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Trump's Rise Poses Threat to Tax Break That Underpins Muni Bonds.

- **Muni tax-exemption is defining feature of local debt market**
- **Policymakers expected to hunt for revenue to offset tax cuts**

The momentum behind Donald Trump's campaign for a second term as president is rekindling concerns that the long-cherished municipal bond tax-break may be scrapped to help pay for permanent tax cuts.

The Tax Cuts and Jobs Act — which lowered levies for corporations and individuals — marked a major Trump policy achievement during his first stint in the White House. Those breaks for individuals are set to expire in 2025. If elected this November, he's promised across-the-board tax cuts, likely raising deficits and pushing lawmakers to hunt for additional revenue. The muni tax-exemption — estimated to cost the US government roughly $40 billion each year — has been mentioned as a target.

"The most extreme impact to the market would be if the tax exemption goes away, if there's massive deficits maybe that comes into play," Chad Farrington, co-head of municipal bond strategy at DWS Investment Management, said in an interview. "That would of course cause intense pushback from states and local governments."

Trump's policies have been thrust into even greater focus after an assassination attempt on the former president over the weekend at a campaign rally. The incident has further rallied the GOP party as it prepares to nominate him at the Republican National Convention in Wisconsin this week.

Established in 1913, the municipal-bond tax exemption is the defining feature of the $4 trillion state and local government debt market where cities, towns, school districts, hospitals and other borrowers raise money to finance the bulk of US infrastructure. Investors in muni debt generally don't pay taxes on the interest they earn, allowing governments to borrow at lower rates.

Repealing that exemption was floated by a conservative think tank earlier this year as a way to keep the Trump tax cuts. Matt Fabian, a partner at Municipal Market Analytics, said that Democratic President Joe Biden's "poor" debate performance has raised the potential for Republican electoral victories in November, risking damage to the tax-exemption.

After the inauguration, next year will be focused on tax reform, Fabian said in an interview. "We worry that munis would be caught up in paying for that as collateral damage," he said.

To be sure, a Trump presidency is not a foregone conclusion. In swing states, Trump led Biden by just 2 percentage points, 47% to 45%, according a Bloomberg News/Morning Consult poll conducted before the shooting. And regardless of who wins the election, investors at MacKay Shields said in a Monday research note that demand for state and local government debt should increase.

Tax-Exemption Rollback

The muni tax exemption has been scaled back before. In 2017, during Trump's first administration, lawmakers eliminated a key refinancing tactic that allowed governments to call back their bonds and replace it with tax-free debt before they were able to be repurchased. The policy initially reduced new issue sales.

An earlier iteration of that legislation also proposed ending the exemption for so-called private-activity bonds which allow companies to issue tax-free debt under certain circumstances like privately run infrastructure projects such as toll roads and airports. That provision was eventually scrapped.

In a red-wave scenario, where Republicans win the presidency and both chambers of Congress, lawmakers would likely focus on extending Trump's tax-cut provisions, strategists at Barclays Plc led by Mikhail Foux and Clare Pickering wrote in a July 10 research note.

"Not only would the focus be on keeping top tax brackets low, but policymakers might also need to find additional pay-fors, and some parts of the tax-exempt muni market might be looked at for additional revenue," the analysts said.

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