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Market Commentary: Tax Reform Proposal Hammers Munis.

Infrastructure? We don't need no stinkin' Infrastructure.

In a document rife with broken promises and misstatements about the muni market, the "Tax Reform" proposal announced last week beats up on the municipal bond market and state and local bond issuers to an extent **never envisioned prior to the publication of that proposal**. Indeed, there had been a list of signs pointed in the other direction:

- Promises from a long list of Federal lawmakers that the municipal bond market and state and local issuers would basically be left alone as a tax bill was drafted;
- Strong indications from the Administration that it was interested in boosting the economy by dramatically boosting investment in infrastructure; and
- There appeared to be at least some recognition that the public sector and private sector participants would need to work together in the future to optimize the amount of funding that would be needed to keep state and local projects and activities from falling farther into disarray.

This recognition, it was believed before Thursday, connected the effective functioning of the municipal bond market to the need to enhance economic growth by maintaining and expanding state and local projects, such as infrastructure, that create jobs and provide needed governmental services.

And yet when the rubber met the road in the form of a new, more complete tax reform proposal, market participants learned that the drafters of this document had no interest in leaving the muni market alone, or in keeping the state and local component of the Federal "compact" intact to meet funding needs.

Factors that would harm the muni market indirectly.

The damage that would accrue as a result of the provisions of the proposal that touch the municipal bond market come in a number of forms. Let us start with key provisions that would substantially increase borrowing costs, even though they are not targeted at the muni market specifically: the proposed reductions in corporate and individual maximum tax rates.

On the corporate side the document confirms a strong desire to cut the maximum corporate tax rate to 20%, even though that rate appears to be sharply lower than the rate needed to keep the U.S. competitive.

According to the Tax Foundation, "we find the United States corporate tax rate of 38.91% is the fourth highest rate in the world. The United States statutory corporate income tax rate is 15.92 percentage points higher than the worldwide average," but that it is only "9.5 percentage points higher than the worldwide average weighted by gross domestic product."

In other words, the rate needed to put the U.S. at the average global rate, weighted by GDP, would be 29.4%, sharply higher than the 20% target in the proposal. We then note that even though the drastic cut in the corporate tax rate is not being done “to the muni market,” the impact of such a large cut in rates are likely to be severe for state and local borrowers:

At a 20% tax rate, muni yields would have to rise sharply before municipals would be competitive with taxable investments for a corporate investor, such a commercial banks or property and casualty insurers.

We expect that this provision, by itself, would push municipal bond yields up by 50-75 basis points, even before the provisions targeted at munis specifically are considered.

Our key points on the corporate tax rate, aside from severe indirect impact on state and local borrowing costs are that:

1. The cuts are sharply greater than those needed to make corporate tax rates competitive on a global basis;
2. Cuts this dramatic sharply increase the projected Federal deficit—which used to be a concern of Republicans—all the way up to the distant past of a month or two ago, when a tax cut bill that raises the deficit by $1.5 trillion or more over 10 years would have been anathema to most lawmakers;
3. The case that cuts of this magnitude will be massively stimulative to the economy is a weak one that has been refuted by most economists, many of whom note that a) unemployment is already extremely low, and unlikely to be pushed significantly lower by such a corporate tax cut; b) corporation are already awash in cash that they have been unable or unwilling to invest in new projects because they do not find such projects to meet profitability targets—a pattern exacerbated by accelerating technological change, which no one seems to want to discuss, but which mutes the benefit of large new brick and mortar projects;
4. Cuts this deep clearly leave a hole in the Federal budget that will be filled over time in ways that are damaging to recipients of disbursements from the Federal government. High on that list will be state and local governments. Witness the likely impact of this proposal, which, in a bolt from the blue, seeks dramatic new revenues from the municipal sector to pay, in part for the massive tax cuts, and which will leave no room for the previously planned, highly publicized “infrastructure program.”

To sum up, we are not opposed to corporate tax cuts as needed to make the U.S. competitive with the rest of the world, given that our rates are already at the top end for developed nations. However, we strongly question the economic and policy case for cuts so severe as to leave the Federal government gasping for revenues, with highly questionable assumptions about the magnitude of stimulus that would occur as a consequence. And, of course, with this proposal, we are already seeing evidence as to the way deep new holes in the Federal budget would beggar state and local governments.

