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## **Federal Taxes & Municipal Bonds Historical & Current Perspective**

November 17, 2009

With income tax increases seemingly around the corner given the budget deficit and a potentially very expensive federal health care plan, the spotlight has returned to municipal bonds and the power of tax-free income. Individual investors have poured money into municipal bond funds at record rates – \$57.6 billion through September 2009<sup>1</sup>. However, many budget crises at State and Local governments around the country have investors worried and perhaps, rightly so. The number of municipal bonds that experienced ratings downgrades in the first six months of 2009 was already 77% greater than all of 2008<sup>2</sup>. Thus, the importance of issue selection has never been greater.

Given this, are municipal bonds still attractive and if so, where can investors find the most value? How do current yields compare to historical yields and how do munis compare to other fixed income vehicles? While municipal bonds provide tax-free income, they are not without risks. The following charts and information are intended to provide you with a historical perspective as you evaluate investing in the municipal bond market.

### **Long-Term Perspective of Taxes and Deficit as a Percent of GDP**

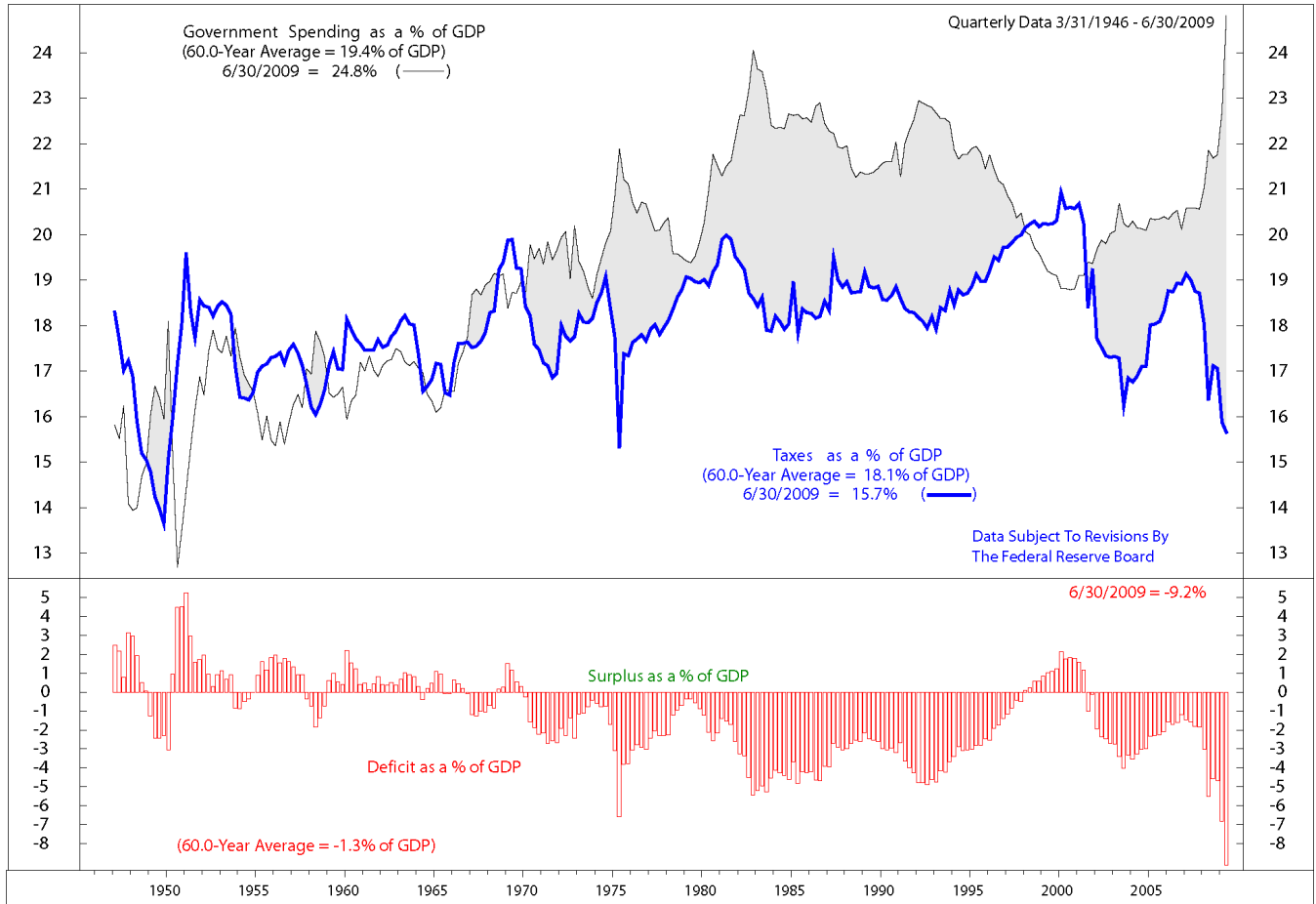
In Figure 1 below, the blue line shows government income from taxes as a percentage of the GDP, which was 15.7% as of June 30, 2009, 2.4 below the 60-year average. At the same time, government spending as a percentage of GDP (black line) was 24.8%, 5.4 above the average. The large amount of government spending coupled with lower than average tax revenues has resulted in the largest deficit in over 60 years, evident in the bottom half of the chart, suggesting higher tax rates will be needed to help close the deficit. However, it is interesting to note that according to the Tax Foundation the federal government would have to nearly triple every tax rate to erase the deficit, putting the highest rate at 95.2%<sup>3</sup>.

