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How the Tax Bill Will Change Governments' Borrowing Costs.

Key provisions will likely increase states and localities' current debt load and make it more expensive for them to borrow in the future. The bill's impact on supply and demand in the municipal bond market, however, is unclear.

For the first time in more than 30 years, Congress has passed a major overhaul of the tax code. The Senate and House have approved the GOP compromise bill, and President Trump is expected to sign it before the end of the year.

The final bill is better than initially expected for state and local governments, but key provisions are still likely to force big changes to their cost of borrowing.

The cause of these changes is indirect: The bill's big break for corporations on their income tax rate will force some state and local governments into higher debt payments on money they have already borrowed directly from banks, thanks to triggers placed in those loan contracts. George Smith, a municipal bond attorney, says it's not unusual for these contracts to have language that allows banks to increase the loans' interest rates in the event of a corporate tax cut.

But Smith, who specializes in municipal borrowing at the Bryant Miller Olive law firm, says there's no way to tell how many existing loan agreements have such a clause since that information is often redacted in public notices. Additionally, while some banks have an automatic trigger in their agreements, other contracts may leave it to the bank to decide whether to hike the initial interest rate. In the latter cases, says Smith, governments can try to negotiate a rate with banks or refinance out of the initial loan.

"But if they don't have that ability," he says, "they're stuck paying the rate."

One recent deal Smith closed for a Florida city had a trigger. Under the contract, the city refinanced $23.6 million with a tax-exempt rate of 2.99 percent over 10 years. If the bank's corporate tax rate is cut, the loan interest rate will shoot up, meaning the city would pay an additional $711,000 in interest costs over the life of the loan.

Going forward, the lower corporate tax rate could also potentially make it more expensive for governments to issue bonds in the municipal market.

Here's why: Banks and insurance companies buy a lot of municipal bonds, making up 28 percent of the market. Banks also lend money directly to state and local governments. The interest rate governments pay in these deals is typically lower than other types of loans because banks don't have to pay taxes on the income they earn from the loan. The same is true for bonds issued in the muni market — the rates tend to be lower because they are tax-free.

But with the GOP tax bill, the corporate income tax rate is slashed from 35 percent to 21 percent. That means that banks and other corporations will start earning more money off other types of investments because their tax rate is a lot lower. It could even mean that, after taxes, those other investments are more lucrative than the low interest rate muni bonds and loans. The result is that muni rates may have to go up in order to be competitive.

Less clear is how all the changes in the bill will impact supply and demand in the muni bond market.

Thanks to the elimination of certain types of tax-free municipal bonds, there has been a mad rush to issue bonds before the end of the year. This has likely shifted some of next year's supply into the current year and has analysts predicting a significant decrease in the municipal bond supply in 2018. Most experts peg the drop around 25 percent, a more than $100 billion drop compared with this year.

With less supply, that could put governments in the driver's seat and help keep interest rates favorable to them. "It's a balancing act," says Todd Ely, director of the Center for Local Government Research and Training at the University of Colorado Denver. "Does the reduced supply counteract the likely reduced buying from corporate entities because munis aren't as great a deal as they used to be?"

There are other indirect circumstances that could also play a role in the cost of borrowing next year.

For one, the caps on state and local tax deductions in tax reform may also encourage taxpayers in high-tax states to shelter more income in municipal bonds.

The market also may get a boost from foreign investors, who of course aren't getting a corporate tax rate cut. While they don't benefit from the tax-exempt status of municipal bonds, slightly higher rates may mean that munis will be a better deal for them than other taxable bonds.

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