SECTOR IN-DEPTH
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Public Finance – US

Losing tax exemption would increase borrowing costs, market-access risks

Summary

A proposal under consideration by the US House Ways and Means Committee to make US municipal bonds taxable is the latest development driving speculation that an impending tax reform would limit or eliminate the tax exemption that currently applies to interest on most municipal bonds. The ability of US public sector borrowers to sell tax-exempt bonds confers numerous credit-positive benefits, including lower borrowing costs and less refinancing risk. Those advantages would be lost if the tax exemption is eliminated.

» **The tax exemption on municipal bonds reduces borrowing costs**. Taxable municipal bonds yield more than comparable tax-exempt bonds of the same issuer, in many cases by more than 50%. The cost benefit of the tax exemption is most pronounced for small borrowers that sell debt infrequently, often in smaller amounts than the taxable market is accustomed to absorbing. The loss of the tax exemption would impose an increase in borrowing costs for the entire sector, in particular for smaller issuers and for issuers with large capital investment programs requiring substantial future borrowing.

» **The tax-exempt bond market allows municipal issuers to structure their debt in a less risky way**. Most tax-exempt bonds are long-term, amortizing, fixed-rate bonds, which allows issuers to fund long-lasting public infrastructure on a pay-as-you-use basis and reduces or eliminates the refinancing risk that is so common for borrowers in the taxable market, who more commonly sell bullet maturities. Municipalities in general do not need to reaccess the market every few years to finance bullet maturities; a world in which they needed to refinance, perhaps multiple times over the course of the useful life of the financed asset, would be a riskier one.

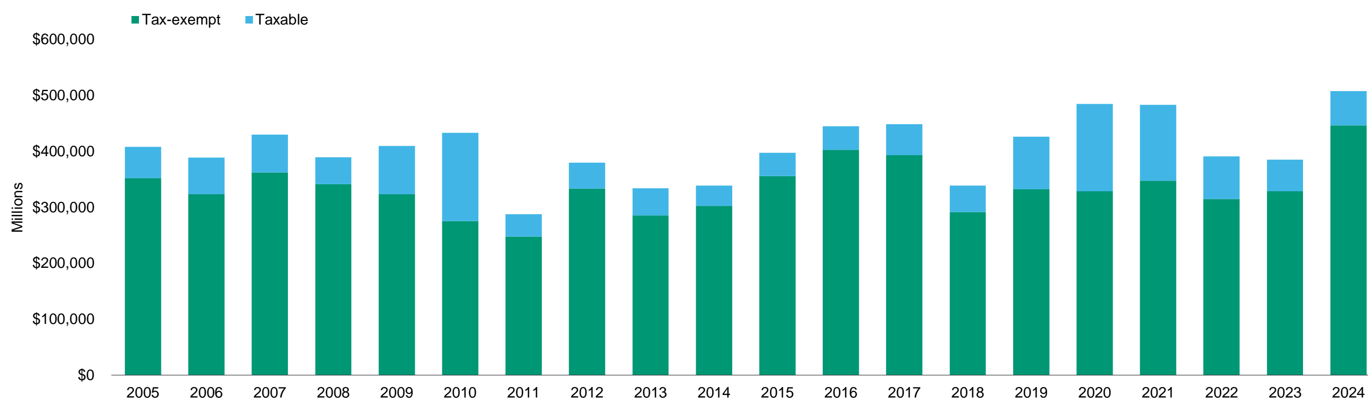
» **Municipal bond issuers would meanwhile try to find ways to mitigate the higher costs**. If the tax exemption for municipal bonds were to be repealed, issuers in the highly fractured, illiquid and at times idiosyncratic universe of US municipal bonds would probably have to change their ways to look more like conventional borrowers in the taxable market. For instance, they would likely have to grow more comfortable selling single-maturity bonds without call options and with simpler security structures than we currently see. Municipal issuers might also employ more pooled borrowings. Eventually the taxable market could grow comfortable enough with these that the yield on a taxable municipal bond would not be quite as high as it is now relative to the existing tax-exempt yield.

The tax exemption on municipal bonds reduces borrowing costs

Municipal bond issuers already sell taxable bonds in some cases (currently, the taxable status of a municipal bond is generally based on how its proceeds are used) – in a typical year, 10% to 15% of new municipal bond issuance is taxable (see Exhibit 1). Yields on taxable municipal bonds are significantly higher than comparable tax-exempt yields of the same issuer. This suggests that if municipalities were unable to sell tax-exempt bonds at all their interest costs would overall be much higher.

Exhibit 1

Municipalities already sell taxable bonds in some cases



Taxable bonds include bonds subject to the Alternative Minimum Tax.
Source: Bond Buyer

To illustrate: Last year, Arizona State University (Aa2 stable) sold both a tax-exempt and taxable bond the same day, and taxable yields were much higher than comparable tax-exempt yields (see Exhibit 2). Similarly, Carroll County, MD (Aaa stable) sold a tax-exempt bond and a taxable bond on the same day, and the taxable bond yielded about two-thirds more than the tax-exempt bond (see Exhibit 3).