The federal government would have to nearly triple every tax rate to erase the current deficit.

Source: Tax Foundation



Figure 1 - Taxes and Government Spending



(E300) Courtesy of Ned Davis Research, Inc.

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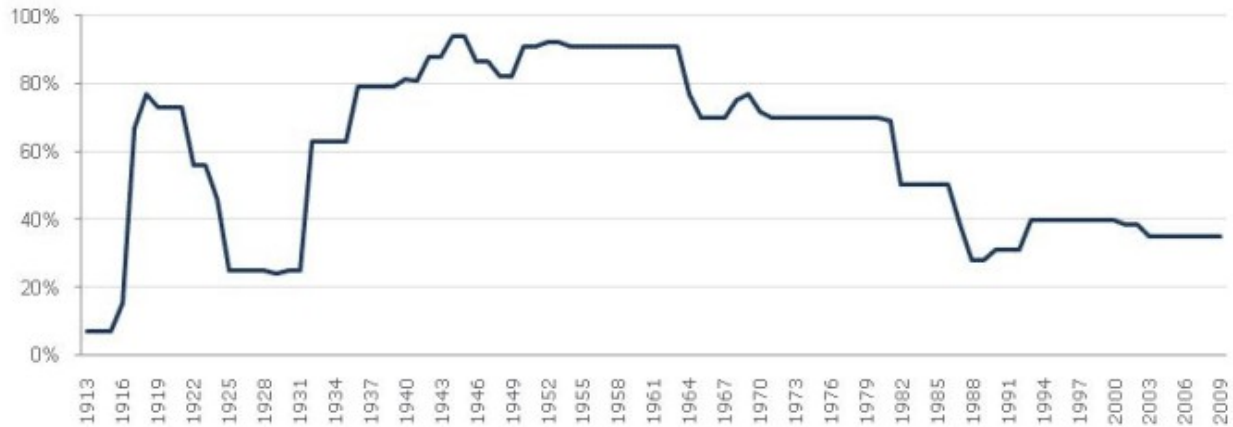
## Historical Highest Marginal Federal Income Tax Rates

*But in this world nothing can be said to be certain, except death and taxes. - Benjamin Franklin*

While taxes are a certainty in life, the rates have changed considerably over the past 97 years as illustrated in Figure 2. Believe it or not, the average historical top marginal tax from 1913 to 2009 was 60%. The lowest rate (7%) occurred in 1913 when income taxes were first introduced and the highest, at 94% in 1944 and 1945<sup>4</sup>.



Figure 2 – Top Marginal Federal Tax Rates 1913-2009



Source: Tax Policy Center

### Municipals and Implied Tax Rates

Since yields for fixed income securities are constantly changing, Ned Davis Research provides a way for investors to analyze the historical valuation of municipal bonds relative to treasuries, agencies, and corporate bonds. The following chart shows 20-year constant maturity treasury bond yields, and, various 20-year municipal bond yields; the ratio of municipal bond yields to the treasury yields, and something called the “implied tax rate.”

