KBRA KROLL BOND RATING AGENCY

FLAWED ESTIMATES PROVIDE MISLEADING SUPPORT FOR THE ELIMINATION OF TAX EXEMPTION FOR NOT-FOR-PROFITS

The House Ways and Means Committee released the *Tax Cuts and Jobs Act* late last week and it contains disturbing news for the municipal bond market. The bill proposes to eliminate the benefits of tax exemption for not-for-profit hospitals and universities, airports, ports, and low income housing (called "private activity bonds" or PABs). It also eliminates tax exemption for advance refunding bonds, which has implications for all state and local borrowers.

These provisions were a complete surprise to market professionals. However, similar proposals have surfaced in the past and the current provisions were seemingly added to the bill in the final hours based upon their perceived benefits of reducing the revenue costs of the tax cuts. Kroll Bond Rating Agency (KBRA) believes the estimated revenue raising benefits of the proposal regarding PABs and advance refunding bonds are overstated. Unfortunately, this overstatement bolsters the appeal of these provisions to policymakers beyond their true merit.

The Joint Committee on Taxation (JCT), which serves both the House Ways and Means Committee and the Senate Finance Committee, analyzes all federal tax proposals. The JCT's revenue analysis of the bill is titled "Estimated Revenue Effects of H.R. 1, The 'Tax Cuts and Jobs Act'" In this analysis, they estimate that the elimination of tax exemption for PABs would yield $38.9 billion over the ten-year period 2018-2027 and that the repeal of advance refunding bonds would yield $17.3 billion over the same period. JCT estimates that the aggregate revenue effect of the bill approaches negative $1.5 trillion. Elimination of PABs and advance refunding bonds, therefore, reduces the total revenue effect of the bill by about 3.5%.

JCT has described its methodology for estimating the revenue effects of proposals that affect the tax exemption of municipal bonds such as the Build America Bonds Program and other proposals.[1] In the JCT methodology, they first estimate Federal tax receipts over a 10-year period. They also estimate Federal tax receipts for any proposed change in tax law. The difference between these two estimates is the revenue effect of the proposed tax law change.

In producing estimates of the revenue effects of tax law changes, the JCT notes that they generally hold constant over the forecast period all other economic aggregates such as gross national product, inflation rates, employment levels and investment levels. To estimate the specific revenue effect of eliminating tax exemption for PABs and advance refunding bonds, the JCT assumes that the reduced supply of tax-exempt bond issuances will lead investors to substitute a like amount of taxable bonds. This assumed increase in investment in taxable bonds will in turn lead to higher Federal tax receipts as the taxable interest received by taxpayers produces higher taxable income. According to the JCT, this produces the revenue effects noted above for PABs and advance refunding bonds of $38.9B and $17.3B, respectively.

[1] "The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions", July 16, 2012

It is unrealistic to assume that reduced tax-exempt bond issuance would result in a like increase in taxable bond issuance and investment. The investor base for the municipal bond and taxable bond markets are very different. The former is dominated by retail investors and the latter institutional. In KBRA's view, it is unlikely that retail investors will simply switch to taxable bonds because the risk profile and other features are very different.

Others have also found that the investor substitution of tax-exempt bonds by taxable bonds would likely be much lower than the levels assumed by JCT. In KBRA's opinion, investors may also consider asset classes such as common stock, which have more favorable tax attributes than taxable bonds. When considering that investors would likely shift to a mix of investments, instead of replacing all tax-exempt bonds with taxable bonds, analysts have found the revenue effect on Federal tax receipts to be 40% to 50% lower than the JCT estimates.[2]

KBRA also notes that JCT's analysis is very limited in scope. It produces a revenue effect for Federal tax receipts only. There is no consideration in this analysis of other budgetary or economic effects. In KBRA's opinion, state and local governments and not-for-profits would likely invest less in infrastructure, which could have undesirable service delivery and economic outcomes. Further, they may require additional taxes or subsidies to offset the financial benefits of the lost tax exemption for their respective debt issuances. In KBRA's opinion, both of these outcomes further offset any positive revenue effect on Federal tax receipts and should be part of the policy-making deliberations.

KBRA recognizes that estimating the effect on Federal tax receipts of tax law changes is a complex and difficult task. No one method is perfect or clearly preferable to all others. However, we believe the JCT's method clearly overstates the revenue effect of eliminating tax exemption for PABs and advance refunding bonds and therefore detracts from the public discussion on the merits of these tax provisions.

[2] "Portfolio Substitution and the Revenue Cost of Exempting State and Local Government Interest Payments from Federal Income Tax", James Poterba and Arturo Ramirez Verdugo, June 2011

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