Municipal Bonds

A Financial Solution to Fund Cities: North America

"Municipal bonds are the country's ***most important source of financing*** *for vital infrastructure and are* ***used to finance everything*** *from multibillion transportation projects to school expansions in* ***communities large and small****." (National League of Cities)*

How do they work?

Investors purchase municipal bonds, which are a form of debt security issued by state and local governments, which gives the local authorities (or the issuer) the money to fund public projects. There are two types of tax-exempt municipal bonds (meaning that the interest that the investor makes isn't taxable, which keeps these bonds attractive):

- **General Obligation Bonds**: issued by a sub-sovereign entity that has the power to levy taxes. They are secured by the issuer themself and are mandated to be repaid through taxation. The term general obligation refers to their backing by central government transfers.
- **Revenue Bonds**: issued for projects that intend to generate revenue upon completion which will, in turn, repay the bonds. These are the primary source of funding for capital projects in the U.S.

One can also distinguish between Governmental Bonds and Private Activity Bonds (PABs). PABS allow for more private sector involvement in projects but are charged a higher interest rate and subject to taxation. Today, over 60% of tax-exempt bonds are held by individuals either directly or through mutual funds, almost half of which would be described as middle class. They are generally sold in increments of $5000. In the last decade, the majority of bond issues (34%) have served as infrastructure investment in primary and secondary schools.

The History and Future of Muni Bonds in the U.S.

The "muni bond" market in the United States originated with the urban boom of the 1850s. In 1913, the federal income tax law established the exemption of tax on the interest paid to the holders of municipal bonds. In 1986, a tax reform act made municipal bonds less attractive to investors by lowering federal taxes for all taxpayers and taking away the tax-exempt status of some of the bonds. Local and state politicians in the U.S. today are seeing municipal bonds' tax-exempt status under threat and are urging the Obama administration not to adopt a proposal that would place a 28% cap on tax-exempt interest, resulting in higher interest rates for borrowing. Obama continues to propose the cap in his most recent budget proposal to generate revenues from the rich but groups like NLC, U.S. Congress of Mayors, as well as certain democrat and republican senators are adamantly against it.

PACE Financing

PACE (Property Assessed Clean Energy) financing is an innovative way of funding energy-efficiency projects. The implementation of a PACE program is usually funded with municipal bonds and is attached to the property receiving the upgrade as opposed to the property owner. All types of building owners can participate in the program which uses municipal bonds for upfront financing and is paid back through property tax assessments. The first PACE financing project took place in Berkeley, California in 2008 with the Berkeley FIRST initiative for solar technology. Legislation that enables PACE financing has been passed in a little over half of the states in the union to date. For the moment, the Federal Housing Finance Agency (FHFA) has blocked residential PACE programs from scaling up, citing risks for lenders and servicers. Issues implicating Fannie Mae and Freddie Mac are leading several local governments to cut their residential programs while commercial programs remain unaffected.

What are the advantages?

Issuing tax-exempt municipal bonds are beneficial for municipalities in the sense that they are able to borrow funds at lower interest rates. The lower interest rate is also acceptable to investors since their interest revenues are not taxed. Furthermore, the tax-free status of municipal bonds shows encouragement from the federal government for decentralizing finance. Several case studies analyzed by the Council of Development Finance Agencies also link municipal bond financing to increased job creation in projects. Municipal bonds are regarded as much safer than corporate bonds and have a relatively low default rate.

What are the main challenges?

For local authorities to issue municipal bonds, they must be credit-rated, and have sufficient budget capacity to issue bonds of a high enough value. Local authorities can usually find funding at better rates and durations from other sources including national specialized financial institutions, donors, or commercial banks. For investors, municipal bonds remain one of the most conservative and least-risky investments. Local governments nonetheless are capable of defaulting and can result in losses for the investor. □

References

Alliance to Save Energy. "Property Assessed Clean Energy Financing Fact Sheet." <<http://www.ase.org/sites /default/files/PACE_factsheet_0.pdf>>.

Best Cash Cow. "Municipal Bonds." << http://www.bestcashcow.com/bonds/ municipal>>.

Council of Development Finance Agencies. "Built By Bonds." <<http://www.munibondsforamerica.org/cms/wp-content/uploads/2012/11/CDFA-Built-by-Bonds1.pdf>>.

Dalehite, Esteban G. 2007. "Advantages and Disadvantages of Exempting Municipal Bonds from the Federal Income Tax : The U.S. Experience." Transylvanian Review of Administrative Sciences. no.19, 2007.

Municipal Bonds for America Website. <<http://www.munibondsforamerica.org/>>

National League of Cities. 2013. "Mayors, County and Local Leaders Oppose Move to Cap Tax-Exempt Municipal Bonds That Would Harm Infrastructure, Jobs". NLC Media Center. February 27, 2013. << http://www.nlc.org/media-center/news-search/mayors-county-and-local-leaders-oppose-move-to-cap-tax-exempt-municipal-bonds-that-would-harm-infrastructure-jobs>>.

Saha, Devashree. "Strengthen Federalism: Enact Legislation Supporting Residential Property Assessed Clean Energy Financing (PACE). November 2012. << http://www.brookings.edu/~/media/Research/Files/Papers/2012/11/13%20federalism/13%20housing%20energy%20efficiency.pdf>>.

Wayne, Leslie. "HAVE I GOT A MUNI FOR YOU!" The New York Times. June 11, 1989. << http://www.nytimes.com/1989/06/11/magazine/have-i-got-a-muni-for-you.html?pagewanted=all&src=pm>>.

REsolutions to Fund Cities

This "Economic Solution" has been produced within the context of FMDV's ***REsolutions*** *program. REsolutions, a four-year international program, offers an invitation to all urban actors to* ***Rethink Economic solutions*** *that operationalize sustainable, efficient, and resilient local development.*

Initiated by a consortium of local authority networks, REsolutions concentrates on identifying, analyzing, transferring and pilot-implementing economic and financial strategies and mechanisms that have improved the impact and performance of local urban development policies.

Anchored and articulated at the regional level in a multi-actor setting, REsolutions seeks to equip local authorities with the tools to integrate and operationalize a wide variety of financial resources for the endogenous development of their cities.

For more information, please visit: http://www.fmdv.net/index.php?id=10&L=2.

FMDV

Supporting local authorities
to access funding

132 rue du Faubourg Saint-Denis, Paris, France • +33 (0)1 40 38 66 95 • www.fmdv.net