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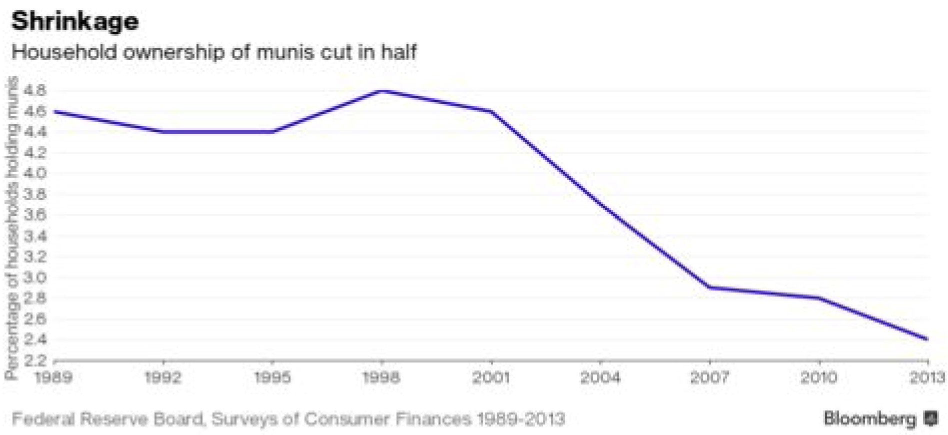
Muni Tax Exemption Risks Becoming Target as Ownership Narrows.

Municipal bonds are becoming concentrated in a fewer number of hands and that may not be good for bondholders and states and local governments.



The share of households owning muni bonds fell by almost half between 1989 and 2013 to 2.4 percent from 4.6 percent as the focus of their investing has shifted to tax-deferred retirement accounts such as 401(k) plans, according to a paper by faculty from Brandeis University and the Massachusetts Institute of Technology.

At the same time, the securities are increasingly concentrated among the wealthiest households. The share of total muni bonds held by the wealthiest 0.5 percent of households rose to 42 percent from 24 percent, according to the paper.

The drop in ownership could weaken the political will of municipalities to pay their debt and of Congress to maintain the tax-exemption of municipal bonds, write Daniel Bergstresser, an associate professor of finance at the Brandeis International Business School, and Randolph Cohen, a senior lecturer at MIT's Sloan School of Management.

"A declining share of households who hold municipal bonds and perceive themselves as benefiting from the tax exemption may place this exemption on a shakier political foundation," they write in a paper presented this week at the 5th Annual Municipal Finance Conference hosted by the Brookings Institution's Hutchins Center on Fiscal and Monetary Policy.

Annual Consternation

Proposals to eliminate or curtail the $3.7 trillion municipal market's tax break are a perennial, if little-noticed, feature of Washington, D.C., budget and tax debates. A 35-page plan released by House Speaker Paul Ryan last month that referred to repealing several "special-interest carve-outs" from the tax code without naming them was enough to raise alarm bells with lobbying groups representing local finance officials and investment banks.

Both the Republican chairman of the House Ways and Means Committee and President Barack Obama have previously proposed limiting the tax-exemption.

Representatives of the National Association of State Treasurers, the Bond Dealers of America and the Government Finance Officers Association questioned the paper's conclusion saying it ignored a vital constituency for the tax exemption: states and local governments that save billions of dollars in financing costs for roads, sewers, schools, and airports. Curtailing the tax exemption would raise state and local government financing costs by $17 billion, according to Washington State Treasurer James McIntire, president of the state treasurers group.

Survey Sample

"Where is that $17 billion going to come from? It's going to come largely from sales taxes and property taxes which have a disproportionate impact on the poor," said McIntire. "We are a necessary and important part of providing the infrastructure necessary to build our economy."

Bergstresser and Cohen's paper is based on data from the Federal Reserve's Survey of Consumer Finances, a survey of about 6,000 families.

Internal Revenue Service data from individual income tax returns differ from Bergstresser and Cohen's findings. According to the IRS, the percentage of individual filers who report tax-exempt income has increased to 4 percent in 2013 from 3.4 percent in 1990, IRS data shows. About 6 million filers reported tax-exempt income in 2013, according to the IRS.

The discrepancy between the data may come from filers who own taxable bond funds, like Pacific Investment Management Co.'s Total Return Fund, that also buy munis, generating some tax-exempt interest, Bergstresser said. The Fed survey would probably classify these funds as general bond funds.

In addition, the Fed survey has a separate category for money-market funds so tax-exempt income generated by a muni money-market funds would be reported to the IRS, but wouldn't be included in the survey's municipal bond and tax-exempt fund category.

Households owned about $2.6 trillion of municipal bonds, either directly or through mutual funds and exchange-traded funds at the end of 2015, down from $2.9 trillion in 2010, according to the

Fed’s flow of funds data. Banks and insurance companies owned about $990 billion. Foreign investors, who have increasingly come to the muni market because they face negative interest rates in their own countries, held $87.2 billion.

The declining share of muni holdings has been most pronounced in the upper middle class, where 2.6 percent of households reported holding municipal bonds, down from a high of 9.6 percent in 1998, according to Bergstresser and Cohen. The upper middle class is defined as households with average financial assets $215,000.

As the ownership rate of munis fell, the share of households owning stocks has soared to 42.7 percent from 27.3 percent, coinciding with the rise of 401(k) s and IRAs.

“Municipal bonds’ tax exemption reduces their pre-tax yields and makes them a very unusual (and even inappropriate) asset for tax-deferred accounts.”

Municipal bondholders tend to invest locally, creating a significant constituency that can be counted upon to support repayment, Bergstresser and Cohen write. A declining base of owners could weaken that connection, they said.

Emily Brock, federal liaison for the Government Finance Officers Association said the authors didn’t cite any evidence supporting that conclusion.

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