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Municipal Bonds and Public Power

Summary
Tax-exempt municipal bonds have financed $2 trillion in new investments in infrastructure in the last decade, including $112 billion in new investments in electric power generation, transmission and distribution, and should be the cornerstone of any plan to address the significant challenges of funding and financing new investments in public infrastructure. Federal tax exemption reduces costs at the margin, but municipal bonds are subject to local control and responsibility. Therefore, the American Public Power Association (Association or 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 U.S. 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 U.S. 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.1 In 1988, a slim U.S. 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.

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 bonds, 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.
taxable 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.

Replacing the exclusion for municipal bonds with a direct payment bond would increase borrowing costs by 16 percent (assuming a direct payment percentage of 25 percent of the issuer’s interest expenses). Direct payment 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.)

To put these numbers in perspective, a $250 million power plant would cost $80 million more to finance if the tax exemption for municipal bonds were repealed; $40 million more if the tax exemption were “capped” and $30 million more if municipal bonds were replaced with direct payment bonds.

**American Public Power Association Position**
The Association believes municipal bonds are the single most effective tool for financing investments in public infrastructure. 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. In sum, any such change would simply shift costs from the federal government onto the backs of state and local residents. As a result, the Association believes that the federal tax exclusion for municipal bond interest should not be limited or replaced.

**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.

For example:

- A repeal of the tax exemption for municipal bonds would increase borrowing costs by 47 percent;
- A surtax on municipal bond interest to create a “cap” on the tax value of the exclusion for municipal bonds would increase borrowing costs by 32 to 35 percent; and
- Replacing the exclusion for municipal bonds with a direct payment bond would increase borrowing costs by 16 percent (assuming a direct payment percentage of 25 percent of the issuer’s interest expenses). Direct payment 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.)

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