



# America Fast Forward Transportation Bonds

WHITE PAPER

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## Background

Surface transportation investments—especially large projects and programs of regional and national significance—generate major “spillover” benefits to the general public. In addition to generating construction jobs and improving mobility, transportation projects can enhance safety, environmental sustainability and community livability, as well as strengthen the nation’s economic competitiveness. The widespread benefits of such major transportation improvements warrant a federal role in encouraging further investment.

The current underinvestment in keeping our nation’s transportation system in a state of good repair has been well-documented: The Highway Trust Fund has insufficient resources to maintain the current level of federal spending on surface transportation, much less help fund major new investment initiatives that may be economically justified. In addition, many federal policy makers oppose expanding direct federal spending programs due to concerns about allocating limited resources in an era of large budget deficits.

Federal tax incentives can be a highly effective tool for encouraging private sector investment in sectors deemed important to achieve public policy objectives. Unlike direct federal spending, tax code measures do not require growing the size of the federal government to administer them. Tax incentives for investment also have the intrinsic advantage of the market discipline of private capital to ensure that the projects being financed are feasible.

To be sure, tax incentives do incur a fiscal cost to the federal government’s General Fund, through foregone revenues (tax expenditures). But these costs are recognized annually, over the term of the tax incentive program. This is more in line with a capital budgeting approach than traditional federal discretionary spending, where the budgetary cost of even long-lived investments is “expensed” upfront.

America Fast Forward Transportation Bonds (AFF Transportation Bonds) are a tax policy initiative designed to stimulate greater investment in the transportation sector. They provide a substantial subsidy to the issuer by having the federal government pay all or most of the annual “interest” due on the bonds in the form of an annual tax credit against the investor’s federal tax liability. On a long-term bond, the interest component of debt service represents 65 percent or more of the financial cost of borrowing.

## Summary of the Proposal

AFF Transportation Bonds would be structured as a sixth class of “qualified tax credit bonds” (QTCBs) under section 54A of the Internal Revenue Code. Over the last decade, Congress has authorized over \$35 billion of QTCBs to assist sectors such as public education, clean renewable energy generation and energy and forestry conservation. AFF Transportation Bonds would represent the first application of QTCBs to the transportation sector.

QTCBs all share certain common features. The annual credit is considered taxable interest income to the bondholder for federal tax purposes. The issuance amount is volume-capped, the use of the proceeds is limited to targeted purposes, and the annual interest subsidy is determined by the Treasury Department. As of January 27, 2014, the federally-subsidized tax credit bond rate was 4.84 percent. To the extent a state or local issuer can price its QTCBs at or below this index rate, it can receive a 100 percent interest subsidy from the Treasury, effectively allowing it to borrow at zero percent.

AFF Transportation Bonds, if enacted, would differ from the other QTCBs in several respects. The maximum maturity could be as long as 35 years, compared to a maximum maturity for other QTCBs currently of only about 20 years. This longer maturity is necessary due to the long-lived nature of transportation projects, which tend to be highly capital-intensive. The Treasury would establish a separate “interest” index for the tax credit rate on AFF Transportation Bonds, reflecting their longer maturity. And lastly, the list of taxes that the credit could be offset against would be expanded to include federal withholding tax on wages and benefits retained by employers and pension plan administrators. This is necessary because of the much larger scale of transportation projects, and would significantly broaden the market for the tax credit bonds to include pension funds.

## Program Terms

The AFF Transportation Bonds would be a \$45 billion program, with eligible projects being surface transportation facilities eligible under title 23 or chapter 53 of title 49: highways, bridges and tunnels; transit and intercity passenger bus or rail; and intermodal freight transfer facilities and private freight facilities conferring a public benefit.

The total issuance volume would be subject to an annual allocation cap of \$4.5 billion per year for 10 years, and would be allocated on a two-tier basis: 35 percent of the volume would be allocated to all states based on their proportion of the nation’s population, and 65 percent would be allocated at the discretion of the Secretary of Transportation among projects costing at least \$500 million and which receive not more than half of their capital cost funding in the form of federal grants (“major transportation projects”). Eligible issuers would be state or local governmental units, and could include projects involving private parties in delivery, operations and financing (public-private partnerships).

## Benefit to Project Sponsors

AFF Transportation Bonds should enable a project sponsor to undertake substantially greater investments within a defined revenue stream for debt service payments than other borrowing approaches, such as tax-exempt bonds or the TIFIA federal credit program. The program also would be substantially more advantageous than the Administration’s version of AFF Bonds contained in the FY 2014 Treasury Revenue Proposals (Green Book), which called for a 28 percent, rather than 100 percent, interest subsidy. The table below summarizes the comparative investment capacity of AFF Transportation Bonds vs. the Administration’s proposed “regular” AFF Bonds (which approximates that of tax-exempt bonds) as well as TIFIA loans.

