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Protecting Bonds to *Save Infrastructure and Jobs* 2013

REPORT BY:

The National Association of Counties
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WITH ASSISTANCE FROM:

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Assumptions and methodology

The issuance data contained in this report represent long-term, tax-exempt issuance by state and local governments and state and local agencies and authorities over the period 2003–2012 for the listed use of proceeds. The source is the Thomson Reuters SDC Platinum database. Taxable bonds and bonds subject to the individual alternative minimum tax are excluded.

Several assumptions were made in calculating the attached estimates. First, the average maturity of bonds is assumed to be 15 years. Bonds are assumed to have been issued at the rate of the median value of the Bond Buyer 20-Bond Index for the year of issuance. It is assumed that the proposal to cap the tax benefit of the tax exemption at 28 percent would have increased borrowing costs by 70 basis points and that the proposal to fully repeal the tax exemption would have increased borrowing costs by 200 basis points, based on various industry reports, including Municipal Market Advisors and Citigroup, and produced by the Government Finance Officers Association. For the estimates of increases in 2012 interest costs by city and county, the 2012 interest payment cost was provided by each government and then the assumptions were completed using with an average maturity of 15 years at the median value of the Bond Buyer 20-Bond Index over the 15-year period 1998–2012. Please note that individual results may vary by jurisdiction.

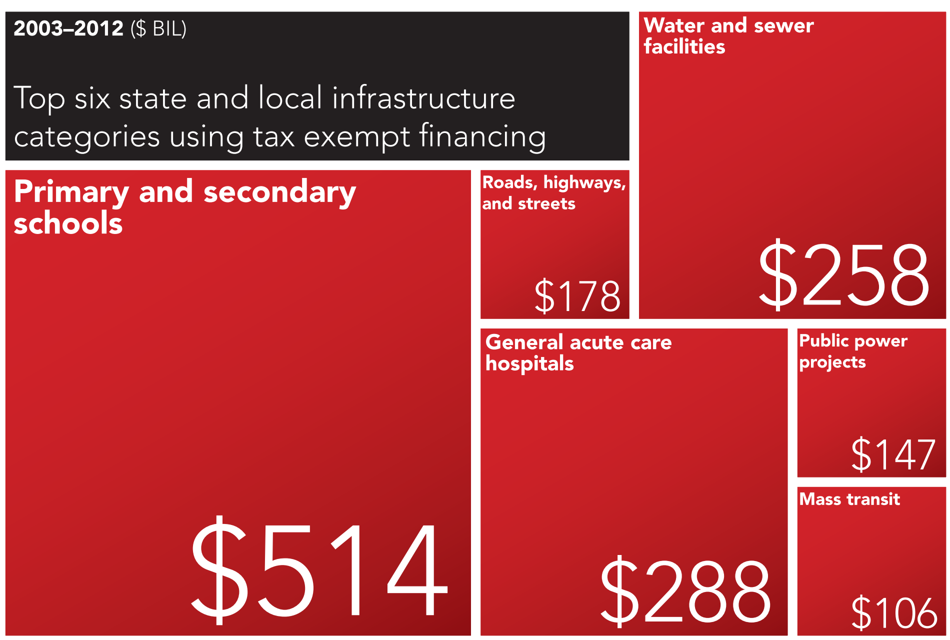
Introduction

Tax-exempt municipal bonds are the most important tool in the U.S. for financing investment in schools, roads, water and sewer systems, airports, bridges and other vital infrastructure. State and local governments financed more than $1.65 trillion of infrastructure investment over the last decade (2003–2012) through the tax-exempt bond market (**Chart E**).

During that decade, $514 billion of primary and secondary schools were built with financing from tax exempt bonds; nearly $288 billion of financing went to general acute care hospitals; nearly $258 billion to water and sewer facilities; nearly $178 billion to roads, highways, and streets; nearly $147 billion to public power projects; and $105.6 billion to mass transit (**Chart A**). These categories represent 90 percent of the total amount of municipal bonds used to finance infrastructure between 2003 and 2012.

In 2012 alone, more than 6,600 tax-exempt municipal bonds financed over $179 billion worth of infrastructure projects.

