Fiscal Cliff, Municipal Bond Interest, and the "Chop" (11/29/12)

Fiscal Cliff

The perfect storm, manufactured in Washington and set to sweep across the country, has been dubbed the "fiscal cliff". Barring congressional action, about $500 billion in tax increases and $200 billion in spending cuts are scheduled to take effect on January 1, 2013. Pundits refer to this scenario as a cliff because implementing these austerity measures could prove to be too much too soon, and snuff out today's modest rate of economic activity. In contrast, a more logical approach to reducing the Federal Government's budget deficit could be one that phases in a variety of spending cuts and tax increases/revenue enhancements over a longer time period. This type of approach would avoid sharp austerity measures being implemented in one year, thus avoiding the "fiscal cliff". During the on-going deficit reduction negotiations, all sources of revenue generation appear to be on the table including an array of deductions and exemptions aimed at high income households, such as ending or diminishing the benefits of charitable contributions and mortgage interest expense.

Municipal Exemption

While the list of potential changes is long and the opportunity for savings is plentiful, the exemption of municipal bond interest from federal taxation is frequently mentioned as an item at risk. President Obama, through his proposal to cap deductions, may target the municipal bond interest exemption as a source of potential savings. Specifically, the administration has proposed a ceiling of 28 percent for tax exemption on municipal bond interest payments. Simply put, an investor in the 35 percent tax bracket would pay a 7 percent tax on their muni interest income. In our opinion, a reduction or elimination of this exemption will likely result in meaningful increases in municipal borrowing costs and diminished access to capital. As a result of these proposals, numerous state and local government groups are mobilized to lobby in favor of maintaining the status quo — to preserve the exempt status of municipal bond interest income.

Is this change in Tax-Exemption likely?

While there have been consistent discussions since 1986 to repeal or limit the benefits of tax exemption, the rhetoric over the last few years has certainly been making new highs. While we still do not believe that it is likely that municipal bond exemption will be curtailed, we must admit that political risk is always the most challenging risk to handicap. Therefore, we can only offer a logical explanation why changing the tax-exempt status of municipal coupon income is not straightforward. Please see below:

Considerations that do not support capping tax exempt interest

While the media has accentuated "headline grabbers" that "tax the rich", there are various arguments based on sound economic logic that argue against limiting the deductibility of municipal bond tax-exempt interest. To this end, the following is noteworthy:

- The nation's state and local capital formation, with the exception of federal governmental transfers, is dependent on access to the tax-exempt market.
- Municipal tax-exempt interest is not just a vehicle for especially high net worth taxpayers. According to IRS sources, over the last few years, roughly half of all tax-exempt income was reported by joint filers with incomes below $250,000 and individuals with reported income below $200,000.
- Keep in mind that the media has not focused on the lobbying efforts from state and local governments who benefit from the lower interest costs associated with the tax-exempt market. This is especially relevant as the needs of the nation's infrastructure are enormous, and that ultimately taxpayers will bear the higher costs of any caps on tax-exempt interest deductibility.
- Democratic governors lead some of the largest states including California, Illinois, and New York. Additionally, Democrats serve as mayors of the majority of the nation's leading cities from coast-to-coast. These voices will be heard and not ignored during the final debate on tax reform.

While we believe that curbing the benefit of tax-exemption will not come to fruition, we realize that we are trying to handicap how politicians attempt to solve today's crises. Therefore, the combination of low interest rates, elevated tax risk, and uncertainties surrounding the resolution of the "fiscal cliff" warrants our attention and respect. When we believe we are more adequately compensated for risk, we will once again extend average maturity and duration. Until then, we have opted to proceed with our "sails" (risk) set at lower levels as we negotiate the current "chop", proceeding with caution.

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