CUT TO INVEST

Revive Build America Bonds (BABs) to Support State and Local Investments

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Summary

The Build America Bonds (BABs) program, which expired in 2010, should be reinstated to encourage budget-constrained state and local governments to invest in economically critical infrastructure projects. While authorized at a lower subsidy rate than the original program, a permanent BABs program would provide flexible, low-cost financing for a broad range of infrastructure projects that will create jobs and foster economic growth for years to come.

Background

Congress created the Build America Bonds program in response to the Great Recession's dramatic effect on state, local, and other public entities' ability to issue debt. According to the U.S. Treasury Department, this credit crunch eventually led to a 68 percent drop in monthly municipal bond issuances and a doubling of borrowing costs. Established through the American Recovery and Reinvestment Act (ARRA, a.k.a. the "stimulus" bill) of 2009, the two-year program authorized state and local governments to issue special taxable bonds that received either a 35 percent direct federal subsidy to the borrower (Direct Payment BABs) or a federal tax credit worth 35 percent of the interest owed to the investors (Tax Credit BABs).

By harnessing the efficiencies of the taxable debt market, the U.S. Treasury found that this unique structure decreased average borrowing costs for states and localities by 84 basis points as compared to standard municipal bonds, saving borrowers an estimated $20 billion. The taxable nature of the bonds provided incentive for a much broader group of investors to participate in the program, including pension funds and institutional investors. In this fashion, the program expanded the traditional infrastructure investment base beyond the $2.8 trillion market for tax-exempt municipal bonds and made BABs appealing investment alternatives in the $30 trillion taxable bond market.

BABs proved wildly popular. From 2009 through the program's expiration in 2010, BABs financed one-third of all new state and local long-term debt issuances. In total, the Joint Committee on Taxation (JCT) identified more than 2,275 separate bonds that were issued to finance $182 billion in new infrastructure investment, with participation from all 50 states, Washington, D.C., and two territories.

Importantly, and unlike other infrastructure programs and proposals, BABs were not divided equally among states; they were instead distributed based on the level of demand and interest in new projects. An examination of data from the U.S. Treasury shows that nearly half of all funding for BABs issuances

(47.6 percent) were for projects in the 100 largest metropolitan areas. Eight percent were in metros outside of the 100 largest metros, and five percent were outside metropolitan America completely. States issued the remaining 40 percent.

Not surprisingly, the states with the largest economies had the largest dollar amount of issuances. Half of the BABs issuances by dollar value went to projects in California, Illinois, New York, and Texas. However, as a percentage of gross state product, the four largest issuers were Kansas, Kentucky, South Dakota, and Wisconsin. Thus even states with smaller traditional tax-exempt debt markets strongly preferred BABs because of their inherent market and yield advantages.

The greatest share of BABs funding (30 percent) went toward educational facilities, with water/sewer projects (13.8 percent), road/bridge projects (13.7 percent), and transit projects (8.7 percent) following behind.

Despite initial skepticism, the BABs program successfully spurred investment in job-intensive and economically critical infrastructure projects across the country, while also stabilizing the municipal bond market. Importantly, it proved that bond issuers and investors were extremely receptive to the tax-credit and subsidy model, which research by Lily Batchelder has shown to be more economically efficient and cost effective than tax-exempt financing techniques. Concerns about high origination costs for these unique structures also proved to be a minor issue, as the U.S. Treasury found that prices fell drastically over the life of the program.

Recently, congressional budget sequestration put a damper on the market as across-the-board spending cuts reduced the federal BABs subsidy by 8.7 percent. Smaller localities, in particular, now face pressure to call in their BABs for a full redemption to cut costs and to take advantage of historically low interest rates in the municipal bond market. Some large BABs have been called in as well, including a nearly $500 million refinancing in Columbus, Ohio.

However, long maturities, large issuances, and contractual provisions against par-value calls are likely to limit the number of BABs redemptions. Even in the face of these challenges, BABs still outperform both Treasury bonds and tax-exempt municipal bonds in U.S. markets.

The Problem

America's aging infrastructure faces unprecedented pressures from a growing population, new economic demands, and an increasingly unpredictable natural environment. These challenges are compounded by decades of systemic underinvestment in critical transportation, water, and power assets that have left the United States trailing its global competitors. To make matters worse, the Congressional Budget Office (CBO) projects that traditional federal funding streams, such as the Highway Trust Fund, are facing an uncertain future as dedicated revenue streams continue to fall short of the nation's investment needs.

While federally-supported grant programs, budget allocations to state and local governments for capital spending, and credit assistance programs remain important tools for infrastructure development, they are playing a diminished role as Washington remains mired in debt and dysfunction. The fiscal crunch at the federal level places new pressure on states and localities to use tax-exempt municipal debt financing to get essential projects done.

Tax-exempt bonding allows states and local governments, as well as a limited number of private entities, to issue a special class of bonds that are attractive investments for individuals and organizations looking to reduce their tax liabilities. A 2009 CBO/JCT report shows that from 1991 to 2007, nearly $1.7 trillion of tax-preferred debt was issued to finance new infrastructure projects in both the public and private sectors.

However, tax-exempt municipal bonds are an inefficient way for the federal government to subsidize infrastructure. According to the CBO/JCT report, the federal government forgoes nearly $26 billion in lost revenue from tax-exempt municipal bonds every year, which significantly exceeds the value of the interest rate deduction passed on to states and localities. An estimated 20 percent of the value of the tax subsidy is passed on directly to bondholders, primarily those in higher tax brackets. Furthermore, this approach buries the cost of American infrastructure investment deep in the tax code, which clouds the true cost of the subsidy. It also creates irregular market incentives in that the value of existing tax-free debt rises when taxes rise and falls when taxes are cut. These windfall gains and losses affect existing holders of debt as well as potential new issuers.