CHART A



The Impact of Proposals to Limit/Eliminate Tax-Exempt Financing

Under the federal tax code, investors are not required to pay federal income tax on interest earned from most bonds issued by state and local governments. The tax exemption for municipal bond interest has been in law since the federal income tax was promulgated 100 years ago, and tax-exempt bonds have financed trillions of dollars of infrastructure investment over that time. The effect of this tax exemption is that state and local governments receive a lower interest rate on their borrowing than they would if their interest was taxable to investors. In typical market conditions, the tax exemption can save states and localities up to two percentage points on their borrowing rates.

Several legislative proposals have been offered to curtail or eliminate the federal tax exemption for municipal bond interest. One proposal would impose a tax-benefit cap of 28 percent for certain taxpayers on many itemized deductions and exclusions, including tax-exempt interest. The effect would be a partial tax on interest that would otherwise be exempt from income tax. In effect, the tax-exempt bond market would no longer be entirely tax-exempt.

If the proposal to impose a 28-percent benefit cap on tax-exempt interest had been in effect during the last decade, it is estimated that this would have cost states and localities an additional $173 billion in interest expense for infrastructure projects financed over the past ten-year period (**Chart B**).

For an investor in the 39.6-percent federal tax bracket, the tax benefit cap proposal would equate to an 11.6-percent tax on municipal bond interest income, the difference between the 39.6-percent tax rate and the 28-percent benefit cap. While it may appear that this tax would fall on high-bracket taxpayers, in effect, it would be borne almost exclusively by state and local governments in the form of higher interest rates

If a 28-percent benefit cap on tax-exempt interest had been in effect during the last decade, it is estimated that this would have cost states and localities an additional **$173 billion** in interest expense for infrastructure projects financed over the past ten-year period.

on their borrowing. Market analysts have estimated that this proposed tax on municipal bond interest would raise state and local borrowing costs by up to 70 basis points (0.70 percentage point) or more. Because the tax would apply not only to new state and local borrowing but also to all outstanding bonds, investors would be taxed on investment which they reasonably expected would be tax-exempt as long as they are outstanding, an unprecedented form of retroactive taxation. As a result, investors would face the new risk that Congress could tax interest on outstanding bonds even more in the future, a risk that would raise state and local borrowing costs even more and create unprecedented uncertainty for investors in the municipal securities market.

Some have proposed an even more onerous full federal income tax on municipal bond interest. For example, the National Commission on Fiscal Responsibility and Reform (the "Simpson-Bowles Commission") in its 2010 deficit-reduction recommendations proposed full taxation for state and local interest for all newly-issued bonds. **If this proposal had been in place during the 2003–2012 period, it is estimated that the $1.65 trillion of state and local infrastructure investment would have cost governments an additional $495 billion of interest expense (Chart B).**

CHART B

Interest costs with and without tax exemption

$ MIL

	current law	with 28-percent cap		with full repeal	
	ESTIMATED INTEREST COST WITH TAX EXEMPTION AS IS	ESTIMATED TOTAL INTEREST COST	COST INCREASE	ESTIMATED TOTAL INTEREST COST	COST INCREASE
2003	114,128.55	130,876.97	16,748.42	161,981.19	47,852.64
2004	96,239.27	110,820.97	14,581.71	137,901.29	41,662.02
2005	121,966.14	141,458.44	19,492.31	177,658.44	55,692.30
2006	118,248.09	137,017.62	18,769.54	171,875.34	53,627.25
2007	125,282.78	145,214.14	19,931.35	182,229.50	56,946.72
2008	140,294.09	161,012.63	20,718.54	199,489.91	59,195.82
2009	110,288.35	126,890.90	16,602.55	157,724.20	47,435.85
2010	91,207.92	105,952.85	14,744.93	133,336.29	42,128.37
2011	83,022.35	95,965.70	12,943.35	120,003.35	36,981.00
2012	100,111.45	118,949.63	18,838.18	153,934.81	53,823.36
TOTAL			**173,370.87**		**495,345.33**

SOURCE: SIFMA ESTIMATES BASED ON THOMSON REUTERS DATA USING THE REPORT'S ASSUMPTIONS

Increased Costs to Select Jurisdictions

Partially or fully taxing the interest on municipal borrowing would have a direct effect on state and local budgets in the form of increased interest expense. Looking at interest expense incurred by some sample local governments in fiscal year 2012 (**Chart C**), it is estimated that individual cities and counties would have faced an increase of approximately 15 percent in interest costs in fiscal year 2012 if the 28-percent cap proposal had been in effect during the 15-year period 1998–2012.This additional financial burden reflects the direct pass-through effect of the additional federal tax if it had been in place when the bonds were issued.Taxing the interest on municipal borrowing for investors would have the same effect as taxing state and local governments directly.

