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Tax Policy Takes Center Stage.

After a federal infrastructure plan and healthcare legislation failed to materialize, an even higher priority has regained the center stage. Congress has now focused on tax reform – or cuts depending on where you stand. Of particular concern is what the effects will be on the municipal market.

Most observers have suggested that lowering the top bracket to 35% from 39.6% will have a marginal effect on demand for municipals. I tend to ascribe to that view. However, the middle bracket is recommended at 25%. That proposed level may have an effect in regards to mom & pop retail investors who may be considering a more modest investment in a mutual fund or exchange traded fund. Demonstrating the after tax return of a municipal will probably prove to be an even more important exercise in a post adoption environment.

Demand from corporations with at 20% rate would be more pronounced. Most corporations that hold municipals either have specific purposes, as insurance companies do, or they desire to shield earnings from the tax collector for a more limited time horizon. Banks remain relatively large holders, though the proportion of their holdings has been greatly diminished since the Tax Reform of 1986. Even so, we would not be hard pressed to see banks become net sellers of municipals, except for those institutions that need to maintain some presence in the market.

In many respects, the changes in the various deductions and credits will pose greater challenges. It is relatively easy to see that there is a fairly strong consensus to preserve the mortgage deduction and the charitable contributions deduction. Lower rates could still have an indeterminate effect on how much cash flow is devoted to each category.

Eliminating the State and Local Tax deduction, or SALT, is huge! Both coasts will be very affected due to the concentrations of high earners with valuable properties. Another aspect to consider is that a lot of states have their own income taxes that are in various ways linked to the federal return by formula. Many states would need to modify their own tax structures swiftly, as well as their individual withholding tables. As I recollect from the 1980's experience, the federal tax tables were out a few months late after the beginning of the year.

Would there be an outmigration from states with relatively high state and local tax burdens? It stands to reason that for those who are more mobile there certainly could be. But small business owners, who may be considered more mobile than wage earners, are also recommended to benefit from a lowering of the federal tax to 25%. When California raised its own income tax to new heights, an almost imperceptible level of outmigration developed. What has become more of a factor since is the high cost of housing that is attributable to many factors beyond just the tax considerations in the state.

On the positive front, repealing the AMT is likely to have many benefits including a lower tax due for those who have been affected in the past. AMT bonds in the municipal market in the past have paid a "penalty" of 25 to 50 basis points more in yield to attract investors. Airports that have many bonds outstanding and that are subject to AMT would enjoy a particularly salubrious effect due to the change. Holders of AMT bonds would potentially have a windfall.

Two strategies that would certainly reap some positive action for the economy include five year "expensing" of capital equipment and repatriation of profits held abroad at a low one-time tax rate. States would need to consider individually if they would match such favorable treatment in their own tax codes. The expensing could lead to much greater investment in equipment and machinery in the near term. Computer hardware would be expected to have a spike in orders along with many other industries.

Holding other factors constant, one would expect lower taxes to lead to greater profitability for businesses and a lower tax collections for all governments concerned. However, it is debatable whether the changes contribute to consistent higher growth of 3% to 4% for GDP.

One of my primary deliberations is whether or not the tax reductions will induce corporations to make more hires. In the past, more shallow tax cuts have not contributed to a greater upside in employment. Given the magnitude of the cuts being considered at this time, one should expect a greater contribution to employment. However, it is also quite appealing to return a fair portion of the upside to shareholders in order to sustain and improve already lofty valuation levels in most industries.

We also continue to be wary of the potential "silent killer." Preserving the tax exemption has been given a voice by administration officials and other key parties throughout this latest thrust for reform. But until we see in print in the bill that the tax exemption will be preserved, we just do not know definitively. There could also be some trimming of sectors that will remain tax exempt.

The "tax expenditure" representing the municipal exemption is worth billions per year. The original offset to the tax reductions would have been to a large extent covered by the repeal of the ACA. The federal government stands to forgo $1.5 Trillion over 10 years in revenue. This is a very large amount to offset even in a federal budget context. We also are reminded that we have to address the budget once again in the near term. Now the pressure is on to find the offsets elsewhere in order to adhere to the budget reconciliation rules. We are now in the mode of if we see something, we will say something.

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