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Forbes: Who Benefits From Muni Bonds? It's More Complicated Than You Think.

Who benefits the most from the tax subsidy for municipal bonds? The easy answer is: Rich people who buy most of the tax-free paper.

That's true, according to a new analysis by my colleagues at the Tax Policy Center, but the story isn't quite that simple. If you look more closely, it turns out that others may benefit as well, including investors in taxable debt. And if you dig even deeper, the answer may depend on what state and local governments do with the subsidy from those tax-free bonds.

The paper's authors, Harvey Galper, Joe Rosenberg, Kim Rueben, and Eric Toder, started with the usual question—who benefits most when you look at after-tax rates of return from tax-exempts?

At first blush, high-income investors benefit more from that exemption than those in lower brackets (top-bracket taxpayers can save 39.6 cents on the dollar while those in the 25 percent bracket may only be able to save 25 cents).

So far so good, but the authors wanted to take a more sophisticated look—a view that goes beyond a simple calculation of the after-tax return on the bonds and looks at broader, real-world consequences.

For instance, what are the effects of tax-exempts on the holders of taxable debt? In the normal course of events, investors accept a lower coupon rate on tax-free munis than on similar taxable bonds.

In general, high tax-bracket investors prefer tax-exempts, while those in lower tax brackets or with assets in tax-advantaged retirement accounts like 401(k)s prefer higher yielding taxable bonds. Eventually, the after-tax return on both investments reaches an equilibrium, at least for some taxpayers.

But usual models look only at the tax benefit to muni investors without considering the lower pre-tax return they get from tax-exempt paper. By ignoring this implicit tax, they ignore the total benefit of buying munis.

Similarly, old-style models don't take into account the higher pre-tax returns from taxable bonds. That omission understates the benefit of munis to investors in taxable debt. Thus, while most of the benefit of the tax-exemption goes to high-income investors, lower-income households who hold taxable bonds in their 401(k)s also receive some advantage.

The authors then ask an even more interesting question: How do the uses of tax-exempt bond income by state and local governments affect the distribution of winners and losers? If, for instance, a state uses the money it saves from lower borrowing costs to reduce taxes, the big winners are likely to be high-income households (depending, of course, on the design of the tax cut).

By contrast, if a state pours the funds into new spending, low- and moderate-income households may end up with a bigger benefit than you might think.

Here's another example: Say you are a successful business owner who buys muni bonds issued by your local government. Do you come out ahead, net-net, relative to a world of taxable bonds? To answer that question, you not only have to consider your return from the bonds but also the possibility that your business will face increased borrowing costs to attract investors who would otherwise buy tax-free munis.

This paper did not try to answer all these complicated questions. But just by raising them it highlights an important issue: The world is complicated and trying to figure out winners and losers is a lot tougher than simply calculating after-tax income. