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More Affordable Infrastructure: Tax-Free Municipal Bonds

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Introduction

This report recommends reconsidering tax-exempt municipal bonds as a financing mechanism for municipal infrastructure. To paraphrase federal Finance Minister Chrystia Freeland's comments on the government's measures to make housing more affordable[1], tax-exempt municipal bonds may not be a 'silver bullet' to slay the spectre of inadequate financing of Canada's municipalities and their capital programs. However, this analysis suggests that exempting municipal bonds from federal and provincial taxation would nonetheless make a timely and sustainable contribution.

The traditional prudence of Canadian municipal governments has positioned them well to recover from the economic and fiscal consequences of the pandemic. Their debt levels are generally low[2], their credit ratings are often higher than provinces and major corporations[3], and they own and manage over 60% of Canada's public infrastructure despite only claiming about 8 cents of every Canadian tax dollar annually (an imbalance that may prove unsustainable). During COVID, extraordinary one-time federal and provincial transfer payments shored-up municipal and transit operating budgets.

There are storm clouds on the horizon. Particularly in Ontario, hard-pressed 'main street' businesses and residential municipal taxpayers are being asked to cost-share a growing range of health care and social services activities, from ambulances, hospital capital contributions, and long-term care to refugee settlement, childcare centres and homelessness. The operational viability of major public investments in transit is being undermined by reduced ridership revenues. Although historically resilient in the face of economic cycles, the municipal property tax base is now being eroded by large digital enterprises that pay relatively little in municipal taxes, in contrast to their bricks-and-mortar predecessors. [4, 5] This impact is equally great on projected development-related revenues used to pay for growth-related infrastructure.

In this adverse budgetary environment, 'discretionary' municipal investments in asset maintenance and infrastructure expansion can be casualties. As governments around the country aim to restore equilibrium to their deficit-ravaged budgets, calls to correct the long-standing municipal fiscal imbalance (between responsibilities and resources) are submerged beneath a cacophony of economic bad news and competing demands from all corners of Canadian society.

Beyond those already announced, major new municipal program expenditures from federal and provincial governments are unlikely for the foreseeable future. Given those realities, municipal leaders need to ask themselves these questions:

- How are municipalities to deal with the cost of expanding – and then operating – the infrastructure needed to support growth and economic productivity and to increase housing supply?
- How are local governments – municipalities, school boards, local electricity distributors, water authorities, transit systems – expected to address the backlog in state-of-good-repair (SOGR) liabilities that are steadily accumulating on their balance sheets?
- How can municipalities fund and deliver 'new' community infrastructure – electric fleets, charging networks, rural mobile 5G broadband, climate-resilient storm drainage and net-zero facilities?

Rather than relying on other orders of government for episodic and occasionally unreliable multi-year capital grant programs, perhaps both large and growing municipalities should be looking for additional ways to fund and finance the capital works they must build and sustain. This warrants a fresh examination of so-called tax-expenditure measures. A good candidate might be 'tax-exempt municipal bonds', the default capital financing mechanism used by most American municipalities and many States, as well by those that build and operate infrastructure projects for them.

Bridging the infrastructure 'deficit'

There are continuing debates about the size of the "infrastructure deficit", influenced by local 'level of service' decisions, the state of technology and engineering appraisals. Despite the inevitable disagreements over assumptions and data sufficiency, some examples show clearly the need to reduce the size of Canada's local infrastructure deficit…

- A 2021 budget report by the City of Toronto estimated the backlog of 'state of good repair' liabilities borne by the municipal tax base at $7.15 billion, projected to grow to $9.2 billion by 2025.[6] (The Toronto Transit Commission's previous SOGR estimate of ~$6 billion is now projected to quintuple!);
- The Ontario Good Roads Association's 2021 report calculated the infrastructure deficit for Ontario municipal roads and bridges at $34.7 billion;[7]
- The Financial Accountability Office of Ontario estimated the municipal infrastructure deficit at $52.1 billion;[8]
- Estimates of the national infrastructure deficit range from $110 billion to $270 billion;[9]
- Beyond the direct municipal government sphere, other parts of local government – from local electricity distributors to school boards – face similar challenges. For example, more than half the Toronto District School Board's schools are more than 60 years old, yielding a $4.3 billion balance-sheet liability that grows each year.[10]

Development charges (DCs), which have front-ended most new capital infrastructure costs in Ontario for decades, may be reaching their practical limits. While the proportion of individual development charges in relation to individual home prices may not have changed over time, the size of DCs imposed on each new residential unit has now risen to the point where DCs arguably operate as a constraint on growth and a thorny component of any effort to increase housing affordability and supply. There is criticism of municipal over-reliance on development charges, predictably from the development industry[11] but even by the Ontario government's housing task force.[12]

Estimates of the national infrastructure deficit range from $110 billion to $270 billion.

