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How Federal Tax Reform Is Changing Government Borrowing.

Fearing more changes from Congress, states and cities are turning less and less to the municipal bond market.

While the most direct effects of the 2017 federal tax overhaul have been on tax revenue, the law has also impacted the way governments borrow money.

With banks making fewer direct loans to governments, many expected them to turn to the municipal bond market. But that hasn't happened.

Governments have continued to be reluctant to increase their debt, a trend that started following the Great Recession. According to the latest report from Moody's Investors Service, the total net tax supported debt issued by all 50 states in 2018 was essentially flat for the eighth straight year with just $523 billion issued. This puts average annual state debt growth since 2011 at just 0.6 percent.

Moody's said in its analysis that lagging infrastructure investment has contributed to limited growth in state debt. "State governments are remaining cautious when it comes to bond issuance," the report continued, "and are increasingly relying on operating revenue to meet their transportation infrastructure needs."

As a result of this quiet market, the cost of borrowing has dropped — saving governments millions even as interest rates are rising.

Governments have been reluctant to issue municipal bonds in part because officials fear that Congress may once again meddle with the bonds' tax-exempt status, says Hilltop Securities analyst Tom Kozlik. The 2017 law already eliminated the federal tax-exempt status of advanced refunding bonds, which effectively killed them. Advanced refunding bonds allowed governments to refinance debt earlier and thus take advantage of lower interest rates years sooner.

Koxlik warns that Congress will be looking for more ways to save money this fall because it will likely face another debate about how to reduce the deficit. "Time could be running out on the municipal bond tax exemption," he says, "and it's possible that the advanced refunding repeal is just the beginning."

Other Programs at Risk

Ksenia Koban, vice president and municipal strategist at the investment firm Payden & Rygel, is more worried that Congress will do away with grant or matching fund programs.

State and local governments use the money from these programs in two main ways. They can use grant money to directly pay back bonds they have issued. Matching funds, on the other hand, offer an incentive for states and localities because money raised by issuing bonds can be at least partially matched by the federal government.

Municipal bonds are commonly used to finance infrastructure projects. Combined with tax reform, Koban says the uncertainty around the federal government's commitment to infrastructure funding is also creating uncertainty in the municipal bond market. "It's definitely changing the landscape," she says. "We're already seeing a lot more hybrid projects or public-private partnerships while local governments are stepping back from traditional types of projects."

Banks Bowing Out

Meanwhile, the 2017 tax law gave banks less of an incentive to invest in municipal bonds. The law slashed the corporate income tax rate from 35 percent to 21 percent. That, combined with rising interest rates, has made low-interest-rate munis less attractive to banks.

Bank holdings of municipal bond debt in 2018 were down $40.9 billion for the year, reports George Friedlander, a managing partner of the Court Street Group.

At the same time, banks' direct loans to governments have also drastically declined. The loans spiked to $40.2 billion in 2017 but are on pace to total just under $7 billion this year.

The severity of this development has been masked by the lack of investment in the municipal bond market. "The implications of this shift would be far greater in a 'normal' muni market, with more total issuance," Friedlander says.

Low Supply, High Demand

2018 was one of the slowest years for municipal bond issuance in the past decade. The market hasn't picked up this year, either.

Through the first half of this year, government issuers have sold more than $166 billion in bonds. That's nearly identical to the $165 billion sold halfway through 2018, according to figures compiled by The Bond Buyer.

But even though governments aren't issuing as many bonds, the demand for them hasn't changed. In some places, such as California, demand has increased because of the federal tax overhaul's cap on state and local tax deductions. Taxpayers are looking to shelter more of their income in municipal bonds.

All these events have led to lower interest rates for governments that are selling bonds — despite the fact that the Federal Open Market Committee has raised interest rates by a percentage point since early 2018.

"There's so much more demand than supply," says Koban, "the market's actually sort of behaving unintellectually. It's just not pricing uncertainty and risk the way it should. It shows there's not a whole lot of other places to go if you're looking for quality-adjusted, positive-yield instruments."

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BY LIZ FARMER | JULY 3, 2019 AT 4:00 AM