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Statement of The Bond Market Association

Before the
United States Senate

United States Senate
United States House of Representatives
Joint Economic Committee

Hearing on Financing Our Nation's Roads
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Submitted for the Record

The Bond Market Association appreciates the opportunity to comment on proposals to lower the cost of state and local investment in road construction. The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities both domestically and internationally. The Association's membership accounts for approximately 97 percent of the nation's bond underwriting activity.

We commend Chairman Bennett for holding this hearing on the important question of financing our nation's road construction. As part of the Joint Economic Committee's examination of financing options for the nation's roads, we believe it is important to consider the removal of barriers to the use of tax-exempt bonds for this purpose. The fiscal challenges presently faced by Congress and the states are a strong argument for making public financing options for road construction as efficient as possible. Allowing the use of "private-activity" municipal bonds to finance a wider range of projects, and exempting those bonds from existing volume restrictions, would increase the financing options of transportation infrastructure funding decision-makers.

Introduction: Private-Activity Bonds

The Internal Revenue Code (the "Code") contains a wide range of transportation tax provisions. The most visible are excise taxes on users and providers of transportation products, equipment and services. In many cases, these excise taxes provide revenues that Congress directs toward specific federal transportation programs. Other transportation excise tax revenues flow into the government's general account.

Less visible but equally important to the financing of the nation's transportation system are the Code sections that govern tax-exempt bonds. Municipal bonds provide an important source of federal assistance from the federal government for state and local road projects. The federal government foregoes the tax revenue on interest earned by investors on qualified municipal bonds, so investors demand a much lower rate of interest than they otherwise would. States and localities benefit through a lower cost of capital.

Tax-exempt bonds provide other benefits as well. They allow states and localities direct access to the capital markets. This helps concentrate decision making at the state and local level where needs are most accurately discerned. Bonds force a market test of investment projects, since investors must determine whether a road can adequately support the debt service associated with new borrowing. Finally, compared to some federal programs that provide assistance to states and localities, federal administration of municipal bonds requires relatively little bureaucratic overhead.

By lowering the cost of capital for states, localities and certain private parties pursuing development of qualified projects, the federal tax-exemption encourages more infrastructure investment than would otherwise occur. Unfortunately, the Code does not allow for an optimal level of investment in transportation infrastructure projects because the ability of states and localities to enter into public-private partnerships is unduly restricted.

The Bond Market Association advocates expanding the use of tax-exempt financing to permit the use of private-activity bonds for road construction. This testimony discusses the main policy obstacles preventing the more efficient use of tax-exempt bonds for road construction: rules governing the use of private activity bond proceeds and the unified volume cap.

A New Class of Private-Activity Bond for Road Construction

The Code specifically defines what types of infrastructure projects are eligible for financing with tax-exempt private-activity bonds by specifically listing a number of "exempt facilities," which include the following: airports; docks and wharves; mass commuting facilities; high-speed inter-city rail facilities; and a range of other publicly oriented projects. Conspicuously absent from the list of exempt facilities are private toll roads, highways, bridges, and other surface transportation projects which are just as important to the public. Congress could encourage such investment to proceed by adding additional types of transportation projects to the list of exempt facilities. States and localities should be free to enter into public-private partnerships on roads, highways and bridges in the same way they are able to do so for airports, commuting facilities and high-speed rail. An expanded list of eligible projects would encourage a level of investment in infrastructure that more thoroughly taps into the demand from the private sector for such opportunities.

If public roads were included among the facilities eligible for public-private partnerships, it would be possible for a state or municipality in partnership with a private developer, to construct a road using private-activity bonds. User fees, or tolls, would provide the revenue to make the interest payments and repay the principal on the bond. Such public-private partnerships could provide an efficient method for financing road construction.

The current law restriction on private-activity bond financing clearly disadvantages public-private partnerships in transportation financing. Project developers must choose between private investment—along with a loss of the financing advantages associated with tax-exempt bonds—or purely public financing. Amending the Code to allow tax-exempt bond financing in conjunction with private investment would allow transportation developers access to the most efficient sources of capital.

Some of the restrictions on state and local borrowing are reasonable to ensure only worthy projects can benefit from the federal assistance inherent in the tax-exemption. But while few would argue the construction of public roads is not a worthy project, it is singled out as one of the only types of traditional public infrastructure investment where tax-exempt bonds cannot be used in conjunction with public-private partnerships. Addressing this restriction would provide meaningful assistance to states and municipalities. In some cases, public-private partnerships could accelerate construction projects. Given the large number of exceptions to the private-use restriction, there is no policy justification for excluding roads from the list of public-private projects eligible for tax-exempt financing.

The Unified Volume Cap

The Code generally prohibits the use of tax-exempt bonds for the benefit of private parties by defining such bonds as "private activity bonds." According to the Code, a private activity bond is any bond that satisfies two tests: the business use test and the private security or payment test. A bond meets the private use test if more than 10 percent of its proceeds are used by a private party. A bond meets the private security or payment test if more than ten percent of the debt service is secured or paid by a private party.

Despite the general prohibition on tax-exemption for private-activity bonds, interest on certain "qualified" private activity bonds is tax-exempt, subject to certain restrictions. The most serious limitation on the issuance of tax-exempt private-activity bonds is the "unified volume cap," which restricts the amount of private-activity bonds that states and localities may issue in any given year. The cap recently rose to the greater of $75 per capita or $250 million per state and was indexed to inflation. Still, in recent years, a number of states have exhausted their annual volume caps and have been forced to postpone or cancel investment in projects involving private activity because tax-exempt financing could not be secured. To ensure states and localities at least have the option to use private-activity bonds for road construction, Congress should authorize this authority outside of the current volume cap. Exemption from the volume would be especially important for surface transportation projects, which can be enormous in scope. It is conceivable that a large road project could exhaust most or all of a state's volume cap for one or more years. Congress has exempted private-activity airport bonds from the volume cap limitations for similar reasons.

Conclusion

Tax-exempt municipal bonds can play an essential role in financing the construction of roads and other transportation infrastructure. Federal tax code restrictions, however, prevent state and localities from maximizing the benefit of municipal bonds to finance road construction. The Bond Market Association advocates modifications of the tax code to expand the use of tax-exempt financing for road construction.