

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

---

## **States, Localities Saved More than \$700B Due to Muni Exemption.**

WASHINGTON — The municipal bond tax exemption saved state and local government borrowers more than \$700 billion in debt service expenses from 2000 to 2014, according to a white paper released this week by two local government groups.

The estimated savings amount was in 2014 dollars, according to the paper, which was issued by the International City/County Management Association and the Government Finance Officers Association.

The paper was written by Justin Marlowe, a professor at the University of Washington. It was released as proposals from Congress members, the White House and other sources have suggested limiting or eliminating the federal tax exemption for munis.

The “vast majority” of state and local capital spending is financed through bonds. The muni market is complex, since there are many issuers that can issue many different types of bonds, Marlowe wrote. Some past analysis of how a major change to the tax exemption would affect state and local governments’ cost of capital have assumed that ending the exemption would uniformly increase interest rates for all munis. However, there are drawbacks to this approach, Marlowe wrote. There is no evidence that ending the exemption would impact all bonds in the same way. Also, if analysts assume that repealing the exemption has a uniform effect on munis, they’re not taking into account day-to-day market movements that affect both tax-exempt and taxable obligations.

Spreads between tax-exempt munis and taxable Treasuries are smaller and greater at different points in time. Since the financial crisis, it is typical for there to be a wide spread between muni and Treasury interest rates. The widening spread could be due to the lower overall liquidity of munis, concerns about state and local governments’ credit quality, and changes in the value to investors of the tax exemption for munis, according to the paper.

Marlowe came up with estimates of the credit, liquidity and tax components of muni spreads that were based on market prices for more than 10 million muni transactions between 2000 and 2014. He found that from 2000 to 2014, the tax component of the muni spread was generally between -225 and -150 basis points, meaning that the muni exemption lowered interest rates on a typical bond by 1.50% to 2.25%.

Then he computed the amounts that borrowing costs would increase if the muni exemption was repealed. The calculations involved: increasing each bond’s interest rates by the average tax component for all munis with the same maturity on the day the bond was sold; creating a “taxable equivalent” interest expense for each bond; and comparing the expense for the taxable equivalent to the expense for the actual bond.

Savings due to the tax exemption were much lower after the financial crisis than before it. This is not surprising because interest rates on Treasuries have been at record low levels for most of the post-crisis period, according to the paper.

Different types of borrowers had fairly consistent amounts of savings per \$1,000 of borrowed money due to the exemption. Since the financial crisis, the exemption has meant savings of about \$70 per \$1,000 of borrowed money for cities in 2009 dollars, \$76 per \$1,000 of borrowed money for counties and \$79 per \$1,000 of borrowed money for schools, according to the paper.

The paper discussed two main alternatives to financing infrastructure through tax-exempt bonds — pay-as-you-go financing and public private partnerships.

“At the moment, there’s no robust alternative to tax-exempt financing,” Marlowe said in an interview with The Bond Buyer. While PAYGO financing and P3s definitely have a place in state and local finance, they’re not as broadly useful as tax-exempt bonds, he said.

PAYGO is more flexible and more transparent than tax-exempt financing, but is hard to use for large projects such as new water treatment facilities, port infrastructure and major bridge replacements.

P3s provide state and local governments with access to new sources of capital and give governments the chance to improve their infrastructure capacity through a private partner. However, P3s carry a variety of risks, and it’s unclear if they can work well to finance non-revenue generating infrastructure and smaller projects, according to the paper.

THE BOND BUYER

BY NAOMI JAGODA

AUG 19, 2015 3:10pm ET