Nobody likes the hand we've been dealt with the economy. But we've all got it. And it's not over yet.

My job is nonpartisan, so I try not to stray into political waters. However, in this case, the City Council passed a resolution back in August in support of the preservation of tax-exempt financing, so I will present on overview of this political issue here.

Use of Tax-Exempt Bonds

There are approximately $2.9 trillion in tax-exempt state and local securities. These were issued by 51,000 state and local government jurisdictions. The vast majority of these tax-exempt bonds have been used to finance capital projects and infrastructure.

Since these are long-lived projects, they are typically financed for 10, 20, or 30 years. This way the payments roughly match the life of the infrastructure improvement. Thus, the people who benefit from the infrastructure and use it over time are the ones who pay for it.

In Evansville, we have issued tax-exempt bonds for infrastructure such as streets, sewer and water, electric system, and the new wastewater treatment plant. And the debt service (the annual principal and interest payments) is covered by property taxes and user charges which are included in the annual budget. We have about $1.9 million in annual debt service payments, with about $1.3 million in principal and $600,000 in interest.

History of Tax-Exempt Bonds

Bonding has been used to finance major infrastructure projects since the early 1800's. In 1895, the US Supreme Court even held that interest on municipal bonds could not be taxed. All of this preceded the establishment of what we now know as the federal income tax.

In 1913, with the establishment of the federal income tax, the tax statutes formally codified the tax-exempt status of interest on state and local bonds. Additionally, many states including Wisconsin, also exempt interest on state and local bonds from state income taxes.

However, in 1988 the US Supreme Court noted that the tax-exempt status had been "effectively overruled by subsequent case law." Despite the legal change, state and local bonds have generally remained tax-exempt. And there are good reasons for them to remain exempt.

The practical importance of tax-exempt bonds is that it allows for lower costs for crucial projects. In general terms, here's how it works. An investor – be it an individual, a company, or a mutual fund – can choose to invest in security A or security B. If risks, liquidity, term of investment, etc are all equal, the better investment is the one with the higher yield. But when we add the impact of income tax to the mix, a security with a

lower interest rate but tax-exempt status can actually match or beat a taxable security with a higher interest rate.

This results in tax-exempt bonds having lower interest rates. And lower interest rates mean lower bond payments. And lower bond payments mean savings for the taxpayers and rate payers at the local level. In essence, the tax-exempt status is a subsidy to support state and local capital projects.

Fiscal Cliff

The Simpson-Bowles Commission recommended repealing tax-exempt status on newly-issued bonds. Repealing and/or capping the tax exemption on new and on pre-existing bonds was part of President Obama's jobs proposal of 2011 and his fiscal 2013 budget proposal. None of these were adopted, but reconsideration of tax-exemption has been a topic of debate the last few years.

The basic argument for these proposals to repeal the tax-exemption is in order to raise revenue at the federal level.

The political argument is that the exemption disproportionately benefits wealthy investors. President Obama has repeatedly called for a balanced approach to include reduced spending and increased revenues. And he has repeatedly called for increased revenues to come from the wealthiest individuals. There is an obvious perception in wealthy individuals comprising the majority of investors in tax-exempt bonds; however, 55% of tax-exempt interest was held by taxpayers with incomes less than $250,000 in 2009 (the most recent available IRS information).

The 2012 Tax Act passed at the opening of 2013 retained the tax-exempt status of state and local bonding. However, in avoiding the fiscal cliff at the beginning of 2013, Congress and the President really just postponed issues of federal tax policy, spending, and debt ceiling for a couple months.

Many expect tax-exemption to resurface as a bargaining issue in serious negotiation and legislative debate over the country's dire fiscal condition.

Impact of Change

A wealthy individual does not need to invest in a tax-exempt bond. The exemption provides an advantage relative to other investment options, and the advantage effectively becomes a lower interest rate for the state or local issuer. In this way, the benefits of the tax-exemption are passed to the state or local level.

If it is repealed, if it is capped by percentage, if it is capped by dollar amount – if the tax-exempt status is changed, then the relative advantage is lessened or even lost. If there are changes to the tax-exempt status for state or local bonds, the result will be higher interest rates at the state or local level.

Estimates by the Government Finance Officers Association, Citigroup, and others put the increase in the range of 60 to 200 basis points (0.6% to 2.0%). It all depends on the details of changes in the exemption and the overall Tax Code. But the National Association of Bond Lawyers noted, "regardless of the magnitude, the direction of the change is clear. State and local borrowers would pay higher interest rates."

The exact impact at the local level is also indeterminate. Higher interest rates may mean higher taxes and fees to support the same level of infrastructure and capital improvements. Or higher interest rates may mean reductions in infrastructure and capital improvements to maintain the same payment level.

City Resolution

In August 2012, the City Council passed a resolution in support of preserving the tax-exempt status of local bonding. A primary reason for the City's position was that low-cost financing is important to the City's maintaining and improving public infrastructure such as streets, sewer and water, electric system, and the new wastewater treatment plant. The tax-exempt status of our bonds allows us to stretch a dollar further.

Another reason for the City's position was the big-picture recognition of the importance of infrastructure to the economy, both locally and nationally. Streets and highways, electricity, water and sewer, school buildings, airports, and other capital projects typically financed with bonds are vital to our economy and wellbeing.