

U.S. Municipal Bond Market

Save the Tax-Exemption, A Call to Action for U.S. Public Finance

- A convergence of risk has the potential to result in the elimination of new tax-exempt municipal bond issuance.
- For the public finance community this analysis is meant to be a call-to-action.
- This is a potential policy threat for investors to monitor, for now.
- The rising U.S. debt-to-GDP ratio along with climbing interest costs are among the leading reasons why there is an even greater threat to the municipal bond tax-exemption today compared to recent decades.
- Reinforcement of this increased threat was recently delivered in the form of Fitch Ratings' U.S. downgrade (August 1) and the CBO's July Monthly Budget Review (August 8).
- The public finance community should escalate support for tax-exempt bonds by educating and informing D.C. lawmakers now, even though we may experience a federal budget cycle or two and a Presidential election before the true threat is imminent. If an educational process does not begin soon, it could be too late to save the tax-exemption by the time potential deficit reduction measures are proposed.

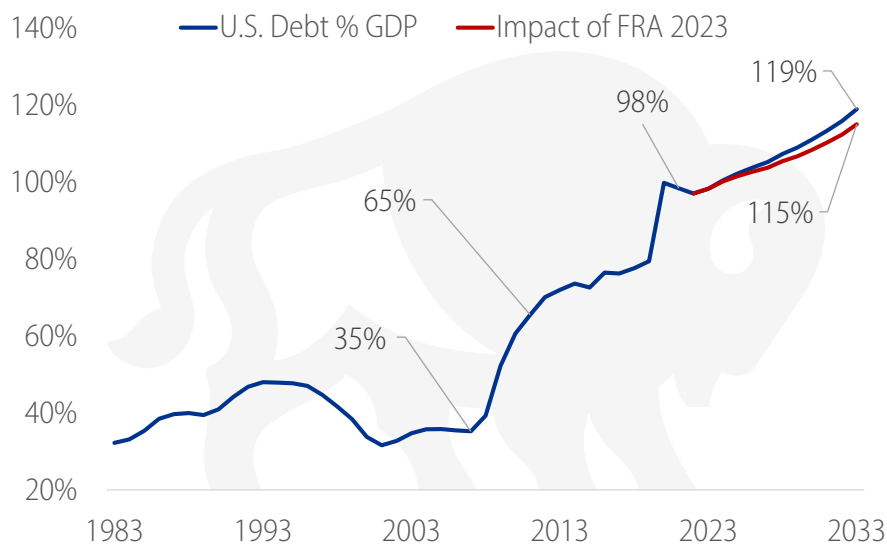
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Increased Policy Risk Could Mean the Tax-Exemption is Doomed, But It Could Be Saved

The evolving political dynamic, the normalization of monetary policy, and the U.S. sovereign fiscal weakening are all increasing the level of policy risk for public finance entities that utilize the tax-exempt municipal bond market. This convergence of risk is intensifying and has the potential to result in the elimination of new tax-exempt municipal bond issuance.

The public finance community should escalate support for tax-exempt bonds by educating and informing D.C. lawmakers now, even though we may experience a federal budget cycle or two and a Presidential election before the true threat is imminent.

The U.S. Debt-to-GDP Ratio Has Risen Significantly Since the Great Recession



Source: CBO and HilltopSecurities.

Please see disclosure starting on page 8.

The threat will not likely surface in this year's budget battle, and it will not likely take shape during a Presidential election year. An imminent threat will likely not emerge until 2025, this is also around when lawmakers will be preparing for the expiration of provisions from the Tax Cuts and Jobs Act of 2017. By that time deficit reduction will likely become a more meaningful issue even compared to 2010 through 2011.

The key takeaway from this analysis for investors is that it is possible that new tax-exempt bonds could cease to be offered if tax law modifications eliminate this incentive. This possibility is not yet reflected in municipal bond market prices, nor should it be. It is too soon. For now, this is simply a potential policy threat for investors to monitor. If the tax-exemption is eliminated for new bond issues, the value of existing tax-exempt municipal bonds will likely rise as investors appreciate the coming scarcity of this tax benefit.

