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Tax Cut Bill Could Wallop Muni Bond Market.

The House and Senate tax cut bills would adversely impact the economies, bond issues and home prices in high-tax states

The sleepy municipal bond market could be subject to a rude awakening if Congress succeeds in passing a tax cut bill.

The final bill, if there is one, will most likely impact the supply and credit quality of municipal bonds and the strength of many state and local economies issuing municipal debt, and their housing markets could be hit by falling home prices.

Here's how the House and Senate bills could impact the muni market:

- The House bill caps the state and local tax (SALT) deduction at \$10,000; the Senate eliminates it.
- The House and Senate bills both eliminate advanced refundings, which muni issuers use to refinance higher interest debt not currently callable with lower interest bonds.
- The House bill eliminates tax-free private activity bonds that colleges, hospitals and affordable housing developers use to finance projects, which constitute about 25% to 30% of municipal bond supply, according to Barclays. The Senate bill has no such provision.

Overall there is little good news in either the House or Senate bill for the muni market, with a few exceptions. Neither the House nor Senate tax bill tampers with the tax deductibility of muni bond interest, which is the primary reason investors buy munis and state and local governments issue them.

Both bills eliminate the AMT, which private activity muni bonds were subject to, and both would likely reduce the supply of tax-free municipal bonds, which could boost the prices of tax-free munis already in the market.

The impact on muni bond demand, however, would be mixed. While changes to the SALT deduction could increase demand for munis from investors in high-tax states searching for tax-deductible investments, many taxpayers may no longer need the deduction because they won't be itemizing deductions due to the doubling of the personal tax deduction, included in both the House and Senate bills. In addition, demand for munis from institutional corporate investors would decline because of the cut in corporate taxes, also included in the House and Senate tax bills.

If Congress passes a tax bill that is close to the House or Senate version, "there will be tremendous pressure on many state and local governments particularly those in the Northeast and on the West Coast," said Mark Zandi, chief economist at Moody's Analytics.

Those governments, primarily in high-tax states like California, Connecticut, New York and New Jersey, would have a difficult time financing services and would have to make big changes, says Zandi, noting that investors in those government bonds would be hurt along with homeowners in those districts.

He explains that home prices in high-tax districts are impacted by the tax deductibility of state and local taxes because people tend to buy as much house as they can on an after-tax basis. If the after-tax affordability of a house declines because of tax changes, those home prices will fall, due to a decline in demand, and that, in turn, would impact the property tax revenues of those districts. And that would increase the credit risks of the muni bonds issued by those districts.

“There is nothing credit positive” for munis in the House or Senate tax bill, says Jane Ridley, senior director in the U.S. Public Finance at S&P Global. She’s not expecting a wide range of downgrades but notes that some states and local governments will find it difficult to balance their budgets if tax revenues decline because they will have a harder time raising taxes that are either not deductible or not fully deductible.

Investors and advisors will need to regard each municipal bond issue on a case by case basis, understanding how the final tax bill will impact an issuer’s revenues and tax base and how the municipality is addressing those changes, advises Ridley.

Certain segments of the muni bond market will be particularly vulnerable if the final bill includes a provision contained in the House bill that eliminates private activity municipal bonds. “The elimination of tax-exempt PABs...would most directly affect debt issuance for transportation infrastructure issuers,” according to an analysis by S&P Global Ratings. The “entire not-for-profit health care sector” would also be adversely affected, according to S&P Global Ratings.

There will likely be changes in the final tax bill before a final vote. The House has passed its bill and as of late Tuesday the Senate bill has made it through the Finance and Budget committees. A full Senate vote could come as early as this Thursday. If the Senate passes its tax cut bill, the horsetrading between the two congressional houses will begin.

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