Bond Case Briefs

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There’s a Better Way to Pay for Infrastructure.

One tweak to municipal finance could get more money where it belongs.

President Joe Biden wants to transform America’s infrastructure. While he’s at it, he should also consider transforming the way state and local governments pay for it.

Washington has long provided incentives for municipalities to invest in public goods. This makes perfect sense, because some of the benefits of things such as roads, bridges and schools accrue to the whole country — in the form of better transportation, a more educated populace, greater productivity.

One big federal subsidy comes in the form of a tax exemption: Investors in municipal debt don’t have to pay income tax on the interest they receive. This has made municipal bonds very popular among tax-sensitive people and organizations, giving rise to a multi-trillion-dollar market. It also allows state and local governments to borrow at lower interest rates, saving them billions of dollars a year.

Yet the tax exemption has some serious flaws. For one, it’s worthless for investors not subject to federal income tax — such as pension funds and foreigners — whose demand could otherwise push borrowing costs down further. Also, because the exemption is worth more to higher-rate taxpayers, some of the subsidy flows to them rather than to the state and local issuers. (An investor in the top income-tax bracket, for example, gets the full 37% break compared with a taxable bond, while an issuer might get an overall discount of only 22% on interest costs.) This “leakage” can amount to several billion dollars a year.

There’s a proven alternative. As part of its efforts to support the recovery from the 2008 financial crisis, the federal government introduced something called Build America Bonds. Instead of offering a tax exemption, the federal government simply paid issuers a portion of the interest, and collected tax from investors as with any other bonds. The program was a success: It eliminated leakage, lowered borrowing costs by expanding the investor base, and coexisted perfectly well with traditional municipal securities. State and local governments raised more than $180 billion over less than two years, for projects ranging from sewers to firehouses.

Unfortunately, politics stalled the program. First, a Republican-controlled legislature declined to extend it beyond 2010, more as a partisan rebuke to the Democratic administration than for any particular failure. Then, a 2011 battle over the federal debt ceiling led to sharp and indiscriminate budget cuts — including to the share of interest that the federal government had promised to pay the issuers. This dealt a blow to confidence that hasn’t been forgotten.

Now, though, some lawmakers are proposing a revival. This is a welcome development, provided it incorporates the lessons of the past. In particular, Congress — which is holding hearings this week on financing infrastructure — would need to guarantee funds for the subsidy, to avoid a repeat of the budget sequestration debacle. Beyond that, keeping the overall cost of support for municipal borrowing steady implies a subsidy of around 28% of interest payments, as opposed to the 35% of the original Build America Bonds.

One might ask why the government should introduce a new financing option now, at a time when the Biden administration is promising trillions of dollars in investment, and when ample demand for municipal debt is pushing yields to extreme lows. The answer is simple. The purpose is not to remedy a shortage of borrowing and investment, but to ensure that federal support for those productive outlays is as cost-effective as possible.

Bloomberg Opinion

By Editorial Board

May 18, 2021, 6:00 AM MDT