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Markets Insight

A better way to pay for infrastructure investments

A revival of the Obama-era Build America bonds would raise funds with less taxes

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There is plenty to like about the proposed infrastructure plan of Joe Biden's administration: who does not want better roads, clean water and faster broadband to binge on Netflix? But while the ends are laudable, it is the means to get there that are more politically contentious. As in, how to pay for the $1tn wish list?

There are only so many wealthy people and corporations to tax, as the left would prefer, and many have access to smart accountants. With bouts of inflation scares in the markets, and rising prices already walloping consumers at the grocery store and on car lots, printing money will not go over well.

Others can argue over the specifics of the president's plan. My concern, and that of many taxpayers who will foot the bill, is where the money comes from. Buried in the Biden administration's proposal is a passing reference to "direct pay bonds", which I believe is the single best way to finance much of the plan.

Despite the generic name, these are essentially juiced-up municipal bonds issued by state and local governments. The interest payments are subsidised by the federal government, and they are taxable, which expands the potential market to pension funds, endowments and sovereign wealth funds. Tax-exempt munis are of little use to that type of investor who prefers to have the higher yields on offer for taxable equivalents.

The president should be familiar with the bonds since they are an updated version of the Obama-era Build America bonds. The American Recovery and Reinvestment Act of 2009 introduced BABs, taxable debt securities that were issued by states and municipalities to finance capital expenditures.

The coupon paid by the issuer of each bond carried a 35 per cent subsidy provided by the federal government, which lowered the cost of borrowing for state and local governments. More than $180bn of them were sold before the programme lapsed at the end of 2010.

A more recent, bipartisan, version was introduced in April as the American Infrastructure Bonds Act of 2021. This would create a new bond with a flat 28 per cent reimbursement rate to the issuers.

The advantage of BABs, as opposed to Treasuries, is that they finance spending at the local level, which effectively makes cities, states and investors partners in infrastructure investments, instead of passive bystanders to the Feds.

Not that deficits seem to matter any more, but BABs also would not add to the bulging national debt like Treasuries. State and local governments already supply almost 60 per cent of the capital costs and a whopping 90 per cent of the operation and maintenance expenses of the nation's infrastructure, according to the Congressional Budget Office.

An expanded version of the Build America Bonds programme — call it BAB 2.0 — could meet a significant portion of the country's estimated $4tn in infrastructure needs, including the Biden administration's spending plans.

Under BAB 2.0, states and cities would issue $4tn over two years to fund a ramped-up schedule of infrastructure projects, with the federal government this time subsidising up to 100 per cent of the interest expense, reflecting the nation's dire need for infrastructure.

At the current interest rate on taxable muni bonds of about 2 per cent, this would cost the federal government $80bn a year. Federal tax receipts on investors' interest income would lower the net budgetary impact. Assuming that half the investors are taxed, and using the highest marginal federal income tax rate of 37 per cent, the annual cost would be reduced to $65bn.

The interest subsidy could be adjusted depending on the appeal of the intended project, with clean-energy technologies, for instance, receiving more support than something producing a large carbon footprint.

One thing we have learnt from previous experience is that a new version of BABs would need to be exempt from sequestration, automatic federal spending cuts that occur through the withdrawal of funding for government programmes. These create uncertainty among issuers. Sequestration is expected to reduce the federal interest subsidies paid to the bond issuers by 5.7 per cent between 2021 and 2030.

But with that and other concerns addressed, BABs would be a smart way to address the nation's infrastructure needs without overly burdening taxpayers. Given the current state of our infrastructure and a mixed economic outlook, Washington needs a bold plan. Bringing back Build America Bonds will not only meet our capital spending needs but will also put people back to work and set the stage for a more productive economy in the long run.

The writer is co-founder and chief investment officer of Guggenheim Partners

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