



Bring Back BABs

A Proposal to Strengthen the Municipal Bond Market
with Build America Bonds

Jordan Eizenga and Seth Hanlon April 2011



Bring Back BABs

A Proposal to Strengthen the Municipal Bond Market with Build America Bonds

Jordan Eizenga and Seth Hanlon April 2011

doing what works

CAP's Doing What Works project promotes government reform to efficiently allocate scarce resources and achieve greater results for the American people. This project specifically has three key objectives:

- Eliminating or redesigning misguided spending programs and tax expenditures, focused on priority areas such as health care, energy, and education
- Boosting government productivity by streamlining management and strengthening operations in the areas of human resources, information technology, and procurement
- Building a foundation for smarter decision-making by enhancing transparency and performance measurement and evaluation

This paper is one in a series of reports examining government accountability and efficiency.

Doing What Works Advisory Board

Andres Alonso

CEO, Baltimore Public School System

Yigal Arens

Professor, USC School of Engineering

Ian Ayres

Professor, Yale Law School

Gary D. Bass

Executive Director, OMB Watch

Larisa Benson

Washington State Director of Performance
Audit and Review

Anna Burger

Secretary-Treasurer, SEIU

Jack Dangermond

President, ESRI

Beverly Hall

Superintendent, Atlanta Public Schools

Elaine Kamarck

Lecturer in Public Policy, Harvard University

Sally Katzen

Executive Managing Director, The Podesta Group

Edward Kleinbard

Professor, USC School of Law

John Koskinen

Non-Executive Chairman, Freddie Mac

Richard Leone

President, The Century Foundation

Ellen Miller

Executive Director, Sunlight Foundation

Claire O'Connor

Former Director of Performance Management,
City of Los Angeles

Tim O'Reilly

Founder and CEO, O'Reilly Media

Ali Partovi

Senior Vice President of Business Development,
MySpace

Tony Scott

Chief Information Officer, Microsoft

Richard H. Thaler

Professor, University of Chicago School
of Business

Eric Toder

Fellow, Urban Institute

Margery Austin Turner

Vice President for Research, Urban Institute

Laura D. Tyson

Professor, University of California-Berkeley
School of Business

Contents

1 Introduction and summary

3 The problem with tax-exempt municipal bonds

- 3 What are tax-exempt bonds?
- 5 Why tax-exempt bonds are inefficient

9 The birth and premature death of Build America Bonds

- 11 The backlash against Build America Bonds
- 12 A return to muni-bond turmoil

14 A proposal to bring back BABs

- 14 BABs promote budget discipline
- 15 BABs can coexist with tax-exempt bonds
- 17 A volume cap on tax-exempt bonds can control costs

19 Conclusion

20 Endnotes

22 About the authors and acknowledgements

Introduction and summary

In the months after the collapse of Lehman Brothers in September 2008, fear and uncertainty in the global credit markets spread to the municipal bond market. Investors fled muni bonds and prices plunged.

Advisers recommended that state and local governments delay issuing new debt because of high yields and weak demand. But pressing financial and infrastructure needs meant that state and local governments often could not just wait out the crisis. The turmoil in the municipal bond market threatened to worsen the nation's plunge into recession.

The municipal bond crisis presented an opportunity for federal lawmakers to not only strengthen the municipal market, but to respond to a longstanding problem in the way state and local tax-exempt bonds are structured. In 2009, the Obama administration and Congress created the Build America Bonds program. Build America Bonds were taxable state and local government bonds for which a portion of the interest costs were subsidized by the federal government.

The subsidized bonds were an innovative financing mechanism that would prove to strengthen the municipal debt market. Over the past two years, these subsidized bonds financed much-needed infrastructure investment at the state and local government level while making the tax-exempt municipal bond market stronger and more efficient. Perhaps most importantly, the program also lowered the borrowing costs for state and local governments.

Despite the success of this program, Congress failed to reach agreement to extend the program at the end of the 111th Congress and it expired on December 31, 2010. The opposition to Build America Bonds stemmed largely from an antipathy to federal spending. But, as we show, Build America Bonds do not necessarily increase the size of the federal government; the program simply makes the federal government more efficient in how it invests taxpayer funds. Build America Bonds provided a streamlined alternative to an existing federal subsidy program: The tax exclusion for municipal bonds.

The yields on tax-exempt bonds have since risen dramatically, with many market analysts attributing the turmoil to the demise of Build America Bonds. State and local governments are already facing severe budget shortfalls, and higher borrowing costs will exacerbate these problems, threatening needed services and investment.

Fortunately, Congress can still revive the Build America Bonds program and make it a permanent feature of the municipal bond market. In this paper, we propose to strengthen the municipal market as a whole through a permanent Build America Bonds program that improves the way the federal government promotes important public investments at the state and local level, and lowers their cost of capital. Specifically, we recommend to expand the Build America Bonds market and to place an annual ceiling on the number of tax-exempt issuances. In so doing, we allow Congress to better manage federal support of state and local finance—a particularly important outcome as our country simultaneously confronts large structural budget deficits and long overdue infrastructure investment.

The problem with tax-exempt municipal bonds

State and local governments issue bonds to finance long-term investments in things like roads, transit, public works, and schools. Bond sales raise funds that can be used immediately while allowing the governments to repay them, with interest, over time and according to a schedule.

What are tax-exempt bonds?

Municipal bonds are an attractive investment because the interest payments received by investors are exempt from federal income taxes, unlike most other forms of income. Because municipal bonds entitle their owners to a tax-free stream of income, investors are willing to accept lower interest payments than they would if the bonds were taxable. The federal tax exemption, therefore, effectively reduces borrowing costs for state and local governments.

