U.S. Municipal Bond Market

A New Decade & The Threat to the Municipal Bond Tax-Exemption

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Foresee an Environment Suitable for a Strong Tax-Exemption Threat

If the quest for deficit reduction measures we saw proposed and considered after the Great Recession are any indication, we believe the municipal bond market could witness an even greater threat to the municipal bond tax-exemption in the coming years. A certain political chemistry in both branches of the legislature and White House ahead of the 119th Congress poses potentially the strongest threat to the municipal bond tax-exemption since 2017. In fact, the threat could be even greater because of how high U.S. debt has risen compared to just a few years ago. The specifics of how lawmakers approach tax policy will be critical in determining the level of the threat closer to and just after the 2024 elections.

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Breakdown of Party Government in the U.S. (106th Through 117th Congress)

Congress	House Majority	Senate Majority	Presidency	Party Govt.
119th (2025–2027)	Unknown	Unknown	Unknown	Unknown
118th (2023–2025)	Unknown	Unknown	Unknown	Unknown
117th (2021–2023)	Democrats	Democrats	Democrat (Biden)	Unified
116th (2019–2021)	Democrats	Republicans	Republican (Trump)	Divided
115th (2017–2019)	Republicans	Republicans	Republican (Trump)	Unified
114th (2015–2017)	Republicans	Republicans	Democrat (Obama)	Divided
113th (2013–2015)	Republicans	Democrats	Democrat (Obama)	Divided
112th (2011–2013)	Republicans	Democrats	Democrat (Obama)	Divided
111th (2009–2011)	Democrats	Democrats	Democrat (Obama)	Unified
110th (2007–2009)	Democrats	Democrats	Republican (G.W. Bush)	Divided
109th (2005–2007)	Republicans	Republicans	Republican (G.W. Bush)	Unified
108th (2003–2005)	Republicans	Republicans	Republican (G.W. Bush)	Unified
107th (2001–2003)	Republicans	Republicans / Democrat	Republican (G.W. Bush)	Unified / Divided
106th (1999–2001)	Republicans	Republicans	Democrat (Clinton)	Divided

Source: U.S. House Archives and HilltopSecurities..

The threat to the municipal bond tax-exemption is not on the radar of most municipal bond market observers or participants right now. It may seem counterintuitive to begin to identify a threat that is potentially years in the making, especially when lawmakers have recently proposed to expand, not reduce the tax-exemption tax expenditure. This is also why we believe now is the time to recognize this as a potential danger.

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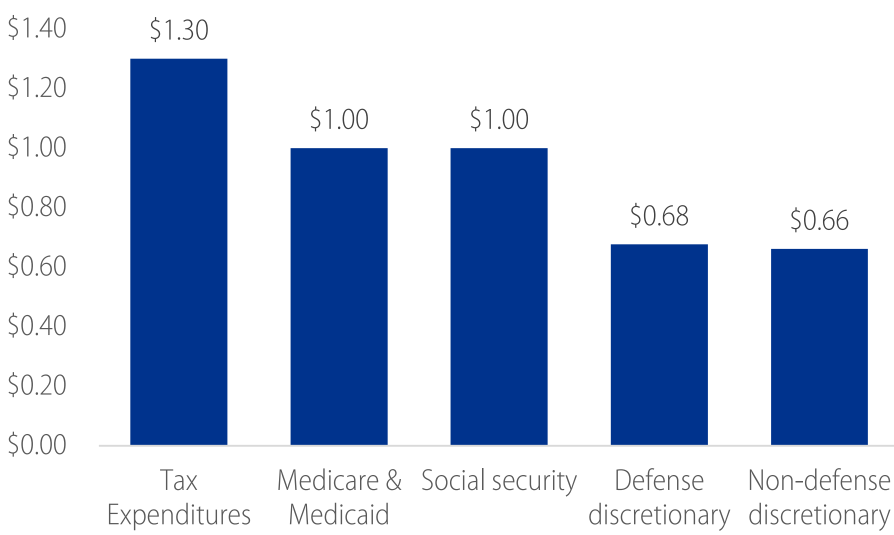
Review of U.S. Tax Expenditures

There are two major ways the federal government delivers benefits to the public. The first is through spending programs, which could be in the form of social programs such as Medicare, or Social Security. This could also be in the form of spending for areas such as national defense. The other major way the federal government delivers benefits to the public is through tax expenditures or special provisions delivered through the tax code. The municipal bond tax-exemption is a tax expenditure. These are recognized as a revenue loss to the federal government and when added together can be considered quite costly. Here is what the sum of the cost of tax expenditures looks like when compared with other major programs.

