AMERICAN PUBLIC POWER ASSOCIATION
Powering Strong Communities

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Municipal Bonds and Public Power

- The American Public Power Association (APPA) believes that tax-exempt municipal bonds are the single most effective tool for financing investments in public infrastructure, including the generation, transmission, and distribution infrastructure used to serve public power utility customers.
- Imposing a tax on municipal bond interest would, in effect, impose a federal tax on the investments needed to build three-quarters of the nation's infrastructure: investments that make commerce possible and communities livable.
- APPA believes that the federal tax exclusion for municipal bond interest should be strengthened through commonsense reforms, including:
    - o Reinstating the ability to issue tax-exempt advance refunding bonds;
    - o Simplifying municipal bond private-use rules; and
    - o Increasing the current small-issuer exception limit from $10 million to $30 million.

Background

A municipal bond is a debt instrument issued for a year or longer, under which the bond holder typically receives annual or biannual interest payments (coupons) until the bond principal is repaid on a specified date (maturity). These payments are exempt from federal income tax, just as interest on U.S. Treasury bonds are exempt from state and local taxation. An issuer can redeem (i.e., "call") a bond before maturity but generally only after a certain period. For example, a 10-year call date is typical for a bond with a 30-year maturity.

State and local governments have issued municipal bonds to finance long-term projects for centuries. Today, there are nearly $3.3 trillion in outstanding municipal bonds.[1] Historically, nearly three-quarters of the core infrastructure investment in the U.S. has been financed by state and local government bonds. Bonds finance the investments that make our communities livable and commerce possible. This includes nearly $70 billion in municipal bonds issued in the last decade to finance public power investments.[2] These include power generation, distribution, reliability, demand control, efficiency, and emissions control projects—all of which are needed to deliver safe, affordable, and reliable electricity.

Since the creation of the federal income tax in 1913, interest on government-purpose municipal bonds has been exempt from federal income tax, just as federal bonds are exempt from state and local taxes. Since then, the federal government has taken steps to regulate municipal bonds, including taxing the interest on bonds determined to be for "private," not governmental use and to limit the ability to use tax-exempt debt to refinance existing debt.

Investors purchase municipal bonds from nearly 42,000 state and local issuers. In part, investors are driven by tax considerations, accepting a lower rate of return because the interest is exempt from federal income tax. These savings are used to make further investments or are passed on to residents in the form of lower rates. Investors also value municipal bonds for their ability to generate a steady stream of revenue for fixed-income households. Individual households own roughly 70 percent of municipal bonds either

1 Board of Governors of the Federal Reserve System, Financial Accounts of the United States, Third Quarter 2024, (December 2024), at 86.

2 The Bond Buyer, 2023 in Statistics, Annual Review (Feb. 13, 2024)(at A8).

directly or through bond funds.[3] And, for more than 60 percent of these households, tax-exempt interest is earned by taxpayers over 65 years old.[4] Investors also appreciate the protections afforded by the municipal bond market. This market is well-established, with a robust and comprehensive federal legislative and regulatory system. Additionally, the default rate for investment-grade municipal bonds is a fraction of the default rate for comparably rated corporate bonds: just 0.08% from 1970 through 2022.[5]

Prior to enactment of the Tax Cuts and Jobs Act of 2017, states and localities could issue tax-exempt advance refunding bonds. Such bonds were used to refund debt to lock in rates or restructure debt prior to a bond's typical 10-year call date. As a result of the Tax Cuts and Jobs Act, issuers now must either wait for a bond's call date to refund it or issue an advance refunding bond as taxable debt; combined this can mean higher costs and less flexibility.

The federal tax exclusion of bond interest means issuers of all sizes can finance their investments affordably. A recent analysis by the Public Finance Network (PFN) shows a 210-basis point difference between the cost of issuing tax-exempt debt versus taxable debt.[6] For example, a 30-year AAA tax-exempt municipal bond would have a 3.90 percent rate, but a comparably rated taxable bond would have a 6.00 percent. PFN estimates this difference will save municipal issuers $824 billion over the next decade.[7] 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, with the cost of investments repaid over time by the customers who use the infrastructure.

