Municipal Bonds and Public Power

Summary
For more than 200 years, state and local governments and governmental entities, including public power utilities, have relied on municipal bonds as a means of financing. Nearly three-quarters of all core infrastructure built in the U.S. is financed with municipal bonds. Since the inception of the federal income tax in 1913, interest paid on these bonds has been exempt from federal tax, just as federal bonds, bills, and notes are exempt from state and local taxes. With the federal government facing severe fiscal challenges—seeking to reduce annual budget deficits while also lowering marginal income tax rates—several policymakers have proposed reversing this 100-plus year precedent. Doing so would simply shift the federal government’s budget problems to state and local governments and, in the case of public power utilities, hurt critical investments in power generation, energy efficiency, safety, security, and emissions controls, while increasing costs for customers.

Therefore, the American Public Power Association (APPA) opposes any efforts to limit or eliminate municipal bonds given these adverse impacts on our public power utility members and their customers.

Background and History
The first recorded municipal bond was issued in 1812. Today, there are $3.7 trillion in municipal bonds outstanding, with more than $200 billion funding new projects every year. Close to five percent of those issuances (as much as $11 billion every year) finance new investments in power generation, distribution, reliability, demand control, efficiency, and emissions control: all needed to deliver safe, affordable, and reliable electricity.

In addition to infrastructure for public power utilities, these bonds finance roads, bridges, sewers, hospitals, libraries, schools, town halls, police stations, and every other sort of government-purpose investment made by state and local governments. In fact, nearly three-quarters of the infrastructure investment in the U.S. is financed by state and local government bonds. Since the creation of the federal income tax in 1913, interest on government purpose municipal bonds has been excluded from federal income tax. This dates back to a series of Supreme Court decisions in the 1800s concluding first, that a state tax on a federal enterprise inherently violated the Constitution and, second, that a federal tax on municipal bond interest likewise would be unconstitutional. Subsequently, the Supreme Court has given the federal government the right to regulate government purpose municipal bonds—for example, requiring issuers to register bonds for the interest to be exempt from tax—and to tax the interest on bonds determined not to be for governmental purposes. By way of example of the latter, the 1986 Tax Reform Act substantially revised the tax treatment of private activity bonds. In 1988, a slim Supreme Court majority in South Carolina v. Baker found that municipal bonds could be taxed, but Congress has been unwilling to overturn decades of precedent by changing the tax treatment of government purpose bonds.

1 Private activity bonds differ from government purpose municipal bonds in that they can be issued by a state or local government to finance certain private projects. Interest on qualifying private activity bonds is exempt from regular federal income tax, but subject to the federal Alternative Minimum Tax (AMT). The volume of private activity bonds that can be issued in a state is subject to an annual cap. While power generation and distribution are among the qualified private activity bond activities, other restrictions and considerations make the use of tax-exempt private activity bonds rare for such purposes. Of 1,150 municipal bonds issued for public power projects from 2007-2011, just 30 were private activity bonds.
Strengths and Benefits of Municipal Bonds

State and local governmental entities—including public power utilities—have limited means to raise funds for their communities’ capital needs. The municipal bond market gives close to 42,000 governmental issuers access to investors. This is particularly important to the vast majority of small towns, counties, cities, and publicly owned utilities that issue municipal bonds. The median corporate bond issue is $210 million. Conversely, while roughly five percent of municipal bond issuances are for $200 million or more, the vast majority of municipal bonds, including for public power investments, are far smaller: the median municipal bond issuance is $7 million.

The federal tax exclusion of bond interest means issuers can finance their investments affordably. Over the past 20 years, the average yield of Standard & Poor’s Corporate Bond (Aaa) Index has been 130 basis points higher than that of Moody’s High-Grade Municipal Bond Index. Adjusting for the cost of call provisions common in municipal bonds, but rare in corporate tax-exempt bonds, the spread is closer to 180 basis points. The difference can save municipal bond issuers 25 percent over the 30-year life of a project. These savings result in more critical investments in infrastructure and essential services by state and local governments and lower costs for the services they provide. Also, municipal bonds are ideally suited to finance capital-intensive and long-lived public infrastructure, such as the assets of a public power utility.