Cost Comparison: Tax Expenditures vs. Selected Major Program Expenditures, FY19 ($ in trillions)



Source: CBPP and HilltopSecurities.

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This Congressional Research Service report Spending and Tax Expenditures: Distinctions and Major Programs (Updated July 9, 2019) cites Joint Committee on Taxation data that estimates revenue loss from tax expenditures of $1.485 trillion, or 7.0%, of U.S. GDP. In fiscal year 2019, the United States federal government spent $4.4 trillion, or 21%, of GDP. About $3.5 trillion of the federal budget was paid for with federal revenues and almost $1 trillion was financed with borrowing. Please see Policy Basics: Where Do Our Federal Tax Dollars Go? for more on this. But, these numbers should give an idea of how large tax expenditures are compared to the overall federal budget.

In fiscal year 2019, the United States federal government spent $4.4 trillion, or 21%, of GDP. About $3.5 trillion of the federal budget was paid for with federal revenues and almost $1 trillion was financed with borrowing.

This relationship highlights the fact that federal tax expenditures, such as the mortgage interest deduction and the municipal bond tax-exemption, when taken together with other tax expenditures can be considered expensive spending line-items for the federal government. The accompanying table shows that the municipal bond tax expenditure is one of the more meaningful tax expenditures ranked by revenue impact. Analysis by the Center on Budget and Policy Priorities also shows a large portion of tax expenditures favor higher income brackets.

There are also arguments against this view and its efficiency. There is also analysis that examines which bondholders benefit the most from the municipal bond tax-exemption. We expect the overall cost and the distributional impact considerations will continue to put the municipal bond tax expenditure in the crosshairs of policymakers when they consider deficit reduction measures in the coming years.

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The 20 Largest Tax Expenditures Ranked by Projected Revenue Effect ($ millions)

Rank	Section	Tax Expenditure/ Provision	2020	2021	2021-2030	% of Top 20
1	121	Exclusion of employer contributions for medical insurance premiums and medical care	191,350	197,530	2,807,130	19%
2	59	Exclusion of net imputed rental income	123,210	130,590	1,645,980	11%
3	66	Capital gains (except agriculture, timber, iron ore, and coal)	99,210	99,890	1,270,250	9%
4	141	Defined contribution employer plans	80,690	87,610	1,168,850	8%
5	140	Defined benefit employer plans	65,920	67,960	762,880	5%
6	116	Deductibility of charitable contributions, other than education and health	40,320	43,610	683,380	5%
7	55	Deductibility of mortgage interest on owner-occupied homes	24,730	25,440	595,980	4%
8	163	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	7,060	6,890	561,020	4%
9	134	Child credit	70,170	73,320	517,920	4%
10	68	Step-up basis of capital gains at death	35,460	37,780	505,450	4%
11	58	Capital gains exclusion on home sales	39,450	40,610	500,660	3%
-	-	Exclusion of interest on State and local bonds for Public purposes	0	0	0	-
-	-	Exclusion of interest on Private activity bonds	0	0	0	-
12	161	Exclusion of interest on State and local bonds for Public purposes & Private activity bonds	0	0	0	3%
13	65	Treatment of qualified dividends	29,450	30,760	387,240	3%
14	144	Self-Employed plans	25,680	28,260	377,030	3%
15	155	Social Security benefits for retired, disabled workers & spouses, dependents & survivors	27,050	27,180	364,900	3%
16	4	Reduced tax rate on active income of controlled foreign corporations (normal tax method)	27,570	29,780	323,560	2%
17	77	Allow 20-percent deduction to certain pass-through income	29,195	50,518	300,225	2%
18	56	Deductibility of State and local property tax on owner-occupied homes	6,450	6,370	294,600	2%
19	8	Credit for increasing research activities	16,940	18,300	247,400	2%
20	142	Individual Retirement Accounts	16,510	17,360	232,340	2%
		Total of Top 20 Expenditures	**1,020,695**	**1,096,378**	**14,428,915**	

Source: U.S. Dept. of Treasury and HilltopSecurities.

A strong economic argument in favor of the municipal bond tax exemption is that it encourages state and local government infrastructure investment.

