MONTHLY REVIEW

July 2023

MAINLINE WEST

The Case for Tax-Exempt

At the moment, things in DC are calm for munis. However, recent friction regarding budget cuts and politics has us thinking Congress may, once again, question the cost and effectiveness of municipal finance. Given all the budget abuses in DC, *focusing on the lost income from tax-exempt financing seems trivial and could cause more long-term harm than good.* MainLine will look at the benefits, costs, and alternatives to tax-exempt financing in this month's review, so Congress can focus on bigger problems.

Munis for the month found their stride, with slight outperformance and seem to be hitting cruise control for at least the next 30 to 60 days.

The Fed tightening cycle is near its end, interest rate volatility has calmed down, and investor confidence returned to munis. *MainLine feels it's time to stop looking at the potholes in the rearview mirror and focus on the calm landscape ahead.*

Muni Market Review

Munis are hitting their stride, and may not be going forward very fast, but are posting the summertime outperformance MainLine has been anticipating. Fund flows are back to positive, supply is picking back up and, with the comfort that the Fed is calming down, munis investors are slowly coming back to the asset class. Other July highlights:

- Bloomberg composite indices for July show munis up .4%, US Treasuries down -.35%, and corporates up .34%. Muni yields for the month were up 4 to 2 bps versus taxables up 18 to 16 bps.
- Muni versus SOFR ratios are a bit on the rich side versus history, but the positive seasonal technicals has MainLine thinking they could get richer before cheaper.
- Fund flows have finally turned positive over the last half of July and appear to be gaining strength – a sign of confidence from muni investors.

In our Annual Outlook, we looked for munis to get things in cruise control once the Fed cycle was near its end, interest rate volatility calmed down, and investor confidence returned (inflows). MainLine thinks that time is now.

Market News & Credit Update:

The rebirth of Detroit continues. The city with a resounding success issued $100 million in general obligation debt ($77 million tax-exempt, $23 million taxable) at attractive spreads and oversubscribed by thirty times. Top yields were originally planned to be 5.59%, but finally sold at 5.04% (2043 maturity). Taxables due in 2028 were priced at 6.84%. Credit ratings were put on positive outlook at BB+/Ba1 by S&P and Moody's.

A recent analysis by Morgan Stanley reviewed the impact of spreads on municipal bonds and credit quality. It shows that spreads are more technically driven (supply/demand related) than they are reliant on credit quality improving or decreasing. What does this mean for an investor? *It comes back to buying bonds with spread versus the general market and earning the additional income, as this far outweighs any additional credit risk.*

Remember our update on the muni market and the changes coming? Well the first one has just occurred. Texas Public Finance Authority approved a pool of 23 underwriters for the State starting this September. Absent from that list are Citibank, and Goldman Sachs. Some "newbees" are Hilltop Securities, Robert Baird, and Stifel. Jefferies is now the top underwriter in the State.

The Case for Tax-Exempt

Introduction:

From time to time, when DC gets desperate for revenue, the debate on where cost savings can be found turns to the income loss due to municipal bonds being tax-exempt. It has been a few years since this has been an issue but, given the recent debates on fiscal control and budget gaps in DC, MainLine thought we would get ahead of the debate and present our case for tax-exempt financing. Hopefully, this saves DC from wasting taxpayers' money to reach the same conclusion.

MainLine will take two approaches to review "The Case". First we will look at an academic study short on numbers by the Tax Policy Center, and then one based on numbers and alternatives MainLine put together.

Tax Policy Center – "Who Benefits from Tax-Exempt Bonds?"

In September 2013, the Tax Policy Center- Urban Institute and Brooking Institution released an application of the theory of tax incidence entitled "Who benefits from tax-exempt bonds? Authored by Harvey Galper, Joseph Rosenberg, Kim Rueben and Eric Toder. This study was followed with a more detailed study in 2014 entitled "Municipal Debt: What Does it Buy and Who Benefits?

The study develops and applies a conceptual framework to estimate the distribution among income groups of the benefits from the Federal income tax-exemption on interest from state and local bonds. The analysis is very comprehensive, short on numbers and focused on the following:

- Benefits received by individuals who earn tax-free income.
- The impact on returns, and relative returns on other financial instruments due to tax-exempt investments.
- Reduce costs of goods and services by state and local governments, due to lower borrowing costs due to issuing tax exempt debt.
- Increased prices of private goods and services, due to higher borrowing costs to businesses that must compete with state and local government for capital resources.