While some argue that municipal fiscal conditions have not materially deteriorated during the pandemic, the reluctance of municipalities to use their tax base to fund debt-supported municipal infrastructure remains. In fact, many Ontario municipalities have the capacity to shoulder a greater debt-financed share of the cost of infrastructure construction and refurbishment.[13]

Canadian municipal debt context

Canadian municipalities are generally only allowed to issue long-term debt to build or acquire long-lived assets, such as bridges or waterworks. For flexibility, municipal capital debt is frequently 'pooled', so that a municipal debt instrument (or debenture) can be used to build several projects, including an array of small or remedial works. Rather than being secured by the specific assets financed by the borrowing, in Ontario and other provinces municipal debentures are a general obligation – secured by the 'full faith and credit' of the municipal government.

In Canada, established practices and fiscal philosophy often do not favour using long-term debt to fund long-term community needs.[14] Pay-as-you-go or front-end approaches are common, combining development levies, accumulated reserves / reserve funds and federal / provincial capital grants.

The contrast between Canada and the US is striking. The US$3.8 trillion municipal bond market sees debt issuance in excess of US$400 billion each year. Although Canada is 10% of the size of the US, the Canadian municipal bond market universe is less than 1% of the size of the corresponding US marketplace, or a mere C$35 billion. Canada sees less than C$5 billion in municipal debenture issues annually.[15]

“Tax-free” municipal bonds - ‘munis’

As with any bond holders, those purchasing municipal debentures in Canada earn interest payments. Those interest payments are taxable,[16] unless the purchasing entity is tax-exempt (e.g., a pension fund, or in the case of individual investors, RRSPs, RRIFs or TFSAs). By contrast, for over a century, American residents (both individual and corporate) who purchase tax-exempt municipal bonds (or ‘munis’) pay no federal tax on interest earned and, typically, do not pay State or local income taxes either.

Some in the US have suggested that the blanket exemption of ‘munis’ from tax is too generous, or not progressive taxation. In successive waves of US tax reform, there have been periodic efforts to reduce these significant tax benefits. Some mitigating measures have included requiring high-income individuals or corporations to pay some guaranteed minimum tax or ‘alternative minimum tax’. However, there remains a significant tax incentive for otherwise taxable US purchasers of ‘munis’.[17] In fact, as States and localities increasingly used concessions and public-private partnerships (P3s) to build and operate things like transportation infrastructure, the tax code was widened to allow ‘muni’ tax treatment on the financing used by private and non-profit entities undertaking ‘municipal’ projects (known as a ‘Public Activities Bond’ or PAB).[18]

Would this US municipal financing mechanism make sense for Canada?

Earlier Canadian reviews of tax-exempt municipal bonds, such as two City of Toronto reports (2000 and 2013),[19, 20] identified three major drawbacks, despite the great popularity of ‘munis’ in the US.

- First, if the goal is to allow the Canadian federal government to subsidize municipal governments, ‘munis’ are “inefficient”. Although municipal borrowing costs are lowered, much of the benefit of federal interest-income tax loss goes to the bondholder, rather than directly to the municipality. For municipalities, federal tax-expenditure measures do not work as well as new sources of tax revenue or direct federal subsidies (i.e., federal program expenditures).

