Taxation, Representation And Municipal Bonds

As the nation goes to the polls tomorrow, more of a figure of speech than anything else as turnout in the last three mid-term elections has been 36.4% in 1998, 37.0% in 2002 and 37.1% in 2006 of the voting-age population, our newly elected Congress will get right to work on the nation's business.

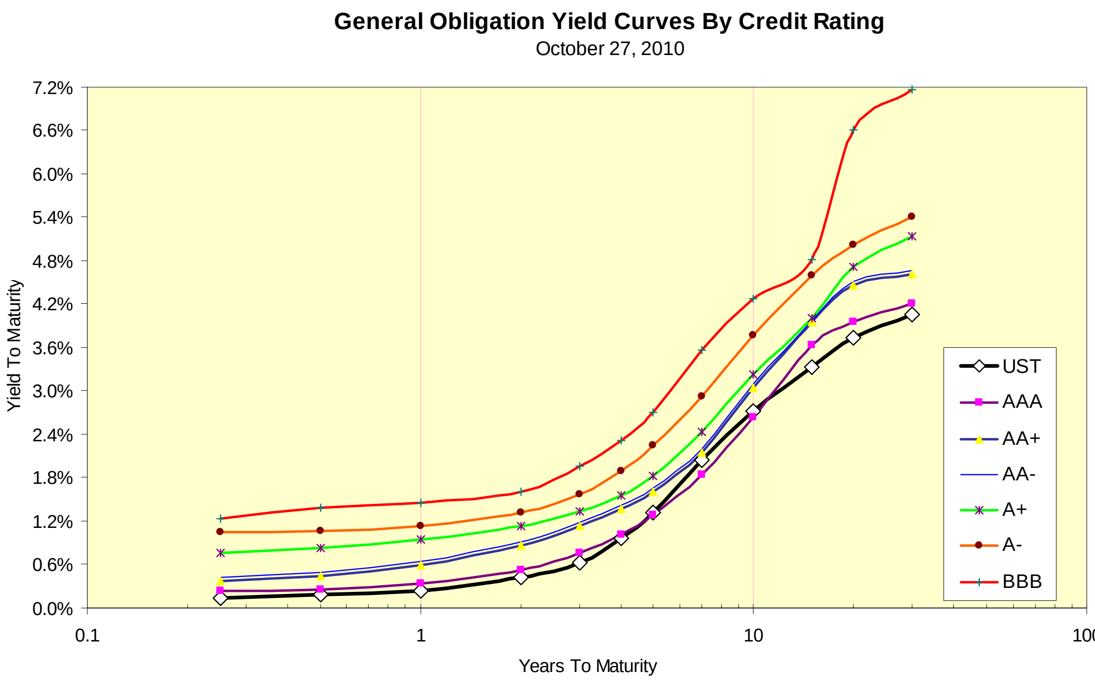
Wrong! The outgoing 111th Congress decided it had more important things to do than address the issues of taxation that have been known since the passage of the Bush-era tax cuts in 2001 and 2003. As the current environment ends with the calendar year and the 112th Congress is not seated until January 3, 2011, we will have a lame-duck Congress with a Democratic majority in the House deciding on fiscal policy.

If W.C. Fields could answer the rube's question, "Is this a game of chance?" with "Not the way I play it," Congress could respond to the statement, "Elections have consequences" with, "Not if we have anything to do with it."

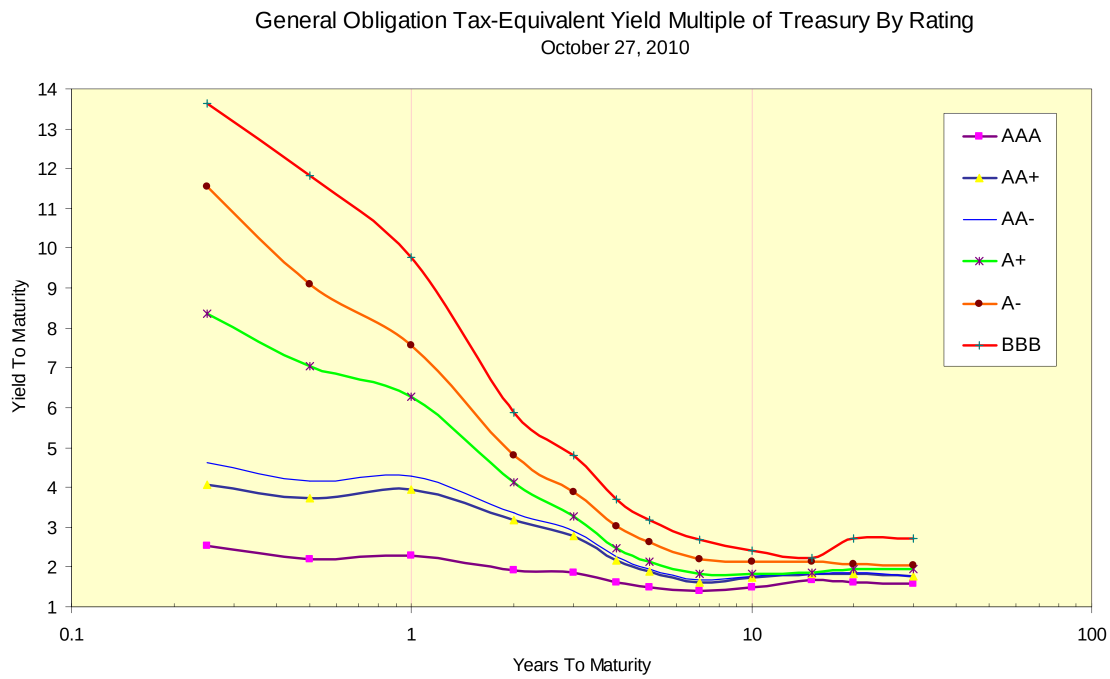
Muni Consequences

This abdication of governing responsibility by the 111th Congress has raised short-term funding costs in the municipal bond market. As most states have balance sheets worthy of street-corner panhandlers these days, higher borrowing costs are about the last thing they need.

If we map national general obligation yield curve indices by credit rating – and no, I am not sure why I map anything by credit rating anymore – we see a rather disturbing pattern of municipal yields exceeding Treasury yields. As these muni G.O. bond indices exclude private-activity bonds subject to the bizarre rules of the Alternative Minimum Tax, they should yield less than Treasuries by the amount of the highest maximum federal tax rate.



We can rearrange the data above to express these municipal yields as a tax-equivalent yield (TEY). Please note how the money-market and one- and two-year note indices are yielding many multiples over their TEY level. Yes, part of this is due to the drive lower in short-term Treasury yields, a drive the municipalities cannot share in as they lack printing presses of their own, but the real reason is no one knows how much assistance the woebegone states will receive from Uncle Sam after the stimulus transfers from 2009 expire in 2011.



Some may hope the 112th Congress will continue handing the federal credit card to Sacramento, Albany, Springfield or whatever garden spot your state's government calls home; others may hope the 112th Congress acts to restore fiscal discipline. The real decisions will be made by the outgoing 111th Congress, however, which gives the 112th Congress the perfect out: Blame it on their predecessors.

This is taxation with expiring representation, something our predecessors from the 1770s could not convert into a catchy battle-cry. If we add it to a central bank seemingly convinced of the wisdom of printing money to solve every problem, we will have a real crisis of confidence on our hands the next time actual leadership is demanded.