We expect the overall cost and the distributional impact considerations will continue to put the municipal bond tax expenditure in the crosshairs of policymakers when they consider deficit reduction measures in the coming years.

Recent History of Tax-Exemption Threats

The threat to the municipal bond tax-exemption has been and continues to be real. The threat to the tax-exemption over the last decade culminated in the loss of public finance issuers' ability to execute advance refundings using tax-exempt bonds at the end of 2017. The threat was so large in the last decade that public finance entities almost lost the ability to use tax-exempts for private activity financings which include organizations such as hospitals and higher education institutions. There were also several proposals from important sources that recommended eliminating, or limiting the municipal bond tax exemption in the last decade.

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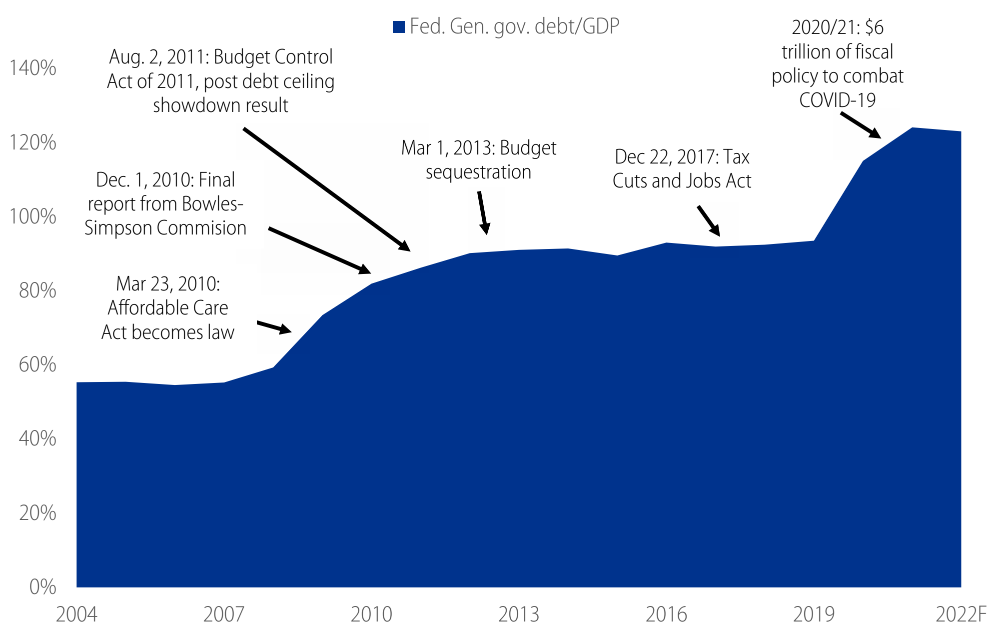
Let's take a quick review of how the threat developed in the wake of the Great Recession. It all begins with discussions about the need to lower the U.S. debt and deficit reduction tactics. Before the 2008 Financial Crisis, the U.S. debt to GDP ratio was about 50%, a relatively healthy level compared to just after the Great Recession ended. Alarm bells began to sound in 2010 when it began to sharply rise. A rising debt to GDP ratio put the U.S. sovereign credit at risk and this metric only worsened as the decade continued. This rising debt to GDP ratio became an important political issue especially for a faction of the Republican party that developed called the Tea Party. These lawmakers began the second decade of the 21st century focused on reducing federal budget spending and they were very much in favor of deficit reduction measures.

Rising U.S. Federal Government Debt, % of U.S. GDP



Source: Moody's, US Treasury, Federal Reserve, and HilltopSecurities.

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Bowles-Simpson, Bipartisan Presidential Commission

President Barack Obama created The National Commission on Fiscal Responsibility and Reform, a bipartisan Presidential Commission on deficit reduction in the beginning of 2010. The effort was commonly referred to as the Bowles-Simpson Commission named after its co-chairs Erskine Bowles and Alan Simpson. The Bowles-

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Simpson Commission included 18 commissioners and required a super-majority, or 14 of the members, to vote in favor of its recommendations and for a vote to be brought before Congress.

