THE MUNICIPAL BOND MARKET:

Building America's Infrastructure

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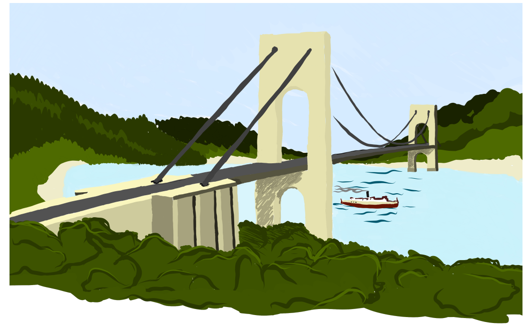
THE MUNICIPAL BOND MARKET – HOW AMERICA INVESTS IN INFRASTRUCTURE



Introduction

Municipal bonds are the principal engine for infrastructure growth and societal benefits for the United States and have been for more than 150 years. It is the original community impact investment. Today, roughly 75% of the infrastructure in the country is financed by municipal bonds: these bonds have built 4 million miles of roads, 500,000 bridges, 16,000 airports and 900,000 miles of pipeline in water systems.[1] These bonds finance the building blocks of a competitive, modern American economy. It's essential for this vital investment vehicle to continue financing our future.

To Begin, What is a Municipal Bond?

It is the way in which nearly 50,000 state and local governments (as well as governmental entities, such as water and sewer districts or airport authorities) raise capital to build and maintain essential infrastructure projects around the country.

Municipal bonds are safe investment instruments that allow citizens to give back to their communities. As an example of the strength of the municipal market, the 40 – year default rate for municipal bonds is just 0.13% – a staggering difference from the 40 – year default rate for corporate bonds, which is higher than 11%.[2]

Nationwide, all research hospitals fund their efforts through tax-exempt municipal bonds. The healthcare sector is funded by the municipal market with $36.4 billion in bonds annually.[3]

To encourage American citizens to invest in their communities, Federal policymakers exempted the federal income tax on municipal bonds – just as Treasury bond interest is exempt from state and local taxes. This is dated back to the 1800s and was incorporated into the modern income tax created in 1913.

Of note, and we will elaborate below, the municipal bond interest exemption was also granted in recognition of the federal and state separation of powers in that federal taxation of interest earned on certain state bonds violated the doctrine of intergovernmental tax immunity. Congress has preserved the tax – exempt status of municipal bonds to cost – effectively finance infrastructure. Intergovernmental tax immunity remains an essential principle so that our state and local governments may continue to raise capital and make local infrastructure decisions without interference from the federal government – **This is the definition of fiscal federalism**.

Why is it Essential that the Interest on These Bonds Remain Tax – Exempt?

If we take away the tax – exempt status that state and local governments, schools and hospitals, and the other issuers that rely on municipal bonds to finance their projects, then borrowing costs would go up for your state and local government constituents. Investors who buy these bonds are lending capital and are willing to accept a lower rate of return because they are not subject to federal income tax. If the exemption is taken away, then investors would demand a higher rate of interest.

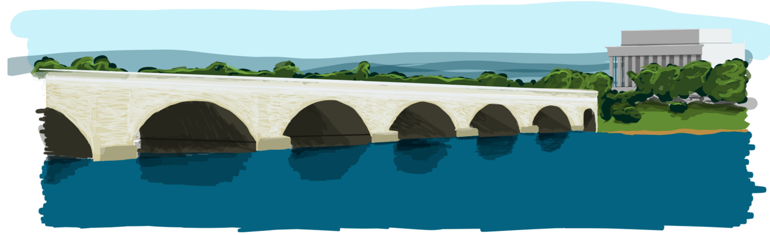
Where Do the Funds Go and Why Does it Matter?

First, many things that we may take for granted are financed by tax – exempt municipal bonds. These bonds finance our schools, hospitals, highways, and bridges. Municipal bonds also help to support higher – education, water and sewer facilities. The airports we use, the ports that bring in goods for our grocery stores and shopping malls, among many others are funded by bonds.