The information in Chart C was determined by taking the amount of interest paid by each jurisdiction in the last fiscal year, with a median interest average of 4.69 over the past 15 years (Thomson Reuters), and applying a 70 BPS increase for what the interest costs would have been if the bonds were issued with a cap in place, and applying a 200 BPS increase for what the interest costs would have been if the bonds were issued without the exemption in place. The estimates have been rounded to the 000.

CHART C

Municipal tax exemption loss and deduction cap impact

2012

	current law	with 28-percent cap		with full repeal	
	ACTUAL 2012 INTEREST PAYMENT COST WITH TAX EXEMPTION AS IS	ESTIMATED TOTAL INTEREST COST	COST INCREASE	ESTIMATED TOTAL INTEREST COST	COST INCREASE
Akron, OH	$37,327,482	$42,898,000	$5,570,518	$53,245,000	$15,917,518
Athens County, OH	$44,993	$51,708	$6,715	$64,179	$19,186
Avondale, AZ	$4,975,700	$5,718,000	$742,300	$7,097,000	$2,121,300
Baltimore, MD	$83,361,980	$95,804,000	$12,442,020	$118,910,000	$35,548,020
Boston, MA	$131,000,000	$150,552,000	$19,552,000	186,863,000	$55,863,000
Burnsville, MN	$2,100,000	$2,413,000	$313,000	$2,995,000	$895,000
Charlotte, NC	$34,750,000	$39,936,000	$5,186,000	$49,568,000	$14,818,000
Chattanooga, TN	$32,080,143	$36,868,000	$4,787,857	$45,760,000	$13,679,857
Chicago, IL	$800,000,000	$919,403,000	$119,403,000	$1,141,000,000	$341,000,000
Cleveland, OH	$103,624,286	$119,090,000	$15,465,714	$147,813,000	$44,188,714
Columbia, SC	$14,689,802	$16,882,000	$2,192,198	$20,954,000	$6,264,198
Dallas, TX	$183,165,993	$210,504,000	$27,338,007	$261,275,000	$78,109,007
Douglas County, NE	$2,730,088	$3,137,000	$406,912	$3,894,000	$1,163,912
Fairfax County, VA	$98,105,012	$112,747,000	$14,641,988	$139,941,000	$41,835,988
Grand Traverse County, MI	$821,279	$943,857	$122,578	$1,171,000	$349,721
Houston, TX	$159,025,000	$182,760,000	$23,735,000	$226,839,000	$67,814,000
Linn County, IA	$628,226	$721,991	$93,765	$896,126	$267,900
Louisville, KY	$592,370	$680,783	$88,413	$844,979	$252,609
Mecklenburg County, NC	$91,136,163	$104,738,000	$13,601,837	$130,000,000	$38,863,837
Mesa, AZ	$52,115,271	$59,893,000	$7,777,729	$74,339,000	$22,223,729
Montgomery County, MD	$94,200,000	$108,259,000	$14,059,000	$134,370,000	$40,170,000
New Haven, CT	$24,500,000	$28,156,000	$3,656,000	$34,947,000	$10,447,000
Oklahoma City, OK	$60,051,714	$69,014,000	$8,962,286	$85,660,000	$25,608,286
Philadelphia, PA	$356,404,987	$409,599,000	$53,194,013	$508,390,000	$151,985,013
Prince Georges County, MD	$53,800,000	$61,829,000	$8,029,000	$76,742,000	$22,942,000
Racine, WI	$4,045,739	$4,649,000	$603,261	$5,771,000	$1,725,261
Sacramento, CA	$54,544,102	$62,685,000	$8,140,898	$77,803,000	$23,258,898
Salt Lake City, UT	$13,826,914	$15,890,000	$2,063,086	$19,723,000	$5,896,086
Seattle, WA	$192,000,000	$220,656,000	$28,656,000	$273,876,000	$81,876,000
Taney County, MO	$902,030	$1,036,000	$133,970	$1,286,000	$383,970
Wake County, NC	$86,324,566	$99,208,000	$12,883,434	$123,136,000	$36,811,434
Wichita, KS	$41,214,518	$47,365,000	$6,150,482	$58,790,000	$17,575,482