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The Bowles-Simpson Commission's final recommendations, The Moment of Truth, were widely controversial upon their release in December 2010. The final report recommended a mixture of spending cuts and tax hikes, most of which rubbed political actors the wrong way. The Commission's proposal included an increase in the retirement age for Social Security, cuts to domestic spending, an increase to the federal gasoline tax, and other tax reforms that among other things specifically eliminated the municipal bond tax-exemption tax expenditure for new issuance (see page 31 of The Moment of Truth). The proposal did not receive the necessary number of votes from the commission's 18 commissioners in order for the proposal to move on for consideration by Congress. However, this was a significant shot across the bow for the municipal bond tax-exemption provision at the beginning of a new decade, and the threat to the tax-exemption only grew from there.

Debt Ceiling Showdown of Summer 2011

The newly formed faction of the Republican party, referred to as the Tea Party, embraced anti-debt political momentum. This group, among other policy priorities, tried to drive deficit reduction measures by reducing spending and cutting government earmarks. The Tea Party is probably best known for the negotiation tactics that led to the debt-ceiling crisis during the summer of 2011, that among other things, led to S&P Global downgrading the U.S. sovereign rating to AA+ from AAA. The debt ceiling negotiations resulted in an 11th hour agreement. Lawmakers finally signed the Budget Control Act (BCA) of 2011 into law on Aug. 2, 2011. The BCA of 2011 created a super-committee that was supposed to identify ways to bring balance to the U.S. budget and if the committee failed, an automatic budget sequestration would be enacted that would automatically reduce federal spending as of Jan. 2, 2013. This mechanism was supposed to incentivize lawmakers to compromise on spending cuts through negotiation. There was not enough incentive however, and the automatic cuts through budget sequestration eventually occurred in 2013.

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The Fiscal Cliff and U.S. Budget Sequestration of 2013

Lawmakers faced a fiscal cliff to begin the 2013 calendar year. The fiscal cliff referred to the combined impact that the expiration of previously enacted laws would have on the U.S. economy. This U.S. economy's ability to recover from the Great Recession was still being questioned at this time, making this cliff an issue to watch for many even outside political circles. The 2001 and 2003 Bush tax cuts were set to expire on Dec. 31, 2012. Federal spending cuts under sequestration were scheduled to begin to start 2013 as well because the super committee formed under the above-mentioned Budget Control Act of 2011 failed to come to an agreement on deficit reduction measures. The Budget Sequestration of 2013 was delayed until the beginning of March, but across the board budget cuts did occur. This is the mechanism that has since cut the subsidy that is paid to issuers of taxable Build America Bonds sold in 2009 and 2010.

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President Obama's Budget Proposal Recommended Limiting Value of Tax Benefits

Another threat to the municipal bond tax-exemption came from presidential budget proposals during the Obama administration. Some state and local lawmakers lobbied against the president's recommendation. In an April 15, 2013 opinion piece in *The Baltimore Sun* titled Obama Wrong to Seek Limits on Tax-Exempt Bonds, U.S. Representative Dutch Ruppersberger (D-Md.) indicated that it was wrong for former President Obama to propose to limit the value of tax benefits for top-earning investors in municipal bonds to 28%, down from 35%. Rep. Ruppersberger countered, "As a former county councilman, county executive and president of the Maryland Association of Counties, I understand that tax-exempt bonds are the most efficient way to fund such infrastructure projects. Unfortunately, not enough members of Congress have local government experience."

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Intense Municipal Bond Tax-Exemption Threat Prior to the 2017 Tax Cut

The most intense threat to the municipal bond tax-exemption came in November and December of 2017 when Republicans in the 115th Congress began to release potential pay-fors for what eventually became the Tax Cuts and Jobs Act (TCJA) of 2017. The TCJA of 2017 was cornerstone tax policy for the 115th Congress and President Donald Trump that reduced individual and corporate tax rates, among other elements. The time period just before the TCJA of 2017 was signed into law was also the pinnacle of the threat to the municipal bond tax-exemption last decade.

Lawmakers' initial proposal would have entirely eliminated tax-exempt bonds for private activity bond issuers and for advance refundings. Municipal issuers were so startled by the suggestion that they raced to the market in November and December selling $155 billion of tax-exempt debt. The five-year average issuance for November and December before 2017 was only $55 billion. When the dust settled, tax-exempts for private activity bonds were saved, but the new law eliminated tax-exempt issuance for advance refundings. This limitation still exists today, but could potentially be reversed based on legislation currently being considered by Congress as part of President Biden's Build Back Better agenda.

