BONDS BUILD PUBLIC POWER

What is a municipal bond?

A municipal bond is a type of debt instrument issued by nearly 42,000 state or local governments (or governmental entities, such as public utility districts) to raise capital. In the last decade, nearly $3 trillion of new infrastructure investments were financed with municipal bonds. This includes $84 billion to finance public power investments. Data suggest that another $4 trillion in state and local infrastructure investments will be financed with municipal bonds – if their tax status is not changed – in the next decade.

Municipal bonds are generally considered safe investments, and the bond market itself is stable and well regulated. In exchange for their capital investment, a municipal bond owner receives periodic interest payments – generally twice a year – and is repaid principal when the bond matures.

Municipal bond interest paid to municipal bondholders is generally exempt from federal income tax (just as Treasury bond interest paid to Treasury bondholders is exempt from state and local tax). This exclusion dates to the 1800s and was incorporated into the modern income tax when it was created in 1913. Private activity bonds are a type of municipal bond used to finance certain qualifying public-private projects. Interest on qualified private activity bonds is exempt from the federal income tax but can be subject to the Alternative Minimum Tax.

What are the economic benefits of financing with municipal bonds?

- Municipal bonds generally finance investments in fixed infrastructure, not ongoing expenses (such as salaries or government benefits).
    - These investments include schools; acute care hospitals; roads, highways, and bridges; subways; seaports and marine terminals; water and wastewater facilities; multi-family housing; libraries and town halls; electric power and natural gas equipment for city-owned utilities; and other public projects.
- $3 trillion – the amount of infrastructure investment financed with tax-exempt municipal bonds in the last decade.[1]
- Nearly two-thirds of the nation's core infrastructure is financed with municipal bonds.[2]

Who buys municipal bonds?

- About 71 percent of bonds are owned by individuals, either directly or through mutual funds and the like.[3]
    - Two-thirds of municipal bond interest paid to individuals is paid to those over the age of 65.[4]

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[1] "BOND BUIYER DATA AVAILABLE AT HTTPS://WWW.BONDBUYER.COM/STATISTICS-REPORTS.

[2] CONG. BUDGET OFFICE, J. COMM. ON TAXATION, SUBSIDIZING INFRASTRUCTURE INVESTMENT WITH TAX-PREFERRED BONDS, 2 (Oct. 2009).

[3] Board of Governors of the Federal Reserve System, Financial Accounts of the United States, Fourth Quarter 2024, (March 2025), at 123.

[4] Internal Revenue Serv., *Statistics of Income—2022: Individual Income Tax Returns*, (October 2024).

- Two-thirds of municipal bond interest is paid to households with income of less than $1 million.[5]

- About 25 percent of bonds are owned by businesses, primarily property and casualty and life insurance companies, but also banks.

Why do investors buy municipal bonds?

- Investors purchase municipal bonds because of the stability of the municipal bond market.
    - State and local governments have issued bonds for centuries – they are a well-known and well-regulated financial instrument.
- Municipal bonds are an extremely safe investment.
    - The 40-year default rate for **corporate** bonds is higher than 11 percent; but
    - The 40-year default rate for municipal bonds is just 0.13 percent;[6] and
    - Not a single AAA-rated municipal bond defaulted during that time.

Bond Defaults per 10,000 Bonds (10 years after receiving rating)		
Rating Category	Municipal Bond	Corporate Bond
AAA	0	50
AA	1	92
A	5	248
BBB	30	474

- The exclusion of interest from federal income tax provides tax savings to investors.
    - *However*, investors accept a lower rate of return on the bond in exchange for the benefit of the tax exclusion, reducing or eliminating any tax "windfall."

What are the financial benefits of financing with municipal bonds?

The strength of issuers, stability of the bond market, and the federal tax exclusion of bond interest reduce borrowing costs for state and local governments.

- Issuing tax-exempt debt reduced borrowing cost by 210 basis points in 2023 – i.e., from an average rate of 6.1 percent for taxable debt to an average rate of 4 percent for tax-exempt debt.[7]
- Over the next 10 years, issuing tax-exempt debt is estimated to save state and local issuers $824 billion.[8]
- Lower borrowing costs for bond-financed projects:
    - Allow for greater investments;
    - Reduce tax and utility rates for residents; and
    - Help create jobs and economic growth.