SOURCE: AS PRODUCED BY GOVERNMENT FINANCE OFFICERS ASSOCIATION

The Broad Use of Tax-exempt Financing

Tax-exempt financing is used widely across the country by communities large and small. The $1.65 trillion of infrastructure financed by state and local governments in 2003–2012 was spread across nearly 58,000 individual transactions, with an average transaction size of $29 million (**Chart D**). Bonds financed everything from large, multibillion transportation projects to school expansions of several hundred thousand dollars and are used by governments ranging from the largest states to the smallest towns and school districts. Because the interest on municipal bonds is usually exempt from state income taxation for residents of the states in which they are issued, investors tend to buy bonds issued within their states. In that manner, local investment is often financed to a significant degree by local capital.

In the last decade (2003–2012) state and local governments financed more than **$1.65 trillion** of infrastructure projects through tax-exempt bonds.

CHART D

Infrastructure borrowing by state

LONG-TERM, TAX-EXEMPT
2003–2012

STATE	$ mil	# of issues	avg size ($ mil)
Alabama	16,984.5	724	23.5
Alaska	4,529.2	69	65.6
Arizona	36,128.0	808	44.7
Arkansas	10,089.9	1,421	7.1
California	232,831.4	4,600	50.6
Colorado	33,869.9	951	35.6
Connecticut	11,659.6	256	45.5
District of Columbia	5,846.7	64	91.4
Delaware	2,897.7	50	58.0
Florida	103,081.0	1,250	82.5
Georgia	40,975.6	676	60.6
Guam	909.8	8	113.7
Hawaii	4,675.0	48	97.4
Idaho	3,625.8	214	16.9
Illinois	59,454.8	2,927	20.3
Indiana	35,905.1	1,594	22.5
Iowa	9,280.2	1,471	6.3
Kansas	14,103.7	899	15.7
Kentucky	18,882.9	1,420	13.3
Louisiana	16,091.7	659	24.4
Maine	2,974.6	89	33.4
Maryland	19,221.8	268	71.7
Massachusetts	37,931.1	592	64.1
Michigan	46,304.3	2,130	21.7
Minnesota	27,593.8	2,309	12.0
Mississippi	5,604.1	383	14.6
Missouri	27,056.6	2,353	11.5

STATE	$ mil	# of issues	avg size ($ mil)
Montana	1,717.2	202	8.5
Nebraska	16,483.5	2,216	7.4
Nevada	19,750.7	253	78.1
New Hampshire	2,900.4	94	30.9
New Jersey	62,502.0	1,559	40.1
New Mexico	9,432.0	441	21.4
New York	149,790.1	3,581	41.8
North Carolina	28,390.8	449	63.2
North Dakota	1,992.6	392	5.1
Ohio	49,473.5	1,855	26.7
Oklahoma	12,851.5	2,209	5.8
Oregon	17,044.2	545	31.3
Pennsylvania	76,471.1	3,579	21.4
Puerto Rico	20,847.6	38	548.6
Rhode Island	3,535.3	101	35.0
South Carolina	28,590.3	681	42.0
South Dakota	2,518.9	357	7.1
Tennessee	18,892.7	574	32.9
Texas	193,415.7	6,524	29.6
Utah	14,070.1	401	35.1
Vermont	864.2	31	27.9
Virgin Islands	232.2	5	46.4
Virginia	25,828.5	359	71.9
Washington	49,529.8	1,264	39.2
West Virginia	4,442.5	132	33.7
Wisconsin	20,545.7	1,631	12.6
Wyoming	1,223.1	48	25.5
TOTAL	**1,661,845.0**	**57,754**	**28.8**

SOURCE: THOMSON REUTERS DATA, FEBRUARY 2013

Conclusion

Tax-exempt municipal bonds are the country's most important source of financing for infrastructure investment. Municipal bonds represent a partnership among the federal government, state and local governments, and private investors in contributing to public infrastructure which creates jobs and improves economic efficiency. The proposals to limit or eliminate the federal tax exemption for municipal bond interest would substantially impair the federalist system of government that currently exists and shift unnecessary cost burdens to local taxpayers. Tax-exempt bonds maintain decision making and project selection at the state and local level, where citizens and elected officials can best determine where needs are greatest and where investments will generate the maximum return. Finally, tax-exempt bonds force market tests of investment projects, since investors will not commit capital until they are convinced the credit behind the borrowing is financially sound. The default rate on borrowing by states and localities is near zero.