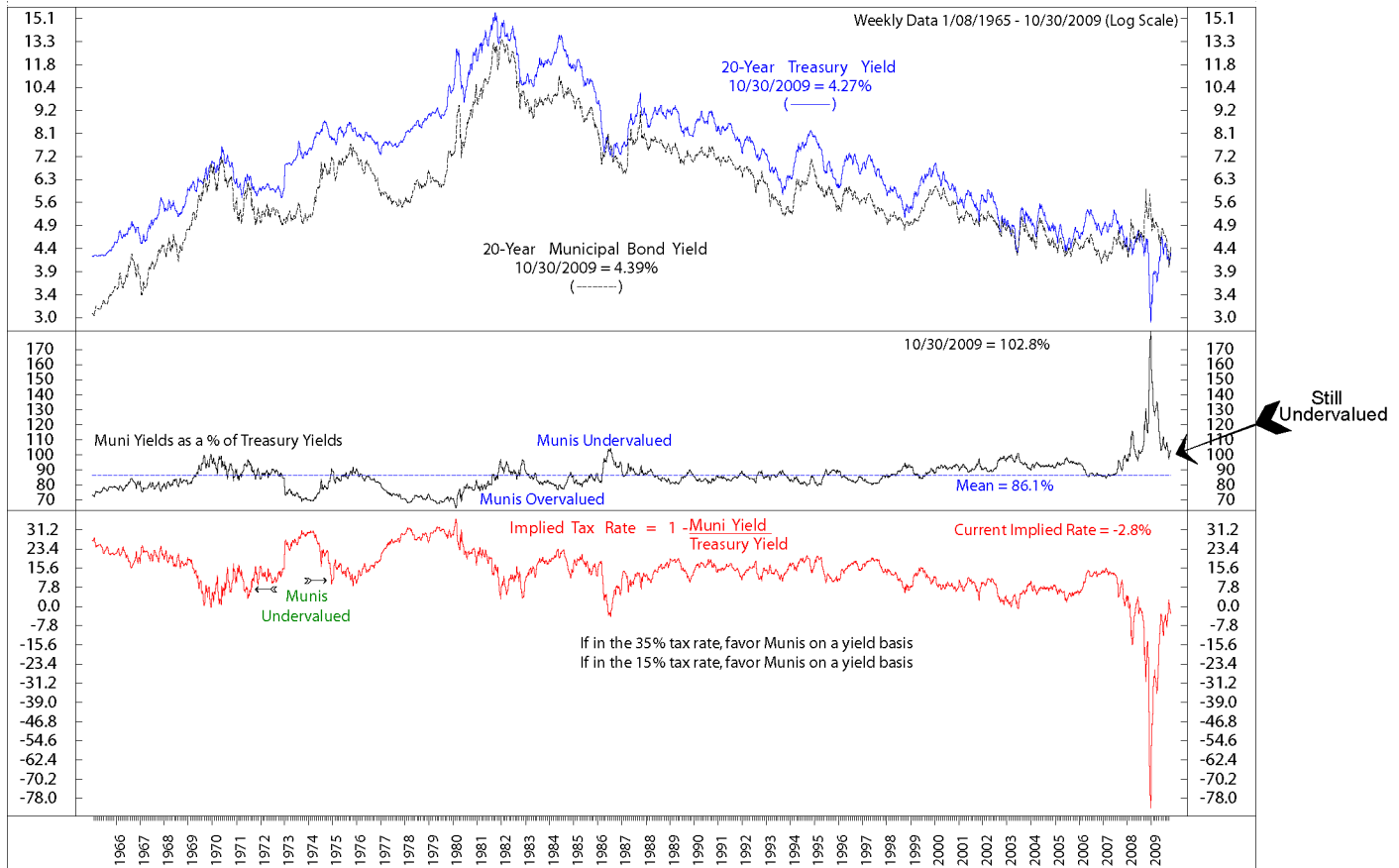
The implied tax rate is the rate that equates the after-tax bond yield (in this case treasury bonds) with the municipal bond yield. It shows what tax bracket you need to be in to make investing in municipal bonds worthwhile on a yield basis. If, for example, the current implied tax rate was 20%, and your tax bracket was higher than 20%, you may be better off on an after-tax basis investing in municipal bonds. Conversely, if your tax bracket was less than 20%, you may be better off investing in Treasury bonds and paying the tax. If you were in the 20% tax bracket, it may not make a difference which instrument you used.

The implied tax rate shows what tax bracket you need to be in to make investing in municipal bonds worthwhile on a yield basis.

Historically, there have been instances, such as late 1974, when the implied tax rate was negative, meaning that municipal bonds yielded more than Treasury bonds before tax. There were other times when the implied rate was negative or close to zero, including the present. On a relative basis, all of these cases proved to be good buying opportunities for municipal bonds. As of October 30, 2009 the implied tax rate relative to treasuries was -2.8%, as the chart below illustrates.



Figure 3 - Municipal vs. Treasury Bonds, & the Implied Tax Rate



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A variety of factors including high government spending, the growing deficit, and a potentially very expensive federal health care plan all signal higher tax rates in the near future, strengthening the case for municipal bond investing. Additionally, the chart above indicates that while municipal yields as a % of treasury yields have come down from their earlier highs, they indicate that munis may still be undervalued. But whether or not tax rates increase, for those in higher income tax brackets, the power of tax-free income is compelling now.

Download the complete reference guide [Federal Taxes & Municipal Bonds – Historical & Current Perspective](#).

Taxes & Municipal Bonds Webinar – presented by Roger Soderstrom, lead manager of the Munder Tax-Free Short & Intermediate Bond Fund

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Footnotes:

<sup>1</sup> Strategic Insight, September 2009

<sup>2</sup> *Wall Street Journal*, "Bargains to be had in Municipals," August 15, 2009

<sup>3</sup> Assumes deductions, exemptions and credits are kept the same as they are now.

<sup>4</sup> Tax Policy Center

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The municipal market is volatile and can be significantly affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes but may be subject to federal alternative minimum tax (AMT), state and local taxes.

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