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5 Muni Market Incentives to 'Build Back Better.'

The White House is formulating a massive infrastructure package. Here are cost-cutting ways for Congress to help states and localities float the bonds to fund their share. Muni "flower bonds," anyone?

With Transportation Secretary Pete Buttigieg, a former mayor, leading the charge to make good on President Biden's campaign pledge to "Build Back Better," state and local officials are daring to hope that a massive new federal infrastructure program will pay for upgraded roads and bridges, transit lines, civic and school buildings, water and sewer systems, and the jobs that building and operating them would bring.

But no matter what shape a congressional deal takes, many if not most intergovernmental grants will require local matching funds to be raised with bond issues and repaid over the life of the new facilities. As Congress plays poker on the overall package, it must also make it easier and more cost-effective for states and localities to finance their matching shares. The federal jackpot will sit just there if governors and mayors can't pony up their ante.

The traditional vehicle for funding public works at the local level has been tax-exempt municipal bonds, which usually enjoy a lower interest rate than equivalent-quality taxable corporate bonds. In the 1988 case of South Carolina v. Baker, the Supreme Court held that this muni bond tax exemption was just a privilege granted by Congress, not guaranteed by the 10th Amendment. Conservative muni finance advocates (and self-interested underwriters) are keen to preserve this privilege and avoid rocking the boat with alternative financing schemes. So don't be surprised to hear some pushback on innovative policy options — especially those that displace the bond peddlers — despite their obvious economic merits. Here are five fiscally efficient ideas that ought to be aired with the White House and the Treasury:

1. Rebrand BABs as B4s. In 2009, responding to the global financial crisis, Congress gave states and localities the option to issue their bonds with taxable interest, with a generous promise to cover 35 percent of the interest costs for the life of the bond. They were called Build America Bonds (BABs). That program expired in 2010. Economists can demonstrate that a more modest, yet ultimately equivalent upfront federal project subsidy today of 25 percent could be more economical for many local taxpayers than allowing wealthy investors to avoid taxes on muni bond interest. Nobody can argue that the muni market wouldn't benefit from having a portion of its bonds taxable, expanding the pool of buyers by making them attractive to pension funds, IRAs and foreign investors who don't care about tax exemption. Call them "Build Back Better Bonds" (BBBBs, or B4s).

2. Go bigger with cheap muni money, right now. Municipalities are required to spend bond proceeds within a limited time period to prevent profiting from playing off short-term taxable money-market interest rates against tax-free muni bond rates. Violations risk loss of tax exemption. This rule makes no sense in today's low-rate market. Congress should actually encourage states and localities to issue the largest possible long-term bond issues they can afford right now, at today's skimpy interest rates. Just eliminate restrictions on investment income before 2026 for muni bond sales in 2022 with a 10-year or longer average life. Only issuers that fail to break ground by 2026 should forfeit any investment profit on the bond proceeds. This can help accelerate infrastructure expenditures in the next two years, when the economy is still recovering, and "bank" low-cost bond proceeds for immediate deployment later, when opportune. Let's outrun inflation in construction costs and inevitably higher interest costs by selling as many munis as possible now, while the Federal Reserve remains accommodative.

3. Open the FFB window to Build Back Better. I've previously suggested that the Federal Financing Bank, an arm of the Treasury, could provide lower-cost loans to states and state bond banks. In today's skewed capital markets, taxable Treasury bonds carry lower interest rates than AA-rated tax-exempt munis, so a straight pass-through would be a win-win for both federal and muni taxpayers. For qualifying deals in 2022-23, the FFB could charge states for principal only, with Congress paying the interest expense until 2025. In today's low-rate marketplace, the FFB's interest cost would then be less than the income tax subsidy now enjoyed by tax-exempt munis. Conceptually, if every municipal bond sold nationwide in 2020 were instead funded this way using 10-year Treasury notes, Uncle Sam's total cumulative net cost would be less than $30 billion over the standard congressional 10-year budget scoring period, about $3 billion annually. That is just a rounding error in a multi-trillion-dollar infrastructure plan.

Of course, an interest-free window that big would put the entire muni bond underwriting industry out of work, which is sure to invite heated muni underwriter and bond counsel opposition cloaked as principled conservatism. A more politically palatable strategy would allow FFB access only for specified priority initiatives. That could include health and safety hazard remediation (including water systems and bridges), mass transit and green initiatives, while keeping this brief FFB borrowing window a limited experiment.

4. Provide a tax break for qualified P3 bonds and dividends. An infrastructure bonanza will undoubtedly include pitches for public-private partnerships, dubbed "P3s" by the trade. Various projects to fund facilities that can be financed by user charges are ripe targets for such privatization or semi-privatization.

What if private partnerships that work collaboratively with public agencies could issue their bonds or preferred stock with payouts subject to preferentially lower tax rates? Normally such income from partnerships is taxable at higher ordinary income tax rates, so the financial incentive would be meaningful. The advantage here is that state income tax revenues would not be reduced, but actually bolstered when compared with tax-free muni bond interest. To qualify, such projects should clearly benefit public purposes and cut carbons while requiring revenue- or profit-sharing with a public agency.

5. Protect bond investors from inflation. All this deficit spending has investors worried about future inflation, which has nudged interest rates higher lately. If future inflation arises, it's arguably a problem caused by Congress and the central bank, not states and localities. To protect fixed-income investors, Congress can add inflation protection to Treasury bonds held at least 10 years by a pension fund or a qualified retirement account, or purchased through local banks as a retail savings bond. Public pension funds can employ these useful tools for various portfolio strategies, including sophisticated swap transactions to attach the inflation protection to their diversified bond portfolios. Congress could also reimburse an inflation adjustment of principal at maturity of taxable municipal bonds (the B4s described above), which would be ideal investments for pension funds and insurance companies.

A novel tax-exempt muni bond enhancement could borrow conceptually from special redemption privileges attached to low-rate Treasury bonds in the late 20th century. They were known as "flower bonds" (as in lilies at a funeral) because they were redeemable at their face value for settlement of federal estate taxes. For zero-coupon muni flower bonds — which would pay no interest and be sold at a discount — that are issued before 2024, Congress could reimburse Federal Reserve System banks for tax-free make-whole redemptions at their accreted value when held by retirees for at least 10 years, or in settlement of estate taxes. That would enable today's issuers to enjoy the lowest borrowing rates of a lifetime while protecting investors from future inflation. All of these inflation protections would reduce municipal borrowing costs, and if future inflation remains as tame as many economists and public officials continue to predict, it would be a win-win for everybody.

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