TAX EXEMPT MUNICIPAL BONDS

The Case for an Efficient, Low-Cost, Job-Creating Tax Expenditure

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BERNARDI SECURITIES, INC. and its senior principals have specialized in the municipal securities investment business for more than 30 years. During that time, we have come to appreciate the wide ranging benefits of tax-exempt municipal financing. Obviously, one of those benefits - the tax exemption on interest - accrues to individual investors who find municipal bonds to be a safe haven for a portion of their investment funds.

Introduction

Less apparent perhaps, but no less important, are the effects that municipal financings have on the lives and pocketbooks of nearly every US citizen. Local governments and authorities – the entities most in touch with local needs – participate in the municipal bond market to finance important projects for their communities: schools, courts, jails, and water/sewer facilities to name a few. In so doing, they take advantage of the lower costs and greater stability offered by the municipal market to build infrastructure and spur the creation of associated jobs.

It is this latter set of benefits that motivated this study defending the tax-exempt municipal bond. For in the face of a chorus of influential voices suggesting repeal of the exemption as a federal revenue producer, we realized that policy-makers might not have as clear an understanding of the totality of these benefits as those of us working on the front lines of the market.

This realization was exacerbated when proposed alternatives called for direct federal subsidies and/or tax credits. At best, we felt that the alternatives would result in unprecedented federal intervention in state and local affairs; at worst, we could see a set of unintended financial consequences to rival those of the sub-prime mortgage era. Our suspicions were further magnified with the release of supporting documentation from the federal

government that badly miscalculated both the revenue impact and the market reaction.

Our examination took us on a trip into the 117-year history of tax-exempt municipal financing, trying to enlighten today's debate with historical perspective. To help us organize our thinking and arrive at our conclusions, we relied heavily on our own accumulated market data to complement our experience with municipal issuers and investors over the past three decades. We also consulted the research of market experts and respected academicians to round out our views.

We owe gratitude to our staff for their willing participation in this project. Without the advantage of their experience and the deep knowledge of the municipal marketplace, our study would not have yielded results nearly as insightful.

Summary Conclusions

Proposals to reduce federal debt have largely missed the mark. That is certainly the case when it comes to suggestions to replace tax-exempt municipal bonds with taxable alternatives or federally subsidized tax credit options. These alternatives not only produce much less in revenue for the US Treasury than most assume, they also result in a loss of local control, diminish access to jobs-producing capital, and put taxpayers on the hook with debt "guarantees" reminiscent of the subprime mortgage era.

That's the conclusion that our team reached after an extensive study of the municipal bond market, whose history reveals an unusually robust set of returns for government initiated projects and whose future has been clouded by an epidemic of shortsightedness when it comes to federal tax and budget policy. We worry, in fact, that proposed structural changes in the municipal bond market are another case of a heavy-handed government opting for simplistic solutions to highly complex problems, a path that inevitably leads to perilous unintended consequences.

The concern arises in response to plans put forward by three prominent groups seeking to advise Congress on debt reduction. The Bowles – Simpson, Domenici – Rivlin and Wyden – Coats plans each call for the elimination of many so-called tax expenditures, i.e. those for which the federal government foregoes tax revenue to incent or reward "investment" behaviors on the part of individuals, companies and institutions.

The home mortgage interest deduction is one such target. At $100 billion a year, it is one of the largest tax expenditures for individual taxpayers; and so is the tax-exemption for individual holders of municipal bonds, which the Joint Committee of Taxation (JCT) asserts could be worth up to approximately $30 billion a year to the US Treasury.

Using popular political calculus, i.e. small (relatively) dollar number + great complexity = less public resistance, repeal of the tax-exemption on municipal bonds figures to be much less controversial than the loss of the mortgage deduction. Yet, if Congress is serious about job creation and infrastructure repair, we think taxpayers would be better served if Congress would abandon expediency and tread more cautiously before tampering with a highly efficient and remarkably productive capital market.

Relying on Bernardi Securities, Inc. data from nearly three decades of participation in the municipal market along with the work of respected scholars, we looked at what might be in store if Congress eliminates tax-exempt bonds and substitutes taxable alternatives and federal subsidies paid to issuers (or investors) in the form of Treasury rebates. The review is much more notable for the risks it reveals than for the revenue opportunities it suggests.

First, subsidy provisions imperil local autonomy by stepping on a century of legal precedents affirming intergovernmental sovereignty. By subsidizing local infrastructure projects, a distant federal bureaucracy would necessarily gain sway over project and financing decisions more aptly left to state and local authorities with vested interests in the associated public policy objectives.

