

# Build America Bonds (BABs)

## Transportation Finance Innovations

### Quick Facts

- ▶ BABs are taxable bonds that can be issued by State and local governments, and are subsidized by the U.S. Treasury.
- ▶ BABs can receive subsidy either through a direct payment from the Treasury or through tax credits provided to bondholders.
- ▶ As of December 2010, about \$48 billion in BABs had been issued for surface transportation purposes.
- ▶ BABs receive a Federal subsidy of 35 percent of the interest payment.

### Contact

Cheryl Jones  
202-366-0317  
cheryl.jones@dot.gov  
www.fhwa.dot.gov/ipd



U.S. Department of Transportation  
Federal Highway Administration

**B**UILD AMERICA Bonds (BABs) were authorized by the American Recovery and Reinvestment Act (ARRA) enacted in February 2009. BABs are taxable bonds that are eligible for an interest rate subsidy paid directly from the U.S. Treasury. States and local governments can issue BABs through December 2010. Surface transportation projects are among other public infrastructure projects (e.g., public buildings, courthouses, schools, water and sewer projects, etc.) that are eligible for BAB financing.

### How Do They Work?

BABs were created to supplement State and local government's capacity to access conventional corporate debt markets for public infrastructure, instead of issuing traditional tax-exempt debt. The BAB program is designed to provide a Federal subsidy for a larger portion of the borrowing costs of State and local governments than traditional tax-exempt bonds in order to stimulate the economy, create jobs, and encourage investments in capital projects in 2009 and 2010.

The BABs subsidy is equal to 35 percent of the interest payment, which results in lower net borrowing costs (see sidebar). The U.S. Treasury has published guidance on use of the BABs program and procedures for applying for refundable credits.

### What Are the Benefits?

BABs may result in net lower interest costs than comparable municipal tax-exempt debt, and there is no cap on the amount of BABs that can be issued through the end of 2010.

For most issuers, BABs offer a considerable advantage over tax-exempt municipal bond issuance given the current subsidy rate of 35 percent versus prevailing interest rates. BABs also have the advantage of broadening the market for municipal issuers by bringing in new investors who do not benefit from the tax-exemption feature available with typical tax-exempt municipal bond investments.

### How Is It Used?

Tax Credit BABs can be used for the same purposes as tax-exempt borrowing (i.e., new construction, refunding bonds, and working capital). Direct BABs proceeds, however, are strictly limited to new construction. As of December 2010, all BABs

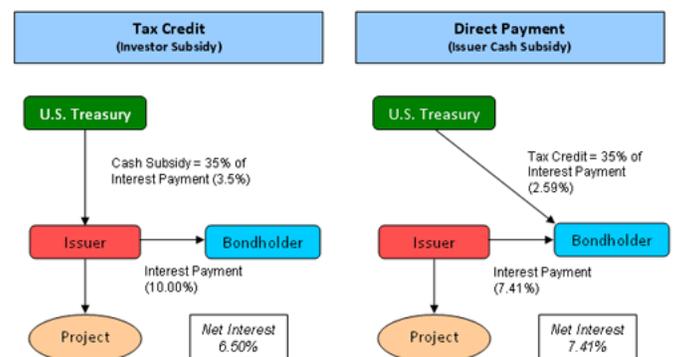


Chart showing the two types of BABs, for an interest rate of 10 percent.

Source: Mercator Advisors; AASHTO Center for Excellence in Transportation Finance

debt issued was direct payment, and about 26 percent of the proceeds (\$48 billion for surface transportation) had been identified for transportation uses.

BABs have been a considerable success in stimulating the bond markets and enhancing investment in infrastructure. As such, bond market representatives and the Obama Administration have called for direct payment BABs to be made permanent. The Obama Administration, in its 2011 Budget proposals, called for BABs to



Dulles Corridor Metrorail Project construction, Northern Virginia

be made permanent, but at a lower interest rate subsidy—28 percent instead of 35 percent. New Congressional Budget Office estimates project the BAB subsidies at \$3 billion per year versus previous estimates of about \$1 billion a year.

### Potential Advantages

- BABs can lower the cost of financing for projects.
- State and local governments do not have to apply to use BABs: there is no limit on issuance as long as rules are followed.

### Potential Limitations

- BABs cannot be used in conjunction with private involvement or private activity.
- Use of direct-subsidy BAB proceeds is limited to new construction. ■

## TYPES OF BAB SUBSIDY ARRANGEMENTS

There are various types of subsidy arrangements under BABs:

► **Direct-Payment (or qualified) BABs**, the most common, in which the issuer (i.e., the State or local government) receives a payment of 35 percent of the interest cost from the U.S. Treasury.

Within this subsidy arrangement, the Recovery Zone BAB has a higher subsidy payment (45 percent of the interest cost); however, these are capped at \$10 billion nationwide and can only be used in economically distressed areas.

► **Tax-Credit BABs**, in which the bondholder receives a tax credit equal to 35 percent of the coupon interest.

### Direct-Payment BABs versus Tax-Credit BABs

Assuming a \$1,000 bond with an interest rate of 10 percent:

► **Direct Payment BAB**—The issuer would pay 100 percent of the taxable rate interest cost to the investor (\$100) and apply for a refundable tax credit itself from the U.S. Treasury in an amount equal to 35 percent of the gross interest paid by the issuer (\$35). For the issuer, the effective interest rate is 6.5 percent.

► **Tax-Credit BAB**—The issuer would pay \$74.07 in interest, and the investor would receive a supplemental credit equal to 35 percent of the interest the issuer paid or \$25.93, to provide the total desired annual return of \$100. In this manner, the effective interest rate for the issuer is reduced by 26 percent. The investor can apply the tax credits against regular income tax liability and alternative minimum tax, and unused tax credits may be carried forward to the next year.



### PROGRAM AREAS OF THE OFFICE OF INNOVATIVE PROGRAM DELIVERY

IPD provides a one-stop source for expertise, guidance, research, decision tools, and publications on program delivery innovations. Our Web page, workshops, and other resources help build the capacity of transportation professionals to deliver innovation.

### PROJECT DELIVERY

IPD's project delivery team covers cost estimation, financial planning, and project management and assists FHWA Divisions with statutory requirements for major projects (e.g., cost estimation, financial plans, and project management plans).

### PROJECT FINANCE

IPD's project finance program focuses on alternative financing, including State Infrastructure Banks (SIBs), Grant Anticipation Revenue Vehicles (GARVEEs), and Build America Bonds (BABs).

### PUBLIC-PRIVATE PARTNERSHIPS

IPD's P3 program covers alternative procurement options (e.g., toll concessions and availability payments), which can reduce cost, improve project quality, and provide additional financing options (e.g., Private Activity Bonds [PABs]).

### REVENUE

IPD's revenue program focuses on how governments can use innovation to generate revenue from transportation projects (e.g., value capture, developer mitigation fees, air rights, and road pricing).

### TIFIA

The Transportation Infrastructure Finance and Innovation Act (TIFIA) program provides credit assistance for significant projects. Many surface transportation projects—highway, transit, railroad, intermodal freight, and port access—are eligible to apply for assistance.



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