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Why Tax Credit Bonds Should Be A Key Part Of Any Federal Infrastructure Policy Initiative.

Major infrastructure investments—especially projects and programs of regional and national significance—can generate major "spillover" benefits to the general public—some, like locks and dams, literally so. This article explains why tax credit bonds should be in the mix of federal infrastructure policy initiatives. Previous generations of tax credit bonds, such as Build America Bonds, were highly successful in broadening the market for infrastructure debt but their authority has expired. We propose creating a new generation of qualified tax credit bonds. A separate article in this issue of Public Works Financing outlines a specific proposal to create "Infrastructure Credit Bonds" (page 12).

While some proposals have focused on the role that equity capital can play in advancing infrastructure projects, it is worth noting that P3 projects have represented just a small fraction of total investment in public infrastructure. For example, CBO reports that in 2014, federal, state and local capital outlays for public infra- structure totalled $181 billion. That same year, according to Public Works Financing, P3 project outlays totalled just $4.2 billion—about 2 percent of the market.

Within the P3 sector, financial equity represents, on average, about 15 percent of the capital sources for P3 projects. Debt capital, on the other hand, represents 60 percent of sources on P3 deals—and for governmental projects debt may fund 90 percent or more of the "capital stack." So clearly, the cost of borrowing has a major impact on project feasibility and financial capacity.

Historically, infrastructure project sponsors have raised debt capital from the following sources:

- Tax-exempt financing (both "governmental" and "private activity" bonds);
- Federal credit assistance (such as TIFIA, RRIF and WIFIA, with loans generally made at the U.S. Treasury rate);
- Bank and other taxable rate debt (especially suitable for P3 project financings);
- State-capitalized loan funds (such as Water Revolving Loan Funds and State Infrastructure Banks)

In more recent years, federal legislation has authorized other forms of tax-advantaged debt:

- Partially-subsidized taxable rate bonds (Build America Bonds) designed to replicate the tax-exempt borrowing rate by offsetting a portion of the interest cost (recently proposed to be 28%) through a refund- able (cash) tax credit for the issuer ("direct-pay" tax credit bonds); and
- Fully-subsidized taxable rate bonds designed to have most or all of the annual interest return provided through an annual (non refundable) tax credit for the investor, which can apply the credit against other tax liability ("investor pay" tax credit bonds).

These programs have been either time-limited (Build America Bonds issuable only in 2009 and 2010) or volume-capped (five separate classes of "qualified tax-credit bonds" totaling about $35 billion for specific purposes such as school construction, energy conservation and clean renewable energy projects.)

Of all the existing and proposed debt instruments, the qualified tax credit bonds offer the greatest present value benefit to the project sponsor per dollar of “scored” federal budgetary cost.

This is not to suggest that other debt instruments aren’t helpful. PABs level the playing field between P3 and governmental projects, but their purpose is simply to match the municipal bond market rates available to governmental sponsors. Similarly, “direct pay” tax credit bond programs like Build America Bonds can broaden the market by attracting taxable fixed-income investors, but are designed to replicate (but not beat) tax-exempt rates. Federal credit can provide greater structuring flexibility in terms of deferrals and prepayments, but may only reduce the effective borrowing cost by ½% or so for investment grade issuers—a savings to be sure, but not enough to dramatically increase a project’s debt capacity. And SRF and SIB loans, while potentially offering very low rates, are severely size-constrained by limits on state capitalization grants.

In contrast, qualified tax credit bonds can more than double an issuer’s debt capacity. Stated differently, a given local revenue stream pledged for debt service can support twice the amount of tax credit bond principal as tax-exempt financing or federal credit.

From a federal policy viewpoint, tax credit bonds offer additional advantages. Unlike federal grant spending or credit assistance, tax code measures do not require growing the size of the federal government to administer them. Tax incentives also have the advantage over grants of harnessing the market discipline of private capital (bond investors) to ensure that the pro ject’s repayment plan is feasible. Unlike federal credit, a tax credit bond does not require the federal government to take any credit exposure on the borrower or the project.

Tax credits attached to bonds can be simpler and more efficient to market than equity-based investment tax credits, provided liquidity concerns are meaning- fully addressed (as discussed in the follow-on article on “Investment Credit Bonds”). And tax credits attached to bonds are “budget-efficient,” since they stretch out the fiscal impact over a longer period of time more commensurate with the economic lives of the assets being financed. The scored cost of the program (effectively the first 10 years of tax expenditures under budget rules) relative to the financial benefit to the project sponsor offers the highest “return on fiscal investment.”

For these reasons, a tax credit bond proposal should be a key component of any new federal policy initiative.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.