

# FINANCING CRITICAL INFRASTRUCTURE WITH PRIVATE ACTIVITY BONDS (PABs)

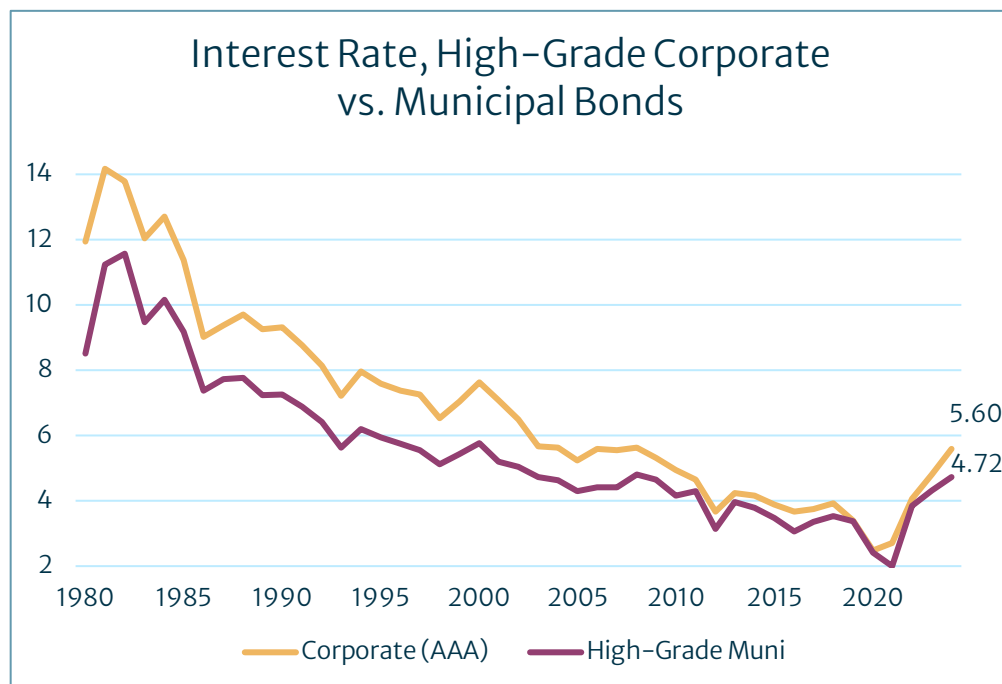
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## A Preferential Tax Treatment

One of the unique features of American public finance is the federal tax exemption for publicly issued municipal bonds. Since the federal income tax was established in 1913, the federal government has exempted interest income earned on bonds issued by state and local governments from income taxes.

Because investors can earn interest on these bonds tax-free, they are willing to accept a lower interest rate. For example, an investor in the top 37% income tax bracket would receive the same yield from a taxable bond paying 10% interest and a tax-exempt municipal bond paying 6.3% interest.

This preference allows state and local governments to issue debt at a cheaper rate than can private enterprises or even the federal government. Indeed, the average municipal bond commands an interest rate of 4.7% compared to 5.6% for high-grade corporate bonds with a similar risk profile.



## **Bonds to Address Bias**

This tax preference allows governments to finance infrastructure projects relatively inexpensively but also creates a bias towards government financing of infrastructure relative to private delivery.

Recognizing this bias, Congress created qualified Private Activity Bonds (PABs). When used to finance certain activities as stipulated by Congress (“qualified” activities), PABs allow private entities to issue bonds on a tax-exempt basis and therefore at a rate competitive to publicly issued municipal bonds. This enables privately financed public-use infrastructure projects to command a similar cost of capital to those delivered by governments and make them more competitive on a value-for-money basis.

Technically, applicable governments issue PABs on behalf of the private borrower in a process known as conduit financing. However, importantly, the issuing government generally has no financial obligation to support the repayment of the bonds, which are the responsibility of the private entity building the project.