This evidence is, unfortunately, likely to become greater over time, as the purported stimulative effects of the cuts fall behind projections, and as deficit hawks lose their “hawkishness” to support this package experience a rebirth of their core philosophy. How will that renewed hawkishness be manifested? For hints, see the Trump/Mnuchen budget proposal from earlier this year. It won’t we pretty, and it won’t be in the form of a renewal of higher tax rates, at least for a very long time. It will, we expect, be in the form of highly damaging new spending cuts. This, by the way, has been a key strategy in tax reform proposals for decades: cut Federal revenues, and then if as a consequence revenues resulting from the purported stimulus do not meet inflated expectations, come back and force through spending cuts to make up the difference.

In addition, while the maximum tax rate for potential individual investors in munis would not be cut, the desirability of munis as an investment for individuals would be diminished somewhat in this environment of lower corporate demand because the threshold for the 39.6% income tax rate would climb because of the $1 million income level at which the maximum tax rate would apply, up from the scheduled 2018 threshold of $426,700 for individuals and $480,050 for married couples filing jointly.

Again, this change is not being done to municipals, but particularly in an environment of sharply lower corporate rates, it would cause the break-even yield at which munis would be competitive with taxable bonds such as corporates to move somewhat higher.

Again, we stress that these changes in tax rates are not targeted at state and local bond issuers. The fact remains that, in combination, they would severely increase state and local borrowing costs, even before the provisions specifically targeted at municipal bonds are considered.

Key provisions specifically targeted at municipal borrowings.

Before listing and describing these provisions, we think that it's important to note two general factors.

First, as we have noted in previous discussions, the methodology and data utilized by the Joint Committee on Taxation has always sharply overstated the cost of a given benefit in the muni sector to the Federal Government, and thereby sharply overstated the benefit to the Federal Government of eliminating a given provision. There is no reason to believe that the estimated benefit to the Federal government from the changes in this proposal are any different: the benefit should be expected to sharply overstate the benefit to the Federal government of each reduction in access to the muni market described below.

In fact, we can virtually guarantee that the benefit of each change is overstated, because we expect that the estimates do not take into account the sharply lower corporate tax rates described above. In other words, if elimination of a given provision would be estimated to increase Federal revenues by $X with a 35% Federal tax rate and strong demand for munis from corporations then the benefit of eliminating that provision would have to be sharply lower if corporate tax rates were only 20%.

Secondly, we think that it is essential to view all of the changes described below in the context of a Federal system of government. If a given change increases revenues at the Federal level, but sharply increases borrowing costs at the state and local level, then in a Federal system, the aggregate increases in costs at the state and local level need to be netted out. After all, state and local governments are NOT "just another special interest;" they are partners with the Federal government in providing governmental projects and services.

Now, on to detail the changes proposed in the muni section:

Elimination of all advance refundings

The proposal would prohibit issuers from refunding bonds more than 90 days before the first call date, with a claimed benefit to the Federal government of $17 billion. Given the factors noted above, and the general short time to first call on recent advanced refundings, we expect that this estimate is wildly on the high side. And the benefit to state and local issuers from being able to take advantage of sharply lower borrowing costs, when they occur, through the flexibility to issue advance refundings is completely ignored.

Elimination of the ability to issue ANY private activity bonds on a tax-exempt basis after 2017 is a shockingly broad-based change to the municipal bond market. It would eliminate access to tax-exempt financing for all hospitals, nonprofit colleges and universities, affordable and low-income housing bonds, qualified redevelopment bonds, airports, ports, solid waste disposal revenue bonds, wastewater treatment facilities that are defined as "private activity," student loan revenue bonds, and a number of other activities.

In our view the rationale for this incredibly sweeping diminution in access to tax-exempt financing, as described in the documents supporting the changes, in particularly misleading and disingenuous. As noted,

"The federal government should not subsidize the borrowing costs of private businesses, allowing them to pay lower interest rates while competitors with similar creditworthiness but that are unable to avail themselves of PABs must pay a higher interest rate on the debt they issue."

