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Bring Back BABs

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

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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.

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