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One of the key points that is often not recognized about 2017 was that for most of the previous decade we recognized a threat to the municipal bond tax-exemption existed mostly as a result of potential deficit reduction measures. However, municipal bond issuers did not lose their ability to use tax-exempts for advance refundings as a result of deficit reduction legislation in 2017. Municipal bond issuers lost (maybe temporarily) their ability to use tax-exempts for advance refundings to fund what was largely considered a tax cut. This reality adds another element to the potential threat to the municipal bond tax-exemption in the coming decade. In other words, it is not only deficit reduction measures that could eliminate the municipal bond provisions, but they could be used to fund other lawmakers' political aims as well. The 2017 TCJA turned out to not only to be a credible threat, but a real danger and showed how vulnerable the municipal bond elements truly are to lawmakers' strategies.

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New Decade, Rising U.S. Debt to GDP, Means Greater Potential for Deficit Reduction

The threat to the municipal bond tax-exemption has not lessened now that we have entered the third decade of the twenty-first century. If anything, the threat is even higher now, because U.S. debt levels grew substantially in the last decade. "At the end of 2019, federal debt was higher than at any other time since just after the war [WWII]," wrote the Congressional Budget Office in March 2020. This is even before lawmakers added another $6+ trillion to the debt to combat COVID-19. In its 2021 Long-Term Budget Outlook the CBO indicated a large federal deficit and rising debt levels. Overall, the federal debt is projected to double to 202% of GDP by 2051.

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Questioning the Direction Tax Policy Will Take This Decade

We will need to watch closely how views and discussions about tax policy evolve. The U.S. is experiencing a unique moment that is being afforded to the Democrats by their victories in the Georgia run-off elections at the beginning of 2021. As a result, the Democrats have a tie-breaking vote from the vice president that could help President Joe Biden deliver as much as $3.5 trillion of his progressive agenda. Discussions about what could be included in a budget reconciliation package are being considered right now, and lawmakers seemed to have shifted into a more compromising mode. However, Senator Kyrsten Sinema, a Democrat from Arizona, recently reinforced her opposition to raising corporate tax rates to help pay for the Democrat's Build Back Better Agenda. This opposition by a moderate Democrat is an important reality about the potential future of where U.S. tax policy is likely to go in coming years.

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At issue in the United States is a larger debate about the role of government and how government should be funded. We have seen this debate play out even in just the first 10 months of 2021. Some progressive Democrats have seemingly misread the political landscape, and this is one of the reasons why the progressives have held out for spending closer to $3.5 trillion in the Build Back Better package. But as we note above, it is a moderate Democrat in the Senate who is pushing back on raising the corporate tax rate.

The Economist went so far in October 2021 to suggest that, "America will never have a European-style welfare state without a Value-Added Tax or (VAT)" on consumption. Another Economist article showed that U.S. total tax revenue as a percentage of GDP is closer to OECD countries like Korea and Turkey, and not Sweden or France, and below the OECD average. However, political sentiment in the U.S. is largely not moving in the direction of a higher level of government involvement.

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Total Tax Revenue as a % of GDP, FY 2019

OECD Country	Rev % of GDP	OECD Country	Rev % of GDP
Denmark	46.6%	Portugal	34.5%
France	44.9%	Canada	33.8%
Sweden	42.8%	Estonia	33.5%
Belgium	42.7%	OECD Average	33.4%
Austria	42.6%	United Kingdom	32.7%
Italy	42.4%	New Zealand	31.5%
Finland	42.3%	Japan	31.4%
Norway	39.9%	Latvia	31.2%
Greece	39.5%	Lithuania	30.3%
Netherlands	39.3%	Israel	30.2%
Luxembourg	38.9%	Australia	27.7%
Germany	38.6%	Switzerland	27.4%
Slovenia	37.2%	Korea	27.3%
Hungary	36.5%	United States	25.0%
Poland	35.1%	Turkey	23.1%
Iceland	34.8%	Ireland	21.9%
Czech Republic	34.8%	Chile	20.9%
Spain	34.7%	Colombia	19.7%
Slovak Republic	34.6%	Mexico	16.3%

Source: OECD and HilltopSecurities.

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During COVID-19, Gallup polling data (page 9) showed that many Americans thought that government "Should Do More," reversing a trend that stood going back to the early 2000s. This is an appropriate reaction after all and most likely a result of the pandemic. "Understandably, the public demanded more from the government. If there are no atheists in a foxhole, there are fewer libertarians in a pandemic," wrote Catherine Rampell in the *Washington Post*. Polling from September 2021 shows a return to the relationship that existed before COVID-19 and more Americans are saying government is, "Doing Too Much." This attitude could have an impact on tax policy as well in the coming years.

