AMERICAN PUBLIC POWER ASSOCIATION
Powering Strong Communities

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Municipal Bonds and Public Power

Summary

State and local governments use municipal bonds to finance public infrastructure investments that enable their communities to function and thrive. Tax-exempt municipal bonds have financed $2.3 trillion in new investments in infrastructure over the last decade, including $68 billion in new investments in electric power generation, transmission, and distribution. The American Public Power Association (APPA) strongly believes Congress should look for ways to improve tax-exempt financing, including reinstating tax-exempt advance refunding bonds, increasing the small-issuer exception threshold from $10 million to $30 million, and simplifying "private-use rules." Congress should also reject any proposal to further limit or restrict the tax-exemption for municipal bond interest.

Background and History

A municipal bond is a debt instrument issued for a year or longer, under which the bond holder typically receives annual or bi-annual interest payments (coupons) until the bond principal is repaid on a specified date (maturity). State and local governments have issued municipal bonds to finance long-term projects for centuries. Today, there are $3 trillion in municipal bonds outstanding, more than $100 billion of which finance electric power-related investments. These include investments in power generation, distribution, reliability, demand control, efficiency, and emissions control—all of which are 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. Nearly three-quarters of the core 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 exempt from federal income tax, just as federal bonds are exempt from state and local taxes. Since then, the federal government has taken steps to regulate municipal bonds. For example, the federal government requires issuers to register bonds for the interest to be exempt from federal taxation and taxes the interest on bonds determined not to be for governmental purposes. Congress has also taken steps to limit the ability to refinance existing debt.

Like refinancing a mortgage, states and localities can "refund" existing tax-exempt municipal bonds by issuing new bonds to pay off the existing ones. This flexibility can mean significant savings over time. One difference, though, is that under the terms of most municipal bonds, states and localities generally must wait 10 years before they can "call" (i.e., pay off) a municipal bond. This is intended as a protection for the bondholder. However, waiting to refund an existing bond until it can be called can be a problem when interest rates are low, but threatening to rise. Until the passage of the Tax Cuts and Jobs Act of 2017, states and localities had an easy fix—go ahead and issue a refunding bond while interest rates were low, then pay-off (or "redeem") the old bond when the call date arrives. Until the call date, the issuer would pay interest on both the refunding and refunded bonds. However, the issuer would save money over the long run. Generally, a refunding is not suggested unless savings equal at least five percent of the bond volume outstanding. A refunding bond issued more than 90 days before the scheduled call date is considered an "advance refunding bond." A refunding bond issued 90 or fewer days before the scheduled call date is considered a "current refunding bond."

The Tax Cuts and Jobs Act of 2017 prohibited the issuance of tax-exempt advance refunding bonds after December 31, 2017. This provision was never debated, never publicly championed by any member of Congress, and never subjected to a vote. As a result, issuers must either wait to issue a current refunding bond or issue an advance refunding bond as taxable debt. Likewise, newly issued bonds are being issued with shorter call dates—closer to seven rather than ten years. This hurts bondholders, who are guaranteed a steady stream of interest payments for less time. Bondholders are demanding a higher rate of return on bonds with these shorter maturities, driving up borrowing costs.

Strengths and Benefits of Municipal Bonds

The municipal bond market gives close to 42,000 governmental issuers access to investors. This is particularly important to smaller towns, counties, and publicly owned utilities that issue municipal bonds. Outside of municipal bonds, state and local governmental entities—including public power utilities—have limited means to raise funds for their communities' capital needs.

The federal tax exclusion of bond interest means issuers of all sizes can finance their investments affordably. For example, APPA estimates that a $25 million project would have cost $9 million less to finance if it had been financed with tax-exempt debt. A $250 million project would have cost roughly $79 million less. 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, with the cost of investments repaid over time by the customers who use the infrastructure.

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.[1]

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, generally 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.

Under current rules, banks generally cannot deduct the carrying cost for tax-exempt bonds. A small-issuer exception to these rules is provided for bonds issued by a locality intending to issue $10 million or less in debt in any given year. This gives banks better access to a secure investment vehicle and more importantly creates a greater appetite for debt issued by small state and local entities that might otherwise have difficulty finding affordable financing for critical projects.

1 See, Internal Revenue Service, "Statistics of Income—2010: Individual Income Tax Returns" (2012).

Congressional and Administrative Action

In response to the elimination of the ability to issue advance refunding bonds in the Tax Cuts and Jobs Act of 2017, in May 2019, Municipal Finance Caucus Co-Chairmen Dutch Ruppersberger (D-MD) and Steve Stivers (R-OH) introduced H.R. 2772, the Investing in Our Communities Act. The legislation would have reinstated the ability to issue tax-exempt advance refunding bonds. On July 1, 2020, Senators Roger Wicker (R-MS) and Debbie Stabenow (D-MI) introduced with six original co-sponsors the Lifting Our Communities through Advanced Liquidity for Infrastructure (LOCAL Infrastructure) Act, which is identical in effect to H.R. 2772, but drafted quite differently. Additionally, Representatives Terry Sewell (D-AL) and Tom Reed (R-NY) introduced H.R. 3967, the Municipal Bond Market Support Act of 2019, on July 25, 2019. The bill would have permanently increased the small-issuer exception from $10 million to $30 million (and indexed the $30 million threshold for inflation). Provisions reinstating advance refunding and increasing the small-issuer exception were incorporated into H.R. 2, the Moving Forward Act, which was approved by the House on July 1, 2020. Further action on these bills was not taken in the 116th Congress, but they could be reintroduced in the 117th Congress.

APPA Position

APPA believes that tax-exempt municipal bonds are the single most effective tool for financing investments in public infrastructure, including the generation, transmission, and distribution used to serve public power utility customers. As such, the association believes the federal tax exclusion for municipal bond interest should not be limited or replaced. In addition, APPA strongly supports enactment of legislation to reinstate advance refunding bonds, simplify municipal bond private-use rules, and increase the current small-issuer exception limit from $10 million to $30 million.

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The American Public Power Association is the voice of not-for-profit, community-owned utilities that power 2,000 towns and cities nationwide. We represent public power before the federal government to protect the interests of the more than 49 million people that public power utilities serve, and the 93,000 people they employ. Our association advocates and advises on electricity policy, technology, trends, training, and operations. Our members strengthen their communities by providing superior service, engaging citizens, and instilling pride in community-owned power.