U.S. Municipal Bond Market

An Almost Imminent Threat to the Municipal Bond Tax-Exemption is Here: Act Now to Preserve This Vital Infrastructure Financing Tool

Tom Kozlik
Head of Public Policy and Municipal Strategy
214.859.9439
tom.kozlik@hilltopsecurities.com

- **Unique Threat Likely in 2025 Amid Political Shift and Fiscal Deterioration -** The current political and fiscal environment, characterized by the "Red Wave" and public dissatisfaction, poses a greater threat to the municipal bond tax-exemption than in past decades. The deteriorating U.S. fiscal situation, increase in national debt, and competing policy priorities further exacerbate this risk, making proactive educational and advocacy efforts more critical than ever.
- **Significant Risk of Elimination -** Without substantial and unified outreach and advocacy from public entities and market participants, there is a 50% or much greater chance that the tax-exemption will be eliminated or significantly curtailed by the end of 2025 during tax policy negotiations.
- **Crucial Infrastructure Financing Tool -** The municipal bond tax exemption is vital for states, local governments, and public entities, providing an effective and efficient means to raise capital for infrastructure projects.
- **Widening Infrastructure Gap -** Eliminating or curtailing the municipal bond tax-exemption would exacerbate the existing infrastructure gap. Public entities would face higher borrowing costs, reduced financial flexibility and independence, potentially leading to delays, underfunding, or cancellations of essential infrastructure investments. Also, the IIJA of 2021 and the IRA of 2022 did little to close the infrastructure gap.

The Urgent Need to Preserve the Tax-Exemption

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The preservation of the municipal bond tax-exemption should be considered a crucial priority for lawmakers in 2025. Tax-exempt bonds serve as a vital infrastructure financing tool for states, local governments, and public entities nationwide. The municipal bond market has proven to be an effective and efficient means for raising capital. Alternative financing options do not offer the same level of access, flexibility, and independence as tax-exempt financings provide. Alternatives are likely to be more expensive, especially for smaller, non-frequent issuers of debt if they can access investment dollars at all.

There is a compelling case to be made to federal policymakers for the preservation of the tax-exemption (and indeed, a very strong argument for its expansion, though protection must come first in 2025). However, without significant outreach led by U.S. public entities and market participants, there is a 50% or much greater chance the tax-exemption will be outright eliminated or significantly curtailed by the end of 2025 during tax policy negotiations.

The appointment of individuals to leadership positions who are unaware of the challenges public entities face heightens the risk of the elimination. Conversely, the more public entities share information about the challenges they face, educate about potential solutions, and vigorously advocate for preserving the tax exemption, the more they can

Please see disclosure starting on page 6.

reduce the risk of its elimination. To safeguard the tax-exemption, it is imperative public entities have supporters participate in tax policy discussions until the end of 2025. The time for action is now; this threat will not simply vanish. This time, the threat is more significant than even we anticipated before the 2024 election.

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Just after the only Presidential debate we published a report warning: Our 2024 Election Preview: We Could See an Unprecedented Threat to U.S. Municipals from Potential Tax Policy Changes. The worst-case scenario that we could have envisioned has developed, and then some. The "Red Wave" and the political momentum behind it are likely to destabilize current tax and fiscal policy in 2025 and potentially in 2026.

Important Tool to Close the Infrastructure Gap

In our article, "As the 2024 Elections Loom, America's Infrastructure Challenges Persist & Threaten to Deepen," we explored the ongoing and intensifying infrastructure crisis in the United States. Despite the $550 billion in new spending from the Infrastructure Investment and Jobs Act (IIJA) of 2021 and the Inflation Reduction Act (IRA) of 2022, a substantial infrastructure gap remains. This gap highlights the urgent need for continued investment and innovative financing solutions. Eliminating a financing tool that could help to close this gap is not logical, but federal lawmakers need to understand why that is the case before substantive policy negotiations begin in 2025.

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We also presented findings from the 2024 HilltopSecurities Public Entity Survey, which included responses from 1,200 public entity employees. The survey revealed that "Aging Infrastructure" is one of the top challenges facing public entities nationwide. Other critical issues identified in the survey include inadequate funding for the maintenance and upgrades of roads, schools, water and sewer systems, housing, and flood control measures. Additionally, there is a pressing need for the modernization of outdated infrastructure and the implementation of weather pattern mitigation strategies. The increasing costs associated with these infrastructure projects, including the need for expanded energy capacity to meet growing demands from artificial intelligence and technological change, further exacerbate the challenges faced by public entities nationwide.

