

Market Eyes Long-Term Impact of Debt Agreement

Tuesday, August 2, 2011 TBB

By [Lynn Hume](#) and [Patrick Temple-West](#)

WASHINGTON — Municipal market participants on Monday were relieved that Congress was moving toward approving a bipartisan agreement to raise the \$14.3 trillion debt limit and avoid a default on federal debt, but were taking a wait-and-see approach on how the plan might ultimately affect the tax-exempt bond market.

Under the plan worked out by congressional leaders and administration officials, President Obama could request a \$900 billion increase in the debt limit now, of which \$400 billion would be immediately available. Once the government's debt increased to within \$100 billion of the ceiling, the president could ask for an additional \$1.2 trillion, which could rise to \$1.5 trillion if that amount of savings were found or if a balanced-budget amendment was sent to the states.

In return, more than \$900 billion in savings would be generated over 10 years through caps on discretionary spending. The caps would include savings of \$350 billion from the base military budget, the first such cut since the 1990s, and a reduction on domestic spending to the lowest level since the Eisenhower era, according to administration officials.

In addition, House and Senate leaders would create a bipartisan, bicameral 12-member congressional committee that would recommend, by Thanksgiving, another \$1.5 trillion in deficit reduction over 10 years.

Administration officials said the committee "will consider responsible entitlement and tax reform," but House Speaker John Boehner, R-Ohio, warned: "Republicans will not raise taxes going forward."

If the committee's efforts failed or its recommendations were not adopted by Congress, sequestration would be triggered, forcing across-the-board spending cuts.

Matt Fabian, a managing director at Municipal Market Advisors, said the plan should be sufficient to dissuade the major rating agencies from lowering the credit rating on the federal government's debt.

"I would think that the rating agencies will give [the government] time and not downgrade immediately. The rating agencies respect a plan," he said. "In the muni world, [an issuer] can get an extended period if it can prove it has some kind of plan to make corrections."

The Securities and Industry Markets Association sent Congressional leaders a letter thanking them for their bipartisan agreement, which, SIFMA said, "will help to strengthen our nation's economy and provide the first steps forward a sustainable fiscal future."

The group urged Congress to quickly enact the plan, warning that “a default would have far-reaching negative implications for the economy as a whole” and could “actually result in more government spending.”

But Frank Shafroth, director of the State and Local Government Leadership Center at George Mason University, said the cuts could affect transportation and other funds used by state and local governments to pay debt service on bonds.

“The problem is now, [issuers] don’t know” how the federal government “will implement this game-changer” after the local governments have already budgeted and issued bonds depending on the federal funds, he said. “You have this huge level of uncertainty, except that there are going to be significant cuts.”

Shafroth also said the cuts will come as it appears the economy “is getting worse” for state and local governments.

The National Governors Association said it is “gratified that the president and Congress appear to have agreed to a plan that will avoid default on U.S. debt, avoiding disruption and higher interest costs for states.”

However, the group worried about the details of the plan and said federal reforms should not just shift costs from the federal government to the states or impose unfunded mandates on the states.

“Don’t try to balance the budget on the backs of the states,” said David Quam, director of federal relations for the NGA. “The devil is going to be in the details. We’re going to need to look at where the cuts come from, which programs do they hit. The hope is that any federal action is going to continue to support recovery.”

John Murphy, executive director of the National Association of Local Housing Finance Agencies, was encouraged that the discretionary spending caps for fiscal 2012 and 2013 are \$24 billion higher than the numbers in the House-passed budget resolution.

“It’s not as bad as it could have been,” he said. “But what happens with this bipartisan, bicameral gang of 12, it’s way too early to know We’ve got to be vigilant and be sure that we are touting the message that tax-exemption is critical to meeting the needs of the public and private sectors that our bonds help.”

A key concern is that at least two commissions, including the deficit-reduction panel created by Obama, recommended tax-exemption for all or some new municipal bonds. In addition, Sen. Ron Wyden, D-Ore., has introduced tax-reform legislation that would make all new munis taxable tax-credit bonds.

“It’s been clear for at least the last six months that there’s a risk that Congress could take action to curtail the ability of state and local governments to use tax-exempt finance or investors to earn tax-exempt interest,” said Michael Decker, a managing director and co-head of SIFMA’s municipal securities division. “If there is a serious attempt at fundamental tax reform, one of the things that Congress will consider is tax preferences and in that context [munis] are a tax preference. There could be a risk that there could be some scaling back of the tax-exemption.”

Mike Nicholas, chief executive officer of Bond Dealers of America, also said that while his group is pleased to see an agreement, “We are paying a great deal of attention to discussions of tax reform and the potential impact on the muni market. It is unclear if any such discussions will arise when the debt-ceiling debate resurfaces later this year and in 2012, but we are closely monitoring it and talking with Hill staff to ensure there is a complete understanding and appreciation for the municipal bond tax-exemption and the savings and efficiencies it allows for state and local governments.”

Charles Samuels, a partner at Mintz, Levin, Cohn, Ferris, Glovsky and Popeo PC, noted that while the administration is stating tax reform will be on the table for the new bipartisan and bicameral committee, Boehner is saying the Republicans will not support tax increases.

“I think the municipal market has to assume it is under a certain level of threat and needs to respond accordingly in terms of its Washington advocacy and its grass-roots advocacy,” Samuels said.