To understand how this works, consider the following example:

John runs a successful accounting firm in Los Angeles. His annual income of \$500,000 easily puts him in the top federal income tax bracket of 35 percent. John is interested in relatively safe investments and is considering various fixed-income securities, such as Treasury and municipal bonds. One option is to invest \$20,000 in taxable 20-year Treasury bonds yielding 4.3 percent a year. The Treasuries would pay John annual interest payments of \$860, or \$559 after federal income taxes. That's equivalent to a 2.8 percent after-tax yield.

Meanwhile, the city of Shelbyville is planning to issue bonds to raise money for a large public-works project. In order to entice investors like John, Shelbyville only needs to offer them 20-year tax-exempt bonds at slightly more than a 2.8 percent yield (assuming, for purposes of this example, the investors believe the likelihood that Shelbyville will default on its debt is

no greater than a federal credit default). The Shelbyville bonds would pay slightly more than \$559 in interest each year, but none of it would be taxed, providing John with the same amount of after tax-income as the taxable Treasury bond.

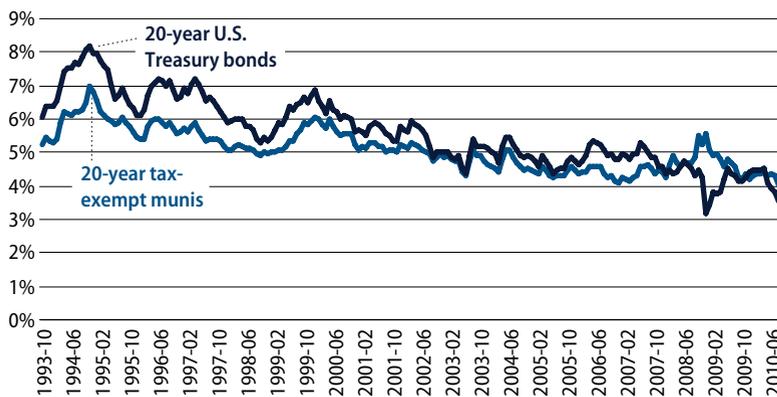
Bottom line: Shelbyville can offer interest rates that are 1.5 percentage points lower than the equivalent-duration Treasury bonds and still find investors who are willing to buy its bonds. That means that Shelbyville, assuming its creditworthiness is good, can finance its capital investments at a lower cost than the U.S. government can.

Even though U.S. Treasury bonds are considered the safest investments, interest rates on tax-exempt municipal bonds have tended to be lower than Treasuries, reflecting the effect of the tax exemption. (See Figure 1)

By letting state and local governments pay tax-exempt interest to their bondholders, the federal government is forfeiting income tax it would have otherwise collected. That’s why economists call this kind of tax rule a “tax expenditure,” or special provision in the tax code that results in lower tax revenue.

FIGURE 1
Tax-exempt interest rates v. Treasury bond rates

The municipal-bond tax exemption lowers the interest rates that investors are willing to accept



The tax exemption for state and local public purpose bonds will cost the federal government \$230.4 billion over the 2012-2016 period, according to estimates published by the Office of Management and Budget, making it one of the largest tax expenditures.¹ There were about \$2.8 trillion in municipal bonds outstanding at the end of 2010. Individual investors and mutual funds, whose shareholders are mostly individuals, own 71 percent of tax-exempt municipal bonds. Insurance companies and banks each own roughly 10 percent of the municipal bond market.²

Types of tax-exempt municipal bonds

General obligation bonds

General obligation bonds, or GO bonds, are secured by the taxing power of the issuing government. GO bonds make up more than 80 percent of the tax-exempt bond market.³ They allow states to finance a variety of public works projects and activities, using future tax revenue to pay back the bonds.

Revenue bonds

State and local governments also issue revenue bonds, so called because they are backed by the revenues expected to flow from the bond-financed project. For example, a bond used to finance the construction of a toll road might be backed by the toll revenue.

Private activity bonds

Private activity bonds are tax-exempt bonds issued by state or local governments for the primary purpose of financing a private project or activity. Congress allows state and local governments to allocate a limited amount of these bonds to encourage certain private development that ostensibly creates a public benefit, such as building hospitals. Each year, Congress restricts the issuance of private activity bonds by implementing an annual volume cap on new issuances. In 2010, the volume cap was \$30.857 billion, a slight increase from the 2009 cap of \$30.607 billion.⁴

Why tax-exempt bonds are inefficient

Tax-exempt municipal bonds lower the borrowing costs for state and local governments, but they are an inefficient and costly federal subsidy. That's because a significant portion of the subsidy intended for the governments is instead captured by bond buyers in the top income tax brackets.

Understanding how this windfall happens is key to understanding why direct-subsidy bonds like Build America Bonds are a fairer and less expensive way for the federal government to subsidize local capital projects.

The main point to keep in mind is that the tax exemption on municipal bond interest, like any income tax exemption, is most valuable for buyers in the top income tax brackets. A muni bondholder in the 35 percent bracket pays \$35 less in taxes for every \$100 in interest income he receives, while a buyer in the 10 percent bracket saves just \$10. That explains why people in the top income tax bracket, the wealthiest Americans, are the most willing buyers of tax-exempt bonds.

If state and local governments sold bonds exclusively to these top-bracket investors, the governments could, in theory, issue bonds paying a 35 percent lower yield than comparable taxable bonds. At that yield, top-bracket investors would find the tax-exempt and taxable bonds equally attractive.

The problem is that the appetite for muni bonds among people in the top tax bracket is insufficient to meet state and local governments' need for financing. The municipal issuers, therefore, must also sell bonds to people with lower incomes who are taxed at lower rates.⁵ And that means the bond issuers have to offer higher rates to all investors, giving the bond buyers in the highest income tax brackets a windfall.⁶

To see how this happens, let's return to John, our \$500,000-a-year accountant:

John, who is in the 35 percent income tax bracket, decides to buy \$20,000 of taxable 20-year Treasury bonds yielding 4.3 percent annually. That gives him an after-tax annual return of \$559, equivalent to a 2.8 percent yield on a comparable tax-exempt municipal bond.

