

Economic Analysis of the *American Jobs Act of 2011*

Overview and Summary

This memo briefly summarizes the President's proposal for an infrastructure bank per Title II, Subtitle F of the above-referenced legislation and offers insights into its effects on the municipal bond market associated with Title IV, Subtitle A of the proposal dealing with the limitations on certain deductions and exclusions. This memo also briefly explores the implications of these proposals for public-private partnerships in the water/wastewater sector.

On balance, and somewhat curiously, the negative effects associated with limits on deductibility of interest on municipal bonds are likely to increase costs for issuers of municipal bonds (including NACWA members) more than the funding provisions are likely to reduce costs to these issuers. The net effect would be higher costs of capital for issuers of municipal bonds and depending on the appetite of bond holders, potentially less infrastructure investment and fewer jobs compared to current policy.

From a public policy perspective, the combined effect of these two Subtitles makes little sense. Higher costs of municipal bonds could lead to reductions in infrastructure spending in excess of any marginal new infrastructure spending from the proposed infrastructure bank. Plus, municipal borrowers could end up paying more in interest costs under these proposals than the federal government will receive in tax receipts.

Finally, the proposed infrastructure bank promotes public-private partnerships through its definition of eligibility and funding criteria. Eligibility is blind as to public versus private ownership or operation of facilities as long as services delivered produce public benefits. Funding criteria seek to maximize private co-financing of facilities and public-private partnerships in service delivery.

NACWA members are likely to be better off under current funding and tax policies.

Title II, Subtitle F: American Infrastructure Financing Authority

This Title would establish a new American Infrastructure Financing Authority (AIFA) as a wholly-owned government corporation that would provide direct loans and loan guarantees to facilitate investment in economically-viable infrastructure projects of regional or national significance. The list of eligible projects is long: highways, roads, bridges, mass transit, inland waterways, commercial ports, airports, air traffic control systems, passenger rail, freight rail, water-waste treatment facilities, storm-water management systems, dams, solid-waste disposal facilities, levees, open-space management systems, pollution-reduced energy generation, transmission and distribution of energy, storage of energy, and energy-efficiency enhancements for buildings. This means that of the proposed \$10 billion in proposed funding, only a small portion would fund wastewater projects.

The bank appears to be focused on large projects. Other than for rural projects with a minimum cost of \$25 million, the bank can fund only projects with costs above \$100 million. Loans cannot exceed 50% of project costs.

Loan and guarantee terms will be set administratively, but interest rates on loans are presumed to be at US Treasury rates plus a small administrative fee. Loan repayment cannot exceed 35 years including a five-year grace period after substantial completion.

Many issues remain unclear. First, the bank appears to be a permanent institution but funding is specified only for the first year at \$10 billion (project funding coming out of the bank in future years is capped after year 2 at \$20 billion a year and again after year 9 at \$50 billion a year). Second, it is unclear whether or how this proposed bank would interact with the existing water and wastewater SRFs. Third, if this proposal were to pass Congress and be signed into law, it is also unclear whether funding for the infrastructure bank would substitute for or complement current appropriations to the SRFs.

Title IV, Subtitle A, 28 Percent Limitation on Certain Deductions and Exclusions.

Beginning in 2013 for individual taxpayers with incomes above \$200,000 (and \$250,000 for married couples filing jointly), this Subtitle would impose a tax on all itemized deductions equal to the difference between the taxpayer's top marginal tax bracket and 28%. Taxpayers in the 35% bracket, for example, would pay 35-28 or 7% tax on items that would otherwise have qualified for deductions or exclusions. If the Bush tax cuts expire and the top tax bracket returns to 39.6%, taxpayers in the top bracket would pay 11.6% tax on these items. One of the items subject to this proposed tax is interest received on formerly "tax-exempt" municipal bonds. Moreover, the proposal is retroactive in that it imposes this tax on interest from existing as well as future bond holdings.

According to IRS data for 2009, some \$35.5 billion (59% of the total) in tax-exempt interest was reported by taxpayers with adjusted annual gross incomes in excess of \$200,000, which means that when high-income investors require higher yields on municipal bonds to compensate for the new tax, municipal borrowing costs will increase. To compensate for the new tax, the yield on a municipal bond formerly at 4% would have to increase to 4.43% for taxpayers at the 35% tax bracket and 4.77% for taxpayers at the 39.6% bracket. On a \$100 million bond, this will increase municipal cost of capital by about \$33 million (11%) and \$43 million (19%) respectively over 30 years. Since investors will almost certainly be made whole through yield increases, eliminating tax exemption in this way is essentially a tax on state and local government and because it would affect existing bond holdings, a reduction in wealth for the bond-holding American public.

Are These Proposals Likely to Add New Capital to the Wastewater Sector?

The short answer is no. Assuming municipal budgets are fixed (which they most certainly are in the short run), reductions in funding associated with devaluing tax exemption on municipal bonds is likely to more than offset any increase in funding flow through the infrastructure bank.

Of the \$10 billion capitalization of the infrastructure bank, only a fraction will go to wastewater projects since the bank is set up to fund virtually all infrastructure that the federal government currently funds through sectoral programs (see above). Whatever that fraction may be (10%....15%?) some portion of it will act as a substitute for current financing sources like the SRFs and the municipal bond market. The substitution effect will depend on the bank's cost of capital, administrative and procedural burden of going through the bank, and the borrower's cost of capital elsewhere. If say 15% or \$1.5 billion went to wastewater and half was a substitute for other sources, the proposed infrastructure bank would add \$750 million in wastewater funding.

NACWA members currently tap the municipal bond market for 53 percent of their capital needs. But since they are the largest utilities most able to access capital in this way, the figure is lower for the broader sector, perhaps 35%. So, of the \$22.5 billion in capital expenditure in the wastewater sector in 2011, the municipal bond market

supplied an estimated \$8 billion in funding. Again, assuming municipal budgets are fixed, an 11% reduction in bond proceeds (the amount that would have to be paid to bond holders to compensate for the new tax) would eliminate \$866 million in wastewater capital. A 19% reduction would eliminate \$1.5 billion.

So, at least in the short run (the first 3-5 years) while the infrastructure bank might add \$750 million a year in wastewater funding (assuming future annual appropriations – see above), devaluing tax exemption would reduce capital formation in the municipal market by \$866 million to \$1.5 billion.

Do These Proposals Promote Private Participation in Ownership and/or Operation?

Language in Section 253 on funding criteria clearly promotes private participation in funding infrastructure, and by extension, broader participation in ownership and operations:

“The criteria established by the Board of Directors shall also provide adequate consideration of: (1) the means by which an infrastructure project is being financed; (2) the likelihood that assistance from AIFA will accelerate the development of the project and lower the overall costs; (3) **the extent to which assistance from AIFA maximizes private investment or supports a public-private partnership**; (4) the extent to which the support mobilizes other financing; (5) the technical and operational viability of the infrastructure project; (6) the proportions of financial assistance from AIFA; (7) the geographic location of the project (in an effort to have geographic diversity); (8) the size of the project and its impact on the resources of AIFA; and (9) the infrastructure sector of the project (in an effort to have projects from more than one sector financed by AIFA).” [emphasis added by the author]