



BEST PRACTICE*

Issuing Taxable Debt by U.S. State and Local Governments (1998) (DEBT)

Background. Taxable debt is commonly issued by governments around the world to finance capital projects. While state and local governments in the U.S. have traditionally relied on tax-exempt debt, the globalization of capital markets has increased the viability of taxable debt as a financing option for some U.S. state and local governments looking to expand the market for their debt or gain financing flexibility. Among the reasons governments may find it advantageous to issue taxable debt are:

- volume cap restraints that have restricted governments' ability to undertake housing, environmental, and other critical projects;
- private activity bond rules that have limited the ability of governments to enter into public-private partnerships that may be advantageous to a community;
- broader market access to pension funds and other investors, including those outside the U.S. domestic market, that prefer taxable interest rates; and
- a desire to avoid burdensome arbitrage regulations.

Recommendation. The Government Finance Officers Association (GFOA) recommends that a U.S. state or local government considering the issuance of taxable debt develop a thorough understanding of the differences between the tax-exempt and taxable markets before proceeding with a planned sale. It should conduct an analysis of how these differences would affect the jurisdiction's overall financial plan and ability to manage its debt program. In evaluating whether to issue taxable debt, a state or local government should:

1. Ensure that it is legally authorized to issue taxable debt and that its debt policy specifically addresses when taxable debt may be used.
2. Develop an understanding of the market well in advance of the planned sale, including types of investors, structural features, and size requirements needed to attract investor interest. It is important to remember that taxable debt may be subject to different types of federal, state, and local laws than tax-exempt debt.
3. Ensure that the taxable debt will be valid under applicable state constitutional and statutory provisions. The various state law requirements relating to public purpose and lending of credit apply to taxable as well as tax-exempt debt, and taxable offerings often must meet the same requirements as an issuer's tax-exempt debt. For instance, issuers should not assume that the absence of federal tax code restrictions on "private activity bonds" will permit the issuance without restriction of taxable bonds that benefit private entities.
4. Evaluate the total cost of issuing taxable debt, including legal, marketing, and other up-front costs and the interest cost over the life of the bonds, in relation to the financing objectives to be achieved. The cost of taxable debt will generally be higher because investors are not able to deduct interest earnings from taxable income. Consideration also should be given as to how proceeds will be invested to minimize possible negative arbitrage.
5. Allow sufficient time to educate potential investors, who may be less familiar with state and local credit, about the offering and the issuer. Care should be taken to properly label an issuer's debt as taxable so that investors and other interested parties are able to distinguish it from tax-exempt debt.
6. Consider structural features that can provide long-term benefits, such as amortizing debt as quickly as possible or embedding early call provisions in order to have the ability to call debt if the project being financed generates excess cash flows. Issuers should recognize that some features that enhance flexibility, such as an early call provision, may be more costly to exercise for taxable debt than for tax-exempt debt.

7. Evaluate the market for taxable state and local government bonds prior to the pricing process, including identification of comparable issues and interest rates, including the use of variable rate debt. Issuers, independently or with their financial advisors or underwriters, should be especially vigilant since less frequent issuance of taxable state and local government bonds increases the risk that a government may pay an interest rate penalty when its bonds are priced.
8. Evaluate whether there are advantages to selling bonds outside of the U.S. domestic market and the costs associated with this approach, such as the costs of registering with a foreign exchange. Legal counsel familiar with particular international capital markets should be involved in order to review specific regulatory and disclosure requirements that may differ from U.S. markets. Also, governments must be sure they have sufficient staff time and expertise to manage debt offered in the international marketplace.

References.

- “Taxable Municipal Securities: At Home and Abroad,” *Government Finance Review*, February 1987.
- “A Cross Section of Opinion on Taxable Municipal Bonds,” *Government Finance Review*, February 1987.

Approved by the GFOA’s Executive Board, 1998

* This Best Practice will be updated in 2010 and may change to be an Advisory.