TORONTO

STAFF REPORT
ACTION REQUIRED

Tax-Exempt and Build America Bonds

Date:	September 4, 2013
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2013\Internal Services\Cf\Ec13016cf (AFS #18081)

SUMMARY

This report reviews the issuance of tax-exempt municipal bonds and Build America bonds by US municipalities, used to raise funding for infrastructure in the capital markets and whether permitting the issuance of these bonds by the Federal and Provincial governments would assist Canadian municipalities in achieving a lower cost of financing without causing a major disruption of the domestic capital markets.

The report recommends that Council request the Provincial and Federal Governments implement a program similar to the Build America Bonds initiative to provide a direct subsidy to Canadian municipalities to lower their effective cost of borrowing.

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer recommends that:

1. The Clerk forward a copy of this report to the Ontario Ministers of Finance and Municipal Affairs and Housing and the Federal Minister of Finance for their consideration.

2. Council request that the respective Ministers implement a program similar to the Build America Bonds initiative that operated in the United States by providing a direct subsidy to municipalities to lower their effective cost of borrowing to finance capital projects.

Financial Impact

There is no immediate financial impact relating to this report. However, if tax-exempt municipal bonds or bonds similar to those issued through the Build America program are approved by the Federal and Provincial governments, this could lower the City's debt servicing costs.

DECISION HISTORY

City Council on June 11, 12 and 13, 2013 adopted the following motion:

1. Council request the City Manager to report to Executive Committee on the following:

    a. initiatives and best practices used in other jurisdictions to reduce the cost of servicing municipal debt, including but not limited to:

        i) Tax-free or exempt municipal bonds such as was used with "Ontario Opportunity Bonds"; and

        ii) Direct-pay municipal bonds such as "Build America Bonds" in the United States; and

    b. recommend actions for City Council to request the Federal and Provincial governments to take to reduce the cost of servicing municipal debt and increase the City's capacity to invest in its infrastructure priorities.

ISSUES BACKGROUND

In the United States, the federal government exempts interest payments on municipal debt from federal income taxes, thus lowering the cost of borrowing for state and local governments. Bonds purchased in one's own jurisdiction are usually also exempt from local and state income taxes, e.g., New York residents who purchase New York City bonds. Purchasers of municipal bonds are willing to accept a lower interest rate because they receive interest payments that are tax-free. A recent U.S. study indicated that for every $225 million tax-exempt bond issued, the federal Treasury loses an average of $70 million in foregone tax collections.

The municipal bond market began in the United States in 1812 when New York City issued its first bond. Thereafter, states and localities issued bonds to finance various projects such as roads, bridges, schools, water and sewage projects necessitated by continued population growth and urbanization. During the nineteenth century, limits on the ability of the federal government to impose taxes that interfered with the borrowing power of states was established in a series of Supreme Court decisions that found federal income tax unconstitutional when levied on the interest payments from state and local debt. The implied tax-exempt status of these bonds was contained in the 16th

Amendment to the U.S. Constitution, ratified in 1913 and the *National Income Tax Act of 1913* where the exemption of interest on state and local bonds was explicitly stated.

The United States is the only country in the world that permits local governments to borrow on a tax-exempt basis.

The Tax Reform Act of 1986 imposed alternative minimum taxable income to generate federal tax revenue for non tax-paying corporations and individuals that had substantially sheltered their taxable income through investment in tax-exempt bonds.

With these changes to U.S. tax legislation, municipal bonds have become less attractive to corporations such as insurance companies and banks, while individual investors' share of this market grew from 25 percent to 70 percent currently.

COMMENTS

Previous Attempts to Issue Tax-Exempt Bonds in Ontario

The Province of Ontario issued $400 million of Ontario Opportunity Bonds in a single series in May 2003 for a five-year term at an annual interest rate of 4.25 per cent. The interest earned on bonds is taxable. However, individuals, trusts and partnerships that purchased OOBs are entitled to a refund of the Ontario income tax paid on the bond interest earned. The bonds matured in May 2008 and were never issued again since the Federal government, although requested by the Province, did not extend any federal tax relief to the bond holders for the interest payable.

Without an exemption or rebate for the federal tax liability, the bonds had very limited attractiveness to certain Ontario investors and did not lower Ontario's borrowing cost and, to date, have not been issued again by the Province.

Advantages of Issuing Tax-Exempt Municipal Bonds

The issuance of tax-exempt bonds could provide a lower cost of funds for Canadian municipalities that would be facilitated through a subsidy from the Federal (and perhaps Provincial) governments by foregoing tax revenue. While having a mechanism that allows these levels of government to share in the costs of financing local infrastructure projects is desirable from the viewpoint of the municipality, it is not considered to be an efficient method of subsidy on an economic basis. The United States Department of the Treasury has tried to replace the tax exemption with a direct subsidy to state and local governments who have successfully resisted this proposal because they fear that it would be easier for future Congresses to lower or eliminate a subsidy as compared to a tax exemption that has been in force for 100 years and has constitutional support.

The availability of these securities could increase the potential investor base for municipal bonds by attracting investors with higher taxable incomes who would be willing to accept lower yields that are accompanied by a reduction in their income tax liability.

Disadvantages of Issuing Tax-Exempt Municipal Bonds

A major disadvantage to issuing tax-exempt municipal securities in Canada is the perception and opinion that the provision of this type of cost sharing is inefficient from an economic viewpoint since a substantial portion of the federal subsidy never reaches the local government. A recent U.S. study estimates that thirty-five cents of every dollar that is forgone from collecting taxes on municipal interest payments is diverted to investors in the highest tax brackets. Therefore, while the Federal government is providing a subsidy to the local bond issuer, it is also transferring wealth from ordinary taxpayers to high tax bracket individuals.