Data Analysis:

- Results for capital markets impact on returns were simulated within the TPC (Tax Planning Center) model. The lone assumption made is that the yield spread differential between tax-exempt and taxable is 25%.
- Study on taxable (BABS) versus tax-exempt showed an average borrowing cost for tax exempt bonds at 5.2% versus 7.1%. The implied tax rate was 26.8%. This would estimate the cost of tax-exempt financing to the US Treasury is 180 bps.

Conclusions:

- The cost of higher goods and services for the private sector and the Federal government is offset by the lower cost of public goods and services. Yet, the benefits within the income classes are different.
- The study finds that the tax exemption of income benefits the rich more than the lower borrowing costs helps the lower income with less expensive goods and services. If the municipality uses the additional costs and reinvests it back into the community the additional savings makes the cost savings to the lower income more closely equal to the tax savings of the wealthy. If instead of reinvesting the cost savings, the municipality lowers taxes, it further benefits the higher income class.
- Lower income families gain a majority of their benefit through better schools, while higher income families save by not paying as much in taxes.
- All-inclusive, the costs and benefits are a wash to society as a whole, depending on how the debt savings costs are "reinvested", higher income classes could benefit more or it could be even across income classes.

MainLine West – “The Case for Tax Exempts”:

In doing a rough calculation in 2022/2023, MainLine shows the cost of tax-exempt financing to the US Treasury is roughly $38 billion. Calculated as follows:

$4 trillion outstanding munis, average yield to worst yield from Bloomberg index of 3.56%, and an average tax rate for Muni holders of 27% (based of Tax Policy Center study), the math comes out at $38.4 billion.

The US Government projected a $2.8 trillion deficit in 2022. The loss of revenue of $38 billion is roughly 1.4% of the US deficit shortfall. This cost does not include the non-monetary benefits and the potential additional cost of using taxable financing for local infrastructure projects. Tax-exempt bonds benefit both issuers and investors, promote accountability, financial efficiency, cost-savings to taxpayers, and replace other alternatives that could be damaging to society. ***MainLine feels the value of public finance exceeds 1.4% of the budget gap it creates.*** What creates this value? Let’s explore them further.

Improve Efficiencies:

The current system allows high net-worth investors an opportunity to earn quality after-tax income while providing society with low-cost financing to build schools, roads, utility plants and other projects for the public good. Otherwise, the entire costs of financing and improving infrastructure would be passed on to the citizens of all income classes in the form of higher taxes and fees. The ability to sell to investors looking for tax-exempt income unburdens local citizens from having to bear the additional costs for infrastructure and improvements.

Accountability:

The current system allows municipalities to be responsible for their own projects, credit quality, and cost of capital. It allows the citizens to decide by voting whether they want to pay taxes or fees for the services the project is providing. This allows the community a sense of accountability that the project works and is built efficiently since they will be paying the bill. The investor will be the final judge on whether they feel the community stands behind its project by the interest rate it requires to buy the bond.

Lower Costs for Services to the Public:

Any increase in borrowing costs will be passed on to the consumer/resident of the municipality. This includes water and sewer rates, electric utility rates, toll road rates, and sales tax rates - just to name a few. If the cost to provide essential services rises, so will the utility bills (the same amount for all income classes).

The Case Against:

However, there are arguments that the current system is not efficient since tax-equivalent yields are higher than what tax rates and credit risk imply. Depending on the maturity date, bonds tend to trade at an implied tax rate of 10%-25%. This is rationalized as an excessive return of 15-30% since the current tax rate is 37%. Advocates against tax-exempt financing feel the high-net-worth investor earning this additional income is taking advantage of market inefficiencies at the expense of the US Government. MainLine would argue that this inefficiency is due, in some part, to the US Government and its waffling of tax and spending policies. More specifically, the extra investment income comes from future tax rate uncertainties and credit concerns. If discussions on making income from municipal bonds taxable or restricting their tax-exempt benefits would stop, some of this inefficiency would go away. A stable, unwavering policy towards tax-exempt income and treatment of municipal finance may help reduce the additional income being earned by investors.

