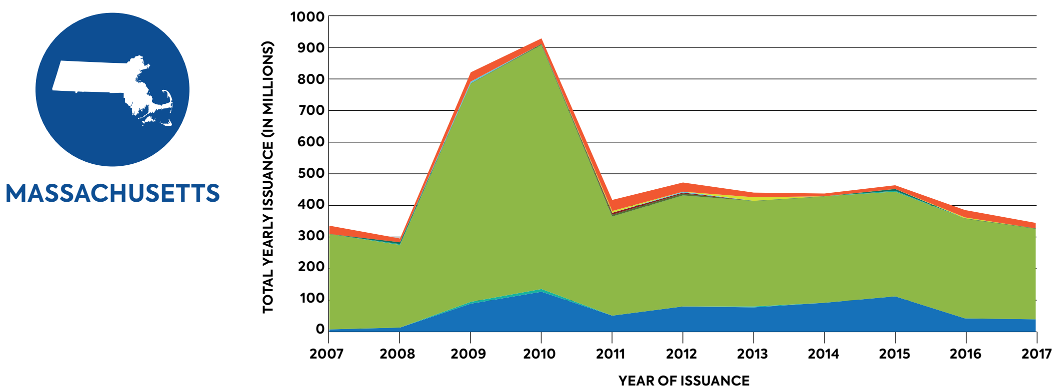
Proposed Legislative Change:

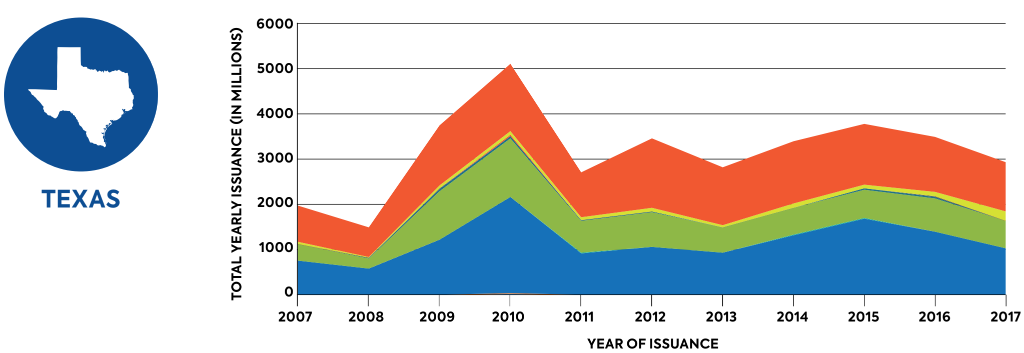
- Increase the maximum allowed bond issuance of "bank eligible" bonds to $30 million from the current level of $10 million. Set in 1986, the limit should be increased and then tied to inflation in future years.
- Permanently modify the small issuer exception to tax-exempt interest expense allocation rules for financial institutions (Section 265(b)(3)). The provision should be modified to apply to governmental issuers and the borrowing organizations separately regardless of the issuer and permit the 501(c)(3) organization to provide the designation.

BQ BOND ISSUANCE BY GENERAL USE OF PROCEEDS: 2007–2017 (in millions)









Source: GFOA analysis of Thomson Reuters data as of 11/28/18

DIRECT SUBSIDY BONDS

Brief Description:

Direct subsidy bonds, like Build America Bonds (BABs), are debt securities (e.g. municipal bonds) issued by a state, municipality, or county to finance capital expenditures. In general, there are two distinct types of BABs: tax credit BABs and direct payment BABs.

Tax credit BABs offered bondholders and lenders a 35% federal subsidy of the interest paid through refundable tax credits, reducing the bondholder's tax liability.

The direct payment BABs offered a similar subsidy that was paid to the bond issuer. The U.S. Treasury made a direct payment to BAB issuers in the form of a 35% subsidy of the interest they owed to investors. As a result of sequestration, issuers saw a reduction in their subsidy payments.

