
Tax Exemption Offsets Lack of Competition in Municipal Bond Markets.

The tax exemption for earnings on municipal bonds cost the federal government almost $31 billion in 2017. The exemption is intended to promote state and local investment, but many analysts argue the policy is an inefficient way to provide such a subsidy.

In a paper presented at the 2018 Municipal Finance Conference at Brookings, Duke University economists Juan Carlos Suárez Serrato, James W. Roberts, Andrey Ordin, and Daniel Garrett show that each dollar of tax exemption for interest paid on municipal bonds generates about $1.80 in savings for municipal authorities. In the paper "Tax Advantages and Imperfect Competition in Auctions for Municipal Bonds," using data on submitted and winning bids at municipal bond auctions, the authors estimate that each percentage point increase in the effective personal income tax rate on taxable bonds reduces municipal borrowing costs by roughly 9 percent, implying state and local governments receive a significant subsidy via the tax exemption.

How is it that the tax benefit has such a large impact on state and local borrowing costs? Suárez Serrato and coauthors say lack of competition in muni bond auctions—which often include few participants who need specialized information about each municipality and bond issuance—allows powerful bidders to suppress the price of the bond below what they would be willing to pay in a competitive auction. When a tax increase raises the value of the tax exemption, additional investors join the auction and bid higher prices. The tax hike not only raises the price investors are privately willing to pay, but also makes the auction more competitive. As evidence for this hypothesis, the authors show the pass through from tax savings to borrowing costs is larger for bonds issued by school districts and smaller jurisdictions, where auctions tend to have very few bidders and often are private.

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What does this mean for the importance of muni bond tax exemptions? The Suárez Serrato analysis implies the tax exemption is an effective policy for subsidizing state and local governments, and that its removal could place substantial burden on municipalities. In an analysis of the effects of the recently enacted Tax Cuts and Jobs Act, the authors find the new law—which limits the deductibility of state and local taxes and hence raises the effective tax rate—may lower interest costs for municipalities by 2.5 percent. An Obama-era proposal to limit the deductibility of muni interest income, on the other hand, would lead to an increase in state and local borrowing costs of around 31 percent, on average.

Suárez Serrato and coauthors note that these large policy effects exist primarily because of inefficiencies in primary municipal bond markets. If the tax advantages turn into public savings because bond auctions tend to be uncompetitive, then policies aimed at increasing competition in municipal bond auctions could significantly lower borrowing costs without sending the bill to federal and state taxpayers.

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