Preparing for Tax Reform in the Municipal Market

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For

NAHEFFA

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Potential timing and patterns

- Strong potential that this will be split into a *corporate* part and an *individual* part.
- The corporate part will be easier, but not easy — Probably by summer. The case for a lower corporate tax rate is very strong, given our rate compared to the remainder of the developed world.
- Strong desire to simplify and recover part of the $2 trillion housed overseas.
- Even with Republicans controlling all three power spots -- little consensus.
- Paul Ryan and the Ways and Means chairman, Kevin Brady of Texas, have both taken ownership of a House blueprint for Tax Reform.

Will the tax-exemption survive intact? Probably yes, but not without a fight.

- Issues: Cost, with JCT still using bad numbers (More on this to come)
- Perception of inefficiency

Issues Not Close to Being Resolved

- Border adjustment tax
- How to measure cost (dynamic scoring?)
- Revenue neutrality
- Distribution of benefit across the income spectrum

Corporates: What is the Maximum Tax Rate?

- Currently talking 20%, but believe it will float up to 25%
- Why: Border tax is going to be tough. 20% on imports, 0% on exports. Splits business sector in half—manufacturers vs. importers/retail. It is also highly inflationary.
- Revenue neutrality is going to be tough without it.
- Other key issues: Deductibility of interest, treatment of pass-throughs.
- Elimination of AMT

Individual Tax Plan

- Closer to consensus there, but the political issues will be tricky—distribution of benefits from cuts will become a huge issue.
- Benefits of elimination of estate tax, reduction in top rate flow hugely to the wealthy.
- Cost/scoring will have to be resolved.
- Nonpartisan Tax Policy Center—3/4 of benefits flow to the top 1%.
- Key issue: Tax rate on capital income—does it include taxable interest? **House, yes, Trump, not clear.** House tax rate incorporates a 50% exclusion that includes taxable bond interest.
- Mnuchin Promised "no absolute tax cut for the upper class."
- Still challenges for how to treat pass-throughs—LLCs, partnerships, Subchapter S corporations—House GOP plan has them at 25%.
- AMT eliminated. This would, of course, be a big deal for private activity bonds (PABs).
- Most itemized deductions would disappear, including one that allows the deduction of state and local taxes. But bigger standard deductions would take away much of the sting, reducing the incentives for most taxpayers to itemize at all. (Instead of 30%, just 5%.)

Republicans Whistling Past the Graveyard on Political Issues?

- Distribution of benefits hugely regressive. That matters more in this era of motivated progressives.
- Deficit hawks will squawk.
- Interplay with potentially costly ACA replacement.
- 16 ½% tax rate on bond interest vs. 33% maximum and 25% middle tax rate on wage income is a potential hot potato.
- Move to dynamic scoring would create huge pushback from economists

Implications for Municipals: A Potential Shift in the Demand Curve

- We will have to watch very closely to see whether the 50% exclusion on capital income includes taxable bonds. Competing with a 16 ½% tax rate would be a problem—substantially lower retail demand.
- At the corporate level, there are potential positives and minuses. **Positive**: elimination of the AMT would help P and C demand considerably, at a price. **Positive**: global shortage of quality long-term bonds. **Negative**: if the tax rate gets too low, the demand curve will shift downward, moving the intersection with the supply curve lower as well at a given yield level. The result would be higher relative rates.
- Watching for threats to the tax-exemption. Likely it survives. Implications get very "noisy" as tax rates, deductions, and other provisions move around.
- Elimination of deductibility of interest makes in-state bonds in high-tax states worth more to very high-income individuals, who are the ones that itemize. It could also have unintended consequences in terms of location of corporate offices, but probably not much.

State and Local Government “Asks”

- Preserve and expand PABs.
- More P3s linked with tax-exempt debt permitted.
- Fix the numbers, not the methodology.
- Pseudo-BABs
- Other forms of Federal spending on infrastructure also need to be “efficient.”
- If you do something for state and local governments that incorporates dynamic scoring, tax-exempts should also get that benefit in the scoring.

Part II: The Case for the Tax-Exemption:
JCT uses lousy numbers and incorporates a single, severe methodological flaw

- How JCT sees the world — Under its analysis, the JCT comes to three conclusions:
- That municipal yields as a percentage of taxable yields are high;
- That this high ratio results in the marginal tax rate of the marginal investor in municipals being low; and,
- That, as a consequence, everyone in a higher tax bracket received a “windfall”— a higher yield than would be needed to needed to attract them to buy municipals.