John's friend, Stan, is an engineer whose salary is \$125,000, which puts him in the 28 percent income tax bracket. Stan also invests \$20,000 in taxable 20-year Treasury bonds paying 4.3 percent a year. That gives Stan an after-tax annual return of \$619, equivalent to a 3.1 percent yield on a comparable tax-exempt muni bond.

While a tax-exempt muni bond issuer would have to pay 2.8 percent to entice John to purchase its bonds, it must offer a yield of at least 3.1 percent to make it worth Stan's while. If not enough top-bracket investors like John buy all the municipal bonds available, the issuers must offer a yield that will also attract investors like Stan.

And that's exactly what happens, generating a windfall for John. The muni issuer competing for Stan's business has to pay a 3.1 percent interest but John gets that rate as well, giving him \$60 more in after-tax returns than what should be needed to motivate him to buy the bond.

That's good for John, but not for the issuer, whose borrowing costs have gone up and who therefore isn't receiving the full value of the federal subsidy. In theory, the issuer should be able to borrow \$20,000 a year for just \$559 in annual interest payments. But because part of the subsidy has leaked to John, the issuer is actually paying \$619 in interest payments—and John is pocketing the difference.

To be sure, this is a simplified example that ignores the many other factors that governments and investors consider when selling and buying bonds. But the evi-

dence shows that the general dynamic is real: Lower-bracket buyers push up the yield on municipal bonds above what a buyer in the top bracket would demand to buy the bonds.⁷ As a result, local governments offering tax-exempt bonds pay higher interest-rate payments than necessary to attract top-bracket investors.⁸ (See Figure 2)

None of this is the fault of high-income tax-exempt bond buyers. They're just buying the bonds that offer the best after-tax yield. The fault lies with an imperfect federal subsidy delivered to states through the tax code.

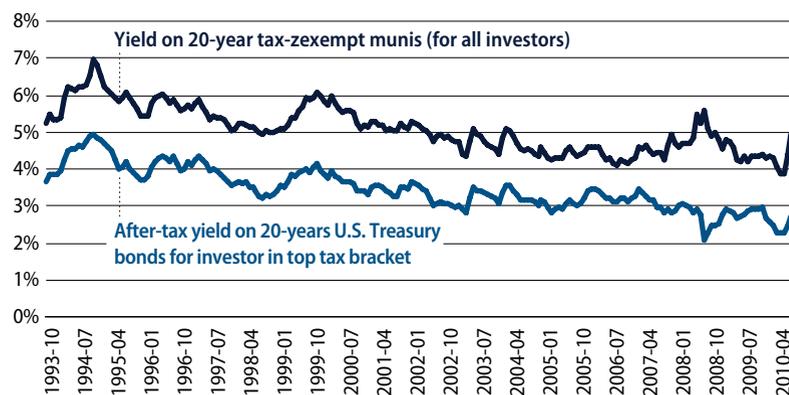
The Treasury Department estimates that 10 percent to 20 percent of the subsidy, intended solely for state and local government issuers, is captured by bond buyers in higher tax brackets.⁹ The tax expenditure for municipal bonds, therefore, constitutes “a federal transfer to bondholders in higher tax brackets.”¹⁰ (See Figure 2)

The cost of this inefficiency is not trivial. With 10 percent to 20 percent of the subsidy leaking to bond buyers, the cost of the inefficiency to U.S. taxpayers in unnecessary foregone revenue could be greater than \$6 billion per year.¹¹ Ultimately, the reduction in interest costs for state and local governments is less than the federal tax expenditure. That is, the federal government forfeits one dollar in tax revenue under the deduction, but state and local governments save only eighty cents.

A Congressional Budget Office-Joint Committee on Taxation study found that “A direct appropriation of funds would purchase more infrastructure on a dollar-for-dollar basis.”¹² That is, the federal government would get more bang for its buck if it simply gave money to state and local governments to spend on capital investments.

Functionally, that's what Build America Bonds do and it's why they offer a distinct advantage over tax-exempt municipal bonds.

FIGURE 2
A costly yield for state and local governments

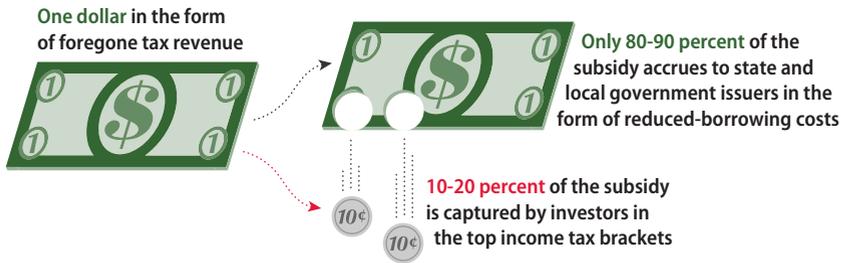


This graphic shows that investors in the top marginal income tax brackets receive a consistently higher yield on tax-exempt bonds than the after-tax yield on comparable Treasury bonds. That means high borrowing costs for issuers.

