

# REPEALING TAX-EXEMPTION

Impact on Small and Medium sized Communities

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# INCREASED LOCAL GOVERNMENT FINANCING COSTS ultimately lead to higher taxes and fees.

This report demonstrates the potentially detrimental effects on taxpayers and residents if municipalities are forced to issue taxable debt as a result of proposed changes to the federal income tax-exemption of municipal bonds. This is a core issue for local governments, particularly in the face of current and future budget constraints. The impacts are no more evident than when viewed from the perspective of small and medium-sized issuers, who comprise the majority of financings that come to market each year. The two examples presented in this report quantify the increased financing costs that will result if the tax-exempt financing option is repealed or if a limit is applied on the value of tax-exemption. These case studies should serve as a warning for thousands of communities across the country.

Each year thousands of communities issue tax-exempt bonds to finance infrastructure projects. They build schools, roads, courthouses, and village halls. They invest in essential water and sewer projects, and public safety initiatives. Without question, every man, woman, and child living in these communities benefit from

these public purpose facilities. Equally indisputable, is that without a tax-exempt financing mechanism the cost of these projects could increase significantly. While the increase in costs will vary from community to community, the result will be: fewer critical projects built, diminished effectiveness of scaled back projects, and almost certainly higher local taxes and fees. We believe local taxpayers and residents across the country would find all of these scenarios upsetting and problematical.

This analysis features two Illinois municipalities that both issued a taxable and tax-exempt series on the same day. Lemont issued in 2012 and Rockford in 2009. Additionally, we chose these two examples because:

- The tax-exempt and taxable series are of similar size and similar structure.
- Both issuers, in recent years, have accessed the market every 12-18 months and are of solid credit quality.
- Both are above average in their levels of market sophistication and understanding.

Our data is based on actual numbers and facts and not grounded in a multitude of abstractions and assumptions. The data represents market reality, not academic theory which often serves as the basis of reports critical of the present day municipal bond market.

Column A shows the issuer’s actual borrowing cost. It shows the combined annual debt service payments of the tax-exempt and taxable series, the total debt service of both issues and the respective Net Interest Cost (NIC) of the tax-exempt and taxable series.

Column B shows a revised debt service payment schedule. Column B totals the cost differential between the issuer’s actual cost of its tax-exempt/taxable series combination versus a similarly structured taxable issuance. This side by side comparison illustrates the increased debt service cost the issuer would incur if prohibited from issuing the tax-exempt bond series captured in the Column A totals and instead issued one, larger, fully taxable series for the entire amount borrowed.

For the issues highlighted in Column A, the respective tax-exempt and taxable series were not identical in par value size and debt amortization schedules did not mirror one another. In order to present the Panel B comparisons, we made these assumptions to arrive at the Column B debt service schedules:

1. We use the longer maturity, Column A amortization schedule of the two series (tax-exempt series in both cases).
2. We combine the par values of each maturity year in the Column A series into one taxable maturity in the Column B scenario. We realize this produces a front end loaded debt

service amortization in each Column B scenario rather than a level debt service run. This is atypical of what we view as a properly structured financing and most likely understates the additional cost incurred by the issuer.

3. We assume the basis point spread for any added maturities in Column B scenarios are at the same basis point differential as the actual spread on the final maturity of the Column A taxable series. This assumption most likely understates the true cost increase to the issuer. In our experience for smaller issuers such as these, the basis point differential for taxable issues tends to increase as the maturity date is extended.

Column C shows revised debt service schedules applying all of the same assumptions as made in the Column B scenarios with one significant modification; we assume a traditional, level debt service run for the issuer, a more likely debt borrowing structure than the Column B structure.

Village of Lemont Summary Debt Service Analysis			
	Column A	Column B	Column C
<u>Maturity</u>	<u>Combined Actual Debt Service*</u>	<u>Total Estimated Debt Service</u>	<u>Total Estimated Debt Service</u>
2013	\$ -	\$ 318,763	\$ 342,882
2014	187,220	326,008	350,675
2015	602,245	621,008	685,675
2016	753,395	775,108	683,975
2017	760,520	785,553	686,835
2018	762,070	788,203	682,735
2019	758,195	784,483	682,795
2020	762,395	783,233	685,933
2021	763,345	789,435	682,063
2022	758,545	783,645	687,048
2023	758,195	781,445	685,648
2024	760,375	782,295	682,798
2025	755,730	775,895	683,438
2026	759,410	777,375	682,278
2027	756,600	772,150	684,958
2028	274,000	290,088	685,970
2029	275,000	288,275	683,145
2030	275,600	285,938	684,008
2031	275,800	282,953	683,003
2032	275,600	279,310	685,100
<b>Total:</b>	<b>\$ 11,274,240</b>	<b>\$ 12,071,158</b>	<b>\$ 13,010,957</b>
<b>%Change:</b>	<b>- %</b>	<b>7.07%</b>	<b>15.40%</b>
<b>\$Change:</b>	<b>\$ -</b>	<b>\$ 796,918</b>	<b>\$ 1,736,717</b>
<b>NIC:</b>	<b>2012A: 3.65%</b>	<b>4.39%</b>	<b>4.72%</b>
	<b>2012B: 4.23%</b>		

\* Combines debt service from both 2012A (tax-exempt) and 2012B (taxable) issues.