[5] *Id*.
[6] http://www.fortpittcapital.com/municipal-bonds-returns-defaults-rates/ (last visited on Dec. 1, 2014).
[7] Government Finance Officers Association, Protecting Bonds to Build Infrastructure and Create Jobs: A Projected 10-year Analysis (March 2025).
[8] *Id.*

A Tax on Municipal Bonds Would Be a Tax on All Americans

Municipal bonds are a stable financial investment valued for their security and ability to generate a steady stream of revenue—often for fixed-income households. Some investors purchase municipal bonds because the interest is exempt from federal tax. However, because of this tax treatment, investors also accept a lower rate of return on these investments, eliminating most of any "windfall" and reducing state and local borrowing costs.

- Taxing municipal bonds—either directly or through some "cap" on the value of the tax exemption—will hurt the value of all bonds (and so hurt *all bond holders*), even if the tax is designed to "target" upper-income earners.[9]
- About 50 percent of municipal bond interest paid to individuals is earned by those with *income of less than $500,000; and 66 percent to those with income of less than $1 million.*[10]
- *Senior citizens would be particularly hard hit* – three-fifths of all bond interest is paid to households with a taxpayer aged 65 or older (more than four fifths to households with a taxpayer aged 55 or older).[11]
- *Citizens and ratepayers of all income levels* will pay higher taxes (or rates) if municipal bonds are taxed and, as a result, state and local borrowing costs increase.[12]
- A tax on municipal bonds could increase borrowing costs by $824 billion over the next decade. That means either fewer investments in critical infrastructure, or increased costs to consumers.
- Public power utility customers alone could be saddled with $40 billion in increased borrowing costs.
- The nation's more than 2,000 public power utilities operate in every state except Hawaii.
  - Some of the nation's largest cities are served by public power utilities.
  - However, 1,600 public power utilities serve rural towns, villages, and boroughs, that can ill afford a federal tax on their capital investments.

[9] Michael Kaske, Bloomberg, "Tax Cap Threatens $200 billion Muni Loss, Citigroup Says" (Dec. 7, 2012) (reporting analysis that limiting the tax value of the exclusion for municipal bond interest will reduce the value of existing bonds in the secondary market); Brian Chappatta, Bloomberg, "Tax-Status Threat Fuels Worst Losses Since Whitney: Muni Credit" (Dec. 21, 2012).
[10] *Internal Revenue Service,* "Statistics of Income—2014: Individual Income Tax Returns" (2016).
[11] *Supra* note 4.
[12] Frank Sammartino, Congressional Budget Office, Testimony before the S. Comm. on Finance Hearing "Tax Reform: What it Means for State and Local Tax and Fiscal Policy" (Apr. 25, 2012) (Testifying that the vast majority of the benefit of the federal income tax exclusion for municipal bond interest results in lower borrowing costs for states and localities).

GLOSSARY OF TERMS

BASIS POINT – An amount equal to 1/100th of 1 percent (i.e a 0.01 percentage point). So, for example, there is a 210 basis point difference in yield between a tax-exempt bond yielding 4.00 percent and a taxable bond paying 6.10 percent.

BOND – A debt instrument issued for a year or longer, under which the bond holder typically receives periodic interest payments (coupons) and is repaid the bond principal on a specified date (maturity).

BONDHOLDER OR BONDOWNER – The person or entity having a legal ownership interest in a municipal bond.

CALL – To redeem a bond prior to its maturity, generally to refinance at a lower interest rate. To call a bond, the issuer generally pays the bond holder the face value of the bond plus, generally, some added premium. Under a "make-whole call," the premium can be much higher, often calculated as the net present value (using then-current interest rates) of the payments that will not be made because of the call. Call provisions are relatively common for municipal bonds, but not for taxable bonds. If a taxable bond includes a call provision, it is generally a make-whole call.

CALLABLE BOND – A bond that includes a call provision.

COUPON – The periodic interest payments (generally twice yearly) made on a bond. The term is derived from the time when physical possession of a bond was proof of ownership and "coupons" attached to the bond entitled the bondholder to periodic interest payments when the coupons came due. Removing the coupon from the bond and presenting it for payment is called "coupon clipping."

DIRECT PAYMENT BOND – A municipal bond the interest on which is taxable, but for which the issuer receives a direct subsidy payment from the U.S. Treasury. The amount of the payment varies but is generally equal to a set percentage of the interest paid. For example, issuers of direct payment Build America Bonds were to be paid an amount equal to 35 percent of the interest paid to bondholders. The payment rate is set by statute, not by contract, and can be reduced (see, sequestration).