FIGURE 3

An inefficient subsidy

Ten to 20 cents of every dollar intended for state and local governments leaks to top tax bracket buyers instead



Source: U.S. Department of the Treasury¹³

An accidental subsidy

The tax exemption for municipal bond interest has been around since the federal income tax was established in 1913. Its original purpose was not to provide a federal subsidy to states, but to comply with constitutional law as it existed at the time.¹⁴

The Supreme Court in 1895 held in *Pollack v. Farmers' Loan and Trust Company* that the Constitution prohibited the federal government from taxing state or municipal financial instruments.¹⁵ (The same case also held the income tax to be unconstitutional, a holding that was overturned by the Sixteenth Amendment.) When the modern income tax was enacted in 1913, Congress provided a specific exclusion for municipal bond interest on the belief that taxing such interest would be unconstitutional under *Pollack*.¹⁶

The principle established in *Pollack*, known as the doctrine of “inter-governmental tax immunity,” was gradually undermined by successive court decisions beginning in the 1930s. In 1988 the Supreme Court ruled that the intergovernmental tax immunity doctrine had been “thoroughly repudiated.”¹⁷ That case, *South Carolina v. Baker*, made it clear that Congress has the constitutional authority to tax municipal bond interest.

In the intervening years, however, the municipal bond market had grown tremendously in size and importance. Strong constituencies developed for retaining the exemption. Numerous efforts to repeal the exemption or convert it into different forms all failed.¹⁸

The birth and premature death of Build America Bonds

The financial crisis that began in the sub-prime mortgage market had by 2008 infected the municipal bond market. Foreclosure rates had spiked, causing state and local property tax revenue to plummet. The credit markets were contracting and the underwriters and insurers that traditionally supported the municipal bond market were in dire straits. Municipal bond insurers were being downgraded, driving up interest rates on the bonds they backed. Investors were fleeing the market as a whole. For some, it was, “the worst crisis in bond market history.”¹⁹

The municipal bond market problems threatened to worsen the economy-wide recession. But they also presented an opportunity for experimentation in state and local finance. In the American Recovery and Reinvestment Act of 2009, Congress created an alternative to tax-exempt bonds, called Build America Bonds.²⁰ Under this program, state and local governments could issue taxable bonds to finance infrastructure investment, but have the federal government pay part of the interest cost. This subsidy was set at 35 percent of the interest costs for 2009 and 2010. That means the direct subsidy on a Build America Bond was equal to the implicit federal subsidy on a tax-exempt bond purchased by an investor in the 35 percent tax bracket.

By making direct payments to the issuer, the federal government eliminated the windfall to high-income investors, ensuring instead that 100 percent of the federal subsidy benefited state and local governments. Build America Bonds promised to be a far more efficient way to subsidize state and local governments than tax-exempt bonds.²¹

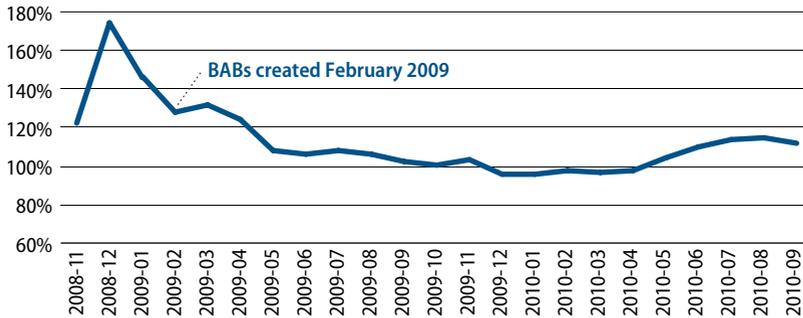
Indeed, the Treasury Department estimates that state and local governments saved over \$20 billion in net present value by issuing Build America Bonds.²² Lower borrowing costs, in turn, mean states pay less for public projects and pass less of the cost of the project onto taxpayers.

FIGURE 4

Build America Bonds strengthened the tax-exempt bond market

The increase in issuances of Build America Bonds reduced the supply of tax-exempt bonds. With fewer tax-exempt bonds in the market, issuers were able to issue bonds at lower rates and generated important cost savings.

AAA GO muni yield as a percent of U.S. Treasuries



The program also helped expand the market for municipal bonds at a time when individual retail investors were fleeing the tax-exempt market. That’s because Build America Bonds were attractive to buyers who aren’t helped by the municipal bond tax exemption, such as pension funds, foreign investors, and life insurance companies. By appealing to a broader array of investors, the direct subsidy bonds accessed untapped demand in the market. “[T]he BAB program has succeeded in opening up the municipal market to non-taxable and other non-traditional

investors,” wrote Andrew Ang, Vineer Bhansali, and Yuhang Xing in what was the first independent report of the Build America Bonds program.²³

Build America Bonds also had salutary effects on the tax-exempt market. “The availability of Build America Bonds has enabled state and local governments to issue fewer tax exempt bonds, which has lowered their borrowing costs in the tax exempt market,” wrote Alan Krueger, former assistant Treasury secretary for economic policy, in December.²⁴ With Build America Bonds available as an alternative, state and local governments could opt to issue tax-exempt bonds only when low yields made them attractive.

In the six months following the creation of the Build America Bonds program, yields on long-term tax-exempt bonds dropped by about 20 to 30 basis.²⁵ More tellingly, the spread between tax-exempt bond yields and taxable Treasury bond yields narrowed significantly over the life of the program. (See Figure 4) When tax-exempt bond yields approach Treasury yields, that’s a sign that the market for tax-exempt bonds is becoming more efficient.

Another positive outcome of the Build America Bonds program was its ability to stimulate critical infrastructure investment. Infrastructure projects typically demand longer-maturity financing because of the longer economic life of projects. Tax-exempt bonds have traditionally been issued at shorter maturities, reflecting the preference for short-term debt of the retail investors they attract.²⁶ This preference created a mismatch between the needs of issuers and the demands of investors.

