

BLOG POST

## Post-Election Update: Financial Services - Public Finance/Tax-Exempt Bonds

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In this update we analyze potential federal tax legislation that could directly affect public-finance/tax-exempt bonds in the 113th Congress and a second-term Obama Administration.

- **Two expected themes for tax legislation/tax reform will affect public finance and tax-exempt bonds.** In assessing the outlook for federal tax legislation that could directly affect public finance, it is helpful to think in terms of the themes that are likely to be predominant in federal tax legislative proposals generally. We expect that a Fair Share theme and a Rate/Deficit Reduction theme will be the predominant themes for tax legislation in the 113th Congress and a second-term Obama Administration.
  - The Fair Share theme (i.e., that wealthy taxpayers should pay a "little bit more" or their "fair share") has been a mantra of most Democrats in Congress for some time now, and was a familiar refrain in the President's re-election campaign.
  - Many Republicans in Congress have said that they are very much in favor of tax reform that eliminates loopholes and uses the resulting revenue to reduce tax rates. During the failed "grand bargain" negotiations in the Summer of 2011, Speaker Boehner and some Republican Senators expressed some willingness to have that process also contribute to deficit reduction-which could lead to tax reform with a Rate/Deficit Reduction theme.
  - Although these themes will compete with each other, they are not mutually exclusive. The big question is whether sufficient pressure will be brought to bear on Congress and the Administration by the financial markets and the nation's business leaders to forge a political compromise that merges these themes.
  - Both themes-Fair Share and Rate/Deficit Reduction-could potentially have significant effects on tax-exempt bonds, whose continued existence has even been called into question by some serious proposals (e.g., Simpson-Bowles recommendations).
- **Fair Share proposals to cap the tax benefit to higher-rate taxpayers of tax-exempt bond ownership will get serious consideration.** The Fair Share theme is almost certain to result in proposals (along the lines of an Obama administration proposal that surfaced in Summer 2011) to "cap" the tax benefits associated with higher-tax-rate investors' ownership of tax-exempt bonds (together with other deductions, credits and exemptions).

- These proposals would result in taxpayers whose marginal tax rate (e.g., 35%) is higher than some specified rate (e.g., 28%) paying a tax on their tax-exempt bond interest at a rate equal to the difference between the two rates (a 7% tax in this example).
- Enactment of this type of proposal would increase, at least to some extent, state and local governments' borrowing costs for public infrastructure, which would in turn result either in less public infrastructure investment or increases in state and local taxes and/or municipal utility rates and user fees that ultimately pay for that public infrastructure.
- If applied to tax-exempt bonds outstanding on the date of enactment, enactment of this type of proposal can be expected to reduce the value of outstanding bonds currently held by investors- by as much as 10% according to at least one analyst.
- **Tax-exempt bonds could also be a target for revenue if there is a move toward "1986-style" tax reform.** If a Rate/Deficit Reduction theme gains prominence and moves toward something like "1986-style" tax reform, in which almost every federal "tax break" is thoroughly reexamined as a source of revenue to achieve rate reduction and/or deficit reduction targets, tax-exempt bonds will be on the table as a revenue target.
  - Tax-exempt bonds' successful century-plus history, and arguments relating to the action's public infrastructure needs, are likely to shield tax-exempt bonds for traditional government-owned public infrastructure (e.g., schools, roads, water systems, transportation facilities, and the like) from drastic reform proposals (e.g., totally eliminating the interest exemption) that go beyond the "capped benefit" proposals discussed above.
  - Nonetheless, in a 1986-style reform environment, state and local borrowers' ability to issue tax-exempt "advance refunding" bonds may face reexamination based on reformers' arguments that the "advance" future of those refundings do not directly add to capital investment.
  - Moreover, in a 1986-style reform environment, certain categories of tax-exempt "private activity" bonds that principally benefit nongovernmental "conduit borrowers" that use those bonds to finance non-governmentally-owned property (e.g., 501(c)(3) organizations and businesses engaged in so-called "exempt activities") are likely to face proposals for further restrictions (e.g., per-beneficiary limits), and perhaps, in some cases, existential threats.
    - While state and local governments are generally supportive of tax-exempt private activity bonds as useful tools for economic development, much of the heavy lifting, in terms of defending legislative threats to those bonds, falls on the shoulders of the nongovernmental conduit borrower/beneficiaries of those financings (some of whom may have other "irons in the fire" in a 1986-style tax reform environment)

**There may be continued discussion of holder-credit and BABs-type direct-pay bonds as options for traditional tax-exempt interest bonds.** State and local governments

should also be prepared for continued discussion about whether there is a "better way" than tax-exempt bonds to deliver a federal subsidy to those governments to encourage their public infrastructure investments.

- ○ "Holder credit" bonds (i.e., bonds whose interest is taxable but with respect to which the bondholder can claim a tax credit) have never gained much market acceptance and are unlikely to get serious consideration as an option for traditional tax-exempt bonds.
- On the other hand, if state and local government borrowers' concerns about immediate and future federal budget/Fiscal Cliff sequestration threats can be addressed satisfactorily, there might be some renewed discussion of BABs-type/direct-pay bonds (i.e., taxable bonds with respect to which the federal government makes a direct payment to the state and local borrowers to subsidize their interest costs) as an option for some types of tax-exempt bonds.
- **There may be potential opportunities amidst the challenges.** Although a comprehensive examination of tax-exempt bonds in this fiscal and legislative environment poses serious challenges to State and local governments, it also presents potential opportunities within the context of those challenges.
- **State and local governments face some challenges in their efforts.** State and local governments face some practical challenges as they seek to make the most effective case to preserve intact the benefits they receive from their ability to issue tax-exempt bonds
- **Historically low interest rates create a risk of shortsightedness.** Historically low market interest rates (which some believe will be around for a while) create a risk that the adverse effect of restrictive federal-tax proposals on state and local government infrastructure investment and borrowing costs might be minimized under a shortsighted view.
  - At some point, market interest rates will return to more normal historic levels, at which time the adverse effect on borrowing costs of new tax-exempt bond restrictions will be magnified, perhaps dramatically, compared to today.
  - Experience suggests that once something perceived as a "tax-break" is legislatively diminished or eliminated, it is exceedingly difficult to restore it.
- **Coordination and Delivery of Message.** There are numerous categories of state and local government entities and officials (some elected and some unelected) with varying degrees of focus on how their ability to issue tax-exempt bonds reduces their borrowing costs. This can present challenges to the public finance community in delivering a coordinated message on tax-exempt bonds to federal lawmakers.
  - Networks of different state and local organizations (such as the National Governors Association, State Treasurers Association, League of Cities, Conference of Mayors, the Government Finance Officers Association and several others) have been

formed to facilitate coordination of message delivery.

- Other segments of the public finance community (e.g., state and local borrowers' bankers, lawyers and financial advisors) provide knowledgeable assistance to state and local governments in delivering the message.
- Enlisting other public infrastructure allies (e.g., engineers, architects, and players in the construction/materials industries) to assist in tying job creation arguments to tax-exempt bonds would be quite helpful to the state and local governments' cause.