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The American Jobs Plan's Effect on the Municipal Bond Market – Taxable Direct Pay Bond

Although there are several versions of the American Jobs Plan at this point, nearly all include a provision to refurbish the nation's crumbling infrastructure, including roads, bridges, public transit, airports, clean water, rail, and ports. Most of the components of these bills contain an element that may affect the municipal market. The three most talked about ideas include tax-exempt bonds, private activity bonds and taxable direct pay bonds. The focus of this article will be to explore the taxable direct pay bonds.

The government's last involvement in taxable direct pay bond issues date back to 2009 and 2010, when the Build America Bond program was introduced. Build America Bonds (BABs) were issued as part of the American Recovery and Reinvestment Act (ARRA). Some $180 Billion of debt was issued using two types of BABs, Tax Credit and Direct Payment.

Tax Credit bonds gave bondholders a 35% federal subsidy on the interest paid through refundable tax credits which could be carried forward. Direct Payment offered a rebate that was paid to the bond issuer. This feature allowed municipalities to issue fully taxable municipal bonds with the Federal Government reimbursing the issuer with a tax subsidy of 35% of the issuers interest expense owed to investors.

Many issuers realized that short-term tax-exempt rates had lower interest costs than the 35% subsidy. Consequently, a hybrid approach was utilized. Shorter maturities were issued as tax-exempt, and as the rebate made it more advantageous, longer maturities were structured using the BABs program. Payments ran smoothly until 2013 when budget spending cuts forced the IRS to reduce the allowable 35% interest subsidy. In 2013 it declined to 26.3% and is currently at 29.3% which is anticipated to remain in effect until 2030 without further congressional actions.

Municipal issuers now realize that without appropriations by Congress the rebate can be affected, and they may be hesitant to utilize the program without those agreements. The taxable direct pay bond programs currently under discussion are trying to overcome obstacles such as sequestration and debit limit ceilings. We believe, depending on market conditions, any future taxable direct pay programs will likely include both tax-exempt and taxable bonds.

The effect on the municipal bond market could be increased issuance which could satisfy the demand from both individual and corporate investors. Depending on the plan adopted by Congress and the President, other changes could be in store for the municipal market.

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