Next, subsidizing taxable securities has the practical effect of shifting local debt obligations to an already burdened US Treasury by "guaranteeing" repayment. With the scent of the mortgage meltdown still lingering, this outcome not only seems antithetical to federal debt reduction objectives, but it also portends a federal guarantee program on the order of FNMA and FREDDIE MAC, whose draw requests on the US Treasury have topped tens of billions of dollars annually since 2008 ... with no end in sight.

Another question that is left unexplored by the current set of proposals for repeal is whether the tax-exempt securities market is doing its job. Here the evidence seems clear. For almost one hundred years, tax-exemptions have provided state and local governments with a subsidy – some might say a market-based incentive – to finance projects deemed essential by constituents within defined taxing localities.

By leveling the competitive playing field for municipal issuers, the tax-exempt bond tends to allocate capital with great efficiency. Indeed, when all the benefits are considered – policy accomplishments, jobs creation, reduced costs of capital, distributions of risk, dividends to investors, etc. – we conclude that taxpayers realize far greater benefits than the price they pay for the subsidy.

In addition, no matter how you calculate it, the mature municipal bond marketplace offers very low borrowing costs for most issuers. On November 29th, 2011 Thomson – Reuters Municipal Market Data index shows a 10-year AAA-rated municipal bond yield of 2.22 percent and 3.21 percent for an A-rated municipal bond, bargain borrowing rates by any estimate. Moreover, using more transparent methods than those offered by JCT and CBO, the non-partisan Urban Institute calculates Treasury revenue "losses" from tax exemption to be about 50 percent less than JCT and CBO estimates.

Last, with the unemployment rate hovering at a seemingly intractable 9 percent and real unemployment at 16 percent, lawmakers need to be cognizant of the jobs impact afforded by a healthy and robust municipal debt market. Though neither JCT nor CBO calculates the jobs effect of projects financed using tax-exempt securities, one need only drive through their own community and take note of people working on administrative facilities, courts, jails, schools, sanitation facilities, and the like to gain a sense of inherent jobs production. If tax-exemption is repealed, the market will lose certain investor appeal and the costs for infrastructure projects will increase as municipalities issue higher cost taxable bonds to finance projects. Certain projects will be scaled back or eliminated entirely and an important employment engine will sputter, adversely affecting a wide swath of our citizenry.

> IF THE TAX exemption is repealed, certain projects will be scaled back - or eliminated entirely - and an important employment engine will sputter, adversely affecting a wide swath of our citizenry.

Its benefits notwithstanding, we did find places for improvement – changes that could be made to help bolster liquidity, further reduce borrower costs for important future infrastructure projects and add another level of stability to the market.

For one thing, Congress and the Administration need to answer the core question: Does the country want local control and responsibility of debt decision-making to prevail...or not?

If they do, then they need to make it clear to issuers and investors that the tax-exempt status of these securities is sacrosanct. Though the municipal market has been more stable than most, this clarification would subject it to even less volatility. In the meantime, the uncertainty only serves to elevate issuer borrowing costs and market volatility, a result that is exacerbated when government officials circulate legislation challenging or limiting tax-exemption.

We also think that the market would be well served by narrowing the definition of "public purpose infrastructure." The universe of valid tax-exempt projects is much too broad. Constraining that universe to municipal facilities only, for example, would reduce new-issue supply and thus lower borrowing costs as the nation grapples with its deteriorating infrastructure.

We also would like to see a concerted effort to standardize reporting requirements for issuers to include adequate and current credit information. We realize that state and local governments prefer Tower Amendment protections, but the fact is this information shortfall contributes somewhat to elevated issuer borrowing costs in today's market.

Finally, to comprehend a future without tax-exempt municipal bonds, we think legislators and policy makers need to understand the history of the market and have an appreciation for the efficiency, equity and effectiveness it has offered borrowers and investors for more than a century. In so doing, we believe policy makers and legislators will reach the same conclusions we did that:

- these instruments have been a critical source of capital for states and municipalities and, as a readily available financing vehicle, supports one of the nation's most consistent and reliable sources of job creation; and

- the tax-exempt municipal market does not need to be restructured or, in parlance du jour, "occupied." Instead, its status needs to be reaffirmed so that it can keep on doing its job without forcing new and unnecessary burdens on issuers, investors and taxpayers.

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