But Build America Bonds could be issued at longer maturities because they catered also to long-term institutional investors. The independent study of the Build America Bond program by Ang, Bhansali, and Xing noted that 54 percent of Build America Bonds have maturities longer than 10 years, compared to just 34 percent for tax-exempt bonds.²⁷

“[Build America Bonds] are the latest mechanism that can efficiently and materially mitigate the structural inefficiencies in the long end of the tax-exempt curve,” wrote JP Morgan municipal market analysts Chris Holmes and Alex Roeber in *Bond Buyer* in November, referring to Build America Bond’s ability to attract buyers with longer investment horizons.²⁸ Build America Bonds, in being issued at longer maturities, helped stimulate investment in infrastructure at a time when such investment was badly needed.

All in all, the Build America Bonds experiment was successful: It strengthened the municipal market, reduced inefficient returns to high income bond buyers, and brought about long-overdue investment in infrastructure at the state and local level. It did so at a time when broader financial markets were fragile and the economy was struggling out of the deepest recession in two generations. And yet, Congress failed to extend the program beyond its expiration on December 31, 2010. Why was that?

The backlash against Build America Bonds

The Build America Bonds program provides federal payments to state and local governments to offset borrowing costs. Those subsidy payments appear as an outlay in the federal budget. Tax-exempt bonds, in contrast, involve no federal outlay because the equivalent government subsidy is delivered as a tax expenditure—or forfeited revenue. Since the Build America Bonds program generates a cost on the spending side of the ledger, it has drawn criticism from conservatives with an ideological aversion to spending.

Sen. Charles Grassley (R-IA) said the Build America Bonds program “increases the size of the already bloated federal government because it takes what used to be a tax-cutting program, namely, [tax-exempt] municipal bonds, and converts that into Build America Bonds.”²⁹ Columnist David Reilly of *The Wall Street Journal* called the bonds a state budget “bailout” that should be scrapped.³⁰

These critiques are based on a meaningless accounting distinction between direct-government spending and indirect-government spending done through the tax code. It makes no difference to the federal treasury whether Congress spends money by collecting taxes and then writing a check, or by forfeiting tax revenue it otherwise would have collected. Money spent and money distributed through tax breaks for specific activities are both a form of government “spending.” Tax-exempt bonds and Build America Bonds are both spending programs that commit federal resources to state and local governments, and involve the federal government in supporting state and local infrastructure. Build America Bonds just deliver the federal subsidy more efficiently.

Build America Bonds critics also noted that underwriting fees were typically higher for direct-subsidy issuances than for comparable tax-exempt bond issuances. To be sure, fees were higher at the outset as underwriters took on the additional risk and effort involved in offering a new product. Since May of 2010, the fees declined steadily in line with underwriting fees for tax-exempt bonds.³¹ Had the program been extended, underwriting fees would have likely been pushed down by more competition among underwriters and an expanding market for the bonds.

A return to muni-bond turmoil

The expiration of the Build America Bonds program has not only restored the inefficient market for tax-exempt bonds, it has contributed to distress in the municipal bond market generally.

Tax-exempt yields are at their highest in a year. Twenty-year general obligation tax-exempt bonds rose 31 basis points in the first week alone after the program’s expiration at the end of December. The municipal market “has basically lost its training wheels, and now it has to learn how to ride a bike all over again,” said Michael Pietronico, chief executive officer of Miller Tabak Asset Management in January. “That means higher yields.”³²

At a time when most states face budget shortfalls, states are now paying up to two-thirds more to borrow than when they issued Build America Bonds in 2010.³³ Others will simply choose not to finance projects because the borrowing costs will be too high. That will mean fewer new investments, with immediate impacts

on job creation and long-term ramifications for economic growth. For deficit-wracked state and local governments, the demise of the Build America Bonds program could not have come at a worse time.

In the next section, we argue that Congress should strengthen the municipal bond market by reviving Build America Bonds. We describe some of the benefits of reviving Build America Bonds and propose a potential way for Congress to manage the depth of the federal subsidy for state and local finance.

A proposal to bring back BABs

Congress should revive the Build America Bonds program, broaden the projects it is permitted to finance, and make it a permanent feature of the municipal bond market.³⁴

The reintroduction of Build America Bonds will again expand the municipal bond market to new investors who tend to purchase bonds at longer maturities. That should add much needed demand to a currently volatile municipal bond market, as well as provide crucial support to state and local infrastructure investment.

This approach should also lower the borrowing costs of state and local government issuers. That will reduce pressures to increase taxes in order to finance important public projects. At a time of great financial distress in many state and local governments, such savings are all the more important.

BABs promote budget discipline

One of the major advantages of Build America Bonds is that they give Congress the ability to determine the amount of federal resources that go toward subsidizing state and local finance.

By contrast, the tax expenditure on tax-exempt bonds is not determined by Congress. For most federal programs that invest directly in infrastructure, such as federal highway spending, Congress sets its annual budget authority through the appropriations process. Tax-exempt bonds, by contrast, operate on autopilot. The cost to the U.S. Treasury from year to year is determined mainly by the aggregate volume and interest rates of tax-exempt bonds that state and local governments issue and have outstanding.

The fiscal cost is also determined by marginal tax rates, principally the top-marginal rate. The higher the top-marginal rates, the more attractive tax-exempt bonds are for investors in those brackets. Yet Congress must weigh innumerable other considerations in setting marginal tax rates other than the appropriate level of subsidy for state and local finance. Tethering that subsidy to increases or decreases in the top marginal tax rate is a strange way of setting national priorities. The point is that, as a matter of principle, the size of the federal subsidy should be the result of deliberate policy decisions concerning federal support for state and local infrastructure investment.

With Build America Bonds, Congress can choose the size of the subsidy simply by adjusting the subsidy rate. During their first two years of existence, Build America Bonds paid a 35 percent subsidy rate. That is, the federal government covered 35 percent of issuers' interest costs. But Congress could choose to renew Build America Bonds at a lower subsidy rate. Different economic conditions in future years might call for a less- or more-generous subsidy.