The Public Entity survey results underscore the importance of the municipal bond tax-exemption as a vital tool for financing infrastructure projects across the entire gamut of the public sector. This financing tool allows public entities to raise capital at lower costs, making it feasible to undertake necessary improvements and expansions. Without the exemption, the cost of borrowing would increase to the tune of 25% (or more), particularly for smaller and less frequent issuers of debt, potentially limiting their ability to access the investment dollars needed for critical projects.

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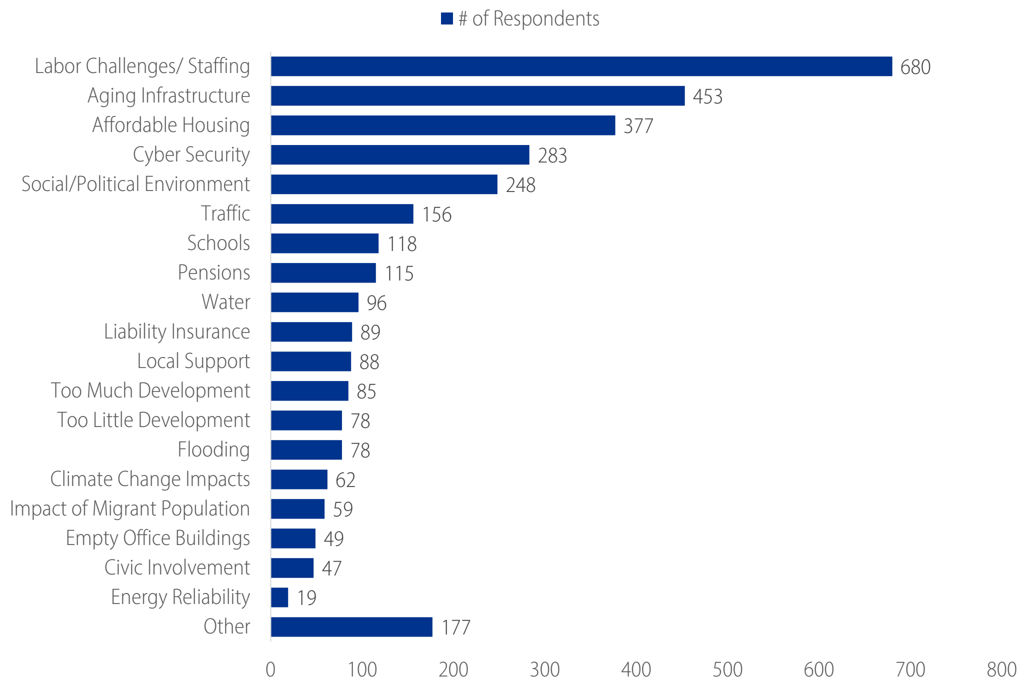
Moreover, the elimination or significant curtailment of the municipal bond tax exemption would likely exacerbate the existing infrastructure gap. Public entities would face higher borrowing costs, reducing their financial flexibility and independence. This could lead to delays or cancellations of essential infrastructure projects, further deteriorating the quality and reliability of public service delivery and slow economic growth.

Challenges Facing Public Entities (From the HilltopSecurities 2024 Public Entity Survey)

3. What are the biggest challenges facing your public entity? (Choose up to four).



Source: HilltopSecurities.

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Considering these challenges, it is imperative for federal policymakers to preserve the municipal bond tax-exemption. However, federal lawmakers who will be in office in the next Congress need to hear this from public entities. As we noted above, there is a compelling case for its protection and even expansion to ensure that public entities can continue to address infrastructure needs effectively. However, achieving this requires significant outreach and advocacy from public entities. Public entities should actively engage in discussions about tax policy and emphasize the critical role of the tax-exemption in supporting infrastructure development.

The threat to the municipal bond tax exemption is more significant than ever, and without concerted efforts to protect it, public entities may face severe financial constraints.

The time for action is now. The threat to the municipal bond tax exemption is more significant than ever, and without concerted efforts to protect it, public entities may face severe financial constraints. As we approach the end of 2025, it is crucial to have supporters for the tax-exemption participate in tax policy discussions. A proactive approach will help to begin to secure the financial resources needed to address the infrastructure gap, ensuring the continued provision of essential public services such as affordable housing, roads, schools, water and sewer systems, flood control, and energy capacity. This strategy will not only maintain these critical services but also foster economic growth.

Why is the Threat Different Now Than in the Past?

As we approach 2025, the threat to the municipal bond tax-exemption is more pronounced and almost imminent compared to past decades. Several factors are contributing to this heightened risk, making it crucial for public entities and policymakers to understand and address these challenges. We identify some of the major factors below.