Smaller issuers receive an additional benefit under current tax laws. Under current rules, banks generally cannot deduct the carrying cost for tax-exempt bonds. A small-issuer exception to these rules is provided for bonds issued by a locality intending to issue $10 million or less in debt in any given year. This gives banks better access to a secure investment vehicle and more importantly creates a greater appetite for debt issued by small state and local entities that might otherwise have difficulty finding affordable financing for critical projects.

Opponents of tax-exempt financing argue that it is too efficient. They argue that reducing capital costs for public projects makes privatization of public services, including electricity, less economically attractive. They also argue that the $3.5 trillion of municipal borrowing is somehow "crowding out" $17 trillion of corporate borrowing and $40 trillion of Treasury and federal government sponsored entity borrowing, and – as a result – driving up interest rates for everyone. Opponents also argue that tax-exempt financing does such a good job at reducing costs that it encourages state and local governments to overspend on core infrastructure projects.

Conversely, some critics argue that tax-exempt bonds are too inefficient, providing a windfall to wealthy investors rather than reducing borrowing costs. And some critics even argue that municipal bonds are both too efficient and too inefficient at the same time, producing a windfall for wealth investors, but at the same time overstimulating state and local investments.

Besides being inherently contradictory, these arguments generally are based on economic theory, rather than actual market results, which as noted above, show that tax-exempt municipal bonds are highly efficient, reducing borrowing costs by 210-basis points on average. Likewise, the idea that the U.S. is over-investing in core infrastructure is not supported by actual experts.[8] Finally, these economic analyses ignore the fundamental question of whether the federal government has any right to tax state and local investments at all.

Congressional Action

In March 2023, Representative David Kustoff (R-TN) and House Municipal Finance Caucus Co-Chairman Dutch Ruppersberger (D-MD) introduced H.R. 1837, the Investing in Our Communities Act. This legislation would reinstate the ability to issue tax-exempt advance refunding bonds. In May 2023, Senators Roger Wicker (R-MS) and Debbie Stabenow (D-MI) introduced S. 1453, the Lifting Our Communities through Advanced Liquidity for Infrastructure Act, which is identical in effect to H.R. 1837, though drafted differently. APPA strongly supports enactment of these bills.

In May 2024, Rep. Terri Sewell (D-AL) introduced H.R. 8396, the Local Infrastructure Financing Tools Act. The bill would reinstate the ability to issue tax-exempt advance refunding bonds, increase the small-issuer exception from $10 million to $30 million,

3 Supra, note 1, at 123.

4 Internal Revenue Service, Statistics of Income Division, Individual Income Tax Returns: Complete Report (2021), Publication 1304 – Rev. 4-2024 (April 2024) at 204

5 Moody's Investor Service, US Municipal Bond Defaults and Recoveries: 1970-2022 (July 19, 2023) at 3.

6 Public Finance Network. "Preserving Tax-Exempt Municipal Bonds: A Project 10-Year Analysis" (January 2025) at 3.

7 Id.

8 American Society of Civil Engineers, https://infrastructurereportcard.org/ (giving the United States an overall grade of C- on infrastructure investment).

and create a new direct payment bond called an American Infrastructure Bond, akin to the Build America Bond. Credit payments would initially be 42 percent of interest for bonds issued before 2029 but phased down over time to 30 percent for bonds issued after 2030. APPA appreciates the goal of the legislation to increase the small-issuer exception cap.

In March of 2024, the House Republican Study Committee (RSC) released its "Fiscal Year 2025 Budget Proposal." It would have, among other provisions, eliminated "miscellaneous tax carve outs" including the tax exemption for municipal bonds. The House of Representatives did not debate a Fiscal Year 2025 budget resolution in 2024 and so, the RSC plan never came to a formal vote.

On January 17, 2025, House Budget Committee Chairman Jody Arrington (R-TX) released a 51-page list of tax and spending options for consideration under budget reconciliation, including a complete repeal of the tax exemption for municipal bonds estimated to raise $250 billion over 10 years. Combined with a repeal of "preferences" for private activity bonds and direct payment bonds, bond provisions are the third largest of the 21 income tax increases proposed by the list.

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> The American Public Power Association is the voice of not-for-profit, community-owned utilities that power 2,000 towns and cities nationwide. We represent public power before the federal government and protect the interests of the more than 54 million people that public power utilities serve and the 96,000 people they employ.

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