## **Limitations on PAB Usage**

PABs are subject to several statutory limitations and requirements. First, the tax exemption only applies to qualified activities specified by Congress (other private activities must issue taxable bonds). Second, certain categories of PABs are subject to a volume cap that limits the amount that can be issued annually in each state (set on a per-capita basis). Third, to make matters more complicated, Congress imposed a separate lifetime volume cap on PABs issued for all highway and freight projects.

The PAB cap was originally set at \$15 billion and raised to \$30 billion in 2021. The U.S. Department of Transportation (USDOT) allocates the limited amount of highway and freight PABs (which also incorporate other transportation projects due to their nexus to highways) to projects. USDOT has since allocated all \$30 billion to existing projects.

Lastly, the issuing government must receive approval from its top elected official and hold a public hearing before issuing PABs.

No such limitations exist for publicly issued municipal bonds, creating an unfair disparity between public and private infrastructure financing.

Type of Private Activity Bonds	Subject to Volume Cap?
Private activity bonds financing exempt facilities (Section 142):	
■ airports	No
■ docks and wharves	No
■ mass commuting facilities	Yes
■ facilities for the furnishing of water	Yes
■ sewage facilities	Yes
■ governmentally owned solid waste disposal facilities	No
■ privately owned solid waste disposal facilities	Yes
■ qualified residential rental projects	Yes
■ facilities for the local furnishing of electric energy or gas	Yes
■ local district heating or cooling facilities	Yes
■ qualified hazardous waste facilities	Yes
■ governmentally owned high-speed intercity rail facilities	No
■ privately owned high-speed intercity rail facilities	Yes <sup>1</sup>
■ environmental enhancements of hydro-electric generating facilities	No
■ qualified public educational facilities	No
■ qualified green building and sustainable design projects	No
■ qualified highway or surface freight transfer facilities	No
■ qualified enterprise zone facilities	Yes
■ new empowerment zone facilities	No
Qualified mortgage bonds (Section 143)	Yes <sup>2</sup>
Qualified small issue bonds (Section 144(a))	Yes
Qualified student loan bonds (Section 144(b))	Yes
Qualified redevelopment bonds (Section 144(c))	Yes
Qualified veterans' mortgage revenue bonds	No
Qualified 501(c)(3) bonds	No
Current refunding bonds <sup>3</sup> that do not exceed the outstanding amount of the refunded bonds	No <sup>4</sup>
Current refunding bonds in excess of the outstanding amount of the refunded bonds	Yes

<sup>1</sup>Volume cap required for only 25% of the bonds.

<sup>2</sup>The amount of volume cap allocated to an issuer is reduced when it establishes a mortgage credit certificate program under IRC Section 25.

<sup>3</sup>See the subsection below, Requirements That Apply at Issuance and Throughout the Life of the Bonds - Limitations on Refunding Private Activity Bonds for a definition of "current refunding."

<sup>4</sup>Maturity limitations apply for refundings of qualified mortgage revenue bonds and qualified student loan bonds.

## Additional PAB Financing Need

PABs have supported hundreds of billions in investments in critical infrastructure projects, including the 47 major transportation projects listed in the appendix.

Given that USDOT has allocated all available transportation PABs, Congressional action is necessary for this important source of financing to be available for future private investment in infrastructure projects beyond those already authorized.

There is a significant pipeline of highway projects that would qualify for and benefit from PABs. These include improvements to I-285 in Georgia, I-24 in Tennessee, I-77 in North Carolina, and I-495 in Virginia.

## The Deficit Impact of Increasing PABs

The “cost” – in other words, the impact on the deficit – to Congress associated with increasing the transportation PAB cap is not the increase of the cap itself; it is the income tax revenue associated with the issuance of such new bonds that is assumed to be foregone. For that reason, the “cost” as scored by the Joint Committee on Taxation is significantly lower than the magnitude of the cap itself, roughly only \$30 million in foregone revenues for each \$1 billion increase in the transportation PAB cap (3%).