Despite these inefficiencies, municipal bonds have served states and localities well for decades, and the municipal bond market is undergoing a measured recovery in the wake of the 2008 recession. Historically low interest rates have pushed the market forward, with a 67 percent jump in transportation infrastructure issuances in 2012 alone, the majority of which were completely new offerings. However, low-credit ratings, debt caps, and limited options for credit enhancements continue to burden many states and localities since many private sector bond insurers left the field after the financial crisis. Concerns over default, spurred by Detroit's financial woes, are increasing scrutiny around municipal debt offerings around the country. However, research by J.P. Morgan and other analysts shows that Detroit's problems are likely unique.

Additionally, the market may face new challenges as the Federal Reserve executes its plan to slowly raise the yield on Treasuries, thereby decreasing the attractiveness of municipal bonds as an investment. Pressure on the federal government to become leaner and more efficient, along with financial challenges at the local level, are driving leaders at all levels of government to seek out new tools for infrastructure finance.

Proposal

To encourage needed investment in U.S. infrastructure, the Metropolitan Policy Program at Brookings recommends **the reinstatement of a permanent Build America Bonds program** at a 28 percent subsidy rate, similar to the proposed America Fast Forward Bonds program in President Obama's FY2014 budget and in contrast to the previous 35 percent rate under ARRA. Further, a renewed BABs program should include a guaranteed subsidy payment to insulate the bonds from federal budget cuts.

Reinstating the BABs program would:

- **Enhance the efficiency of infrastructure investment** by matching the cost of the federal program to the interest rate savings at the state and local level

- **Expand the market for municipal issuers** by attracting investors that are not usually able to take advantage of the tax exemption offered through standard municipal bond investments

- **Reduce borrowing costs for struggling state and local governments**, thereby supporting and fast-tracking investments in critically needed infrastructure projects

- **Increase transparency in infrastructure financing** by moving investments into the appropriations process, rather than obscuring their cost through tax exemptions

A permanent BABs program would foster long-term investments in economically critical infrastructure projects for years to come.

Budget Implications

Relative to the cost savings for borrowers, the costs of administering a BABs program are quite low for the federal government. Initial government estimates suggest that the annual cost of subsidizing the program under ARRA was approximately $340 million. Since the bonds were taxable, the government also expected to recoup some of these costs through the additional tax revenue produced. More recent estimates from the Joint Committee on Taxation put the annual net cost of a new BABs program at under $100 million.

However, critics argue that these costs would be higher because BABs have been previously owned by tax-advantaged investors, such as pension funds. According to the U.S. Treasury, for every dollar of BABs subsidy, the government would only receive 31 cents in tax revenue. In addition, the underwriting costs for BABs were initially higher than those for tax-exempt bonds due to their novelty as well as added risk and uncertainty upon their introduction. Those costs decreased markedly over the lifetime of the program and by the end were on par with traditional munis.

Based on an analysis from the U.S. Treasury, lowering the tax subsidy from 35 to 28 percent would make the program revenue-neutral "relative to the estimated future federal tax expenditure for tax-exempt bonds." States and municipalities do not need the same aggressive subsidy they did after the 2008 financial crisis, when borrowing costs spiked and the monthly issuance of bonds dropped by nearly one-third. It is important to note, however, that a significant drop in maturities would probably accompany the lower subsidy rate. At the same time, the true costs of the program to the federal government cannot be known with complete precision, given that the uptake of the bonds may vary significantly depending on prevailing market conditions.

State of Play

Many localities, states, and potential investors support the establishment of a permanent BABs program, as does the Obama administration, which called for a renewal of the BABs program at a reduced subsidy rate in its FY2014 budget request. With average savings of 84 basis points as compared to tax-exempt bonds, BABs have greatly reduced borrowing costs for municipalities and fueled an increase in long-term infrastructure investment. In 2010 alone, $117 billion of BABs were issued with an average issuance-weighted maturity of 24 years.

Nonetheless, the BABs program is not without its detractors. Many key Republican leaders, including Senators Orrin Hatch (R-UT) and Charles Grassley (R-IA), oppose the extension, arguing that BABs represented a "disguised state bailout." Opponents further contend that extending the program would provide financial assistance to inefficient projects at the local level and would encourage reckless spending behavior.

The underwriting fees for BABs also emerge as a point of concern, as financial firms received over $1 billion in fees in the program's first year based on an analysis conducted by the *Wall Street Journal*. However, later analysis from the U.S. Treasury showed that these high fees are not uncommon with a new financial instrument and found that the costs decreased markedly over the course of the BABs program.

Furthermore, concerns that an extension of a BABs program will be paired with a cap on the tax-exempt benefits of municipal bonds is driving caution from a number of infrastructure stakeholders. The President's National Commission on Fiscal Responsibility and Reform (also known as Simpson-Bowles) recommended ending the exemption for municipal bonds as a way to eliminate the tax breaks afforded to wealthy Americans who buy tax-exempt municipal bonds and to the state and local entities that issue them. A number of congressional leaders, including House Majority Leader Eric Cantor (R-VA) and Sen. Elizabeth Warren (D-MA), as well as national organizations such as the National Association of Counties, the National League of Cities, and the U.S. Conference of Mayors expressed opposition to any changes

to traditional municipal bonds. This opposition cast suspicion on the similarly designed America Fast Forward Bonds proposal, which some fear was a step toward eliminating traditional municipal bonds. Furthermore, sequestration has shaken confidence in the federal government's ability to deliver on direct subsidy models like BABs.

Implementation Requirements

Reinstating the BABs program would require legislative action, possibly as part of a major tax reform bill or through the 2014 budget negotiations.

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Remaking Federalism | Renewing the Economy

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