2019 Bond Modernization

By Emily S. Brock

> The 116th Congress may continue to look at changes to the tax code that affect public finance going forward, but the tax exemption for municipal bonds is always vulnerable.

While the tax exclusion for municipal bond interest remained intact despite threats of elimination during the *Tax Cuts and Jobs Act (TCJA)* debate in 2017, the 116th Congress may continue to look at changes to the tax code that affect public finance. Providing the tax exemption to municipal bond investors comes at a cost to the federal government, though, so the exemption itself is always vulnerable.

The benefit of the municipal bond market is no surprise to state and local government finance officers. Tax-exempt bonds are the primary mechanism through which state and local governments raise capital to finance a wide range of essential public infrastructure projects. The volume of municipal bond issuance for the period from 2007 to 2017 amounted to $3.6 trillion. The Joint Commission on Taxation tallied the total cost of providing the tax exemption at $359 billion.[1] What this means is that state and local governments are using the tax exemption to provide tenfold the investment in infrastructure that it costs the federal government to provide. If state and local governments lose the ability to use tax-exempt bonds and are compelled to issue taxable bonds an alternative, there could be devastating consequences to our nation's infrastructure.

Despite a notably lengthy partial federal government shutdown, the 116th Congress began work in January 2019 to address their work product for the coming two years; this will undoubtedly include an intense interest in finding solutions for infrastructure and a critical assessment of the federal government's ability to provide a funding stream for infrastructure. Together with the Administration, the Democratic House and the Republican Senate will work toward advancing mutual goals, including plans that will address America's infrastructure.

Below is an overview of GFOA's positions on legislation that would help modernize the municipal bond market and allow issuers to continue to improve and enhance our nation's infrastructure.

FEDERAL TAX POLICY AND THE 2017 TAX CUTS AND JOBS ACT

Current Status of Federal Tax Policy. The Tax Cuts and Jobs Act (TCJA), which was passed by Congress and signed into law in 2017, made several changes to the tax code that are 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 refunding.
- The elimination of tax credit bond programs.
- The reduction of the corporate tax rate and the elimination of some corporate, bank, and insurance tax incentives to purchase municipal securities.

Issuing Bonds in a Dynamic Market: 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+.[2] The 10-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.

Issuers have saved substantial sums over time through the use of advance refunding, which freed up capital to use for other infrastructure needs. In the absence of advance refunding, new market-borne financial products intended to achieve savings similar to those found previously have emerged. 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.

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Advance refunding represented 27 percent of municipal bond market activity in 2016 and 19 percent in 2017. The TCJA decreased the overall corporate tax rate from 35 to 21 percent and eliminated other tax incentives that could impact overall demand for municipal bonds. Market experts are watching the market carefully to see how it will react to reduced supply, reduced demand caused by 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.

RESTORE ADVANCE REFUNDING BONDS

In the previous sessions of Congress, bipartisan legislation was introduced to reinstate governments' availability to use advance refunding. 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 refunding in the TCJA as a cost-savings tool for state and local governments has limited the options for refinancing 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: GFOA's primary objective for this 116th Congress has focused on infrastructure, to fully reinstate state and local government's authority to issue tax-exempt advance refunding bonds. GFOA is encouraged by and supportive of the efforts of the House Municipal Finance Caucus to restore advance refunding municipal bonds. We encourage members of congress to join the Caucus and to support legislation like the *Investing in Our Communities Act*, sponsored by Dutch Ruppersberger (MD-2) and Steve Stivers (OH-15), which would reinstate state and local governments' ability to advance refund municipal bonds in full. The 10-year federal government budget effect would be approximately $17 billion.

REINSTATE FULL SUBSIDY PAYMENTS OF DIRECT-PAY SUBSIDY BONDS

Direct-pay 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 and direct payment. Tax credit BABs offered bondholders and lenders a 35 percent federal subsidy on 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 percent subsidy on the interest owed to investors. As a result of sequestration, issuers saw a consistent annual reduction in their subsidy payments.

Proposed Legislative Change: GFOA has supported issuers' access to capital, including through the form of direct-pay subsidy bonds. The federal government should honor its commitment and protect 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. The10-year budget effect would be approximately $1.7 billion.

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PRIVATE USE LIMITATIONS

The core private use restriction applicable to a governmental bond issue is found in Section 141(b) of the code, which provides that no more than 10 percent of the proceeds of such issue can satisfy the private business tests. The only use that is not private business use is by a state or local government (an individual not in trade or business, or the general public). The rule is complicated by a number of supplemental restrictions.

Proposed Legislative Change: GFOA has long supported restrictions on these types of financings because of their impact on the cost of borrowing for public purposes, but we do not believe that arbitrary volume caps are an appropriate way to deal with the issue. Proposed legislative change will eliminate duplicative and burdensome rules and address our concerns.

The government should repeal the five percent unrelated or disproportionate test (Section 141(b)(3) of the code), the $15 million per project limit on private business use on certain output facilities (Section 141(b)(4)), and the volume cap requirement for governmental bond issues with a nonqualified private business amount in excess of $15 million (Section 141(b)(5)). The 10-year budget effect of these three items would be $75 million.

PARTNERSHIP FINANCINGS

The administration has proposed new programs that would provide incentives for public-private partnerships to help fund public-sector infrastructure needs. GFOA believes that the federal government should work in partnership with state and local government to achieve mutually beneficial outcomes, with minimum disruption to these entities and the tax-exempt bond marketplace. In addition, we always urge the federal government to hold public hearings on matters that affect local and state governments. 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 your government.

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CONCLUSIONS

Stay tuned and keep an eye on GFOA's weekly newsletter for updates related to the significant activity in the 116th Congress related to state and local governments. Additionally, the numerous resources discussed above will continually be updated, so visit gfoa.org/research-reports often as the administration and Congress move forward with new and continuing initiatives. New reports addressing our federal initiatives include: *Infrastructure Funding in the New Budget Environment*, *Tax-Exempt Municipal Bonds and Infrastructure: Over 100 Years of Building Together*, and *Understanding Financing Options Used for Public Infrastructure* (all available at gfoa.org).

Notes

1. Tax Expenditures," U.S. Department of the Treasury, Office of Tax Analysis (treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2019.pdf).
2. The American Society of Civil Engineers' Report Card for America's Infrastructure (infrastructurereportcard.org).

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