A tax exemption on income from municipal bonds in Canada does not have any historical or constitutional references as exists in the United States. Therefore, any changes would require amendments to the federal *Income Tax Act* and tax collections agreements with the Provinces and require broad-based support from the federal government who could experience a negative fiscal impact of approximately $100 million per year, based upon forecasted municipal debt issuance of $3.0 billion as provided by various Canadian investment dealers.

Since these securities are tax-exempt, they do not attract tax-exempt investors such as pension funds, other levels of government and individuals who are utilizing their RRSP capacity. These groups traditionally purchase approximately 75 percent of municipal debt issued in the Canadian domestic market.

In the current environment of encouraging investment from various international sources to increase access to capital funds at competitive interest rates, the tax-exempt market would only appeal to a small number of wealthy individuals and corporations with a high tax bracket who operate in the domestic market.

Issuing tax-exempt municipal bonds would have no impact on tax-exempt investors such as levels of government and pension funds who would not benefit from an exemption on the interest payable from the bond.

Since our domestic tax base does not contain the number of wealthy individuals and corporations as exists in the United States on a proportional basis, a possible Canadian tax-exempt market likely does not have the capacity to provide a majority of municipal financing requirements.

However, most economists agree that a direct subsidy to offset the costs of local infrastructure investment is more efficient than an indirect subsidy provided through *the Income Tax Act.*

Build America Bonds

Build America Bonds are taxable bonds that also carry special tax credits and federal subsidies for either the bond issuer or the bondholder. Whereas tax-exempt bonds are issued by a municipality at a lower than market interest rate since the rate of return received by an investor is affected by his personal income tax bracket, Build America Bonds provide a subsidy to the municipality issuing bonds at market interest rates to lower their effective cost of borrowing as well as small tax credits that are available for most taxpayers instead of only individuals in higher tax brackets.

Build America Bonds were created under Section 1531 of Title I of Division B of the American Recovery and Reinvestment Act that U.S. President Barack Obama signed into law on February 17, 2009. The program expired December 31, 2010

The purpose of Build America Bonds was to assist the US economic recovery by reducing the cost of borrowing for state and local government issuers so that they could afford issuing more debt to finance various infrastructure projects and increase local employment.

Build America Bonds provided states and localities with substantial savings on their borrowing costs by the Federal Government providing municipalities with a 35% subsidy on the interest costs incurred when issuing debt as well as a tax credit that was paid directly to the investor. While the subsidy did not allow municipalities to issue bonds at lower than market interest rates, this subsidy as well as the tax credit paid to investors reduced their effective interest cost.

According to the United States Department of the Treasury, the savings for a 10 year bond are estimated to be 31 basis points or .31% and the savings for a 30 year bond are estimated to be 112 basis points or 1.12% versus traditional tax-exempt financing.

For example, if the City issued $100 million for a 10 year term and the coupon interest rate was 3.75%, the City would have saved 0.31% or $310,000 in interest costs on an annual basis or $3,100,000 for the 10 year term and would have borrowed at an effective interest rate of 3.44%.

If the City issued $100 million for a 30 year term and the coupon interest rate was 4.50%, the City would have saved 1.21% or $1,210,000 in interest costs on an annual basis or $36,300,000 for the 30 year term and would have borrowed at an effective interest rate of 3.29%.

A total of $181 billion Build America bonds were issued while the program operated from April 2009 until December 31, 2010. The bonds are held mainly by insurance companies, mutual funds, foreign central and commercial banks as well as individual investors.

The ending of the program was the result of the Democrats and Republicans not agreeing to extend it and has increased yields on municipal debt as well as increasing financial pressure on municipalities.

There is strong evidence from the U.S. experience that tax-exempt bonds may not be the most effective or efficient method to stimulate or subsidize local infrastructure investment. While providing lower borrowing costs to municipalities and a subsidy to investors in a high tax bracket, these bonds are not attractive to tax-exempt investors such as pension funds and other levels of governments who have traditionally supported municipal bond issues and are very active in the domestic capital market.

However, a program whereby either the Provincial and Federal governments provide a direct subsidy to municipalities to lower their borrowing costs would be more attractive to all levels of government since it would not require any changes to the existing income tax regulations and would not create a new market of tax-exempt securities that would be confusing for investors who would be provided with a tax benefit that would transfer wealth from the average taxpayer to higher-income tax payers and not directly assist municipalities.

Tax-exempt bonds, paying lower interest rates to investors due to their tax deductibility, would not appeal to traditional supporters and investors in Canadian municipal debt such as pension funds and other levels of government who are very active as investors in the municipal debt market and do not pay income taxes.

Given that previous attempts to introduce a tax-exempt municipal bond market to Canada have not succeeded due to the resistance of other levels of government, it is felt that the Federal and Provincial governments should be urged to establish a program similar to the successful "Build America Bonds" program in the United States that would provide municipalities with a direct subsidy to at least partially offset the interest cost incurred through debt issued to finance their infrastructure capital projects. This program would not affect the domestic bond market or investors as municipal bonds would still be issued at market interest rates but the interest cost would be subsidized by the program.

Municipalities could either choose to issue the same amount of debt which would now be more affordable under the program or leverage the savings and issue more debt for the same cost, depending upon their respective capital expenditure requirements and budgets.

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SIGNATURE

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