- Second, the Canadian municipal debt marketplace is relatively 'thin', with only about 15 major issuers and a market comprised mainly of banks, insurance companies, pension funds and registered savings plans (e.g., RRSPs, TFSAs, etc.).[21] Since the latter two groups are already tax exempt, these investors would see lower 'muni' yields as a disincentive to invest.[22] For the concept to work in Canada, some of the tax-exempt portion of the existing market would need to be replaced by new (otherwise taxable) purchasers. [23] As a practical matter, Canada may also have (proportionally) fewer higher-income taxpayers than in the US to attract to a 'muni' market.
- Third, and perhaps most significantly, the structure of the 'muni' in the US means that the biggest beneficiaries are high-income taxpayers. 'Munis' are not a 'progressive' tax measure, at least at the federal level. Of course, this would be a greater concern for the federal treasury than for municipalities, as the latter would achieve lower borrowing costs for all of their local taxpayers.

For Canada, the essential trade-off might be whether the benefits of lowering the cost-of-capital to major and growing municipalities would justify using a tax mechanism that results in losses to the federal treasury and tax benefits to higher-income investors in Canadian infrastructure.

As interest rates increase and inflation drives up the cost of capital work, the rising municipal cost-of-capital and keeping within regulated municipal debt-service limits will emerge as bigger issues for municipal treasurers.[24] Tax-exempt bonds could "deepen the pockets" of debt-conscious municipalities by lowering the carrying cost of capital projects. 'Munis' would encourage municipalities to make better use of their good credit and borrowing capacity to fund much-needed long-term infrastructure and to extend the life of existing capital assets. Rather than substituting debt for DCs, which they are reluctant to do, municipalities could supplement DCs and DC-supported debt with additional debt supported by property taxes and utility rates. In plain language, 'munis' would increase municipalities' ability to undertake more infrastructure projects for the same budget.

'Munis' would encourage debt-funded infrastructure to be built immediately to meet immediate needs, while being amortized over its decades-long useful life by future users, not just by current users. By contrast, many Canadian municipalities have traditionally accumulated tax revenues in reserves and reserve funds before making a capital expenditure, and used debt primarily when supported by development charges or utility rates. 'Munis' might cause a re-evaluation of that approach.

How much expanded financing and funding capacity might be created? US investment websites have a variety of software to calculate the actual impact on the individual taxpayer of interest income from taxable and non-taxable bonds.

'Munis' would encourage debt-funded infrastructure to be built immediately to meet immediate needs.

Let's take the case of an individual investor earning an annual taxable income just under $220,000, who buys a municipal debenture. The applicable federal tax rate on that taxpayer's marginal income is 29%. If one adds the provincial tax onto this taxpayer's marginal income, in Ontario, the tax rate is a further 12.16%, for a total tax of 41.16% on the debenture's interest income.[25] As a result, in the case of a typical 2022 taxable debenture paying an interest rate of 3.25%,[26] the investor could earn the same amount from a tax-exempt debenture paying annual interest of only 1.91%.

In theory, municipalities could pay an interest rate that is potentially 40% less than current market conditions require by issuing tax-exempt debentures. As interest rates rise, that differential obviously becomes more valuable. With annual Canadian debenture issues averaging C$5 billion, that represents a significant reduction in annual municipal debt-service costs and/or an opportunity to increase infrastructure spending within existing capital budgets.

An idea whose time has come?

The pandemic has led to several shifts that now warrant giving 'munis' serious considerations in Canada.

- Federal and provincial governments have made it clear that there will be no reform to fiscal federalism, and if it were to occur in the future, healthcare transfers would top the list, not municipalities. For municipalities, transfer payments or tax points may work better in theory, but they are generally not on the table (although the British Columbia government's current municipal finance review may be a "toe in the water").
- The non-RRSP savings rate among middle-income Canadians has skyrocketed, although high inflation may eat into this 'cushion' and potential investment pool. The Bank of Canada suggests C$180 billion has been accumulated during the pandemic. Much of those savings remain as undeployed investment 'dry powder' in the face of volatile real estate and stock markets. [27] Although some of that money may find its way into TFSAs, many individual Canadian investors will be looking for reliable after-tax returns.
- Rising interest rates mean that municipalities will be paying more both to issue and to roll-over their debt. As a result, higher rates paid on municipal debentures will cost municipal taxpayers more. Correspondingly, higher interest rates on municipal debt will attract investors, particularly those looking for 'green' municipal infrastructure investments or to allocate more funds to highly-rated fixed-income assets.