Investors purchase municipal bonds in part because of tax considerations, accepting a lower rate of return because the interest is exempt from federal income tax. Municipal bonds are also valued for their ability to generate a steady stream of revenue for fixed-income households. Individual households are the investors in over 70 percent of municipal bonds. Nearly 60 percent of this household tax-exempt interest is earned by taxpayers over 65 years old. In 2012, 48 percent of all municipal bond interest paid to individuals went to those with incomes of less than $250,000.\(^2\)

Recent market performance and the “flight to quality” underscore that municipal bonds are also valued as stable financial investments. Now more than 200-years old, the U.S. municipal bond market is well-established, with a robust and comprehensive federal legislative and regulatory system that protects investors. Likewise, municipal bonds themselves are typically extremely secure investment vehicles: the default rate for investment grade municipal bonds is far less than 0.1 percent, a fraction of the default rate for comparably rated corporate bonds.

Congressional and Administration Actions—Threats to Municipal Bonds

Calls to tax municipal bonds to pay for federal income tax rate cuts or deficit reduction are on the rise. All would have the same effect: limiting or eliminating the income tax exemption for interest from municipal bonds would reduce investments in vital infrastructure across the country and increase the cost of electricity for public power customers. Ultimately, a disproportionate share of this burden will be shouldered by those who can least afford it.

The draft report of the President’s Commission on Fiscal Responsibility and Reform (the “Bowles-Simpson” report) proposed taxing interest on newly issued municipal bonds. It is unclear whether the taxable bond market could accommodate 12,000 municipal bonds issued every year and how smaller issuers—who would be dwarfed by the typical corporate issuer—would fare in the taxable market. Analyses show that financing debt with taxable bonds would increase municipal issuers’ costs by as much as 38 percent. On average, public power municipal bonds finance as much as $11 billion in new projects every year. Repealing the exclusion for municipal bond interest would add an estimated $2.5 billion in borrowing costs over the life of each year’s issuances. Ultimately those costs will be paid by public power customers in the form of higher electric bills.

The Obama Administration has proposed capping at 28 percent the tax value of the exclusion for municipal bond interest and other deductions and exclusions. This would have the effect of imposing a surtax on bond interest. An analysis of this proposal shows that it would increase borrowing costs by 32 to 35 percent. Moreover, the proposal would apply retroactively to $3.7 trillion of existing bonds—an unprecedented and unfair tax that would cause instability in the municipal bond market. At the levels being discussed—a flat dollar cap on deductions and exclusions—if it included municipal bond interest, would be even worse, effectively repealing the income exclusion for most bond holders.

Former House Ways and Means Committee Chairman David Camp (R-MI) proposed his own 10 percent surtax on municipal bond interest, and former Senate Finance Committee Chairman Ron Wyden (D-OR) proposed repealing the exclusion for municipal bonds, partly replacing the exclusion with an income tax credit available to individuals, but not corporations. Despite numerous efforts at creating workable tax credit bond programs, they have had little acceptance among investors, and the prices that investors have been willing to pay for these bonds have resulted in tax credit bonds having their own inefficiencies that far exceed the purported inefficiencies of tax-exempt bonds.

The Congressional Budget Office (CBO) has proposed replacing the exclusion for municipal bonds with a direct cash subsidy from the federal government to issuers. Currently such “direct payment bonds” work as a complement to tax-exempt bonds, not a replacement. They could not, however, accommodate the 44,000 state and local governments that routinely participate in the municipal bond market, most of whom are very small issuers. As a result, many local governments would be shut out of the bond market. One analysis shows that total borrowing costs would increase by 16 percent if the direct payment bond were set at 25 percent of the issuer’s interest expenses. A payment of 15 percent—as proposed by CBO—would raise $30 billion annually for the federal government primarily at the expense of bond issuers. Bond issuers would also be vulnerable to the annual budget process, as evidenced by the ongoing sequestration order for Build America Bond payments. (See APPA’s fact sheet, “Sequestration for Build America Bonds’ Credit Payments” for additional information.)

**APPA Position**
The American Public Power Association (APPA) believes that municipal bonds should be preserved and enhanced, and, as a result, the federal tax exclusion of the interest from such bonds should not be limited or replaced with a tax credit or direct payment subsidy. As not-for-profit, consumer-owned utilities, our members’ mission is to provide reliable and affordable electricity for our customers. Taxing municipal bonds would impose higher borrowing costs that would limit investment in critical infrastructure and, ultimately, impose higher electric rates on our residential and business customers, with unclear benefits for purposes of the overall economy and federal budget. As a result, APPA opposes any effort to undermine this important financing tool.

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APPA is the national service organization for the more than 2,000 not-for-profit, community-owned electric utilities in the U.S. Collectively, these utilities serve more than 48 million Americans in 49 states (all but Hawaii). APPA was created in 1940 as a nonprofit, non-partisan organization to advance the public policy interests of its members and their customers.