

CUT TO INVEST

Exempt Private Activity Bonds (PABs) from the Alternative Minimum Tax (AMT)

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Summary

Private Activity Bonds (PABs) should be exempted from the Alternative Minimum Tax (AMT) to encourage infrastructure investment. By attracting additional financial support from the private sector, this exemption will spur the development of numerous needed infrastructure projects nationwide, particularly at airports, and incur a relatively low cost for the federal government.

Background

Constrained by tight budgets and driven by a growing need to finance infrastructure improvements, metropolitan areas must embrace innovative strategies to position themselves strategically in the global economy. To facilitate the unfettered movement of goods and people, benefit from the use of more sustainable designs and technology, and remain competitive for years to come, they must grapple with ways to overcome long-standing financial barriers and current fiscal realities.

For the most part, public spending accounts for the broad majority of infrastructure investment, with state and local governments shouldering most of this cost. Since the 2008 financial crisis, though, this has been particularly difficult for states and localities to afford. Over the past decade, the federal government has contributed to only about 25 percent of total public spending on transportation and water infrastructure, while overstretched state and local governments have covered most capital expenditures as well as maintenance and operation expenditures.

Given the declining rate of growth in public infrastructure investment, additional channels of funding are essential for municipalities. Increased private sector involvement may offer a viable source of financing in years to come, serving as an attractive alternative for state and local governments that lack the resources to invest in needed infrastructure improvements.

While municipal bonds are geared toward infrastructure projects with a public benefit, Private Activity Bonds (PABs) are directed at those projects that primarily benefit private entities but also serve some public purpose. PABs are issued by state and local governments for projects where more than 10 percent of the proceeds benefit a nongovernmental entity and are directly or indirectly paid back by a private business. In many cases, PABs are not tax-exempt and mainly cover privately-owned and operated facilities. Depending on the specific project, however, there are a range of qualified private activities that can be financed by tax-exempt PABs, including sewage facilities and high-speed intercity rail facilities.

PAB exemptions are especially important to consider for airports. Collectively, there are four main sources of funding for airport capital improvement projects: federal Airport Improvement Program (AIP) grants, Passenger Facility Charge (PFC) revenues, locally generated revenues, and most significantly, airport-issued bonds. These bonds alone typically account for more than half of the funding used for new airport infrastructure, while AIP grants and PFC revenues together account for about 30 percent. Bonds used by airports are generally classified as PABs since facilities are provided for private service carriers—even though state and local government bodies generally oversee these same facilities, which provide an additional public benefit through increased transportation and trade.

The Problem

Federal tax policy, however, has undercut the potential of PABs to pull sorely needed private financing into critical infrastructure projects. The Alternative Minimum Tax (AMT), in particular, has limited their ability to attract potential investors over time. As a tax on individuals and corporations, the AMT is enforced beyond the regular income tax and takes into account the taxpayers' alternative minimum taxable income, which includes interest earned on PABs. PABs are also not necessarily tax-exempt for certain airport facilities and are further burdened by the AMT.

Lacking an AMT exemption, then, PABs hold less appeal for investors in many cases, thereby driving down demand for future investment and hindering the development of new infrastructure. State and local governments, as a result, must pay higher interest rates on PABs—more than 25 basis points on average compared to other tax-exempt bonds—to compensate investors for their tax liability, which in turn leads to higher infrastructure costs.

To address these challenges, the American Recovery and Reinvestment Act (ARRA) included provisions that exempted new PABs from the AMT in 2009 and 2010 and allowed refinancing of PABs issued from 2004 to 2008, which has helped promote increased infrastructure investment. Still, if private investors are continually dissuaded from PABs as a result of the AMT, necessary infrastructure upgrades may be delayed or put off altogether. Without the proper incentives in place, as they appeared under ARRA, project delivery will remain slow, innovation will be stifled, and users will be subjected to rapidly outdated and increasingly inefficient facilities. Ongoing financial and regulatory uncertainty, moreover, will continue to impede the competitiveness of metropolitan areas.

For that reason, legislation has been introduced exempting all PABs, including those for airports, from the AMT.