Severe Flaws in the Comparison

- Under their methodology, long-term municipal yields as a percentage of corporate yields would indeed be quite high—roughly 94% on long-term A1/A+-rated paper. However, the high ratio vanishes when two simple but essential adjustments are made to the calculation:
- Compare municipals to corporate bonds that are actually similar, which the Joint Tax report demonstrably did not.
- Increase municipal yields to the levels that would be needed to clear the market if these municipals came as taxable bonds. That is a higher yield than that which would show on corporate indices. Disadvantages include weaker call provisions, lower liquidity on smaller maturities, and a weaker disclosure regime than on corporate bonds.
- Having shown how these two adjustments would look, we then discuss two other factors, which provide important pieces of evidence that the conclusions of Joint Tax are incorrect.

Severe Flaws in the Comparison (Cont.)

- The bottom line is that in our view, the 2012 report out of Joint Tax on their methodology for determining the efficiency of the tax-exemption was severely factually flawed:
- Triple-A corporates were compared to A1/A+ municipals using the Bond Buyer 20-Bond Index (BBI);
- The fact that the BBI severely overstates actual borrowing costs in the municipal bond market was ignored;
- The fact that municipals with shorter maturities compare much more favorably than longer bonds in comparison with taxable bonds was ignored; and,
- The more favorable structure of corporate bonds with respect to call provisions, liquidity and disclosure, which reduces their borrowing cost relative to the likely cost of fully taxable municipals was ignored.
- All of the above factors create an illusion the JCT analysis that muni yields as a percentage of corporate bond yields are much higher than they are in the real world.
- Finally, the underlying assumption that, if tax-exempts did not exist, investors would only buy fully taxed corporates as an alternative, is simply incorrect, as Joseph Poterba at MIT has shown. At the maximum 40% tax rate on corporate bond interest, a vast number of investors would, if they could not buy tax-exempts, seek out an alternative with a lower Federal tax rate, such as the 20% maximum rate on dividends and capital gains.

Working Through the Numbers

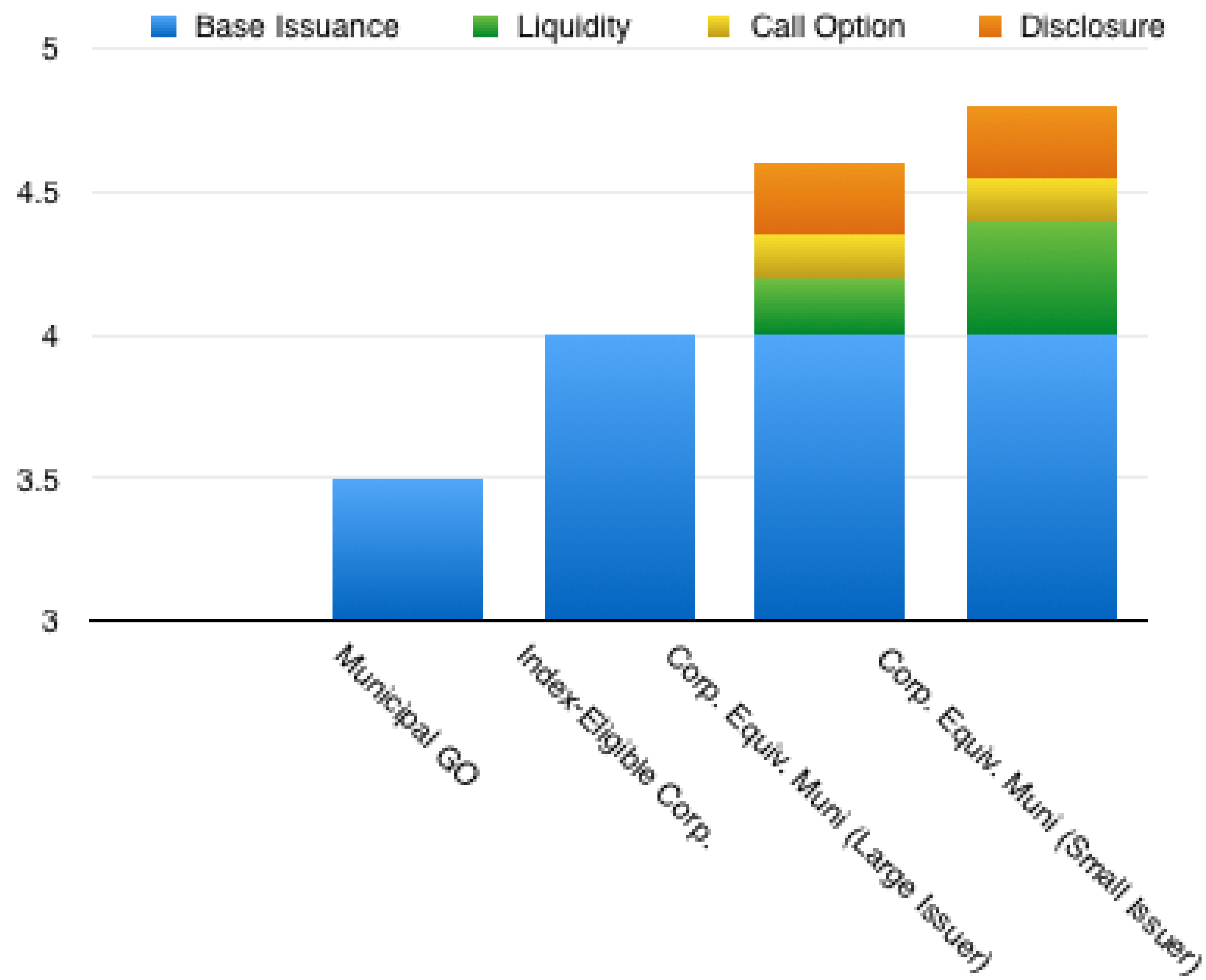
- ***I. We start with the yield ratio we would expect JCT to derive using its flawed data.*** Using this starting point, we would have a triple-A corporate bond index of roughly 3.50%, and a yield on the Bond Buyer 20-bond Index of roughly 3.87%. This provides a starting point ratio of roughly 107%.
- Adjusting for the factual inaccuracies in the data as shown by JCT in its own analysis works out as follows:

