POLICY RECOMMENDATIONS

- Adopt bond modernization provisions to help state and local governments meet infrastructure challenges of the 21st century and beyond

- Protect the full tax-exemption for municipal bonds, a fundamental component of the federal/state/local partnership that develops the nation’s infrastructure

- Restore advance refunding bonds, a critical tool that allowed state and local governments to achieve substantial savings for taxpayers

**Background**: There is no doubt that state and local governments powered through adversity the last two years, continuing to provide quality infrastructure, healthy communities and rally a strong bond market despite the crippling effects of the 2017 tax reform law. The steadfastness of state and local governments exhibits an unparalleled accomplishment of our investments via the municipal bond toward our nation’s infrastructure.

We remain concerned that the threat of elimination is still prevalent. If state and local governments lose the ability to use tax-exempt bonds and are compelled to issue taxable bonds as an alternative, it is estimated that debt issuance costs would increase around 25%, and possibly more for smaller governments.

**Tax-exempt Bond Issuance** (thru 12/31/2019)

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>Amount (in billions)</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>110.45</td>
<td>26%</td>
</tr>
<tr>
<td>General Purpose</td>
<td>99.2</td>
<td>24%</td>
</tr>
<tr>
<td>Utilities</td>
<td>46.0</td>
<td>11%</td>
</tr>
<tr>
<td>Transportation</td>
<td>69.3</td>
<td>16%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>39.3</td>
<td>9%</td>
</tr>
<tr>
<td>Housing</td>
<td>25.4</td>
<td>6%</td>
</tr>
<tr>
<td>Public Facilities</td>
<td>7.1</td>
<td>2%</td>
</tr>
<tr>
<td>Electric Power</td>
<td>10.9</td>
<td>3%</td>
</tr>
<tr>
<td>Development</td>
<td>10.34</td>
<td>2%</td>
</tr>
<tr>
<td>Environmental Facilities</td>
<td>3.7</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$421.69</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Source: GFOA analysis of Thomson Reuters data as of 10/31/18
Tax-exempt bonds are the primary mechanism through which state and local governments raise capital to finance a wide range of essential public projects. The volume of municipal bond issuance for the period from 2009 to 2019 amounted to **$4.2 trillion**. Communities across the country would be negatively impacted if federal tax policy reduced the financial power of state and local governments to meet their capital needs. This further exacerbates the current situation faced by state and local governments in continued reductions or elimination of federal assistance of various kinds over the years, including categorical grants and general revenue sharing, and seeing a rise in costs due to federal mandates (legislative or regulatory requirements imposed by the federal government upon states and localities). No federal program has or would be able to finance all the capital needs across the country. For over 100 years, the municipal bond market has worked fairly and efficiently to address these needs, whether it is in our largest states and cities or the rural areas across the United States.

**Current State of Federal Infrastructure Policy**
*The Tax Cuts and Jobs Act (TCJA)* passed by Congress and signed into law by the President in 2017 made several changes to the tax code of interest to governments. Although the full tax exemption for municipal bond interest was successfully retained, other changes noteworthy to issuers of municipal bonds include:
- the elimination of advance refundings;
- the elimination of tax credit bond programs; and
- the reduction of the corporate tax rate and elimination of some corporate, bank and insurance tax incentives to purchase municipal securities.

Unfortunately, this has created a difficult finance environment for many public issuers to address critical needs like developing or updating local infrastructure. Whether it is through program funding or policy changes, which includes adopting municipal bond modernization provisions, we NEED our federal partners to help us address these challenges. We have a proven track record of resilience but it takes all levels of government working together for the good of all our constituents.

**Issuing Bonds in a Dynamic Market**
Advance refundings represented 27% of municipal bond market activity in 2016 and 19% in 2017. Additionally, the TCJA decreased the overall corporate tax rate from 35% to 21% and eliminated other tax incentives that could impact overall demand for municipal bonds. Market...
experts are keeping a keen eye to see how the market will react to possibly reduced supply, less demand due to corporate tax changes, or perhaps increased demand by individuals who are looking for tax exempt products to help alleviate tax exposures due to new state and local tax deduction limits. Governments should be aware of these market dynamics as they consider going to market and determine appropriate action with consultation of outside professionals.

WHAT ABOUT INFRASTRUCTURE?

The country’s infrastructure needs continue to grow. According to the 2017 Infrastructure Report Card by the American Society of Civil Engineers (ASCE), our nation’s infrastructure earned a cumulative grade of D+.[3] The ten-year funding gap between the $4.6 trillion in infrastructure needs and public spending necessary to achieve a state of good repair is $2 trillion. Attempts to reinforce and modernize roadways, public transit and utility systems across the country through a comprehensive infrastructure bill has proven challenging. State and local governments find themselves managing an expanding burden with diminishing support from their federal partners. Federal grant programs do provide valuable resources, but action is needed to ensure that this critical responsibility is shared equitably between the federal government and its many partners.

Action Items for GFOA Members

Halfway through the 116th Congress, an educational campaign is still needed on these important issues. GFOA members are encouraged to reach out – email, tweet or call – and educate your federal representatives about the role tax-exempt bond financings have in your communities. Provide them with specific examples of projects that are supported by municipal bonds and how they are meeting the needs of your communities.
WHAT PUBLIC FINANCE ISSUES COULD SEE ACTION THIS CONGRESS?