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## Comparing Investment Capacity of Different Borrowing Techniques

*[Assuming a Revenue Stream of \$10M/Year to Pay Debt Service\*]*

TYPE OF BOND	INTEREST RATE	LEVEL ANNUAL DEBT SERVICE	BONDING CAPACITY
Tax-exempt/regular AFF Bonds <sup>1</sup>	3.93%	\$10.0 M	\$189 M
TIFIA Loans <sup>2</sup>	3.66%	\$10.0 M	\$196 M (1.04x increase)
AFF Transportation Bonds <sup>3</sup>	0.00%	\$10.0 M	\$549 M (2.90x increase)

*Assumptions (as of 1-27-14):*

*\*35-year level debt service structure and assumed issuer annual revenues of \$10.0 million/year.*

*<sup>1</sup>The tax-exempt borrowing rate is assumed to be 3.93% (average coupon for A and AA issuers) and the “regular” AFF Bond with a 28% interest subsidy is assumed to have the same net borrowing rate.*

*<sup>2</sup>The TIFIA Rate is based on the comparable term U.S. Treasury yield; TIFIA may offer greater flexibility as concerns back-loaded repayment and other features.*

*<sup>3</sup>The AFF Transportation Bond borrowing rate is 0.00% (with a 2.50% sinking fund reinvestment rate).*

QTCBs not only offer a zero nominal interest rate; they also allow the borrower to make regular, equal payments to a sinking fund to retire the bonds at their stated final maturity date. Together, these features allow an issuer to support over twice and potentially up to three times the debt capacity (2.90x under the current assumptions) for any given repayment stream, compared to conventional tax-exempt debt. This enables a project sponsor to more than double the capital investment supportable by available project revenues or dedicated taxes.

## Form of the Tax Credits

Up until 2010, the annual credits on QTCBs took the form of non-refundable credits, which required the investor to have other federal tax liability in an amount at least equal to the tax credits for the investor to derive economic value from the credits.<sup>1</sup> The marketplace for such bonds had been limited, due to the unusual (non-cash) nature of the annual “interest payment,” and because of investors’ uncertainty regarding their tax position in future years. Recognizing this impediment, Congress in 2010 made the credits on most tax credit bonds “refundable” (that is, presentable to Treasury for cash, either by the investor or the issuer).<sup>2</sup> Refundable credits made the QTCBs similar to conventional taxable bonds, dramatically broadening the marketplace and reducing the yields required by investors by approximately 100 basis points (1.00 percent/year).

However, there has been growing opposition to the use of refundable credits among some members of Congress, because it entails Treasury cash outlays to refund the credits and appears similar to direct federal spending. Refundable credits (which require direct cash outlays by the Treasury) also are vulnerable to sequestration, in the event of federal budgetary cutbacks, creating uncertainty for issuers and investors.

In more recent legislation, the tax credits for newly-authorized qualified bonds have reverted to non-refundable status, where the tax credits may only be applied against other tax liability of the investor, with no associated direct federal outlays. For example, when Congress extended the term of one of the QTCB programs (qualified zone academy bonds) through 2013 in the American Taxpayer Relief Act of 2012, it made the tax credits non-refundable.

Securities dealers and other municipal bond market participants have long noted the greater inefficiency and market challenges involved in selling non-refundable tax credit bond issues. To address both the federal spending concerns about refundable tax credits and the market inefficiency concerns about non-refundable tax credits

among issuers and bond investors, AFF Transportation Bonds have been proposed as *non-refundable* credits – but with a *wider range* of eligible federal taxes. This should substantially broaden the market, attracting major institutional investors such as pension funds and major insurance companies, which have highly predictable, long-term withholding tax liability.

## Budgetary Cost of the Program

The fiscal cost of the program would be estimated by the Joint Committee on Taxation at the time the legislation is introduced. The federal budget score takes into account the annual issuance volume of the program, the estimated tax credit rate and the assumed average tax bracket of investors (since the tax credit is considered taxable interest income.) Based on JCT cost estimates for similar proposals, it is estimated that the scored cost of AFF Transportation Bonds would be about 20 percent of the face value of the program authorization, or about \$9 billion over the 10-year budget window.

## Conclusion

AFF Transportation Bonds can play a meaningful role in addressing the nation’s infrastructure investment gap – without relying on increased federal spending through grants. To attract capital investment, the issuer would need to demonstrate that it could repay the bonds with project user charges or other pledged revenues. The AFF Transportation Bond program would be focused on new investments in the surface transportation sector conferring substantial public benefits: either capacity expansion or State of Good Repair capital renewal of existing infrastructure. Because the program size is volume-capped and the Treasury sets the interest (credit) rate, federal policy makers can have confidence in the anticipated level of tax expenditures. And AFF Transportation Bonds would not be vulnerable to sequestration, as is currently happening to Build America Bonds. The scored cost of the program would be only about 20 cents on the dollar – compared to 100 cents on the dollar for a new or expanded grant program.

In summary, AFF Transportation Bonds represent a more cost-effective way for the federal government to subsidize investment in major transportation facilities than conventional spending or other approaches.

<sup>1</sup> Credits could also be carried forward to subsequent years, or stripped and sold to other investors.

<sup>2</sup> Section 301 of *The Hiring Incentives to Restore Employment Act (P.L. 111-147, enacted March 18, 2010)* converted the clean renewable, energy conservation, qualified zone academy and school construction tax credit bond programs to refundable credits.



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