The Obama administration has proposed renewing Build America Bonds at a 28 percent subsidy rate. That is what the administration projects as the “revenue neutral” subsidy rate, or the rate at which the cost of the Build America Bond subsidy is naturally offset by a reduction in forfeited revenue from fewer tax-exempt bond issuances.³⁵ Others in Congress have proposed reviving Build America Bonds at a 32 percent subsidy rate.³⁶

Congress could even offer varying subsidy rates for the Build America Bonds that fund different types of investments, better targeting federal funds toward desired purposes. And to ensure that Build America Bonds become a greater share of the municipal bond market, Congress could expand its eligible uses to include refunding and other activities that they were not permitted in its original incarnation.

BABs can coexist with tax-exempt bonds

Earlier this year, Sens. Ron Wyden (D-OR) and Dan Coats (R-IN) proposed replacing tax-exempt bonds with tax-credit bonds.³⁷ Erskine Bowles and former Sen. Alan Simpson, co-chairs of the President's Commission on Fiscal Responsibility and Reform, in December 2010 proposed to achieve deficit reduction by simply eliminating the tax exemption for new issuances of municipal bonds.³⁸

While we believe Build America Bonds are superior to tax-exempt bonds, we think that the two financing vehicles can co-exist. The country’s recent experiment with Build America Bonds proves that their availability has salutary effects on the tax-exempt bond market by reducing supply pressures.

Of course, it might be argued that the immediate elimination of tax-exempt bonds could create turbulence in an already unstable market. According to the National Conference of State Legislatures, 35 states are expected to have budget gaps for state fiscal year 2012.³⁹ An immediate and dramatic change to the municipal bond market might increase borrowing costs for state and local governments at a different time.

A sensible approach is to gradually reduce the supply of tax-exempt bonds while nurturing the taxable bond market through the Build America Bonds program.

To this end, Congress could reintroduce Build America Bonds with a high enough subsidy rate to draw more and more issuers away from issuing tax-exempt bonds. Of course, the higher the subsidy rate, the greater the cost to the federal treasury. Assuming the revenue-neutral subsidy rate on Build America Bonds is 28 percent, their reintroduction at a subsidy rate higher than 28 percent would be revenue-negative. That is, the cost of subsidizing Build America Bonds at a higher rate would outweigh the revenue gained from luring issuers away from tax-exempts.

But a subsidy rate lower than 28 percent is not necessarily correspondingly revenue-positive for the U.S. Treasury. It could result in fewer Build America Bonds, but also more tax-exempt issuances—which means a bigger tax expenditure for tax-exempt bonds.

A volume cap on tax-exempt bonds can control costs

Congress can overcome this challenge by setting a volume cap on public purpose tax-exempt bonds, similar to the volume caps that currently exist for private-activity bonds. Assuming demand for tax-exempt bonds stays constant, the reduction in their supply would decrease yields to the point at which state and local governments captured the entire federal subsidy, and leaked none of it to high-income investors.

This volume cap could be set periodically by Congress. Tax-exempt bonding authority could be allocated to states on the basis of population size; state bond commissions could in turn distribute bonding authority to local governments. Alternatively, the federal government could allocate bonding authority by auction: Those governments that offer to remit to the federal government the highest percentage of their interest proceeds on the bonds would win the right to issue them. As envisioned by Calvin Johnson, a law professor at the University of Texas at Austin: “The winners of the auction would be those entities that have a capital project that can pass the highest hurdles.”⁴⁰ The bond issuers would receive the same subsidy that it would under the current tax-exempt bond system, but the “windfall” would be remitted to the federal Treasury rather than accruing to top-bracket investors.

Regardless of the method of allocation, the cap would help ensure that all buyers of newly issued tax-exempt bonds are in the top marginal-income tax bracket. This would mean that there would be no buyers from lower tax-brackets pushing up yields beyond what a top tax-bracket investor would demand—and therefore no unintended windfall to those top-bracket investors. And to prevent short-term disruption in the municipal bond market, the cap could be implemented over time with the ceiling on tax-exempt issuances set high at first and then gradually reduced.

By imposing a cap on tax-exempt issuances, Congress can eliminate the inefficiency, strengthen the tax-exempt bond market, and nurture the market for Build America Bonds—without spending more than it already does through the municipal bond tax expenditure.

It can do all this because both a volume limit on tax-exempt bonds and the subsidy rate for Build America Bonds would be under Congress’s control.

By wielding two policy levers—the subsidy rate for Build America Bonds and the volume cap for tax-exempt bonds— Congress can create a municipal finance subsidy that is simultaneously:

- **More efficient:** By reducing the supply of tax-exempt bonds, the windfall to investors in the top marginal-tax bracket is eliminated and borrowing costs for states are lowered.

- **More fiscally responsible:** The depth of the overall subsidy could be ratcheted up or down to address federal fiscal challenges and national priorities.
- **More flexible:** Congress can adjust the tax-exempt volume cap and the Build America Bonds subsidy rate for various types of projects and in response to changing economic conditions.

Conclusion

The municipal bond market appears poised for a troubling year ahead. Demand for tax-exempt bonds is weak and borrowing costs are increasing for municipal issuers. To further complicate matters, the municipal bond market in its current form is extremely inefficient and is far from the best way to subsidize important public investments. Billions of federal tax dollars, intended to subsidize state and local governments, are captured by bond buyers in higher-income tax brackets.

This is a troubling state of affairs for two principal reasons. First, municipal finance is critically important to our economy. It allows state and local governments to raise the money necessary to fund projects that benefit the public good, improve our quality of life, and strengthen communities. It helps finance the construction of bridges, roads, and sewer systems, and pay for essential services provided by police officers, nurses, and teachers.