This statement is incredibly misleading and incorrect in a number of ways. First, many activities listed as "private activities" under the code are not substitute or competitors for bonds issued on a taxable basis. The list where this would be the case includes nonprofit hospitals and educational facilities, airports, ports, solid waste disposal facilities, affordable and low-income housing bonds, redevelopment bonds, and a number of other types of bonds that are defined as PABs.

If these activities, which clearly relate to governmental activities, had to be financed in the taxable market, borrowing costs would be sharply higher. The estimated benefit to the Federal government of this change according to Joint Tax, would be $39 billion. Again, for reasons noted above, we expect that this estimate overstates the federal benefit, while at the same time ignoring the increased costs to state and local governments if the elimination of PABs were effectuated.

Reduction in the benefit of owning tax-exempt bonds for certain institutional investors. The proposal would increase the "haircut" on tax-exempt income for property and casualty companies owning munis, and create a new "haircut" for life insurance companies. This would reduce the benefit from owning such bond, after that benefit has already been reduced sharply through the cut in the maximum corporate tax rate to 20%.

In other words, the benefit for insurers owning tax-exempts, especially for P and Cs, would be as if they were paying a tax rate well below the statutory 20% rate in the proposal. There is no grandfathering in this provision, as far as we can tell, so if the provisions were enacted, insurance companies would have a strong incentive to sharply reduce current holdings of tax-exempts. The provisions are estimated to increase Federal Revenues by $2 billion in the case of P and Cs and $1 billion in the case of life insurance companies, which already get relatively limited benefit from owning tax-exempts. Once again, we expect that the estimated benefits are overstated, and that the costs to state and local governments are ignored.

Other, less drastic provisions. The proposal would eliminate the tax-exemption for stadium revenue bonds, and repel the limited amount of tax credit bonds that can be issued each year.

The case for maintaining Private Activity Bonds

In our view, this case is extremely strong. It includes, at the very least:

- The fact that the description of most PABs as being in direct competition with corporate activities funded on a taxable basis is simply factually incorrect;
- The important governmental purpose provided by a large proportion of the sectors defined in the

code as “private activities” including (but not limited to) nonprofits, airports, ports, redevelopment agencies, affordable housing bonds, waste disposal facilities, sewerage treatment facilities, and on and on.
- After months of the administration calling for more private capital and tax credits to fund infrastructure that the proposal would be designed to cut these same existing programs that have helped issuers fund infrastructure.

The challenge for the issuer community represented in DC is that they needed to focus so heavily on maintaining the tax-exemption, and fighting for deductibility of state and local taxes (a fight they lost in whole or in part). As a consequence, they may have lost an opportunity to show why having more tools in the toolbox was and is compelling. In particular, we would make the case that under current and future conditions, the need for public-private partnerships to effectively fund projects as technology changes rapidly is going to grow, or even explode. Issuers are going to be extremely challenged to keep up with accelerating technological change in a number of areas, including transportation as we discussed last week.

Given these challenges, the need to partner up with private vendors early in the design, funding, construction and operation of a vast proportion of projects is simply going to grow over time. This permanent change in the infrastructure landscape is going to be made more costly and more difficult by provisions that limit or eliminate private involvement in combination with tax-exempt financing, such as this one would do.

Market implications

It is probably not a surprise that muni yields increased modestly this week, even as long-term Treasury yields dropped by roughly 12 basis points. The muni market is beginning to consider:

- The risk to the demand side of a sharp decline in marginal tax rates;
- The potential rush to market for advanced refunding bonds before year-end;
- The potential rush to market for private activity bonds before year-end.

At the same time, the portion of outstanding private activity bonds that are subject to the alternative minimum tax rallied fairly sharply. The reason is that, if this proposal were to be enacted, the alternative minimum tax would be eliminated, which would eliminate that difference in tax treatment between outstanding non-AMT and AMT bonds.

The only “good news” for issuers at this point is, first, the possibility that major Tax Reform may not be enacted at all, and second, the possibility that some of the more onerous provisions described above might be modified in the tax bill writing process. We are not hugely optimistic regarding the second possibility. Nevertheless, we believe that the case for such modifications is extremely strong and compelling. We expect to discuss these topics further in future writings.

Neighborly Insights

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