Congress should preserve the tax exemption for interest on municipal bonds. The tax exemption has successfully provided trillions in low-cost financing for infrastructure investment. Curtailing or eliminating the tax exemption would raise costs for financially-strapped state and local governments and would result in less investment in infrastructure at a time when jobs are scarce and the physical state of our public works is deteriorating.

CHART E

Infrastructure issuance volume by use

LONG-TERM, TAX-EXEMPT, $ MIL

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	totals
Airports	3,366.2	2,950.7	5,446.5	2,191.0	4,029.8	3,393.3	6,581.9	13,844.1	3,051.1	4,471.0	49,325.6
Bridges	2,721.7	1,213.4	706.9	3,228.2	1,957.7	2,471.0	1,698.1	1,362.0	1,424.2	3,380.3	20,163.5
Combined utilities	1,746.8	2,894.4	1,526.6	1,071.5	1,094.3	1,079.8	1,420.4	647.3	787.4	1,947.4	14,215.9
Fire stations & equipment	230.0	215.4	296.3	357.4	312.2	230.8	319.6	193.6	276.5	212.6	2,644.4
Flood control	6.2	0.0	0.0	0.0	1.0	0.0	1.6	4.4	5.4	0.0	18.6
Gas	0.7	352.6	397.7	515.2	2,957.2	3,477.3	2,210.6	1,322.5	186.8	2,176.6	13,597.2
General acute care hospitals	19,295.3	17,303.2	28,642.1	29,182.3	36,241.6	53,343.2	37,021.3	23,652.3	19,025.6	24,198.8	287,905.7
General purpose/public improvement	71.3	101.9	235.8	58.6	87.1	170.1	215.3	211.0	75.3	0.0	1,226.4
Government buildings	8.0	0.0	25.3	0.0	2.0	0.0	22.2	0.1	186.8	0.0	244.4
Mass transportation	9,011.7	9,922.6	11,627.9	13,775.1	8,405.5	12,635.7	8,348.2	5,607.3	9,143.2	17,146.0	105,623.2
Multifamily housing	7,055.1	3,585.1	2,923.6	1,826.1	952.3	2,357.5	3,216.7	3,141.3	2,539.0	3,439.7	31,036.4
Police stations & equipment	170.0	255.7	51.6	538.8	151.4	119.1	381.3	33.5	74.5	143.2	1,919.1
Primary & secondary education	51,432.5	54,059.4	72,570.7	59,218.1	62,631.5	47,084.3	40,915.7	34,221.0	37,375.3	54,548.3	514,056.8
Public power	15,834.3	6,524.2	12,983.8	21,190.4	19,717.1	19,762.0	11,743.8	17,137.1	9,905.7	12,194.2	146,992.6
Recycling	112.7	258.4	3.8	0.0	10.0	21.7	0.0	0.0	0.0	2.5	409.1
Sanitation	1,084.2	552.8	465.4	731.8	1,205.1	465.5	731.9	219.8	564.6	275.4	6,296.5
Seaports/marine terminals	1,062.8	276.4	328.6	790.0	1,889.4	1,211.4	719.7	1,821.7	943.6	100.1	9,143.7
Solid waste	1,091.2	815.8	522.7	755.5	819.2	1,724.1	703.4	1,602.2	846.2	387.6	9,267.9
Toll roads, highways, & streets	29,946.9	26,903.1	17,478.1	13,963.1	17,717.8	17,141.5	13,743.7	13,668.5	9,413.9	18,000.3	177,976.9
Tunnels	0.0	0.0	800.0	0.0	0.0	99.6	0.0	0.0	0.0	240.3	1,139.9
Water & sewer facilities	15,261.2	10,688.3	28,607.6	29,364.4	29,640.2	30,531.5	28,124.1	21,738.2	27,444.9	36,546.9	257,947.3
TOTALS	159,508.8	138,873.4	185,641.0	178,757.5	189,822.4	197,319.4	158,119.5	140,427.9	123,270.0	179,411.2	**1,651,151.1**

SOURCE: THOMSON REUTERS DATA, FEBRUARY 2013

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