Second, federal dollars are increasingly scarce at a time of structural budget deficits and serious long-term fiscal challenges. Federal lawmakers have begun to consider what to do with beleaguered state and local governments. The proposal outlined in this paper provides the 112th Congress with a viable way to stabilize the market in the short term, and strengthen the efficiency and potency of the municipal bond market in the long term. This proposal provides crucial support to state and local governments when they need it most.

The advantage of this proposal is that it is based on a Build America Bonds program that has been tested and shown to work. Given the immediate fiscal challenges facing all levels of government and the ongoing need for infrastructure investment, we should not let such a good idea go to waste.

Endnotes

- 1 Office of Management and Budget, "Federal Receipts," available <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/receipts.pdf>.
- 2 Investment Company Institute, "Municipal Bond FAQs" (2008), available at http://www.ici.org/policy/markets/domestic/faqs_muni_bond.
- 3 Federal Reserve bank, "Flow of Funds Accounts of the United States," (2011), available at <http://www.federalreserve.gov/RELEASES/z1/Curent/z1.pdf>, p. 91, Table 211.
- 4 Council of Development Finance Agencies, "Original Research: 2010 State Private Activity Bond Volume Caps" (2010), available at [http://www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b2928b086256efa005c5f78/2011ba83544470729862576a40051f3a9/\\$FILE/2010%20volume%20cap%20figures%20report%20final.pdf](http://www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b2928b086256efa005c5f78/2011ba83544470729862576a40051f3a9/$FILE/2010%20volume%20cap%20figures%20report%20final.pdf).
- 5 Congressional Budget Office, "Subsidizing Infrastructure Investment with Tax-Preferred Bonds" (2009), available at <http://www.cbo.gov/doc.cfm?index=10667>.
- 6 T. Atwood, "Implicit Taxes: Evidence from Taxable, AMT, and Tax-Exempt State and Local Government Bond Yields," *Journal of the American Taxation Association*, 25 (1) (2003).
- 7 Congressional Budget Office. "Subsidizing Infrastructure Investment with Tax-Preferred Bonds."
- 8 The higher yield on tax-exempt municipal bonds compared to the after-tax yield on comparable Treasuries cannot be explained by a supposed heightened risk of default with municipal bonds. Research by John Chalmers and others demonstrates this point. For further information, see John Chalmers, "Default Risk Cannot Explain the Muni Puzzle," *The Review of Financial Studies*, (Summer 1998), available at <http://odin.lcb.uoregon.edu/jchalmers/muni.pdf>.
- 9 Alan Krueger, "Build America Bonds At Year One" (Washington: US Department of Treasury). Presentation to National Municipal Bond Summit, March 18, 2010.
- 10 Congressional Budget Office. "Subsidizing Infrastructure Investment with Tax-Preferred Bonds," p. 34.
- 11 Authors' calculations based on tax-expenditure figures from the Office of Management and Budget. For more, see Office of Management and Budget, "Federal Receipts."
- 12 Congressional Budget Office. "Subsidizing Infrastructure Investment with Tax-Preferred Bonds."
- 13 Alan Krueger, "Build America Bonds At Year One."
- 14 Calvin Johnson, "Repeal Tax Exemption for Municipal Bonds," *Tax Notes* 117 (2007):1260. (Citing early legislative history).
- 15 *Pollack v. Farmers' Loan & Tr. Co.*, 157 US 429, 583-86 (1895).
- 16 This history is discussed at length in Kevin Yamamoto, "A Proposal for the Elimination of the Exclusion for State Bond Interest," *Florida Law Review* 50 (145) (1998):162-66.
- 17 *South Carolina v. Baker*, 485 U.S. 505, 520 (1988).
- 18 Congressional Budget Office. "Subsidizing Infrastructure Investment with Tax-Preferred Bonds."
- 19 Ben Waxman, "Philadelphia zapped by bond market turmoil," *Philadelphia Enquirer*, October 13, 2008, available at: http://articles.philly.com/2008-10-13/news/24991933_1_bond-market-bond-buyer-tax-revenue.
- 20 Securities Industry and Financial Markets Association, "US Municipal BABs Fact Sheet, 2010 Q3" (2010), available at <http://www.sifma.org/research/Item.aspx?id=19650>.
- 21 In addition to authorizing the issuance of direct subsidy bonds, the Build America Bonds program also permitted state and local governments to issue a "tax credit" Build America Bond. How would the tax credit bond have worked?

A buyer of the tax credit Build America Bond would have received both interest payments from the issuer and a federal tax credit equal to a percentage of the interest payments. In the case of tax credit Build America Bonds, Congress set the size of the tax credit at 35 percent of the interest payments.

Of the two options available under the Build America Bonds program, most, if not all, state or local governments chose to issue tax credit bonds throughout the life of the program, opting instead to issue direct subsidy Build America Bonds. The reason for this was that the direct subsidy Build America Bond offered a greater subsidy for issuers than did the tax credit Build America Bond. This is not due to inherent drawbacks of tax credit bonds, but a result of the 35 percent subsidy rate set by Congress. State and local governments would have saved only 26 percent in reduced interest expenses if they had issued tax credit Build America Bonds, while the direct subsidy option guaranteed interest savings of 35 percent.

To better understand why this is true, let's return to John the investor. Suppose John buys a tax credit Build America Bond worth \$1000. Each year he receives \$75 in annual interest payments and a tax credit equal to 35 percent of these interest payments or \$26. In turn, that tax credit saves John \$26 he would ordinarily have to pay to the federal government in taxes. Together, the tax credit and the interest payment amount to a total annual yield to John of \$101, or just over 10 percent. For John to receive the same yield on a normal, taxable bond, the issuer would have to cover that \$26 and pay the full \$101 in interest payments.