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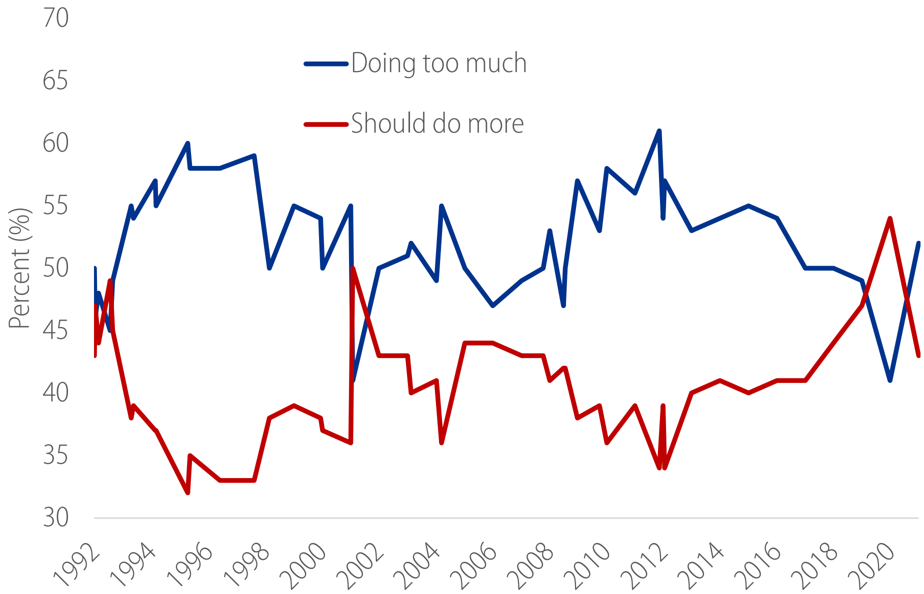
Poll: Is the Government Doing Too Much, or Too Little



Source: Gallup, Washington Post and HilltopSecurities.

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Debate Leading Up to the 2022 and 2024 Elections

When the calendar turns to 2022 we expect that the political focus in Washington will be on the 2022 mid-term elections. Just recently House Republican Kevin McCarthy appeared on *Fox and Friends* (Sept. 14, 2021) and described his opposition to the tax and spending policies the Democrats are trying to approve. McCarthy is focused on winning back the Republican majority in 2022. To get there he is focused on a "partial revival of now defunct Tea Party's slash-government spending ethos and alarm over the debt," according to Bob Woodward and Robert Costa's new book, Peril (p. 192). In fact, Rep. McCarthy is counting on "alarm over the debt" as being a leading issue next year. "I think the debt is going to become a bigger issuer than people think because it's the hangover afterward…I think people are going to wake up," McCarthy says. During a foreign policy related speech at the Nixon Presidential Library the Minority Leader identified U.S. debt as one of the two key threats to the U.S. "Our greatest threats going forward is the debt and China," the Minority Leader said. Therefore, we are very much expecting that the topic of the rising U.S. debt and debt reduction tactics will receive a significant amount of attention.

Just recently House Republican Kevin McCarthy appeared on Fox and Friends (Sept. 14, 2021) and described his opposition to the tax and spending policies the Democrats are trying to approve.

Of course, we will have to see how the importance of the debt and deficit reduction measures evolve in 2022 and before the 2024 elections. Political results are also a leading input we will be watching for as well. However, if the quest for deficit reduction measures we saw proposed and considered after the Great Recession are any indication, we believe the market could witness an even greater threat to the municipal bond tax-exemption in the coming years. We currently foresee an environment suitable for a strong threat to the municipal bond tax-exemption that could exist for years.

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Recent HilltopSecurities Municipal Commentary

- Lawmakers Shift to Compromise, Some Spending Jettisoned, Municipal Elements Remain if Only For Now, Oct. 20, 2021
- White House Scrambles to Revive its Approval Rating & Legislative Agenda, Municipal Friendly Elements Hang in the Balance, Oct. 15, 2021
- Municipal Bond Friendly Elements Could Be Lost if Build Back Better Agenda is Pared Back, Sept. 30, 2021
- The Road to Getting Infrastructure Done in 2021, Sept. 20, 2021

Readers may view all of the HilltopSecurities Municipal Commentary here.