How SALT spices up municipal markets
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Chicago Fed

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This Discussion

- The effect of the SALT repeal
  - on the bond market
  - on municipalities finances and investments

SALT Deductability: Quick Algebra

Full deductibility (2016).

- Tax paid: $\tau_F \cdot (I - \tau_S I) + \tau_S I$
- Tax rate: $\tau_F + \tau_S - \tau_F \tau_S$

Capped deductibility (2018).

- Tax paid: $\tau_F \cdot (I - C) + \tau_S I$
- Tax rate: $\tau_F + \tau_S - \tau_F \cdot C/I$

Tax rate differential.

- Pre/post-TCJA (time dimension):

$$\tau_{\text{post}} - \tau_{\text{pre}} = \tau_F \cdot \left(\tau_S - \frac{C}{I}\right) \simeq 40\% \cdot 10\% \simeq 4\%$$

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- Account for lower top marginal tax rate: $\tau_{F,\text{pre}} > \tau_{F,\text{post}}$:

$$\tau_{\text{post}} - \tau_{\text{pre}} = \underbrace{\tau_{F,\text{pre}} \cdot \left(\tau_S - \frac{C}{I} \right)}_{\simeq 4\%} + \underbrace{(\tau_{F,\text{post}} - \tau_{F,\text{pre}}) \cdot (1 - \frac{C}{I})}_{\simeq -3\%} \simeq 1\%$$

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- Most of the effects are in the cross-section:

$$\Delta_{\text{county}} \left(\tau_{\text{post}} - \tau_{\text{pre}} \right) = \tau_{F,\text{pre}} \cdot \Delta_{\text{county}} \left(\tau_S - \frac{C}{I} \right)$$
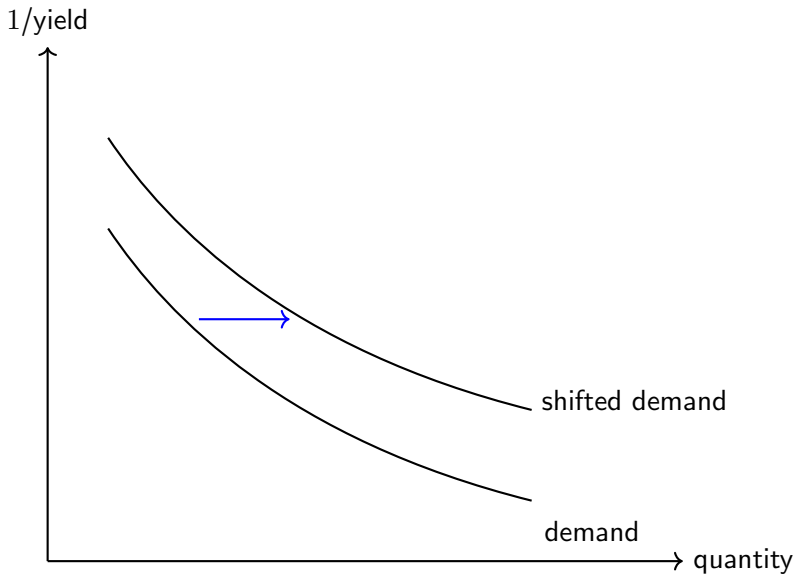
- Variation comes from local tax rate or wealth composition (C/I).
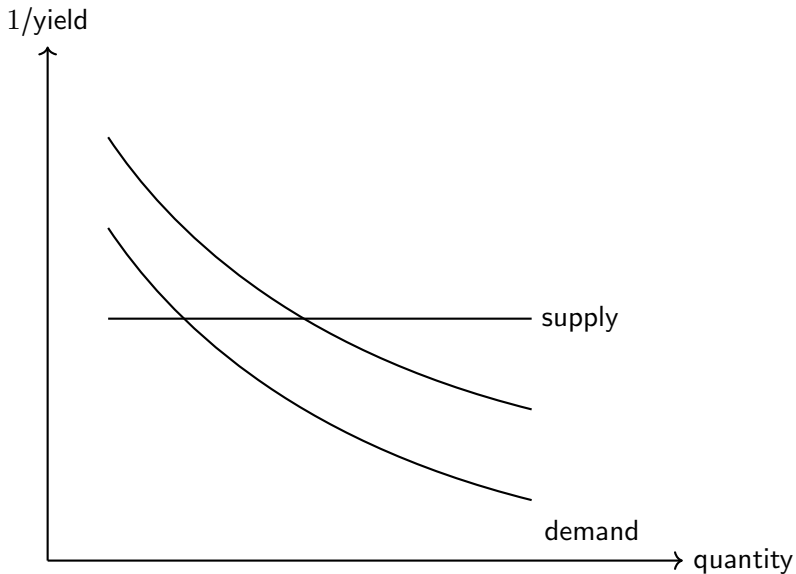
Municipal Bond Pricing

Different views: whose demand?

