Applying a 28% Limit on the Value of the Municipal Exemptions: A Federally Imposed Local Tax

Background

The Administration and some in Congress have proposed a 28% limit on the value of deductions and exemptions, and the proposal would apply retroactively to the tax exemption on municipal bonds. This proposal seeks to "broaden the base" to raise revenues so that the Federal Government can address its deficit. The reality of the proposal, however, is to fundamentally alter 100 years of precedent in the relationship between the federal government and state and local governments by essentially taxing state and local government bonds, making their access to capital markets more expensive. The proposal amounts to a federally imposed local tax.

Tax-exempt municipal bonds are the means by which state and local governments access capital – borrow money – to finance roads, schools, bridges, affordable housing, hospitals and other infrastructure that provides a public benefit. These public works make the nation's cities and towns attractive places to live, and competitive places to do business. The tax exemption arises from the strictly public purpose of the infrastructure. Bonds are repaid to investors, and repaid with extraordinarily low historic default rates, making them attractive for investors. From the perspective of state and local issuers, they are an affordable financing tool. The interest payments investors in municipal bonds receive are exempt from taxation, which means lower interest rates can be paid to investors by local governments seeking to borrow funds.

Proposals to limit the value of the municipal bond exemption would raise borrowing costs for state and local governments, shift federal costs to local taxpayers, limit public infrastructure and put the federal government – rather than the marketplace – in charge of determining the cost of local capital. Worse, the proposals would not solve the nation's fiscal crisis. Instead, the federal government is simply shifting costs at the expense of the nation's own infrastructure. Whether retroactively applied to harm the value of bonds currently held by investors, or prospectively applied to tax historically exempt interest on new bond issues, the proposals would needlessly increase state and local borrowing costs and harm investors.

Market Analysis

Beyond the flaws inherent in limiting the value of the municipal bond exemption, there are analyses available that help describe the level of havoc the proposal would wreak in the bond markets. For earners in the 39.6% bracket, the 28% limit on the value of the municipal bond exemption amounts to a tax of 11.6% on income that was once entirely exempt from taxation. There are two market issues with this approach: (1) the quantifiable destruction of the value of bonds for all investors due to the reduced value of the exemption, which equates to higher local government borrowing costs, and (2) the

amplification of this effect due to the perception that the federal government has started down a slippery slope wherein taxes on municipal bond interest will continue to increase.

The effects of a 28% limit on the municipal exemption can be estimated by examining recent market experiences. For a period in December, when investors first perceived that the cap could be enacted, municipal bond funds experienced net cash outflows. The increase in tax-exempt yields for municipal bonds was 14 - 40 basis points greater than the increase in Treasury yields, which likely reflects the market's reaction to the mere possibility that a 28% limit could be imposed. By the numbers, for someone in the 39.6% bracket, the 28% limitation would lower by 29 basis points the after-tax return on a tax-exempt bond (assuming an average yield of 2.5%). In addition to increasing the borrowing costs for state and local governments, such increases in yield reduce the value of outstanding bonds for all holders, as investors who might purchase those bonds must now demand higher yields to adjust for the limit on the value of the tax exemption. Assuming an average duration of 6.5 years (based upon the Standard & Poor's Municipal Bond Index), a 29 basis point increase in yields would reduce the value of $3.7 trillion in outstanding municipal bonds by about $70 billion.

Moreover, while the 28% limit is designed to target only wealthier investors, the reality is that all bond investors felt the effect of yield increases in December and would feel the effect if the proposal were enacted. It is noteworthy that 55.5% of all tax-exempt income was reported by taxpayers with AGIs of under $250,000. And, almost 60% of the tax-exempt income is reported by earners over the age of 65.

The numbers provided above are quantifiable measures of the effects of a tax on interest income on municipal bonds. But there is another factor that is likely to worsen the effects of the cap. The effects of the tax on municipal bond interest would be amplified due to uncertainty about the future – specifically, the perceived risk that the federal government, once it begins to undermine the exemption, will seek to reduce the exemption even further in the future. History can be a guide to the harm to the markets caused by uncertainty. Following the 2008 financial crisis, the ratio of the value of Municipal to Treasury yields jumped considerably, from 90% to 200%. In December of 2008, the 30-year AAA municipal benchmark was 5.21%, while the 30 Year Treasury was only 2.57%. This was the result of a flood of municipal bonds being dumped on the markets due to fiscal uncertainty. This was costly for state and local governments with investors demanding extraordinary returns on municipal bonds due to perceived risks. Essentially, the market for the bonds issued to raise capital was frozen in place, choking the ability of state and local governments to fully function.

Given the uncertainty, a premium demanded by investors to account for the risk of future tax increases could be as much as 30-40 basis points. The resulting increases in borrowing costs would restrict infrastructure development and constrain the type of economic or job growth that is essential to addressing the fiscal crisis. Moreover, the combination of a retroactive cap and such a market reaction to tax uncertainty could, according to a January 18 Citigroup Municipal Strategists' analysis, decrease the value of existing municipal bonds by at least $185 billion. Applying a limit on the value of the municipal tax exemption shifts federal burdens to state and local governments and taxpayers and needlessly harms investors.

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