For the public finance community this analysis is meant to be a call-to-action. The public finance community needs to awaken to the political and fiscal realities and recognize the increasing likelihood of the elimination of the tax-exemption tax-expenditure. Then, well in advance of the time when lawmakers in D.C. are seriously discussing comprehensive tax reform, stakeholders should take the appropriate action to save their ability to issue tax-exempt bonds.

Increased Threat to the Tax-Exemption, It Is Different This Time

I have spoken to many market observers and participants who have reinforced to me the history of the "threat to the municipal bond tax-exemption." There were regular warnings every decade since the 1980s, even before. Steady rumblings re-surfaced when D.C. lawmakers were searching for resources.

There are key differences today versus the past. In previous decades there were arbitrage and private versus public use worries and other related questions. Federal budget concerns often emerged, but the federal fiscal situation and its outlook were never this fragile. Increased nervousness about the direction of federal spending started to rise in the wake of the Great Recession. Attempts to control spending in 2010 and 2011 were largely not successful.

S&P Global lowered the U.S. sovereign rating to "AA+" from "AAA" on August 5, 2011 for fiscal and political reasons. In 2011, the U.S. debt to GDP ratio was 65%. The U.S. debt to GDP ratio has risen almost 80% and stands at 98% as of 2023. Fitch Ratings lowered its U.S. rating to AA+ during the first week of August 2023 also for fiscal and political reasons. And the U.S. debt-to-GDP ratio is forecast to rise to 115% by 2033 according to current spending levels and considering the impact of the Fiscal Responsibility Act of 2023 (FRA 2023). The rising U.S. debt-to-GDP ratio along with climbing interest costs are among the leading reasons why there is an even greater threat to the municipal bond tax-exemption today compared to recent decades.

No Longer Immune to High/Rising Federal Debt

The landscape has changed. Lawmakers can no longer ignore how risky the nation's fiscal situation is currently and is likely to become. Financial markets and the U.S. fiscal status is no longer immune to the near unprecedentedly high and increasing federal debt.

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It was not that long ago that President Joe Biden proposed a \$6+ trillion Build Back Better legislative agenda. Only select pieces of that agenda became law. The political circumstances have certainly changed. Trillion-dollar spending packages are no longer in vogue, and probably never should have been. Now, a budget showdown for early fall of this year is developing, although the deadline could be punted to December or another date.

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It was also not long ago that investors and financial market observers were concerned with the potential impact of negative interest rate monetary policy. That concern sure shifted. The U.S. Federal Reserve has been aggressively increasing its key interest rate to subdue prices and control inflation since the beginning of last year. More importantly it has been this aggressive monetary policy that has exposed the precarious nature of the U.S. fiscal situation because U.S. debt is becoming much more expensive to finance. Some are even whispering about a potential debt crisis or a debt spiral. Such warnings could be what it takes to give lawmakers a motivation to better manage the deficit and cut spending partially through comprehensive or other configurations of tax reform.