EXEMPT FACILITY BOND – A private activity bond that is considered a qualified tax-exempt bond because it finances one of 15 specific facility types. While technically benefitting a private business (or private businesses), these exempt facilities generally serve a public function. These include: (1) airports, (2) docks and wharves, (3) mass commuting facilities, (4) facilities for the furnishing of water, (5) sewage facilities, (6) solid waste disposal facilities, (7) qualified residential rental projects, (8) facilities for the local furnishing of electric energy or gas, (9) local district heating or cooling facilities, (10) qualified hazardous waste facilities, (11) high-speed intercity rail facilities, (12) environmental enhancements of hydroelectric generating facilities, (13) qualified public educational facilities, (14) qualified green building and sustainable design projects, or (15) qualified highway or surface freight transfer facilities.

GENERAL OBLIGATION BOND – A municipal bond payable from general funds of the issuer. Most general obligation bonds are said to entail the full faith and credit of the issuer. Compare: "Revenue bond."

ISSUE – A group of bonds sold on a contemporaneous (or nearly contemporaneous) basis in one or more series that are authorized under the same bond contract.

ISSUER – A state, territory, political subdivision, municipality, or governmental agency or authority that raises funds through the sale of municipal securities, such as bonds and notes.

MUNICIPAL BOND – A bond issued by a state or local government or governmental entity. Municipal bonds include tax-exempt bonds, private activity bonds, taxable municipal bonds, tax credit bonds, and direct payment bonds. Often the term "municipal bond" is used to refer to a tax-exempt bond.

NOTE – A short-term debt instrument for which the note holder is repaid principal and interest on a specified date. Notes generally mature in one year or less but can be longer.

PRIVATE ACTIVITY BOND – A municipal bond the proceeds of which are used to finance activities benefitting nongovernmental persons. The Internal Revenue Code states that a "private activity bond" is taxable, unless it is a "qualified bond" (26 USC

103(b)(1)). In common parlance, however, the term "private activity bond" is often used to refer to a "qualified bond." (See, qualified bond.)

QUALIFIED (PRIVATE ACTIVITY) BOND – A private activity bond the interest on which is tax-exempt, although such interest is generally subject to the federal alternative minimum tax (AMT). A qualified bond is sometimes referred to as an AMT bond. A qualified bond may be: (A) an exempt facility bond, (B) a qualified mortgage bond, (C) a qualified veterans' mortgage bond, (D) a qualified small issue bond, (E) a qualified student loan bond, (F) a qualified redevelopment bond, or (G) a qualified 501(c)(3) bond.

RECIPROCAL IMMUNITY – The principle that neither the states nor the federal government may tax income received from securities (bonds, notes, etc…) issued by the other. The doctrine dates to a series of U.S. Supreme court decisions in the 1800s and is the original basis for the exemption from the federal income tax of interest paid on municipal bonds (and notes).

REFUNDING – A procedure whereby an issuer refinances outstanding bonds by issuing new bonds. There are generally two major reasons for refunding: 1) to reduce the issuer's interest costs or 2) to remove a burdensome or restrictive covenant imposed by the terms of the bonds being refinanced.

REVENUE BOND – A bond that is payable from a specific source of revenue. Pledged revenues may be derived from operation of the financed project, grants, or excise or other specified non-ad-valorem taxes. Generally, no voter approval is required prior to issuance of a revenue bond. Compare: "general obligation bond."

REVENUE ANTICIPATION NOTE -- Notes issued in anticipation of receiving revenues at a future date.

SERIAL BOND – The portion of a bond issue consisting of bonds with maturity dates that are staggered over a number of years, rather than a single maturity date for the entire issue (see term bond).

TAX CREDIT BOND – A municipal bond the interest on which is taxable, but holders of which receive some sort of income tax credit. The exact amount of the credit can vary. For example, the credit for certain tax credit bonds is set at the date of issuance by the U.S. Department of Treasury to be equal to the amount of credit necessary to allow the bond to be issued with a price equal to its face amount.

TAXABLE MUNICIPAL BOND – A municipal bond the interest on which is subject to federal income tax. An issuer may issue a taxable bond because: it is financing activities that would not qualify for tax-exemption.

TAX-EXEMPT BOND – A municipal bond the interest on which is excluded from income for federal income tax purposes. Such interest may, or may not, be exempt from state or local taxation. Generally, municipal bond interest is exempt from tax because the bond is being used to finance a governmental activity, just as interest on federal bonds is exempt from state and local tax (See, reciprocal immunity).

TERM BONDS – Term bonds are bonds of an issue that mature on a single date, rather than over a series of dates.

YIELD – A measure of the annual rate of return on an investment. There are a variety of ways to calculate yield, but generally it is calculated based on the bond purchase price, the bond interest rate, and the length of time the investment is held.

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