

BACKGROUND

Municipalities in Canada are restricted to only a few sources of revenue. These include property taxes, service fees, operating grants from their respective provincial governments and grants from both the provincial and federal governments for infrastructure projects and special initiative programs. Of all these sources municipalities only have control over property taxes and service fees. These two sources can be adjusted to address the operational needs of a municipality to an extent. What these two sources do not have the capacity to address is the growing infrastructure deficit that is plaguing many municipalities. The grant funding provided by provincial and federal governments provides some assistance in addressing the priority projects. However, it is not enough to put a significant dent in this growing problem.

As municipalities tackle the infrastructure problem, they are exploring alternate ways to generate the needed funding to invest in capital projects. A suggested revenue source that may be viable is the issuance of municipal bonds.

What is a bond?

When a corporation or government wishes to borrow money from the public on a long-term debt basis, it usually does so by issuing and selling debt securities – notes, debentures, and bonds. Bonds are securities and can be readily bought and sold either over the counter or on a major stock exchange. The prices of bonds are established in the marketplace by negotiations between buyers and sellers. Bond prices are expressed on an index with a base of 100. A bond trading at 100 is trading at face value (or par), whereas a bond trading at 97 is trading at a discount (or below par). Similarly, a bond trading at 102 is trading at a premium (or above par).

A bond is secured debt; however the term bond is often used generically to refer to both secured and unsecured debt. It is normally an interest-only loan where the borrower pays the interest every period (usually semi-annually), but none of the principal is repaid until the end of the loan.

Why would a municipality want to issue bonds?

Municipalities are looking for alternate ways to fund capital projects in their communities. Bonds appear to be a desirable option as they can attract investment from other sources than local taxpayers.

In the United States bonds are proving to be a viable source for municipalities to assist in meeting various demands on both their operational and infrastructure challenges. Most recently they have garnered a lot of attention as part of the Government of the United States stimulus package to address the current recession. Labeled as Build America Bonds, these municipal bonds carry several tax incentives and federal subsidies that are attractive to investors. In many cases these bonds are being purchased by large institutions such as the Bank of Montreal Capital Markets. Several municipalities have taken advantage of this program, for instance the City of Phoenix's Civic Improvement Corporation sold approximately \$550 million of tax-exempt revenue bonds to refinance water-system debt and fund local improvements.

What is the Municipal Bond history in Canada?

There has been relatively little interest within the municipal sector in Canada to issue bonds. This is specifically true for bonds that would fund operational components of a municipality. This lack of interest can be attributed to the fact that many municipalities are adverse to debt and in many situations are legislated not to operate in a deficit position. Therefore, any bonds that have ever been issued are usually for capital investments. In addition, many municipal bonds are issued by Municipal Finance Authorities and are usually fully guaranteed by the province and consequently considered provincial rather than municipal bonds.

There also exists that lack on incentives. In contrast to the American situation where municipal bonds are immune to certain income taxes, Canadian municipality's interest is taxed as straight income. However, this situation may change. In January 2009, Senator Jerry Grafstein introduced a private members bill in the Senate that would allow tax free municipal bonds. Senator Grafstein proposes that the Business Development Bank of Canada would be tasked with handling the sale of the bonds for municipal projects that generate a revenue stream. This bill has received first reading in both the Senate and House of Commons; it is currently being discussed at the Senate committee for Banking, Trade and Commerce.

What are the impacts to a municipality that issues bonds?

Benefits:

- Provide just in time financing for immediate construction.
- They are equitable on an inter-generational level, and they provide potential cost savings on repayment (because of discount rates, repayment can be less expensive than payment upfront if the economy is expanding or per capita income is increasing).
- Local ownership in community development can be encouraged through a bond issue.
- Possibility of getting money at a lower borrowing cost than the existing debenture market.

Negatives:

- Bonds can be an expensive option: not only do governments have to pay the private investors the present value of the bond principal; they also have to compensate the private sector for the risks it assumes.
- Costs associated with implementing an over the counter sale program can be much higher than simply accessing funding through other portfolios.
- Long term costs associated with staff resources to administer the program.
- Potentially lengthy learning curve in educating investors about the terms, conditions and pricing behavior.
- Any unsold bonds would have to be acquired by the municipality. Depending on the amount unsold, the amount and time of purchase may not fit within the investment strategy of the municipality.
- The debt financing terms may not meet the preferred investment term. That is municipalities typically fund capital projects with a ten year or more term, investors are often looking for returns within five years.

Can all municipalities issue bonds?

Legislation permits municipalities to issue bonds. However, the same criteria for accessing loans must be met before a municipality is approved by the Municipal Board to issue a bond. In addition, the municipality must also have a credit rating in order to issue the bond. Small municipalities that are not rated or do not have good bond ratings may not be able to issue

bonds; therefore, implementation potential in small communities without good bond ratings is restricted unless the province has a centralized agency. For example, the Municipal Finance Authority of British Columbia is a centralized agency that can borrow on the capital market at lower interest rates and lend the funds to municipalities. Another example is the Ontario Municipal Economic Infrastructure Financing Authority, which issues tax-exempt Ontario Opportunity Bonds to support local infrastructure. The interest that investors earn from Ontario Opportunity Bonds is exempt from provincial income tax.

Are bonds a viable source of revenue for infrastructure projects?

Municipalities are looking for any source of revenue that will assist in addressing their infrastructure priorities. The issuing of bonds is a matter that is solely up to the investment strategy of each municipal council. At a glance a bond issuance seems like an excellent idea as it has the potential to bring in significant outside investment and can also provide local residents with an opportunity to invest in their community. However, as most municipalities are fairly limited in their borrowing capacity, the ability to issue bonds to generate additional funding would be difficult. In many situations municipalities that do have the capacity to borrow tend to have high credit ratings due to the strict regime imposed on municipal borrowing. More than often these municipalities can access more funding from sources at interest rates that are far superior to what a bond would be able to produce. The amount of time, effort and risk in offering a bond must also be considered. Many municipalities in Saskatchewan are already stretched on the administration side, to add the task of organizing a bond issuance might just be too much. In 2002 the City of Saskatoon reviewed the option of issuance municipal bonds. At that time their administration recommended that council not pursue this option as it was just not feasible.

Information for this discussion paper was collected from the following sources:

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