- Marginal investor (Miller)
- Local commercial or community banks: variable tax liabilities (Poterba)
- Segmented markets (Mussa-Kormendi): banks at the short-end and households at the long-end
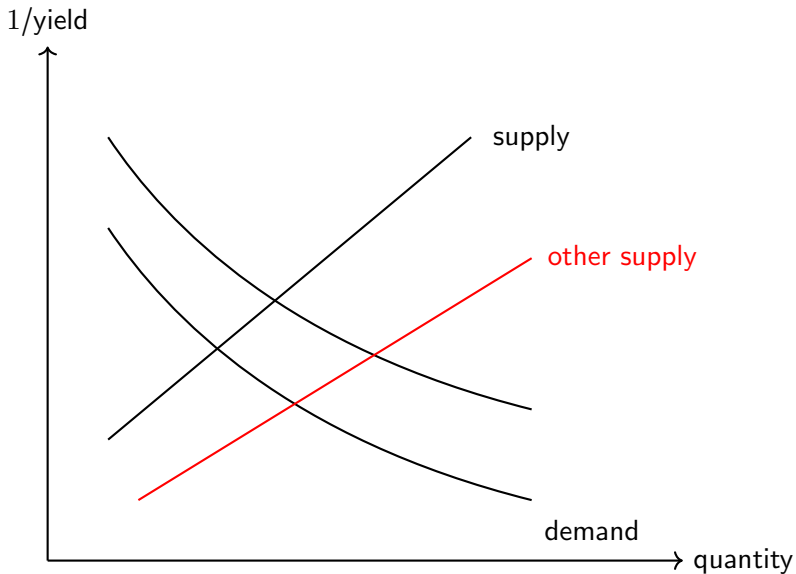- ...

SALT Shock as a demand shift outward

Miller Hypothesis: Elastic Supply

This paper .... Differentiated Supply Curves

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How municipalities respond to a shift in demand?

- Refinancing opportunities: callability of bonds (see Ang et al.)
- Institutional constraints on borrowing
- Need for novel capital-intensive projects

Who are the marginal bond issuers?

Learning About the Municipal Bond Market
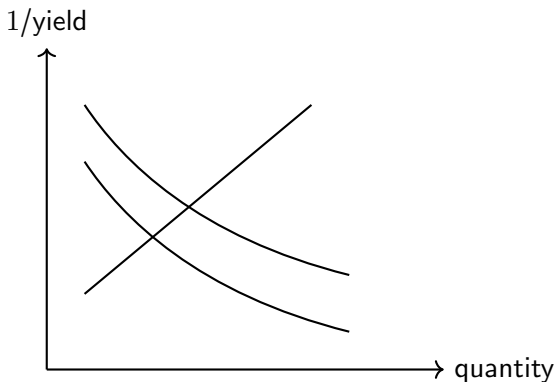
What does the demand for munis look like?

- Variation in supply: trace out the demand curve
- How much can I raise and at what price?
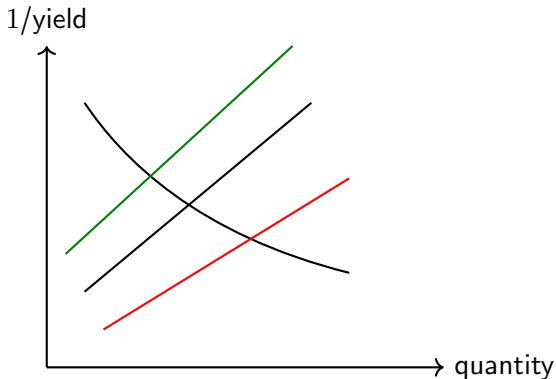
Learning About the Municipal Bond Market: this paper

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What does the supply for munis look like?

- Shock the demand
- Look at how the we move along the supply curve
- What is the size of the shock in demand?
- Relative increase in tax liability: $\tau_F \cdot \tau_S$
- How does this translate into dollars flow into the municipal bond market?

$$\text{muni-tax-elasticity} = \frac{\partial \text{muni-flow}}{\partial \text{tax-liability}}$$

SALT Deductibility as a Shock

Strong exclusion restriction.

- SALT shock only affects the yields through an increase in demand

Other potential concurrent effects.

- Migration to low-tax states (Ken Griffin)
- Pressure on state taxes:

$$\text{before: } \frac{\partial \tau_{\text{total}}}{\tau_S} = (1 - \tau_F); \qquad \text{after: } \frac{\partial \tau_{\text{total}}}{\tau_S} \simeq 1$$

- concurrent decrease of top federal tax rates

Final Thoughts

Great Paper! Worth reading.

Take away

- SALT deductibility repeal had an effect on muni bond markets
- Municipality issuance suggest that they are somewhat financially constrained