Recent Reminders of Fiscal Pressure: Fitch U.S. Downgrade and CBO Report

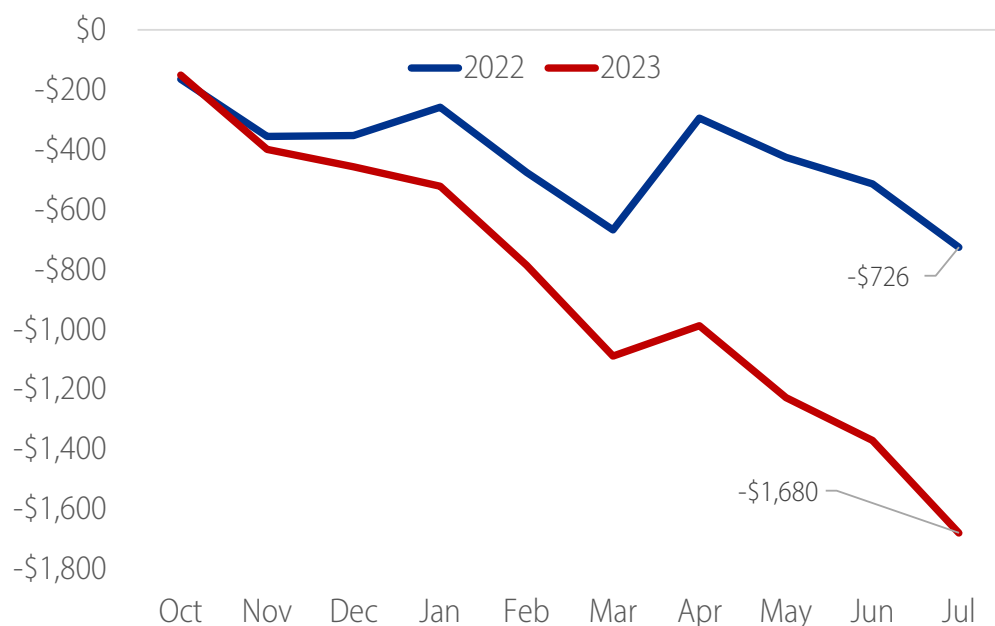
Financial markets were reminded about the deteriorating U.S. fiscal situation in recent weeks. On August 1, 2023 Fitch Ratings downgraded the U.S. sovereign to “AA+” from “AAA.” The rating agency wrote that the downgrade, “reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance. . .” Perhaps Fitch anticipated lawmakers would address the U.S. fiscal circumstances during the 2023 debt ceiling debate. The result of the debt ceiling deliberation instead was the Fiscal Responsibility Act of 2023 (FRA), which made only minimal changes to the medium-term debt outlook. The changes in the FRA were unsurprisingly not enough for the U.S. to keep its “AAA” Fitch rating.

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The negative impact U.S. monetary policy has had, and is expected to have, on the U.S. fiscal outlook was highlighted in the Congressional Budget Office’s (CBO) Monthly Budget Review: July 2023, released on Aug 8. There are almost two more months remaining in the federal government’s fiscal year which ends on Sept. 30 and so far, the CBO reports that federal revenues are down 10% for the year. That is not even the worst news from the CBO. U.S. federal government spending is rising. In fact, total outlays are up 10%. The line item that has risen the most year to date is interest on the accumulating federal debt. Interest on the debt rose 34%, or \$146 billion to \$572 billion. Interest on the debt is now 15.5% of federal spending. This expenditure is likely to continue to increase as well. The U.S. federal budget deficit was \$1.6 trillion in July 2023, more than double compared to July of 2022. CBO estimates forecast the budget deficit will be \$1.7 trillion by the end of the fiscal year, about \$200 billion higher than predicted in May. However, the CBO estimates may even be “too optimistic,” according to the Wall Street Journal.

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U.S. Federal Government Cumulative Monthly Deficits (Fiscal Years 2022 and 2023)



Source: CBO and HilltopSecurities. \$ in billions.

Other Spending Priorities Could Crowd Out the Municipal Bond Tax-Exemption

Accomplishments and challenges in U.S. public finance have been consistently linked to the federal government in one form or another. The interconnectedness of fiscal policy specifically and U.S. public finance was highlighted in both 2017 and 2021. The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated the ability of state and local governments and other public finance entities to use tax-exempt bonds for advance refundings. This has been mostly considered a negative for the public finance community because it eliminated a commonly utilized re-financing tool.

While making the case for his COVID spending plan and his Build Back Better agenda President Biden said, "with interest rates at historic lows, we cannot afford inaction" in January 2021. The almost \$2 trillion American Rescue Plan Act of 2021 (ARPA) was signed into law unsurprisingly just a few months later on March 11. It passed Congress through a legislative process called budget reconciliation, was thought to be "action" that took advantage of the low interest rate environment yet added more onto the already rising U.S. deficit.

ARPA was described as a COVID-19 stimulus package and included at least \$600 billion of direct relief for public finance sectors. Treasury Secretary Janet Yellen described the ARPA fiscal policy as a correction to the policy error that occurred in the wake of the Great Recession when lawmakers did not provide resources for state and local governments to close their budget gaps. This year the Treasury Secretary recommended leftover funds be used for job training programs and housing.

It was the ARPA aid that kick-started a significant boost to public finance credit quality. This is what we have referred to as the initial catalyst helping to form the Golden Age of Public Finance. The Golden Age will continue until at least the end of 2023 and probably into 2024. However, now that interest rates are higher and the U.S. deficit situation is

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worse, it is a reminder of how quickly the political landscape has changed because of monetary policy.

