



# Municipal Bonds in Arkansas

Municipal bonds (sometime called munis) are certificates of debt used to finance large projects, similar to home mortgages in the private sector. Municipal bonds may be issued by states, cities, counties or other government entities. There are two primary classifications of municipal bonds used for financing development efforts in Arkansas:

- (1) **General Obligation (GO) Bonds** are backed by the full faith and credit of the issuing entity.
- (2) **Revenue Bonds** are backed by a dedicated revenue stream, which may include sales tax revenues or other revenue sources.

General obligation and revenue bonds are described in more detail later in this publication.

Within these two classifications, munis are further categorized as “governmental” or “private activity” bonds. Governmental bonds are used to finance public projects such as roads, schools and sewer systems. Private activity bonds are municipal bonds used to finance projects outside the realm of pure governmental functions. For example, private activity bonds might be used to finance local sports facilities, bond refinancing, privately-led housing developments and under-funded legal obligations of state and municipal governments.

It is important to note that the distinguishing factor between general obligation bonds and revenue bonds is the source of revenue used to repay the bonds. The distinguishing factor between governmental bonds and private activity bonds is how the revenue generated by the bonds is to be used.

## Why issue bonds?

Municipal bonds work in much the same way as consumer mortgages. They provide a means of financing large expenditures over a period of time. When faced with a large capital project, such as building a road or making facility improvements, a government entity may not have sufficient cash to pay for the entire project at one time. Instead, the government entity will issue (sell) bonds. The proceeds from the bonds are used to fund the project, and the bond issuer will repay the bonds, with interest, over time. Typically, the benefits derived from the project begin immediately and are expected to continue for the life of the bond issue or beyond.

## Costs of issuing municipal bonds

Similar to a home mortgage, there are debt service costs of bonds which include payment of principal, interest and administrative fees.

- Principal payments are used to pay off the dollar amount borrowed.
- Interest is the amount paid to the bond purchaser for the use of their money. The interest rate will vary depending on market conditions.
- Administrative fees include expenses related to issuing the bonds, such as investment firm fees, fees for financial advisors and other transaction costs. These are similar to costs incurred when taking out a mortgage, such as loan origination, title insurance and other closing costs.

## Why purchase bonds?

Investors purchase municipal bonds to receive a relatively low-risk stream of income over a period of time. In return for purchasing a bond, the bond holder (investor) receives interest payments plus the original investment. These payments are repaid on a schedule determined when the bond is issued.

Another reason investors purchase municipal bonds is the tax treatment of the investment. Because there are public benefits associated with the use of bond revenue, the interest received by investors on municipal bonds often receives preferential tax treatment. However, all municipal bonds are not subject to the same tax rules. Examples of different tax treatments include:

- Exempt from local, state and federal income taxes.
- Exempt from taxes only if the purchasers are residents of the state where the bonds are issued.
- Exempt from state and local taxation, but fully taxable at the federal level.
- Exempt from regular federal income tax, but not the alternative minimum tax.

Federally taxable municipal bonds reflect the federal government's reluctance to subsidize financial support of local and state projects that do not meet the test of broad-based general public benefit. Federally taxable bonds may also be issued to partially finance public projects that are too large for tax exemption. Most Arkansas municipal bonds are exempt from Arkansas income tax. However, if the owner lives in another state, bond interest will probably be taxable under that state's income tax law.

## Arkansas' constitutional provisions

In Arkansas, units of government do not have uncontrolled authority to enter into public debt. Amendment 20 of the Arkansas Constitution says the state may issue new bonds only if approved by a majority vote in the general or special election. Sometimes voter approval is achieved through specific requests for a particular project, such as a county referendum to approve the issuance of bonds for courthouse improvements. In other instances, voters are asked to grant authority to a government entity to issue bonds at its discretion provided certain requirements are met. For example, Arkansas voters approved Amendment 82 in 2004, authorizing the state to issue general obligation bonds for economic development projects meeting certain criteria.

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## General Obligation Bonds (GO Bonds)

General obligation bonds are legally backed by "full faith and credit" of the issuing government. This means that the interest, principal and administrative costs associated with the bond will be paid using any revenue source available to the issuing entity. General obligation bonds reflect a preemptive allocation of funds, meaning that debt service associated with the bonds must be paid before all other expenses. Because of the full faith and credit backing, general obligation bonds are considered low risk to investors and generally command lower interest rates than other types of bonds.

General obligation bonds allow units of government to finance projects at lower interest rates than most other credit sources. These bonds are used to finance large capital improvement projects which are costly and difficult to fund through a governmental entity's annual budget. Examples of projects that might be financed through the issuance of general obligation bonds include:

- roads and highways;
- facility improvement;
- infrastructure, such as water, sewer and drainage; and
- land purchases.

## Revenue bonds

Revenue bonds are secured by revenues resulting from the project or improvement for which they are issued. For example, a city may issue revenue bonds to support the construction of a new water and sewer system. The revenue collected from residential and business customers of the water and sewer system is used to make interest and principal payments to the bondholders.

Revenue bonds are generally higher risk than general obligation bonds because revenues used to fund the bond repayment could fall short of predicted or expected levels. If revenues are not high enough to pay bondholders, payments to bondholders could be deferred or in the worst case not made at all. Due to this higher risk, revenue bonds may have higher interest rates than general obligation bonds. Examples of projects that might be financed through revenue bonds include:

- sports arenas;
- industrial development sites;
- rural water systems; and
- turnpikes.

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PIEC003-15M-11-05N