The Case for Establishing Qualified Municipal Infrastructure Bonds

To the Editor:

It is widely accepted that the nation's infrastructure is in bad shape. Many have proposed spending vast amounts of federal dollars to give to state and local governments to fix it. But what if current federal budgetary resources are unavailable or insufficient to enable states and localities do what they should be doing themselves? And how will granting more federal money for state and local infrastructure ensure that best practices will be followed in the planning, financing, and managing of public infrastructure renewal?

We suggest a new approach that will lead to lower financing costs and lower federal tax expenditures. Further, because this approach uses federal tax incentives and tax expenditures, it does not require annual appropriations, a challenge that characterizes many of the current proposed solutions to the infrastructure problem.

In 2009 and 2010, Congress provided cash subsidies for taxable state and local debt instead of a subsidy via federal tax exemption; these were Build America Bonds. While about $185 billion worth of these bonds were issued, Congress chose not to extend this direct subsidy program, and the bonds remain controversial. In retrospect, we know that this financing did not reform or require best capital budgeting practices and that only half the bonds were competitively placed. Moreover, because continuing the program required ongoing appropriations, Congress did not renew it and thus created uncertainty about the future of this sort of solution to the infrastructure problem.

We propose instead 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 determine tax exemption ***before***the sale of qualified municipal infrastructure bonds (QMIBs); and
2. obligate QMIBs to be competitively sold and issued only by governmental entities with the authority to tax.

The reformed sequencing will lower tax exemption risk, while the competitive bidding requirement will minimize cost. Examination of 2.3 million municipal bond transactions over the last 20 years indicates that yields from privately placed municipal bonds, holding all else constant, are about 130 basis points more expensive than the yields from competitively placed bonds. Moreover, bonds sold by governmental units with the power to tax, holding all else constant, were five basis points cheaper to finance.

Under the QMIB plan, the Treasury secretary would determine within 45 business days of submittal whether a proposed QMIB meets the following requirements for QMIB designation and federal tax exemption:

i. the QMIB is issued only by a state or local governments with the authority to levy taxes;
ii. its proceeds are used only for purely public, enumerated purposes such as the construction, maintenance, and repair of roads, airports, ports, waterways, buildings, housing, sewers, storm and water systems, mass transit, and energy production and distribution systems;
iii. annual public financial and project reporting requirements are compulsory throughout the life of the QMIB-financed project; those requirements include the filing of signed reports that disclose the purpose, location, useful life, and term of the project and bond; status of projected and actual toll, tax, and sinking fund finances; use of the project upon sale of QMIB's bonds; and scheduled and actual project

maintenance;

iv. the QMIB's maturities equal the economic life of the assets and repairs;

v. the QMIB is issued with sinking funds for 80 percent or more amortization of principal and interest;

vi. the QMIB's sinking fund arbitrage investments are limited to and must remain safe public securities, and its net profits are invested in the funded projects;

vii. regarding the governmental unit that issues the QMIB, at least 50 percent of its QMIBs are revenue bonds (for example, interest and principal to be paid off by earmarked taxes and earmarked user charges); and,

viii. the QMIB is countable in the denominator of bank stress tests (for example, for section 2A purposes).

Failure to meet any of these reporting requirements would jeopardize the ongoing tax-exempt status of the QMIB. These eight 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 that this ***optional*** framework will lead to more rationally managed infrastructure projects and thereby engender public support.

Some have suggested that QMIB status be accorded to consortia of state and local governments to meet public infrastructure needs on a regional basis. But individual governments with the power to tax can do this; to do otherwise could easily lead to complicated constitutional questions. From our point of view, if an area is represented by elected (not appointed) officials, and the resulting government has the authority to tax and impose and collect fees, we are comfortable that the democratic process and political competition can find responsible, regional solutions to regional infrastructure problems.

Robert P. Strauss
Professor of Economics and Public Policy,
Carnegie Mellon University
rs9f@andrew.cmu.edu

Kenneth P. Kramer
Managing Director, Rushton Atlantic LLC
ken.kramer@rushtonatlantic.com

June 14, 2021 ■