In the near-term federal fiscal pressures are going to intensify. Tax reform and deficit reduction measures could gain favor from D.C. lawmakers because of the evolving political dynamic and weakening fiscal status. Some tax expenditures such as the municipal bond tax-exemption are not as politically popular as they once were. In comparison, lawmakers are struggling to find support to eliminate the SALT (state and local government tax) cap, a topic that has been described as a potential “economic civil war.” Since ARPA became law, there has been and still is much dialogue and debate going on about the SALT cap. There is little discussion about the tax-exemption.

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The 20 Largest Income Tax Expenditures Ranked by Projected Revenue Effect (FY 2023-2032)

Rank	Section	Tax Expenditure/ Provision	2022	2023	2023-2032	% of Top 20
1	123	Exclusion of employer contributions for medical insurance premiums and medical care	\$224,520	\$237,400	\$3,366,320	20%
2	61	Exclusion of net imputed rental income	128,950	133,660	1,679,550	10%
3	142	Defined contribution employer plans	106,710	115,490	1,535,700	9%
4	70	Capital gains (except agriculture, timber, iron ore, and coal)	112,050	118,340	1,492,400	9%
5	57	Deductibility of mortgage interest on owner-occupied homes	34,430	35,660	1,005,510	6%
6	164	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	5,750	8,200	977,340	6%
7	119	Deductibility of charitable contributions, other than education and health	55,500	58,860	964,810	6%
8	141	Defined benefit employer plans	69,340	69,560	741,850	5%
9	72	Step-up basis of capital gains at death	46,750	49,240	652,090	4%
10	60	Capital gains exclusion on home sales	49,200	50,540	647,070	4%
11	162	Exclusion of interest on State and local bonds for Public purposes & Private activity bonds	52,350	52,240	503,420	3%
-	-	Exclusion of interest on State and local bonds for Public purposes	38,610	38,560	381,570	-
-	-	Exclusion of interest on Private activity bonds	13,740	13,680	121,850	-
12	145	Self-Employed plans	34,420	37,250	495,310	3%
13	58	Deductibility of State and local property tax on owner-occupied homes	5,110	7,420	484,020	3%
14	69	Treatment of qualified dividends	33,290	34,830	455,600	3%
15	156	Social Security benefits for retired, disabled workers & spouses, dependents & survivors	29,760	31,350	420,370	3%
16	143	Individual Retirement Accounts	23,600	24,430	362,930	2%
17	4	Reduced tax rate on active income of controlled foreign corporations (normal tax method)	30,540	32,840	335,910	2%
18	8	Credit for increasing research activities	23,260	24,980	321,230	2%
19	135	Child credit	66,840	67,520	306,870	2%
20	126	Deductibility of medical expenses	9,910	10,900	219,720	1%
Total of Top 20 Expenditures			\$1,089,930	\$1,148,470	\$16,464,600	

Source: U.S Dept of Treasury and HilltopSecurities, \$ in millions.

Bowles-Simpson Commission on Fiscal Responsibility and Reform

There was already a bullseye on the municipal bond tax-exemption. This was illustrated in 2010 when the National Commission on Fiscal Responsibility and Reform (also known as The Bowles-Simpson Commission) proposed the complete elimination of the municipal bond tax exemption for new issuance in their December 2010 final report, The Moment of Truth. The elimination of the tax-exemption would force public entities like state and local governments, school districts, non-profit hospitals, and higher education institutions to sell only taxable debt at more expensive levels.

The U.S municipal bond market totals about \$4 trillion according to the latest Federal Reserve data. The amount of outstanding bonds on the majority of state and local government balance sheets is manageable. Median debt service as a percentage of revenue for state governments is only about 4% and median debt service as a percentage of revenue for cities is a little higher, but still only 5% both according to Moody's Investor Service. There is no public finance related fiscal reason to limit the issuance of tax-exempt debt. If anything, the fact that the American Society of Civil Engineers Infrastructure Report Card is still only a "C-" remains a strong argument for the need for more infrastructure investment in public finance sectors like state and local government, schools, transportation and water and sewer facilities among other categories.