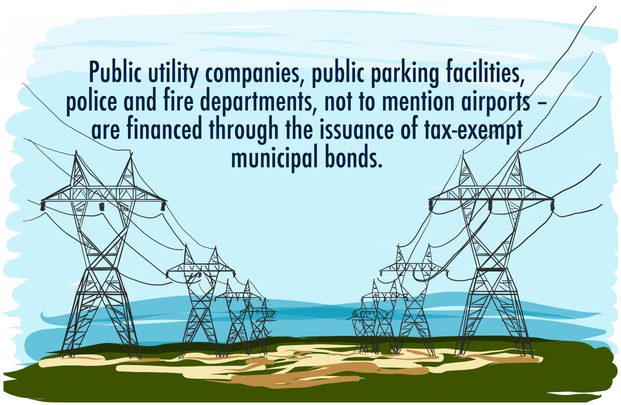
Just about every aspect of our lives as Americans have been impacted by the proceeds of projects financed by municipal bonds. Our parents and grandparents have invested in these bonds to make our communities better, our futures brighter and our bridges stronger. The younger generations are starting to follow suit and are finding a keen interest in these vital investments. It's our communities that are at stake here, and we know it.

In the last decade, more than $2 trillion of infrastructure investment has been financed as a result of the municipal bond market.[5] The data is conclusive in that municipal bonds will finance the next $2 to $3 trillion in infrastructure over the next 10 years.

If their tax status is changed, we jeopardize this tried and true marketplace. The bottom line is that everyone benefits from tax – exempt municipal bonds. All of these facets of our lives – the things and activities that make up the fabric of our daily routines – are, in some way, made possible by this $3.7 trillion bond market.



LET'S DELVE DEEPER: THE MUNICIPAL MARKET AND THE U.S. ECONOMY



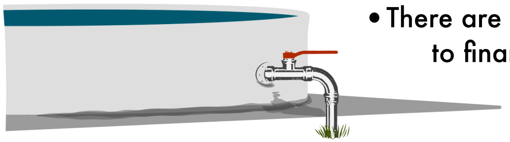
Consider today's U.S. bond market, which represents more than $40.7 trillion of outstanding obligations – the most significant securities market by far, even more substantial than the U.S. stock market, which had a combined market value of about $30 trillion through the end of 2017.[6]

The bond market is the principal source whereby governments and corporations that need to borrow money are matched with lenders who have money to invest. Participating as intermediaries, bond dealers buy from issuers and then sell to investors – a primary market activity. Bond dealers use their capital after the bonds have been issued to sell and offer bonds from their securities firms and banks to bid (sell) and offer (buy) to investors – a secondary market activity.

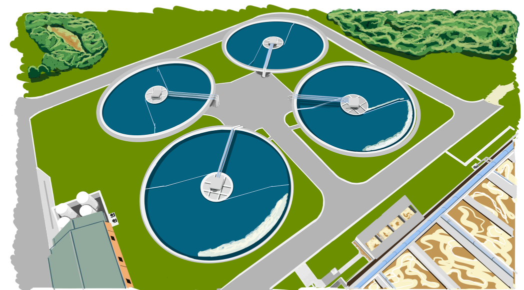
Municipal bond issuers repay investors in a few ways:

- Projects benefiting communities as a whole are usually financed by general obligation (GO) bonds that are repaid by using general tax revenues.

- Projects that benefit only their users, such as utilities (ex. water treatment facilities) and toll roads, are typically financed by revenue bonds, which are often repaid with the fees collected from those who use the service of the facility itself.



- There are other types of municipal bonds, such as private activity bonds (PABs), which are used to finance specific, qualifying public – private projects.
- Interest on qualified PABs is exempt from the federal income tax but can be subject to the Alternative Minimum Tax (AMT).



Washington, DC Water Treatment Plant

Currently, there is $3.9 trillion worth of capital in the municipal market, with roughly 70% of outstanding bonds held by individuals, either through direct investment or indirectly through mutual funds and separately managed accounts (SMAs). We sometimes call this portion of the investor base, "mom and pop" investors. This is because municipal bonds are integral to retirement portfolios for many Americans seeking a safe and consistent return on their investments – the definition of fixed income – which is incredibly important to the millions of Americans who rely on their investments to retire comfortably.

This is a crucial consideration for, in supporting retention of the tax – exemption of municipal bonds for our families across the U.S. They are investing in the future of their communities.

Because of the District of Columbia Water & Sewer Authority, or the Fairfax County Water Authority, or the Washington Suburban Sanitary District, you can turn on the spigot and water comes out. You can flush the toilet, wash your clothes and run your dishwasher.

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CONGRESS AND THE MUNICIPAL MARKET – WHY YOUR VOICE MATTERS

Tax laws and regulations governing municipal bonds have remained mostly consistent over the past few decades since the Tax Reform Act of 1986 which made sweeping changes to our market, both concerning the restrictions imposed on issuers of tax – exempt bonds and investors in those bonds.