In this example, the issuer was able to reduce its borrowing costs by 26 percent in issuing the tax credit bond. But, that issuer would have been even better off if it had issued a direct subsidy Build America Bond that offered the same total yield of \$101 to John the investor. The federal government would have subsidized 35 percent of the \$101 in interest payments, saving just over \$35. John would have been no better or worse off than before, and the issuer would have reduced its borrowing costs by 35 percent. This demonstrates that, at a 35 percent subsidy rate, the direct subsidy bond option actually offered a deeper subsidy to issuers than did the tax credit bond option. With equal subsidy rates, issuers opted for the more generous direct subsidy Build America Bond.
- 22 Alan Krueger and John Bellows. "Build America Bonds: A New Approach to Municipal Finance." AEA Meetings, January 7, 2011.

- 23 Andrew Ang, Vineer Bhansali, and Yuhang Xing, "Build America Bonds" (Columbus: Council of Development Finance Agencies, 2010), available at: [http://www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b-2928b086256efa005c5f78/eba3283f20ee9da486257791007179d8/\\$FILE/BAB%20Report.pdf](http://www.cdfa.net/cdfa/cdfaweb.nsf/fbaad5956b-2928b086256efa005c5f78/eba3283f20ee9da486257791007179d8/$FILE/BAB%20Report.pdf).
- 24 Alan Krueger, "Extend Build America Bonds," *Huffington Post*, December 6, 2010, available at: http://www.huffingtonpost.com/alan-b-krueger/extend-build-america-bond_b_792811.html.
- 25 Michael Decker, "Build America Bonds: An American Success Story," *Bond Buyer*, November 2, 2009, available at: http://www.bond-buyer.com/issues/118_210/build_america_bonds_success_story-1003300-1.html.
- 26 Helen Avery, "Municipal bonds: Build America Bonds are here to stay" September 2009, available at <http://www.euromoney.com/Article/2296313/Municipal-bonds-Build-America-Bonds-are-here-to-stay.html>
- 27 Ang, Bhansali, and Xing, "Build America Bonds."
- 28 Dan Seymour, "BABs: The Last Pillar Standing," *Bond Buyer*, November 29, 2010, available at: http://www.bondbuyer.com/issues/119_476/build_america_bonds-1020407-1.html.
- 29 United States Senate Committee on Finance, "Grassley Asks GAO to Review Accountability of Tax Dollars in Build America Bonds Program" (2010), available at: <http://finance.senate.gov/newsroom/ranking/release/?id=78ff744e-2e82-4ba0-9e50-77b56d85d09e>.
- 30 David Reilly, "Build America Bonds: Past Sell-By Date," *Wall Street Journal*, November 16, 2010, available at <http://online.wsj.com/article/SB20001424052748704865704575610922863520994.html>.
- 31 Alan Krueger, "Extend Build America Bonds Too"; Alan Krueger, "Retuning the Bad Rap for BABs," *Huffington Post*, June 18, 2010, available at http://www.huffingtonpost.com/alan-b-krueger/retuning-the-bad-rap-for_b_617138.html.
- 32 Michael Scarchilli, "Yields rise as Even Good Credits Have Hard Time," *Bond Buyer*, January 14, 2011, available at http://www.bondbuyer.com/issues/120_10/bond_buyer_indexes-1022121-1.html.
- 33 Brendan A. McGrail, "Wisconsin Suffers as Build America Bonds Demise Raises Costs: Muni Credit" *Bloomberg*, January 13, 2011, available at: <http://www.bloomberg.com/news/2011-01-13/wisconsin-suffers-as-build-america-bonds-demise-raises-costs-muni-credit.html>.
- 34 The American Recovery and Reinvestment Act of 2009 restricted Build America Bonds to financing infrastructure projects. Future legislative proposals may lift this restriction.
- 35 President Obama proposed to extend Build America Bonds for 2011 and 2012 at a subsidy rate of 28 percent. This was the subsidy rate that would be "revenue neutral" to the federal government. In other words, at that rate, the total direct-federal subsidy for Build America Bonds was expected to equal the revenue *gained* from issuers choosing to issue taxable Build America Bonds rather than tax-exempt bonds.
- 36 For more, see H.R. 992 – *Building America Jobs Act of 2011*.
- 37 Patrick Temple-West, "Sen. Wyden Touts Tax Credit Bonds, Hits Tax Exemption for New Munis," *Bond Buyer*, April 13, 2011.
- 38 The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (2010) available at http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.
- 39 National Conference of State Legislatures, "State Budget Update: November 2010" (2010), available at: http://www.ncsl.org/documents/fiscal/november2010sbu_free.pdf.
- 40 For more, see Calvin H. Johnson, "A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax," *SMU Law Review* 56 (13): 50-51.

About the authors

Jordan Eizenga is a Policy Analyst with the Economic Policy team at American Progress. Prior to joining the Center, Jordan was a Hamilton Fellow in the Department of the Treasury where he worked with community development financial institutions to expand credit and equity investments in distressed and underserved domestic markets.

Seth Hanlon is Director of Fiscal Reform for CAP's Doing What Works project. Prior to joining CAP, Seth practiced law as an associate with the Washington, D.C., firm of Caplin & Drysdale. He previously served on Capitol Hill as a legislative and press aide to U.S. Reps. Harold Ford, Jr. (D-TN) and Marty Meehan (D-MA).

Acknowledgements

The authors wish to thank Donna Cooper, Gadi Dechter, and James Hairston for their contributions to this report. The authors would also like to thank The Rockefeller Foundation for its support of the Doing What Works project.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is “of the people, by the people, and for the people.”

Center for American Progress