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Important Tax-Related Events, Notes & Dates for Public Finance

Date	Event, Note
Feb. 3, 1913	16th Amendment to US Constitution allows Congress to levy income tax, municipal bonds exempt
June 28, 1968	Revenue and Expenditure Control Act of 1968 defined PABs
Sept 3, 1982	Tax Equity and Fiscal Responsibility Act of 1982
Oct. 22, 1986	Tax Reform Act of 1986
1988	Rep. Beryl Anthony (D-AR) created the bipartisan Anthony Public Finance Commission
Apr 20, 1988	South Carolina v. Baker 485 U.S. 505 (1988), Supreme Court ruled TEFRA did not violate Tenth Amendment
Oct 1989	Preserving the Federal-State-Local Partnership: the Role of Tax-Exempt Financing published by the Anthony Commission
2007	U.S. Debt to GDP ratio was 35%
Feb 17, 2009	The American Recovery and Reinvestment Act of 2009, created taxable subsidized Build America Bonds (BABs)
Dec., 2010	Bowles, Simpson Presidential Commission publishes "The Moment of Truth," recommends eliminating the tax-exemption
2011	U.S. Debt to GDP ratio rises to 65%
Aug. 2, 2011	Budget Control Act of 2011, signed amid the 2011 debt ceiling showdown, creates Super Committee on Deficit Reduction
Aug. 5, 2011	S&P downgrades U.S. to "AA+" from "AAA" b/c of "political risks and rising debt burden"
Mar. 1, 2013	2013 U.S. Budget Sequestration, automatic spending cuts via BCA of 2011
Dec. 22, 2017	Tax Cuts and Jobs Act of 2017, eliminated ability to use tax-exempt bonds for advance refundings
Mar 11, 2021	American Rescue Plan Act of 2021, \$600 billion for public finance ushers in The Golden Age of Public Finance
Nov 15, 2021	The Infrastructure Investment and Jobs Act of 2021, did not renew BABs or bring back tax-exempt adv. refundings
2023	U.S. Debt to GDP ratio rises to 98%
June 3, 2023	Fiscal Responsibility Act of 2023, in wake of 2023 debt ceiling debate, suspends debt limit until Jan. 1, 2025
Aug. 1, 2023	Fitch downgrades U.S. to "AA+" from "AAA" b/c deterioration in governance & growing debt burden
2033	U.S. Debt to GDP ratio forecast to rise to 115% by CBO

Source: HilltopSecurities.

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There are key differences today versus the past. In previous decades there were arbitrage and private versus public use worries and other related questions. Federal budget concerns often emerged, but the federal fiscal situation and its outlook were never this fragile.

Since ARPA became law, there has been and still is much dialogue and debate going on about the SALT cap. There is little discussion about the tax-exemption.

Hilltop Reports about the Threat to the Tax-Exemption

- [A New Decade & The Threat to the Municipal Bond Tax-Exemption](#), Oct 22, 2021
- [Not an Immediate threat to the Tax-Exempt Status, Funding for Higher-Ed, or Other Municipals Despite President's Tweet; We Continue to Expect D.C. Support](#), July 10, 2020
- [The Threat to the Tax-Exemption Means Uncertainty for Municipals](#), June 4, 2019

Recent HilltopSecurities Municipal Commentary

- [First Half Public Finance Primary Issuance Down 20%, Foreshadows Potential Scarcity of Municipal Investment Options](#), July 5, 2023
- [Municipal Yields are Historically Attractive – Our View on How to Finish Out the Second Quarter of 2023](#), June 8, 2023
- [Debt Ceiling Deal Likely to Avert Default, Not Expected to Claw Back State & Local Govt. Fiscal Aid](#), May 31, 2023
- [First Quarter 2023 Public Finance Infrastructure Financings Lower, as Expected – Our Update on Issuance, Fund Flows, & Benchmark Yields](#), April 12, 2023
- [Municipals Seen as Quality Amid Bank Stress, Economic Uncertainty](#), April 6, 2023
- [The Fed is Not Changing Course, Reaffirms Our 2023 Municipal Outlook](#), Feb. 3, 2023

Readers may view all of the HilltopSecurities Municipal Commentary [here](#).

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