The Case for Establishing Optional, Federal Tax Exempt "Qualified Municipal Infrastructure Bonds" (QMIBs)

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May 11, 2021 Version 2.0

1.0 Introduction: The Problems of Fixing our Public Infrastructure at Least Cost

It is widely accepted that the Nation's physical infrastructure is in bad shape. One need only drive on interstate highways, regional and local roads to conclude that the potholes and aging bridges are increasingly dangerous. Many have proposed spending very large amounts of federal dollars to give to state and local governments to fix these and related problems. But what to do if current federal budgetary resources are unavailable or insufficient to enable states and localities to do what they should be doing? And how will simply providing more monies for infrastructure insure that best practices will be followed in the planning, financing, and managing of infrastructure renewal? We suggest a new, optional approach to the problem which at the margin, because it reduces risks of such bond finance, will not only lead to lower financing costs, but also lower federal tax expenditures for state and local tax exempt bonds.

2.0 The First Step towards Solving our Public Infrastructure Problems: Qualified Municipal Infrastructure Bonds (QMIBs)

We believe that part of the infrastructure problem can be solved by reorganizing and clarifying the current, highly diverse and complex municipal bond market. Some years ago the Hamilton Project at the Brookings Institution endorsed the notion of a system of uniform municipal bonds to improve state and local access to capital markets. Under the Hamilton plan, an independent, private agency would advise state and local governments about infrastructure borrowing, and develop a common bond contract. However, no such standardized instrument resulted.

Instead, we propose that the federal government establish, through changes to federal tax and banking law, a new class of *optional* state and local tax-exempt borrowing for well-defined state and local infrastructure purposes. Our basic idea is to:

1) change the sequence by which state and local infrastructure bonds become federally tax exempt by requiring IRS federal tax exemption to determined tax exemption *before* the sale of QMIBs;

and,

2) obligate QMIB bonds to be competitively sold and issued only by governmental entities with the authority to tax

The reformed sequencing will lower the "tax exemption risk" while the competitive bidding requirement will cost minimize. Examination of 2.3 million municipal bond transactions indicates that

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yields from private placement bonds, holding all else constant, are 140 basis points *more* expensive than competitively placed bonds over the past 20 years. Also, bonds sold by governmental units with the power to tax, holding all else constant, were 5 basis points cheaper to finance.

Under the optional QMIB bond plan, the Secretary of the Treasury and his delegate, the Commissioner of the Internal Revenue Service, would determine within 60 business days whether or not a proposed QMIB would meet the following requirements for federal tax exemption:

i. Issued only by state and local governments with the authority to levy taxes;
ii. The proceeds of QMIBs would be only for purely public, enumerated purposes: the construction, maintenance, and repair of:

a. Public roads and bridges and related public capital facilities
b. Public airports and related public capital facilities
c. Public ports and public water ways and related public capital facilities d. Public buildings for public use (school buildings, municipal buildings)
e. Public housing for low and moderate-income renters
f. Public sewer, storm water and water systems
g. Public mass transportation systems and related capital facilities
h. Public energy production and distribution systems

iii. Annual public financial and project reporting throughout the life of QMIB financed projects would be required of successful QMIB issuers to the Secretary of the Treasury and his delegate, the Commissioner of IRS, e.g. the purpose, location, useful life and term of the QMIB bond[s], status of toll, tax, and sinking fund finances, use of project upon completion, and scheduled and actual maintenance would be required to be disclosed;

iv. The maturity of any QMIB must equal the economic life of the assets/repairs financed by the sale of QMIBs;

v. All QMIBs must be issued with sinking funds for 80% or more amortization of principal and interest;

vi. Sinking fund arbitrage investments would be limited to safe public securities, and net profits would be required to be put into the funded projects.

vii. At least ½ of any governmental unit's QMIBs would have to be revenue bonds, e.g. interest and principal to be paid off by earmarked taxes as well as earmarked user charges; and,

viii. A QMIB would be countable in the denominator of bank "stress tests" , e.g. for Section 2A purposes.

These 8 characteristics represent best practices in the capital planning, construction, financing, and implementation cycle of capital project management, as well as encourage large, commercial banks to hold QMIB bonds. We believe this optional framework of best practice will lead to not only more rationally devised infrastructure projects, but those which are successfully run and thereby engender public support.

3.0 Discussion

Bonds that meet the above requirements would be high-grade,and should attract the interest of municipal bond funds as well as individual investors. The independent determination of promised qualified status and ongoing compliance with these requirements would ensure lower borrowing risk, attending lower interest rates, and continuing investor interest. The Internal Revenue Service has had considerable expertise in performing these administrative functions through its historic responsibilities administering state by state caps on other kinds of qualified state and local bonds, and also has been responsible for administering rules governing various kinds of taxable and tax-exempt sinking funds.

Over time, as the market for QMIBs matures and broadens, it is imaginable that state and local governments will prefer to issue QMIBs rather than their historical heterogeneous portfolio of federally tax-exempt borrowing instruments, because fulfilling the above requirements will materially improve the management of public assets.

Elected officials will begin to think more clearly, not only about the replace vs. repair decision, but also engage in more thoughtful dialogues with their electorates about the cost vs. benefits of building infrastructure for now and in the future, with the result that that beneficiaries over time will pay their fair share of the costs of public capital assets. The enhanced reporting requirements in conjunction with their ongoing public disclosure are designed to improve public confidence and support in long-term state and local public infrastructure projects.