Exhibit 2

Arizona State University pays a substantial premium on taxable bonds

Maturity	Tax-exempt yield	Taxable yield	Ratio
2025	3.36	5.27	1.57
2026	3.20	5.12	1.60
2027	3.01	5.08	1.69
2028	2.91	4.94	1.70
2029	2.89	4.99	1.73
2030	2.89	5.09	1.76
2031	2.87	5.14	1.79

All of the above maturities are noncallable.
Source: Arizona State University

Exhibit 3

Carroll County's taxable bonds yield much more than its tax-exempt bonds

Maturity	Tax-exempt yield	Taxable yield	Ratio
2025	2.77	4.46	1.61
2026	2.63	4.41	1.68
2027	2.60	4.41	1.70
2028	2.62	4.41	1.68
2029	2.68	4.46	1.66
2030	2.72	4.52	1.66
2031	2.77	4.60	1.66

All of the above maturities are noncallable.
Source: Carroll County, MD

According to the US Census Bureau, interest on debt represents 2.8% of direct expenditures for state and local governments, a figure that over time would likely escalate significantly as existing tax-exempt debt matures and higher-yielding taxable debt takes its place. The operating impact could be material. In 2023, the median implied debt service[1] was 5% of revenue for cities. Assuming a 50% increase in interest costs, that burden would increase to 5.8%, all else equal. Assuming a 70% increase, the burden would grow to 6.1%.

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Most tax-exempt debt is also callable (which is not the case in the taxable market), presenting opportunities to reduce interest costs when interest rates go down. This is another positive aspect of the tax-exempt market that would likely be lost if the tax exemption on municipal bonds were to be repealed, as call options are less common in the taxable market.

The tax-exempt bond market allows municipal issuers to structure their debt in a less risky way

In addition to lower borrowing costs, the tax-exempt bond market enables municipal issuers to structure their debt as long-term, fixed rate, amortizing bonds, which allows borrowers to fund infrastructure on a pay-as-you-use basis and greatly reduces or even eliminates the refinancing risk so common in the taxable market.

The tax-exempt bond market has grown completely accustomed to debt structures like this one sold last year by the Allegheny County Sanitary Authority, PA (Aa3 stable): fixed rate, level debt service over 30 years, callable after 10 years, no single maturity greater than 11% of total par. For bonds issued to fund long-lasting infrastructure (in this case, wastewater treatment assets), a structure like this enables this issuer to build known debt service costs into long-term projections and set its rates accordingly, and (importantly, for credit risk purposes), never to have to refinance the debt.

It might be hard to sell a structure like this in the taxable market, which is more accustomed to structures like this one from Ford Motor Co. (Ba1 stable): bullet maturities of $1 billion or more.

The bullet maturities that are so common in the taxable market require frequent refinancing, which is itself a credit risk not currently faced by most municipal issuers. Rural water utilities, small villages, local school districts and the like would face a new credit risk if they began to sell bullet maturities to the taxable bond market and then regularly had to reaccess the market to finance them.

Municipal bond issuers would meanwhile try to find ways to mitigate the higher costs.

Without the ability to sell tax-exempt bonds, many smaller borrowers would likely resort to bank loans and private credit sources, which is how subnational borrowers access the market in much of the world outside the US. Issuers could also sell their debt as taxable bonds at higher yields.

In the event that the tax exemption were to be repealed, municipal bond issuers would likely over time try to find ways to adapt. Namely, there would probably be more pooled borrowings, and issuers would modify their debt structures to be more palatable to the taxable bond market.

The US municipal bond market is fragmented, illiquid, and at times idiosyncratic. This is a market where a school district with enrollment of 50 students can sell a bond with a $175,000 maturity; where a $5 million financing secured by the taxes paid at a single building can be sold; and where a small territory nearly 4,000 miles from the closest state can sell hotel occupancy tax revenue bonds in the middle of a pandemic.

The fact that the tax-exempt bond market is comfortable with these types of credits means that a huge and highly diverse swath of small, unrecognizable municipal issuers are able to sell bonds and fund capital projects at affordable rates.

The taxable market would probably not be immediately ready to absorb these kinds of debt issuances, at least not without exacting a substantial price. Some US municipalities would probably have to adapt to look more like conventional borrowers in the taxable market: single-maturity, noncallable bonds with simpler security structures.

Municipal issuers would probably also create more liquid credits by joining together to do pooled borrowings. Rather than a school district with 50 students trying to entice investors in the taxable bond market to buy a $3 million amortizing bond, the district could band together with many other districts to create one large maturity that the taxable market could be interested in.

Examples of this already abound, from state-run pools like the Vermont Bond Bank (Aa2 stable) to local-government-created pooled like the Delaware Valley Regional Finance Authority, PA (A1 stable).

By adopting the conventions of the taxable bond market, and by pooling together to create more liquid names, municipal issuers could possibly over time achieve borrowing costs in the taxable market that are not quite as high relative to tax-exempt yields as they are today.

Endnotes

1 This statistic includes both interest and principal, both inferred using certain simplifying assumptions to ensure comparability.

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