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1. The "Red Wave" and Its Implications: We are assuming the 2024 elections result in Republican control of Congress. This "Red Wave" not only provides lawmakers with a mandate to overhaul fiscal and tax policies but also incentivizes them to disrupt the status quo. This political shift is expected to generate substantial noise and uncertainty from Washington, D.C., complicating advocacy efforts. The mandate for political change implies a more aggressive approach to fiscal policy, potentially targeting long-standing tax benefits that create "economic distortions" like some might believe exists with the municipal bond tax-exemption. This needs to be highlighted to lawmakers.

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2. Public Dissatisfaction and Demand for Change: Nearly three out of four Americans are dissatisfied with the current situation in the U.S., a sentiment that has been worsening since the end of the first Trump administration. This widespread discontent fuels a desire for significant policy change, leading to increased policy uncertainty. The Gallup polling data below illustrates this growing trend of dissatisfaction, which could translate into support for policy that destabilizes the status quo and results in drastic fiscal reforms that threaten the tax-exemption.

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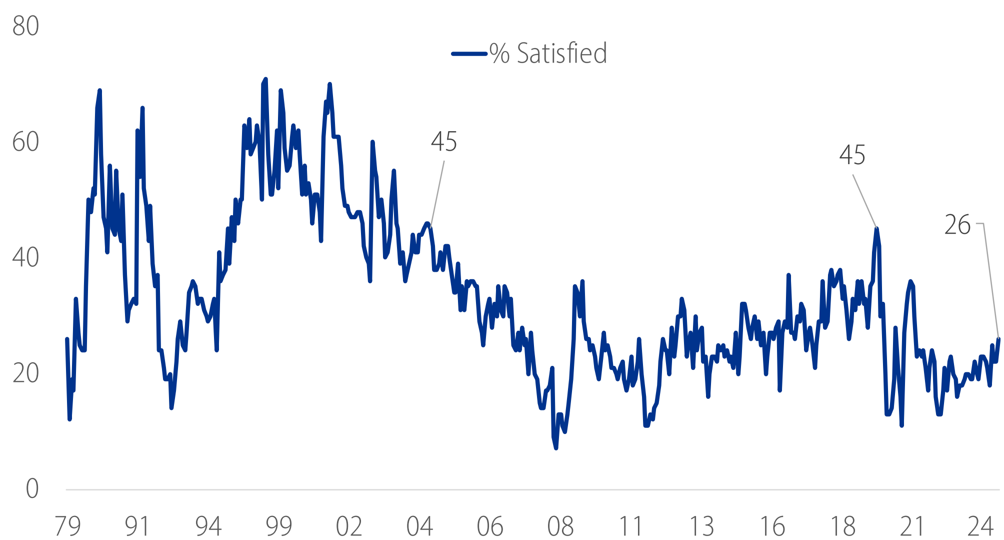
3 out of 4 Americans are Not Satisfied With the Way Things are Going in the U.S.



Source: Gallup.

3. Deteriorating U.S. Fiscal Situation: The U.S. fiscal situation has significantly worsened over the past decade, a fact underscored by Fitch Ratings' downgrade of the U.S. credit rating on August 1, 2023. This downgrade highlighted the urgent need for fiscal reforms. In response, we published our report, "Save the Tax-Exemption: A Call to Action for U.S. Public Finance," emphasizing the critical nature of this issue. Historically, the threat to the tax-exemption has always existed, but it has never been fully eliminated, and only recently curtailed in 2017. The U.S. fiscal deterioration is going to put pressure on lawmakers to identify new revenue sources, or offsetting payfors, making the tax-exemption a likely target.