By addressing the shortcomings in US-style 'munis', could Canada create a class of public infrastructure bonds that uses tax-expenditures (rather than program expenditures and federal / provincial deficits) to build, maintain and refurbish local government infrastructure? It may be an attractive option for the Government of Canada, especially since it avoids intrusion into areas of provincial jurisdiction, always a sensitive matter with Canada's larger provinces.

Higher rates paid on municipal debentures will cost municipal taxpayers more.

The federal government has historically been reluctant to pledge long-term federal revenues to the municipal sector, whether through programs or directly. While not a complete solution to the financial challenges facing Canadian cities, tax-exempt bonds might be seen by the government as offering municipalities a useful fiscal "tool", based on its long and generally successful history in the United States. Given their local infrastructure funding demands, it seems likely that provincial jurisdictions could be persuaded to match the tax exemption, which would make it equivalent to the US 'muni'.

For the federal treasury, 'munis' have the potential to be funded within the existing budgetary envelope, as a tax-expenditure measure. Even if 'muni' uptake by municipalities does not meet expectations, the federal government could still argue that it is contributing the value of its 'lost' tax revenue to meeting municipal infrastructure needs. If debt-conscious municipalities did not take full advantage of the tool, the federal government would incur less cost, while still claiming credit for creating a new municipal financial instrument.

Program design considerations

'Munis' might predictably be criticized by some for mostly benefitting high-income investors. Others might argue that restricting the tax measures to municipalities would discourage innovative funding and financing, such as P3s.

Tweaks based on the experience of the US 'muni' model, such as imposing a guaranteed minimum effective tax rate on high-income purchasers and/or embracing PABs for infrastructure P3s, would strengthen a Canadian model for 'munis' and promote its acceptance as good fiscal policy. Although it would take cost-benefit analysis beyond the scope this paper, could banks, credit unions and mutual funds develop consumer products for the retail investment market, with the goal of drawing some of the pool of $180 billion in investment-ready savings into tax-exempt municipal debentures?

To ensure good market access and to reduce fiscal-agency fees, smaller municipalities might need to participate in 'pooling' of 'muni' debentures with other municipalities. The Municipal Finance Authority of British Columbia already does this with success for conventional debt, since its debentures are jointly backed by most BC municipalities. In Ontario, Infrastructure Ontario has a program of borrowing on behalf of smaller municipalities and Regional Municipalities issue debentures on behalf of their constituent municipalities.

For pay-as-you-go jurisdictions elsewhere in Canada, where DCs are not a mainstay, 'munis' might lower the cost of long-term infrastructure financing now borne by homeowners, utilities and municipal taxpayers.

By design, the primary beneficiaries of tax-exempt bonds should be municipal property taxpayers, not property developers. Tax-exempt status might be awarded only to bonds issued for new infrastructure (after deducting development-revenue contributions). Another option could be to restrict 'munis' to state-of-good-repair projects that are generally ineligible for development charges or community-benefits levies. This is particularly relevant for older municipalities in Ontario that cannot rely on development charges and interest-earned for "pay as you go" financing of infrastructure budgets (Dr. Almos Tossanyi has coined the phrase "mature municipalities syndrome" to describe this dynamic).

Another way to keep the initial market smaller and subject to careful evaluation would be to restrict Canadian 'munis' to certified "green" purposes that would qualify for ESG designation. Project eligibility might also exclude non-physical capital expenditures, like information technology or land purchases unrelated to physical infrastructure.

> **Attractive 'munis' would give Canadians an opportunity to invest in their home communities and provinces.**

From a federal treasury viewpoint, one 'negative' effect of a Canadian 'muni' initiative would be foregone interest-income taxes on individuals and corporations.[28] However, unlike a program-expenditures regime, a federal treasury tax-expenditure provision would obviate the need for a bureaucratic delivery program and would be less vulnerable to changes in political winds. The Canadian experience with tax expenditures, like the long-lived depletion allowance for oil and gas or the capital cost allowance for landlords, suggests that a municipal debt tax expenditure provision would allow a Canadian market to develop and be more reliable over time than the vagaries of annual program budgeting with periodic changes in government priorities.

Attractive 'munis' would give Canadians an opportunity to invest in their home communities and provinces, while still earning a safe, competitive return for their $180 billion in additional savings, 40% of which is held by so-called high-income Canadians.[29] Municipal bonds offer a combination of 'preservation of capital' and relatively risk-free annual returns.