- **II. *Currently, municipal yields are inflated to a degree by tax risk fears.*** In our estimation, long-term municipal yields would be at least 30 basis points lower under "normal" conditions. Adjusting for tax risk fears, and the ratio declines to 3.57% vs. 3.50%, or 102%.

- **III. *Different quality bonds are being compared.*** A Triple-A rated Corporate Bond index is compared to the A1/A+ Bond Buyer Index. Use of comparably rated bonds would reduce the ratio on municipal yields to corporate yields considerably. (3.57% /3.60% would become 3.57%/4.10%). The yield ratio would thus move down from 102% to 87%--still very high, but wait…

- **IV. *The greatly inflated yield on the BBI.*** The Bond Buyer Index utilized by the JCT in their analysis ALWAYS yields considerably more than actual municipal bonds, as it did over the entire time period included in the JCT report. During their measurement period, the difference typically ran 80-120 basis points. Now, with lower yields in all sectors, the difference still runs 50 basis points for similarly rated bonds due in 20 years. So, the 3.57% to 4.10% comparison above becomes 3.07% to 4.10% when real-world yield levels are used instead of the massively inflated BBI, and the ratio declines to 75%.

- **V. *Differences in call provisions, liquidity and disclosure*** between A1/A+ corporates and A1/A+ municipals are ignored. To be sold in the taxable market without corporate-like attributes, we estimate that municipals would have to have roughly 40-basis-point higher yields than like-rated corporates, and 60 basis points more for smaller, less-liquid issues.
- Differences include the lack of call risk on corporate bonds versus the 10-year call on nearly all municipals, stronger liquidity resulting from higher per-maturity issue size, and stronger disclosure requirements. So, the comparable ratios become 3.37% to 4.50%, and 3.37% to 4.70%, or the 74.9% to 73% range, for what we call "corporate equivalent munis."



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- **VI. *A focus on long maturities.*** As we discuss below, municipal yields as a percentage of taxable yields tend to be dramatically lower on bonds 11 years and shorter than they are on longer-maturity paper.
- By our estimate, the ratio in the 10-year range would be at least 7 percentage points lower in 10 years than it is in the 20-year bonds used in the JCT analysis, and on 5-year paper would be another 7 percentage points lower. Using an average of a 10-percentage-point drop for paper inside 10 years, and the ratio declines to from 64.9% to 63%.

