



Federal Fiscal Stimulus: Limited Impact on Municipal Bonds

By

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Introduction

While the recent American Recovery and Reinvestment Act of 2009 affords some fiscal support to states and some revenue bond issuers, the stimulus plan is mostly helpful at the margin, and as a short-term fix to stabilize state credit quality. (On April 7, Moody's Investors Service put local municipal issuers on "negative outlook" for possible downgrade. While the announcement does not include state issuers, it does underscore the broad problems facing the municipal market.) The Act also attempts to improve marketability of municipal securities. Most of those measures, however, address more peripheral parts of the municipal bond market without providing sweeping structural reforms.

Solutions for the long-term have yet to be proposed. In a recent report, Moody's Investors Service noted that "if economic recovery is not substantial enough to restore revenue by the time most federal assistance runs out within two years, municipal issuers may face renewed, or even greater, credit stress."¹ And the Act neither restores efficient operations of the municipal market, nor provides a means for re-opening affordable access to the debt markets for issuers.

Near-Term Positives for Several Strained Municipal Sectors

Over the next several years, states and several other municipal sectors are slated to receive a fiscal boost of as much as \$290 billion out of the \$787 billion provided by the Act (Exhibit 1). This aid to the municipal market comes in the form of direct funding, tax credits and tax-law changes. This injection is temporary and will likely have near-term benefits for some municipal credits.

Exhibit 1 - Federal Stimulus: Major Initiatives Affecting Municipal Bond Sectors

Temporary increase in Federal Medicaid share	\$87 billion	2009 - 2010
State Fiscal Stabilization K - 12 and higher ed	54 billion	2009 - 2013
Special education	12 billion	2009 - 2011
Disadvantaged students	13 billion	2010 - 2012
Pell Grants	17 billion	2009 - 2011
Higher ed tax credits	13 billion	2009 - 2010
Research funding	16 billion	2009 - 2011
Highway capital spending	28 billion	2009 - 2016
Expand unemployment health benefits	24 billion	2009 - 2010
Healthcare IT	20 billion	2009 - 2019

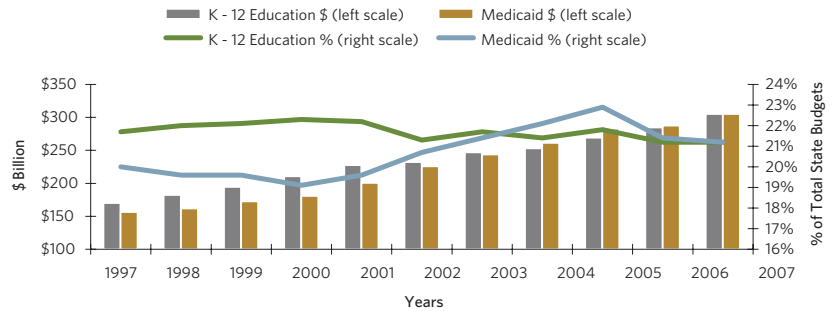
Source: Congressional Budget Office, Library of Congress

State and Local Government — \$173 billion

States will receive nearly \$150 billion in direct federal funding, with most arriving between 2009 and 2011. Under the Act, the federal share of Medicaid reimbursement rises temporarily from 57 to 63 cents, at a total cost of \$87 billion. Medicaid spending accounts for an estimated 22% of total state budgets (Exhibit 2), so reducing the state share is likely to have a substantial impact on state financial operations. However, the positive effects of the Act's spending are likely to be offset, to a large degree, by the continued steep ascent of Medicaid expenses, exacerbated by severe recession and unemployment. It is likely that the Act's subsidy will be dwarfed by the ongoing Medicaid burden on states.

¹ U.S. Federal Stimulus Likely to Relieve Short-term Credit Pressures Facing a Number of Municipal Issuers, Moody's Investors Service, February 2009

Exhibit 2 – State Medicaid and Education Budget Spending



Source: National Association of State Budget Officers

A total of nearly \$28 billion of federal highway capital outlays will replace state-funded initiatives over a seven-year span. While helpful, these numbers are a fraction of what states actually spend. For example, the National Association of State Budget Officers reported that state capital spending for infrastructure was \$57 billion in fiscal 2007 alone.

Another \$54 billion of stabilization fund grants-in-aid will help restore previous state budget cuts for K-12 and public universities. While this will most likely have the beneficial effect of forestalling teacher layoffs, it represents a relatively small portion of state education spending.

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Cities and counties generally will not receive substantial new funding under the package. An additional \$4 billion of law enforcement and community policing funding will help to modestly ease budget pressures.