The case for action

For the federal government, tax measures are frequently used as a mechanism to influence the investment choices of higher-income Canadians, such as favouring dividend-paying Canadian corporations. As noted, 'munis' could be a tax-expenditure provision favouring investment in Canadian infrastructure, without the costly 'friction' of developing a bureaucratic funding program on the edge of federal constitutional jurisdiction.

Although a less-than-progressive tax-exemption structure may seem sub-optimal, the reality is that the potential investment funds are already wealth in the hands of higher-income Canadians. In fact, federal pandemic response policies arguably helped create a pool of undeployed capital. 'Munis' represent a mechanism to deploy some of that money into productivity-enhancing Canadian infrastructure.

While US projections might suggest a diversion of otherwise highly-taxable income into tax-exempt investments, the Canadian reality may be more benign and the net losses smaller in comparison:

- Infrastructure spending yields a net benefit to the federal treasury, so more Canadian infrastructure investment would offset any theoretical tax-base losses. For every $1 billion invested in infrastructure as part of the planned $130 billion Ontario infrastructure investment program, the Canadian Centre for Economic Analysis calculated that $1.7 billion would be paid in Provincial tax revenues and $1.6 billion would be paid in Federal revenues.[30]
- Canadian municipalities generally do not employ very long-term bonds (e.g., 30 years), which allow US 'muni'-related tax 'losses' to accumulate over decades.
- Canadian bonds can only be used for capital purposes, unlike US bonds covering things like underfunded municipal pensions or annual operating deficits. As a result, the potential volume of tax exempt municipally-related debt in Canada would be smaller than in the US experience. Eligibility criteria could further shrink that volume.

While tax-exempt municipal bonds are no 'silver bullet' or panacea to solve inadequate funding and financing of Canadian municipalities and their capital programs, they nonetheless would be a welcomed tool in the toolbox of local governments. In this regard, the federal government should take a close look at the potential sustainable contribution of 'munis' in Canada.

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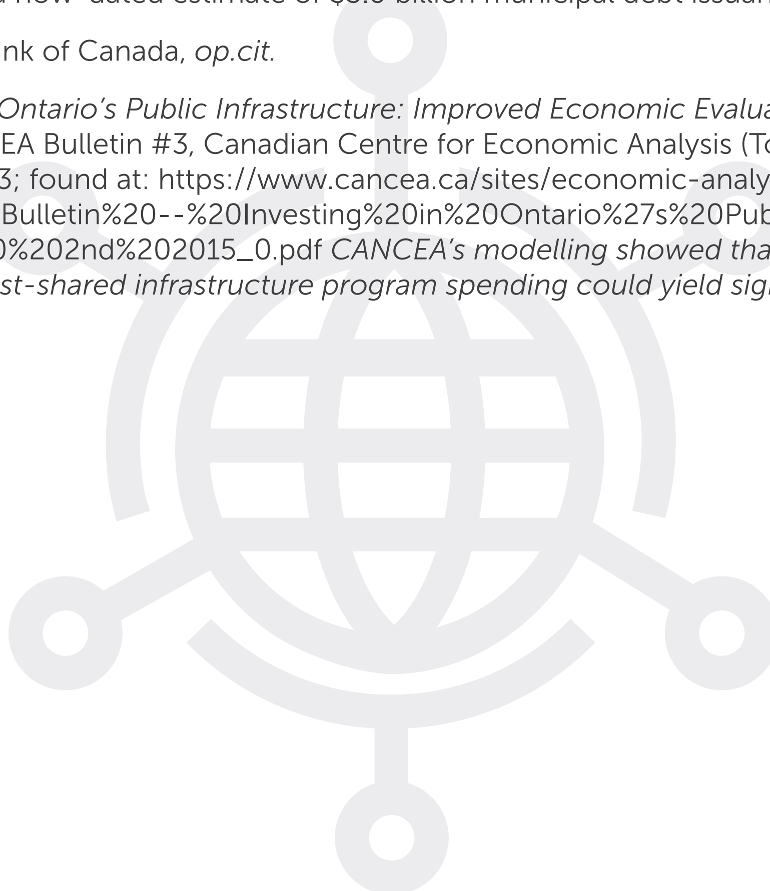

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