RESTORE ADVANCE REFUNDING BONDS

**Brief Description:**
The 115th Congress saw a bipartisan effort to restore advance refunding to the federal tax code. In the 116th, led by House Municipal Finance Caucus Co-Chairs Dutch Ruppersberger (D-MD) & Steve Stivers (R-OH), the efforts continue through the introduction of H.R. 2772, the Investing in Our Communities Act. Advance refunding bonds allow states and localities to refinance existing debt with the greatest flexibility, resulting in substantial reductions in borrowing costs. The elimination of advance refundings in the TCJA as a cost-savings tool for state and local governments has limited the options to refinance debt, especially since interest rates will certainly fluctuate over the lifetime of outstanding governmental bonds (which in many cases is 30 years). As a result, state and local governments are now paying more in interest, a cost that must be paid by state and local residents.

**Proposed Legislative Change:**
Reinstate authority to issue tax-exempt advance refunding bonds.

» Cosponsor H.R. 2772 and call on House leadership to advance this critical legislation to reinstate advance refunding bonds. H.R. 2772 would fully reinstate tax-exempt advance refundings, including private activity bonds and qualified 501(c)(3) bonds.

» 10-year revenue effect estimated at ~$17 billion.4

SMALL ISSUER EXCEPTION

**Brief Description:**
House Committee on Ways & Means members Terry Sewell (D-AL) and Tom Reed (R-NY) introduced H.R. 3967, the Municipal Bond Market Support Act of 2019, a bill that offers a proven incentive for local banks to purchase the tax-exempt debt of small local governments and borrowers such as small colleges, health care facilities and other charities. Governments issuing $10 million or less in bonds (a limit that has not changed since 1986) per calendar year can have those bonds designated (or qualified 501(c)(3) bonds) as bank-qualified, which allows them to bypass the traditional underwriting system and sell their tax-exempt bonds directly to local banks at a cost savings for taxpayers.

In the late 2000s, the limit was temporarily increased, which created a market for thousands of small borrowings that stimulated the economy as well as cash strapped small governments and nonprofits.

**Proposed Legislative Change:**
» Increase the maximum allowed bond issuance of “bank eligible” bonds to $30 million from the current level of $10 million. Set in 1986, the limit should be increased and then tied to inflation in future years.

» Permanently modify the small issuer exception to tax-exempt interest expense allocation rules for financial institutions (Section 265(b)(3)). The provision should be modified to apply to governmental issuers and the borrowing organizations separately regardless of the issuer and permit the 501(c)(3) organization to provide the designation.
BQ BOND ISSUANCE BY GENERAL USE OF PROCEEDS: 2007-2017 (in millions)

Source: GFOA analysis of Thomson Reuters data as of 11/28/18
DIRECT SUBSIDY BONDS

Brief Description:

Direct subsidy bonds, like Build America Bonds (BABs), are debt securities (e.g. municipal bonds) issued by a state, municipality, or county to finance capital expenditures. In general, there are two distinct types of BABs: tax credit BABs and direct payment BABs.

Tax credit BABs offered bondholders and lenders a 35% federal subsidy of the interest paid through refundable tax credits, reducing the bondholder’s tax liability.

The direct payment BABs offered a similar subsidy that was paid to the bond issuer. The U.S. Treasury made a direct payment to BAB issuers in the form of a 35% subsidy of the interest they owed to investors. As a result of sequestration, issuers saw a reduction in their subsidy payments.

Proposed Legislative Change:

Protection of Build America Bond payments to issuers in case of sequestration (Section 6431(b)).

- Credit payments to issuers of Build America Bonds were not intended to be subject to budget sequestration. This would conform treatment of these payments to treatment of other tax credit payments.
- 10-year budget effect -$1.7 billion.5

GENERAL USE OF ISSUED BABS IN THE U.S. (in millions)

Source: GFOA analysis of Thomson Reuters data as of 11/28/18

YEAR OF ISSUANCE
PRIVATE USE LIMITATIONS

Brief Description:
The core private use restriction applicable to a governmental bond issue is found in Section 141(b) of the Code and provides that no more than ten percent of the proceeds of such issue can satisfy the private business tests. The only use that is not private business use is use by (i) a state or local government, (ii) an individual not in trade or business, or (iii) the general public. The rule is complicated by a number of supplemental restrictions.

Proposed Legislative Change:
- Repeal the five percent unrelated or disproportionate test (Section 141(b)(3) of the Code).
- Repeal the $15 million per project limit on private business use on certain output facilities (Section 141(b)(4)).
- Repeal the volume cap requirement for governmental bond issues with a nonqualified private business amount in excess of $15 million (Section 141(b)(5)).
  (10-year revenue effect of preceding three items $75 million.)
- Repeal the limit on the use of bond proceeds to acquire non-governmental property (Section 141(d)). The 10-year revenue effect of this change is unknown.

PARTNERSHIP FINANCINGS

Brief Description:
The Administration has proposed various new programs that would provide incentives for public-private partnerships to help fund public sector infrastructure needs. While it is unclear if Congress will address these proposals, governments should be aware of potential financial tools that are or may be available and evaluate them to determine if they may be appropriate for their government.
ENDNOTES

1. GFOA analysis of Thomson Reuters data.

2. GFOA analysis of Thomson Reuters data.