School Districts and Higher Education — \$71 billion

School districts and public universities will benefit as federal spending flows in to fill gaps in state education budgets and offset losses in investment portfolios. Special education funding is slated to be increased by \$12 billion, and an additional \$13 billion is targeted to assist in educating disadvantaged students.

Additional research funding totaling \$16 billion from the National Institutes of Health will likely result in some benefit for private and public research universities. And a \$17 billion increase in Pell Grants and \$13 billion in tax credits may stave off enrollment declines by making college more affordable for students and their families.

Hospitals — \$60 billion

Benefits to hospitals include an increased federal share of Medicaid payments, though the combined federal/state payments are likely to still be below hospitals' costs. An additional initiative provides \$40 billion to fund expanded health care coverage (under COBRA) for recently unemployed workers, potentially reducing uncompensated care. Hospitals will also see some positive effects from the \$20 billion allocated for information technology as well, although these are projects with long horizons.

Other

Funding for transportation (\$9 billion) and water and sewer projects (\$6 billion in grants to state revolving funds) is relatively modest and will probably be targeted to a few high-profile projects.

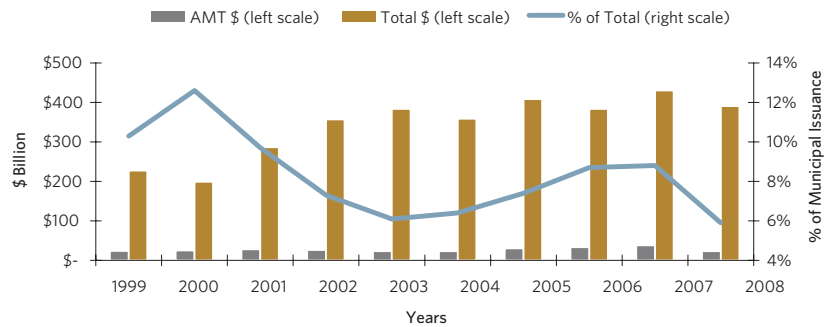
Potential Gains in Valuations for "Private Activity" Tax-Exempt Bonds

The Act contains measures which could improve prices and marketability of municipal securities subject to Alternative Minimum Tax (AMT). However,

like most of the provisions for improving the market for tax-exempt bonds, the measures would have a relatively minimal impact on municipal supply and demand, as AMT bonds are a small part of overall municipal market activity (Exhibit 3).

The market for sectors such as airports, housing, and industrial development could expand as interest on bonds issued within the two-year window will not be considered a preference item in calculating AMT taxes for individuals.

Exhibit 3 – AMT Share of Municipal Issuance



Source: Thompson Reuters

The stimulus bill suspends for two years the “private activity” classification, so no municipal securities issued in 2009 or 2010 will be subject to the AMT. The market for sectors such as airports, housing, and industrial development could expand as interest on bonds issued within the two-year window will not be considered a preference item in calculating AMT taxes for individuals.

In addition, the bill allows for the non-AMT refinancing of many outstanding private activity bonds. Such bonds issued within the last five years may be replaced over the next two years with new AMT-free bonds. We expect that only the strongest issuers who still have access to refinancing capital will be able to take advantage of this two-year hiatus.

Modest Boost to Bank Demand for Municipals

Banks will be allowed under the Act to deduct 80% of the carrying cost of owning municipal bonds as long as total tax-exempt securities are less than 2% of the bank’s total assets. This provision likely will generate little new demand; in the most recent Federal Reserve statistics from September 30, 2008, bank holdings of municipals were already 1.8% of assets. Similarly, the limit for small issues that receive special treatment to induce bank buying was raised to \$30 million from \$10 million. However, increasing this “bank-eligible” limit has little impact in a \$2.7 trillion market.

Conclusion

Temporary infusions of federal assistance may stave off a wave of state ratings downgrades, but the stimulus program is not designed to make long-range structural changes. In our view, it merely chips away at the edges of persistent liquidity and credit deterioration in the municipal bond market. Broader federal support of the market is likely needed to help permanently resolve the ongoing supply/demand imbalance as well as the looming deficits that many issuers may face in the economic downturn.

Today’s municipal market remains characterized by discounted prices reflecting severe liquidity disruptions. For improvement to occur, investors must evolve from net sellers to net buyers, municipal insurers must gain stability, and economic decline must end. In the meantime, if the federal government were to take a more active role in improving marketability for municipal bonds, it might look toward developing broader fiscal or operating support to aid in the rebalancing of supply and demand in the municipal marketplace.

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