Tax-exempt finance essential to recovery

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Budget hawks alarmed by the looming “fiscal cliff” have suggested eliminating the tax-exempt status of municipal bonds. They view this tax exemption as a “loophole” depriving the U.S. Treasury of as much as $37 billion.

Here is another view: Federal lawmakers should not be permitted to clean their fiscal house by punishing state and local governments and raising their borrowing costs. Tax-exempt financing for local governments has helped build our nation’s schools, roads, bridges, water and sewer systems, libraries, airports and other infrastructure for more than a century. It is a critical tool for the country’s economic development.

Three-quarters of the country’s public spending on roads, highways, water and sewer systems and other infrastructure is paid for by state and local governments, who are also solely responsible for building most of the country’s educational facilities. Local officials, elected by local voters, driven by local concerns, are making the decisions about these local projects. And they are paying for them with local money. Nonprofit institutions such as hospitals and museums also rely on tax-exempt bonds.

First, a little background:

Unless Congress acts soon, the federal government is headed for a fiscal cliff at the end of 2012. What is the fiscal cliff? It is a creature of Congress’ own making. After the debacle of the debt-ceiling negotiations and the failure of the Super Committee to reach an accord on long-term deficit reduction in 2011, Congress created a sort of drop-dead deadline for itself. If Congress doesn’t address these deficit issues in a substantive way before the end of 2012, all of the Bush-era tax cuts will expire, along with the Obama payroll tax cuts, and massive across-the-board cuts will take place in national defense and social services.

Hardly anyone, right or left, Republican or Democrat, wants to see these tax increases and budget cuts enacted. Sure, these actions will cut the deficit, but the Congressional Budget Office forecasts that such a dramatic shock to the system would shrink the U.S. economy by 0.5 percent in 2013, and boost unemployment above 9 percent.

One of the “easy” deficit targets being discussed is the tax exemption for municipal bonds, partly because the federal government sees the estimated $37 billion it could collect if the tax exemption were eliminated.

But this is a short-sighted and false choice.

If the tax exemption on municipal bonds is eliminated, local governments’ borrowing costs – ultimately borne by local taxpayers – will increase dramatically. It can’t be over-emphasized that the infrastructure projects paid for by tax-exempt finance are paid for locally and not with federal dollars. The bulk of these projects are for structures and services used every single day, including schools, roads, sewers, water and other public facilities.

To drive this point home, the financial analysis department at Peck Shaffer reviewed borrowing costs and tried to forecast the impact on governments if the tax exemption is eliminated.

If a city or county issued $100 million in tax-exempt bonds in 2011, it would pay approximately $130 million in interest over the life of the bonds. If the tax exemption is removed, the city or county would likely pay another $16 million.

It is popular today to say that tax-exempt bonds are a benefit for the rich, although there are many middle-class owners of tax-exempt bonds. As a matter of fact, domestic households are the largest category of municipal bond investors, and retail investors as a whole – including individual households, money market funds and mutual funds – own approximately 70 percent of municipal bonds.

Tax-exempt finance is not a budget gimmick or a loophole. It’s essential for repairing, expanding and building the infrastructure our economy needs.