Proposal

To attract additional private-sector investment in infrastructure and heighten the ability of municipalities to carry out future projects, the Metropolitan Policy Program at Brookings recommends **the exemption of Private Activity Bonds from the Alternative Minimum Tax**. Tax exemptions on PABs will reduce the cost of borrowing for issuers and give them added flexibility to make targeted investments in those projects that promise the greatest impact on the area economy.

Exempting PABs from the AMT would:

- **Help boost private-sector investment in infrastructure**, spurring the development of projects throughout the nation
- **Lower existing costs of PABs** for state and local governments faced with declining revenues and restricted by tight budgets

- **Facilitate investment in infrastructure projects with a clear public benefit**, including capital improvement projects at airports that connect metropolitan areas and foster trade
- **Build on the success of the previous exemption under ARRA**, providing greater financial clarity and regulatory certainty for investors in the long term

In this way, by promoting favorable regulation on bonds, the federal government can encourage private- and public-sector infrastructure investment and streamline the delivery of necessary infrastructure projects.

Budget Implications

Based on estimates from the Joint Committee on Taxation, eliminating the AMT on all PABs (including airports) would cost the government about \$49 million annually from 2012 to 2017. At the same time, the exemption would generate billions of dollars in additional economic activity and lead to cost savings of almost \$748 million for airports alone over the next ten years. Policymakers should be encouraged by these factors when considering a possible AMT exemption.

PABs play a large role in financing infrastructure projects across the country. Although many PABs are subject to a statewide volume cap (which creates a ceiling on the aggregate amount of qualified tax-exempt PABs that can be used in states each year), they help promote several short-term and long-term projects annually, ranging from highways to freight transfer facilities. Roughly \$15 billion of qualified tax-exempt PABs have been issued annually in each of the past two years, with a notable increase following the AMT exemption in 2009. For example, the number of qualified tax-exempt PABs issued in 2010 marked the first increase in over three years. In contrast, when the exemption expired in 2011, the number of qualified tax-exempt PABs issued saw a marked decline (13 percent) across these projects nationwide.

Since 2000, airports have invested an average of \$12 billion annually in capital improvements, with about half coming from all airport-issued bonds. On average, roughly \$3.5 billion to \$4 billion per year for improvements has come from PABs over the past decade. Following the enactment of the ARRA provisions, airports took advantage of tax-exempt PABs, selling \$5.4 billion in these bonds by December 2009. In total, nearly \$12.7 billion in PABs were sold by airports from 2009 through 2010, allowing them to pursue several projects during this time while saving more than \$1.8 billion in financing costs. Reflecting national patterns, though, airport issuances fell to \$4.3 billion in 2011, the lowest amount since 2007.

State of Play

Extending the AMT exemption has gained support from various members of Congress. Senator John Kerry (D-MA) and Representative Richard Neal (D-MA), in particular, have assumed a lead role in this effort. Neal and Representative Jim Gerlach (R-PA), who serves as a member of the House Ways and Means Committee, recently introduced related legislation.

The most obvious cost of any federal tax incentive comes from the diminished revenue collected by the federal government. From 2008 to 2012 alone, it is estimated that the government lost more than \$132 billion in tax revenue, or an average of \$26 billion annually, from tax-exempt bonds issued to finance infrastructure. Despite encouraging additional borrowing and infrastructure investment, the AMT exemption on PABs would similarly add to this deficit, which (if persistent) can lead to higher interest rates in the long run. In addition, since tax-exempt interest is more valuable to higher-income taxpayers, they may realize higher benefits from the AMT exemption and profit from a less progressive income tax

regime. The exemption's link to ARRA may also draw criticism, while the AMT itself may experience significant changes after the presidential election.

While some may emphasize the cost of an AMT exemption for PABs, the return on such an exemption far outweighs the expenditure. By making PABs more attractive to private investors, an AMT exemption can promote private and public sector involvement, which helps draw from a larger pool of investors and spread the financial risk involved in projects. This increased investment can consequently drive the construction of new infrastructure, improve public safety, fuel economic output, and create numerous jobs in the short and long term—all of which have stood as clear benefits in different proposals.

Implementation Requirements

Exempting PABs from the AMT would require legislative action, possibly as part of a major tax reform bill in 2013.

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