- ***VII. Evidence for a very high clearing marginal tax rate on shorter maturities comes from BABs.***
- During the period from mid-2009 through 2010, nearly 40% of new issues came as Build America Bonds—fully taxable to the investor, but with a 35% subsidy provided to the issuer.
- Issuers thus had a choice: accept the reduced yield provided by access to the tax-exemption, or accept a 35% subsidy. The two choices would essentially be break-even when munis yielded exactly 65% as much as taxable BABs.
- In terms of measuring the efficiency of the tax-exemption, **here is the interesting result: during that period, a very large proportion of bonds with a maturity longer than roughly 11 years came as BABs, but nearly all bonds with a maturity inside 11 years came in the tax-exempt market.**
- As far as the efficiency of the tax-exemption is concerned, the implications are clear: inside roughly 11-year maturities, municipal bonds were clearing with a ratio to taxable bonds lower than 65%. This compares with the implied tax rate for municipals during 2009 in the Joint Tax analysis of 13.2%.

- ***VIII. The Poterba Adjustment to portfolio patterns.***
- Thus, simply comparing apples to apples—takes the clearing marginal tax rate up from 8% to 34%-38.5%. However, even this purely factual analysis based upon current market conditions ignores an important invalid assumption in the Joint Tax Analysis: That investors who could no longer buy tax-exempts would only buy taxable bonds taxed at their maximum income tax rate as an alternative.
- The problems with the assumption that taxable bonds are the only alternative in the absence of tax-exempts, is shown in the work of Joseph Poterba and teammates at MIT.
- **In the current environment, many investors would buy stocks, or stay in cash, with a tax rate at 40—or put more money in 401(k)s and IRAs**. (Example: Portfolio Substitution and the Revenue Cost of the Federal Income Tax-Exemption for State and Local Government Bonds, Poterba, James M. and Verdugo, Arturo Ramírez, National Tax Journal, June 2011.)

- Our message in the above is that, when comparisons between munis and corporates are measured properly, municipal yields as a percentage of taxable yields are vastly lower than that shown in the Joint Tax analysis.
- **Quite simply, the low marginal efficiency of the tax-exempt market described by Joint Tax in their analysis results from inaccurate data.**
- **We do not attack their methodology, we simply show that the clearing marginal tax rate for municipals, properly measured, is quite high under most market conditions.**
- In addition, the question has come up as to what the impact would be of a 28% cap on the tax-exemption.

PABs and the AMT

- In our view there is already evidence of the impact from the functioning of the market for PABs subject to the AMT.
- These bonds are subject to a "surtax" on the interest, but only for investors who pay the AMT. For other investors, the AMT has no effect.
- Even with this limited target for the surtax, bonds subject to the AMT cost issuers roughly 30 basis points more than non-AMT paper. To investors who do not pay the AMT, the extra yield is a "windfall" that provides no tax revenue to the Treasury. Now consider what would occur if all municipals were subject to a surtax in the form of a 28% cap: **we would expect the cost of borrowing in the municipal market to rise substantially more than 30 basis points.**

The Bottom Line

- Decision makers often cite the Joint Tax methodology in explaining why they believe the tax-exemption to be an inefficient subsidy. To a very significant degree, we believe that the JCT analysis is flawed, not because its methodology is incorrect, but because its data is wrong: its comparison is a clear "apples to oranges" comparison.
- When the data is adjusted to compare similar bonds in both sectors, we discover that muni yields as a percentage of corporate bonds actually provide a marginal tax rate that is impressively high.
- **Given all of this, the premise that the muni market clears through investors with a low marginal tax rate—thereby giving a windfall to high-bracket investors—is incorrect**.

One Final Point…

- JCT estimates of the annual cost of the tax-exemption only go up.
- 2013 report has the evidence: Public activity bond costs were predicted to go from $25.95 billion in 2012 to $40.68 billion in 2016, an increase of 57%.
- And yet, bonds outstanding over that period are up roughly 3%, and average Treasury yields—a part of the calculation—are down roughly 40 basis points. So the actual outcome should have been less than the initial $25.95, even using their flawed data.
- Currently, they have public activity bond costs going from $28.89 billion in 2016 (note the adjustment from the projection, but it's still wrong) to $41.42 billion in 2021, an inconceivable 43.4% increase.
- **Bottom line: like it or not, we are going to have to fight bad data at some point after tax rates are adjusted in a Tax Reform Plan**