At the same time, new regulations since 1986 on broker – dealers and the municipal securities market, most recently under the Dodd – Frank Act, has lent stability and transparency to the marketplace. In the name of increased market transparency that benefits issuers, investors and taxpayers, broker – dealers, are fully regulated by the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB), and must comply with rules governing such issues as comprehensive disclosures to investors, pay – to – play restrictions, licensing requirements, record retention, requirements for fair dealing and many more.

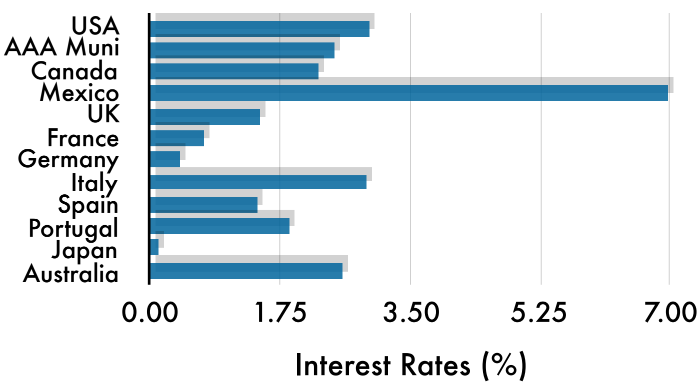
The MSRB created the Electronic Municipal Market Access (EMMA) system, which allows market participants a window into the municipal market that was not available 10 years ago, with trading and ownership activity clear, for investors to see. The municipal market has relied on available regulations and consistent tax law treatment to build a vibrant trading platform that provides effective financing for issuers of every size and type, and a stable return for investors.

These systems are typically built and maintained through the issuance of tax-exempt municipal bonds. And the same is true across the country. ***Water utility bonds are funded through the municipal market across the country with $40.6 billion worth of bonds issued every year.***[7]

So in the End, Why Do Investors Buy Municipal Bonds and Why Does it Matter?

Investors purchase municipal bonds because of stability. State and local governments have issued bonds for more than a century, dating back to the financing of the Erie Canal, and have one of the lowest default rates in all markets. Not a single AAA – rated municipal bond has defaulted during that time. The exclusion of interest from federal income tax provides tax savings to investors.

Ten-Year Interest Rates Around The World (Source: Bloomberg)



In turn, they accept a lower rate of return on the bond in exchange for the benefit of the tax exclusion. Municipal bonds provide this incentive to investors, which lowers the cost of capital for state and local governments investing in their infrastructure. State and local governments underwrite bonds to invest in their communities – cities, states, school districts and water quality – to improve their overall quality of life. The municipal market provides the opportunity for a safety net for the investor, the state or local government and their neighbors.

- The U.S. Municipal bond market IS efficient and improving (see tax exempt rates vs. sovereigns in the chart shown). In fact, there is a growing interest from international investors who want to invest in American infrastructure.

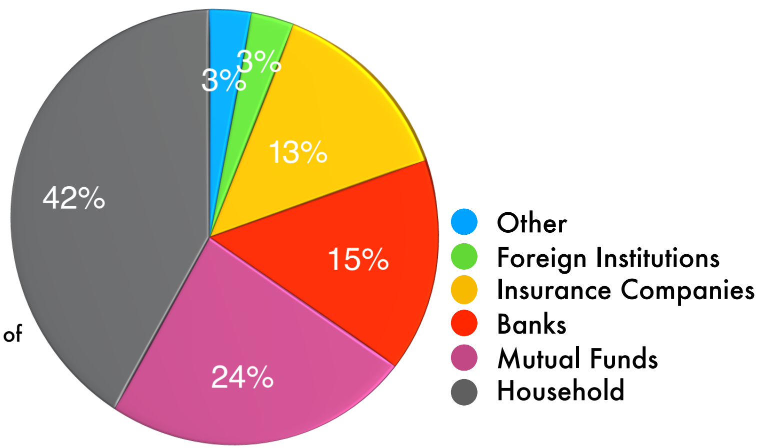
Why Are We Giving You This Information?

Potential changes to the tax – exempt status of municipal bonds will have immediate and long – term effects on state and local governments, investors, taxpayers and American infrastructure. Policymakers and regulators alike need to be mindful that policies affecting the vast and crucial municipal market should not be created in a vacuum that denies the current existence of an efficient marketplace that provides the ready source of capital and liquidity needed for our states and cities (and taxpayers).

As Congress contemplates how to finance infrastructure investments in the U.S., we must not let the municipal bond market fall out of focus – It should be the focus for how our country moves forward.

Holdings of U.S. Municipal Securities

Source: Federal Reserve Financial Accounts of the U.S. (as of December 2017)



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For additional information on municipal bonds, visit www.munibondsforamerica.org

Municipal Bonds for America

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