City of Rockford Summary Debt Service Analysis			
	Column A	Column B	Column C
Maturity	Combined Actual Debt Service*	Total Estimated Debt Service	Total Estimated Debt Service
2009	\$ 97,641	\$ 103,229	\$ 104,839
2010	130,188	138,150	140,305
2011	230,188	238,150	225,305
2012	225,225	234,150	226,905
2013	220,263	229,950	228,125
2014	215,288	225,550	223,945
2015	210,313	220,950	224,575
2016	230,313	241,150	224,775
2017	224,113	235,025	224,630
2018	217,913	228,775	229,130
2019	211,713	222,400	228,010
2020	255,513	265,900	226,510
2021	246,638	256,625	224,620
2022	237,675	247,175	227,330
2023	278,613	287,550	224,355
2024	267,075	274,950	225,955
2025	155,438	162,125	226,835
2026	149,500	155,000	227,145
2027	143,500	147,625	226,525
2028	137,500	140,250	225,315
2029	131,250	132,625	228,115
<b>Total:</b>	<b>\$ 4,215,853</b>	<b>\$ 4,387,304</b>	<b>\$ 4,543,249</b>
<b>%Change:</b>	<b>- %</b>	<b>4.07%</b>	<b>7.77%</b>
<b>\$Change:</b>	<b>\$ -</b>	<b>\$ 171,451</b>	<b>\$ 327,396</b>
<b>NIC:</b>	<b>2009A: 4.86%</b>	<b>5.54%</b>	<b>5.63%</b>
	<b>2009B: 5.56%</b>		

\* Combines debt service from both 2009A (tax-exempt) and 2009B (taxable) issues.

As you can see, the result of losing tax-exempt status is telling and financially significant for these two local governments.

In the Village of Lemont, Illinois scenarios, the total interest cost and total debt service costs increase dramatically. This is a direct outcome of having to issue taxable bonds for the entire village hall renovation project rather than relying on tax-exempt financing for approximately 43% of the project cost.

Specifically:

- A. Lemont's total project cost will increase almost \$800,000 or 7 percent in the Column B scenario. This equates to an annual debt service cost increase of approximately \$44,000, not an insignificant increase given the Village's 2012 operating budget of \$7 million. If this increase in debt service is not funded out of general operating revenues then local real estate taxes and fees may be raised to compensate for the shortfall or the project scope will be reduced. Either scenario is dubious for Lemont and its residents.
- B. The Column C scenario offers an even direr picture for the Village, Lemont's total project cost will increase over 15%

compared to its actual cost. This debt structure scenario is more likely than the structure used in Column B adding \$1,737,000 of project costs for Lemont and its residents. At these costs levels, the project is likely untenable.

- C. Similarly, Rockford, Illinois would see its financing costs increase 4 percent in the Column B scenario and approximately \$327,000 or 8 percent in the third scenario.

These examples show the important role tax-exempt financing plays in lowering building costs in these communities making essential public purpose building projects financially feasible. Additionally, there are many taxing bodies serving these communities. Lemont taxpayers and residents are typically assessed by more than one dozen different jurisdictions. The debt service costs of these jurisdictions would also increase similarly.

Communities across the country would experience similar increases in their project costs if tax exemption is repealed or reduced. In fact, we would expect less frequent, lower credit issuers to see cost increases of even greater magnitude than what "Aa2" rated Lemont and "A1" rated Rockford scenarios show.

Repealing tax-exemption or substantively altering it by capping it at 28% will increase financing costs for local building projects across the country. This impacts all of us in a significant way.

Tax-exemption allows local officials, driven by local needs to make affordable infrastructure investments their communities need, want and are willing to finance. The current market tends to allocate capital efficiently when all its benefits are considered- jobs creation, reduced cost of capital for local building projects, risk distribution to investors, autonomous decision making. These are dynamics of a healthy and efficient market that should be fostered not curtailed. Today, local governments can raise capital at low interest rates not seen in over four decades independently of the federal government.

Tax-exemption helps ensure this independence. Not all tax expenditures are bad policy. Tax-exempt municipal bonds issued to finance essential purpose building projects is one such instance.

Why alter this successful dynamic?

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