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Memorandum

To: Randy Wade
From: Keith D. Curry
Re: Review of July, 2004 CBO Report on Tax Credit Bonds

You have asked us to review and comment on the July, 2004 paper issued by the Congressional Budget Office (CBO), *Tax Credit Bonds and the Federal Cost of Financing Public Expenditures*.

The purpose of this paper would appear to be the documentation of cost impacts to the federal treasury related to various tax advantaged funding alternatives, including the issuance of tax credit bonds for transportation infrastructure.

The paper makes the following points:

First, that tax credit bonds are inherently more expensive to the federal treasury compared to appropriations or standard federally issued bonds. This is really a restatement of prior comments by the US Department of the Treasury. The assumption of higher cost is based on three factors; illiquidity, uncertainty about the continuation of the tax credits and risk of return of principal. I would note that illiquidity is a result of their being few of these types of bonds issued, and as to repayment risk, a structure requiring defeasance at issuance would provide AAA rated protection equal to the credit quality of the federal government. This leaves only the potential that Congress would repeal the tax credit during the life of the bonds as a risk. This of course is in the complete control of the federal government.

As for appropriations, the paper ignores the leveraging effect that projects would receive 100 percent funding up front, while the tax credit would be amortized in 1/20ths over the life of the tax credit bonds.

A second point relates to traditional tax exempt debt. The author points out that the federal "subsidy" for tax exempt debt is 21%-35% depending on the tax bracket of the bondholders, and based on a value of the exemption vs. taxable debt. He notes that with tax credit bonds, the federal subsidy is 100 cents on the dollar. This is correct but it fails to recognize that traditional bonds require a repayment revenue source for the life of the bonds and tax credit bonds do not.



The third point, and conclusion of the paper, is that if state and local entities issued taxable bonds, and the federal government appropriated a subsidy in the form of a tax credit that would go to the bondholder in order to take the place of the traditional tax exemption benefit, that option would be cheaper to the federal government than either traditional tax exempt debt or tax credit bonds.

Of course, the amount of bonds that could be issued under this scheme would be limited nationally by the amount of federal appropriation. Investor appetite for bonds that place 30% of the annual return at the whim of congressional appropriators each year remains to be tested.

The bonds must still be repaid by the state or local issuer, and the use of taxable bonds with this tax credit subsidy provides state issuers with no more funding capability than they have now with tax exempt bonds. In fact, they give up substantial flexibility since bond issuance would be restricted to an available allocation of these credits from Congress.

In summary, this is a theoretical look at “costs” of financing that is devoid of real world application. The prescription of removing tax exempt issuing authority from state governments and replacing it with an annual appropriated tax credit “subsidy” is unworkable from many perspectives. This document contains no solutions that would be helpful to the development of high speed rail systems in the US.

I hope this information is helpful; should you have any questions, please do not hesitate to contact me.

Best wishes.