It is also arguable that the assumptions underlying this scoring methodology are inaccurate because they assume the debt financing the projects would otherwise have been issued as taxable bonds, whereas the projects more likely would be delivered via tax-exempt municipal bonds and therefore result in no revenues for the federal government. Furthermore, the private entities delivering the project also pay corporate taxes, further mitigating the revenue impact.

## Unlocking Private Investment for Public Good

Short of wholesale reform to the municipal bond tax exemption, Congress can unlock billions in private infrastructure investments by increasing or eliminating the cap for transportation PABs. This would be a low-cost and effective way to increase investment and innovation in infrastructure in the next surface transportation authorization.

## Appendix: Private Activity Bond Allocations for Transportation Projects

State	Project	Amount Allocated	Amount Issued
VA	Capital Beltway HOT Lanes		\$589,000,000
TX	North Tarrant Expressway		\$400,000,000
TX	IH 635 (LBJ Freeway)		\$615,000,000
CO	Denver RTD Eagle		\$397,835,000
IL	CenterPoint Intermodal Center, Joliet		\$150,000,000
IL	CenterPoint Intermodal Center, Joliet		\$75,000,000
VA	Downtown Tunnel/Midtown Tunnel, Norfolk		\$675,004,000
VA	I-95 HOV/HOT Lanes		\$241,950,000
IN	East End Crossing, Ohio River Bridges		\$676,805,000
TX	North Tarrant Expressway 3A and 3B		\$274,030,000
NY	Goethals Bridge Replacement		\$460,915,000
CO	U.S.36 Managed Lanes/BRT Phase 2		\$20,360,000
IN	I-69 Section 5		\$243,845,000
PA	Rapid Bridge Replacement Program		\$721,485,000
OH	Portsmouth Bypass		\$227,355,000
NC	I-77 Managed Lanes		\$100,000,000
IL	CenterPoint Intermodal Center, Joliet		\$100,000,000
TX	SH-288 Toll Lanes		\$272,635,000
IL	CenterPoint Intermodal Center, Joliet		\$130,000,000
MD	Purple Line Light Rail		\$313,035,000
VA	I-395 Express Lanes		\$232,995,000
VA	Transform 66		\$737,000,000
FL	AAF-Brightline Phase 1		\$600,000,000
CO	Central 70		\$114,660,000
MI	I-75 Modernization Segment 3		\$610,300,000
FL	AAF-Brightline Phase 2		\$1,150,000,000
FL	AAF-Brightline Phase 2		\$950,000,000
VA	Fredericksburg Express Lanes Extension		\$262,000,000
TX	North Tarrant Expressway 3C		\$653,865,000
OK	Gilcrease Expressway West Turnpike		\$125,000,000
IL	CenterPoint Intermodal Center, Joliet		\$150,000,000
NV/CA	Brightline West Passenger Rail		\$1,000,000,000
NY	NY State Thruway System Service Areas		\$269,455,000
ND	Fargo – Moorhead Flood Diversion		\$273,395,000
VA	I-495 Express Lanes Extension (Project NEXT)		\$112,105,000
MD	Purple Line Light Rail Transit		\$643,455,000
DC	Washington DC Smart Street Lighting		\$144,485,000
FL	Brightline Florida Passenger Rail Expansion		\$485,000,000
PA	Major Bridge P3 Initiative – Package 1		\$1,759,135,000
TX	North Tarrant Expressway 1&2 Ultimate Capacity		\$397,315,000
LA	I-10 Calcasieu River Bridge		\$1,322,990,000
NV/CA	Brightline West Passenger Rail		\$1,500,000,000
PR	Puerto Rico Toll Roads Monetization		\$286,235,000
GA	SR 400 Express Lanes		\$3,438,000,000
NV/CA	Brightline West Passenger Rail (additional)	\$3,000,000,000	
TN	I-24 Southeast Choice Lanes	\$2,000,000,000	
GA	I-285 Express Lanes Project Phase 1	\$1,100,000,000	
<b>Subtotals:</b>		<b>\$6,100,000,000</b>	<b>\$23,900,000,000</b>
<b>Total Issued &amp; Allocated:</b>		<b>\$30,000,000,000</b>	