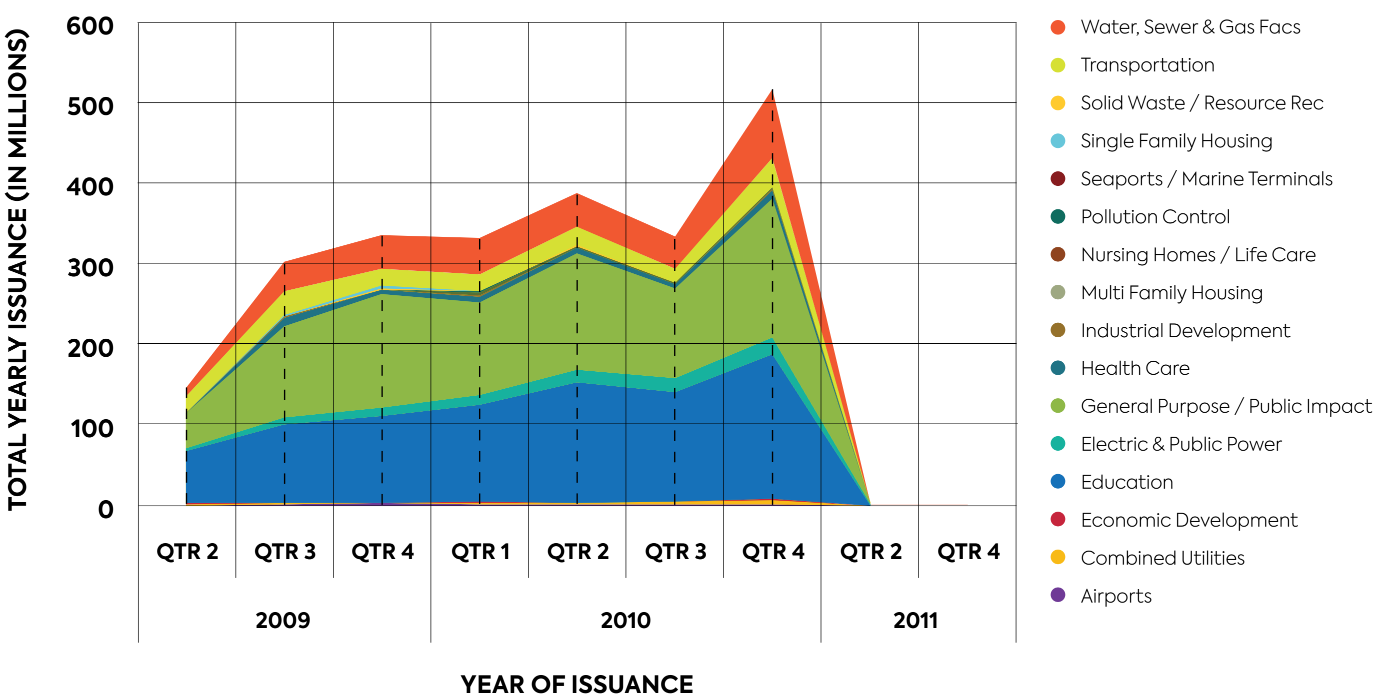
Proposed Legislative Change:

Protection of Build America Bond payments to issuers in case of sequestration (Section 6431(b)).

» Credit payments to issuers of Build America Bonds were not intended to be subject to budget sequestration. This would conform treatment of these payments to treatment of other tax credit payments.

» 10-year budget effect ~$1.7 billion.[6]

GENERAL USE OF ISSUED BABS IN THE U.S. (in millions)



Source: GFOA analysis of Thomson Reuters data as of 11/28/18

PRIVATE USE LIMITATIONS

Brief Description:

The core private use restriction applicable to a governmental bond issue is found in Section 141(b) of the Code and provides that no more than ten percent of the proceeds of such issue can satisfy the private business tests. The only use that is not private business use is use by (i) a state or local government, (ii) an individual not in trade or business, or (iii) the general public. The rule is complicated by a number of supplemental restrictions.

Proposed Legislative Change:

» Repeal the five percent unrelated or disproportionate test (Section 141(b)(3) of the Code).

» Repeal the $15 million per project limit on private business use on certain output facilities (Section 141(b)(4)).

» Repeal the volume cap requirement for governmental bond issues with a nonqualified private business amount in excess of $15 million (Section 141(b)(5)).

(10-year revenue effect of preceding three items $75 million.[7])

» Repeal the limit on the use of bond proceeds to acquire non-governmental property (Section 141(d)). The 10-year revenue effect of this change is unknown.

PARTNERSHIP FINANCINGS

Brief Description:

The Administration has proposed various new programs that would provide incentives for public-private partnerships to help fund public sector infrastructure needs. While it is unclear if Congress will address these proposals, **governments should be aware of potential financial tools that are or may be available and evaluate them to determine if they may be appropriate for their government.**[8]

For more information about the municipal bond market and GFOA's activities in Washington, DC related to the tax-exempt bonds, please visit www.gfoa.org/FLC.

ENDNOTES

[1] GFOA analysis of Thomson Reuters data.

[2] See GFOA Best Practices Selecting Bond Counsel, Selecting and Managing Municipal Advisors and Selecting and Managing Underwriters for Negotiated Bond Sales. Also see GFOA Advisory Use of Debt-Related Derivative Products. Available at http://www.gfoa.org/best-practices.

[3] GFOA analysis of Thomson Reuters data.

[4] 2017 Infrastructure Report Card, American Society of Civil Engineers available at https://www.infrastructurereportcard.org/.

[5] Staff of the Joint Comm. on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act" (JCX-67-17), at 4 (Dec. 18, 2017).

[6] Estimate derived from Cong. Budget Office, Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act, at 8 (Sept. 12, 2011); Office of Mgmt. & Budget, OMB Report to the Congress on the Joint Committee Reductions for Fiscal Year 2019, at 13 (Feb. 9, 2018)).

[7] Staff of the Joint Comm. on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2017 Budget Proposal (JCX-15-16), at 11 (March 24, 2016).

[8] See the GFOA Advisory Public Private Partnerships available at http://www.gfoa.org/public-private-partnerships-p3.