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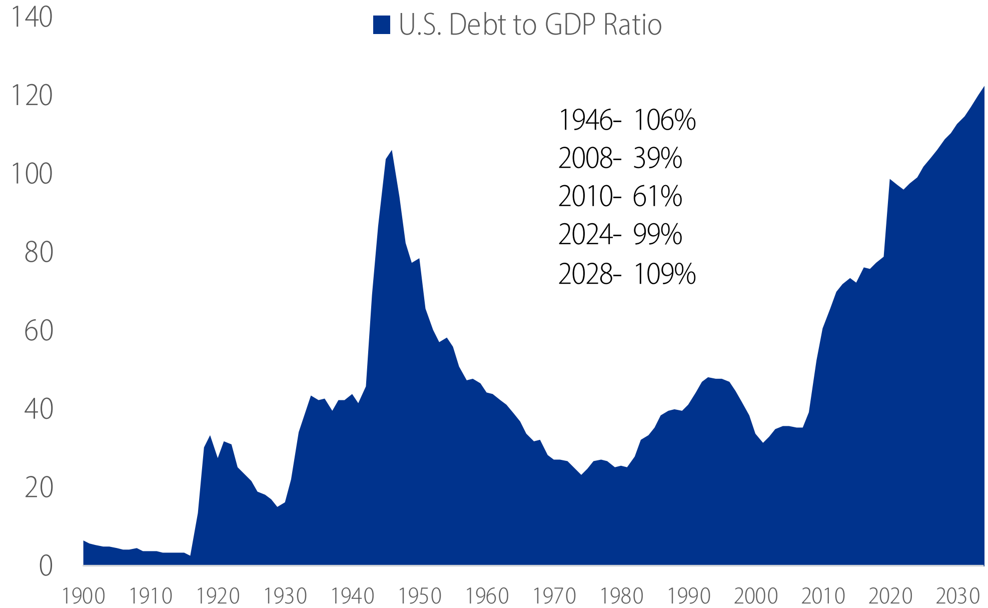
The Rising U.S. Debt to GDP is a Key Reason the Threat to the Tax-Exemption is Severe



Source: CBO and HilltopSecurities.

The competition for limited fiscal resources means that the tax-exemption could be sacrificed to fund other policy initiatives.

4. From Deficit Reduction to Competing Fiscal Policies: In the past, threats to the municipal bond tax-exemption were primarily tied to deficit reduction efforts. For example, the 2010 National Commission on Fiscal Responsibility and Reform, chaired by Alan Simpson and Erskine Bowles, proposed measures targeting the exemption as part of broader deficit reduction strategies in The Moment of Truth. However, the current threat extends beyond just deficit concerns. In 2025, the primary challenge could likely come from competing policy priorities. This shift was evident in 2017 when public entities lost the ability to use tax-exempt bonds for advance refundings, not due to deficit reduction, but to fund the Tax Cuts and Jobs Act of 2017. The competition for limited fiscal resources means that the tax-exemption could be sacrificed to fund other policy initiatives.

The combination of political mandates for change, public dissatisfaction, fiscal deterioration, and competing policy priorities creates a perfect storm that could significantly undermine this critical financing tool.

Given these factors, the threat to the municipal bond tax-exemption in 2025 is unprecedented. The combination of political mandates for change, public dissatisfaction, fiscal deterioration, and competing policy priorities creates a perfect storm that could significantly undermine this critical financing tool. It is imperative for public entities to engage in proactive advocacy, ensuring that the importance of the tax-exemption is clearly communicated to lawmakers and the public. The time for action is now, as the consequences of inaction could be severe, far-reaching, and long-lasting.

Past HilltopSecurities Reports & Podcasts on the Threat to the Tax-Exemption:

Election 2024 Results Point Toward a "Red Wave," Still Appealing Municipal Yields, and Potentially a Stronger Threat to Tax-Exemption than 2017, Nov. 6, 2024

As the 2024 Elections Loom, America's Infrastructure Challenges Persist & Threaten to Deepen, Oct. 29, 2024

It is imperative for public entities to engage in proactive advocacy, ensuring that the importance of the tax-exemption is clearly communicated to lawmakers and the public.

Our 2024 Election Preview: We Could See an Unprecedented Threat to U.S. Municipals from Potential Tax Policy Changes, Sept. 11, 2024

PODCAST: Hot Topics in D.C. – Infrastructure, Immigration, A New Age of Warfare, & The Future of Tax Policy, April 22, 2024

The Efficiency of the Municipal Bond Tax-Exemption was Called into Question and the Same Analysis Proposes to Eliminate the Tax-Exemption, March 26, 2024

PODCAST: The 2024 Election Year Political Landscape and the Threat to the Tax-Exemption, March 4, 2024

Save the Tax-Exemption, A Call to Action for U.S. Public Finance, August 17, 2023

A New Decade & The Threat to the Municipal Bond Tax-Exemption, Oct. 22, 2021

The Threat to the Tax Exemption Means Uncertainty for Municipals, June 4, 2019

Recent HilltopSecurities Municipal Commentary

- Election 2024 Results Point Toward a "Red Wave," Still Appealing Municipal Yields, and Potentially a Stronger Threat to Tax-Exemption than 2017, November 6, 2024
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- As the 2024 Elections Loom, America's Infrastructure Challenges Persist & Threaten to Deepen, October 29, 2024
- The Risk of Unexpended Proceeds Calls Remains Low: The Effect of Declining Rates on Single Family Mortgage Revenue Bonds, October 21, 2024
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