Alternatives to Tax-Exempt Financing for Infrastructure?

If we are to assume that the revenues earned by taxing municipal bonds are indeed a big "fix" to the budget deficit, then we must also identify alternatives to keep infrastructure strong. However, these alternatives must not create costs and inefficiencies somewhere else. It is estimated in a study by the American Civil Engineers that by 2025, the US will need $4.5 trillion worth of infrastructure improvements. This is a lot, even for the municipal market to fund. For this comparative study, let's assume we want to get half of this going over the upcoming years ($2.2 trillion). The most efficient way to fund these projects is with tax-exempt bonds. Let's review three other options that have been proposed over the years. We highlight the additional costs to taxpayers through higher taxes, or a lower ability to borrow funds.

Taxable Municipal Bonds: If our elected politicians decide to make all municipal bonds taxable, the increased cost to finance $2.2 billion in infrastructure projects rises substantially. A rough calculation shows an additional cost of $31.2 billion to fund these projects, I calculated the $31 billion as follows:

Refinance $2.2 trillion tax-exempt munis at the current implied cost difference between tax-exempt debt and taxable muni debt, which I show as 141 bps (difference in yield to worst for the Bloomberg taxable municipal index versus the tax-exempt) and the math calculates an increase of $31.2 billion to finance with taxable debt.

Using the USA population of 331.9 million (2021), that gives every US citizen a local tax increase of $94 annually. Now, how should we bill this? Each citizen in Fargo, ND pays the same as those living in Beverly Hills? Will citizens without a current infrastructure project pay for those that have one?

Subsidized Taxable Bonds: In 2009, as part of the American Recovery and Reinvestment Act, the Build America Bond Program was created. This was a program designed to allow municipalities to fund infrastructure projects by issuing taxable bonds and receive a 35% subsidy payment from the US Government to offset the additional costs of issuance. Remember, the above studies show that 25% is the implied tax savings rate. So 35% is a much higher cost and would need to be reviewed. The investors of BABs already harbor distrust with the program in early 2013, as the "fiscal cliff" crisis automatically cut the BAB's subsidy by 7.6%. This changed the 35% subsidy to 32.3%. While this does not seem to be a huge change, it does identify the vulnerability and control the Feds have on the program. It shows that the US Government would consider changing the program's subsidy rate, which could impact an issuer's ability to meet debt service coverage, going forward. This adds uncertainty to principal protection and will ultimately increase borrowing costs. This increased borrowing cost will increase the burden on taxpayers. ***Once again, should an investor trust the local municipality who would be responsible for the 'tax-exempt project", or the Federal government subsidizing a local project in which it has no interest?*** It seems like a "not-so-trustworthy" alternative to provide lower financing to municipalities.

US Government Infrastructure Bank?: This is the theory that the Federal government decides what needs to be built and where. Bonds are issued by the US Government and tax dollars pay them off. This resurrects the politically-charged societal discussion of whether the government or the private sector can do a better job of managing projects. That leads to an equally charged discussion of why more money goes to states such as California and New York, but the rest of the USA pays for it. After all, what California may view as an important infrastructure project, residents in Wyoming may not. Why should Wyoming tax dollars go to make life easier for people in California? Plus, you are now introducing the world of politics to the analysis. The political clout of one state may bump out the infrastructure dollars for another state. There is no accountability, and the smaller states get taken advantage of by the larger ones. The Founding Fathers recognized this potential problem, thus the creation of the Senate. This seems like another "not-so-trustworthy" alternative to provide lower financing to municipalities.

Conclusions:

In my humble opinion, the idea to eliminate tax-exempt bonds appears to be poorly conceived, because there are no better options and the non-monetary benefits outweigh the nominal cost savings. There are major infrastructure needs across the country. There are also borrowers looking for money to address these needs, and there are investors willing to lend them money for their projects. The US Government needs to let the system continue to do its job and go about managing its own business. This marginal deficit reduction would be at the expense of efficient and accountable infrastructure financing, and cost residents higher service fees and state taxes. **I have a better idea: How about the states decide to collect state income tax on US Treasury bonds and use those funds to pay for infrastructure projects?**

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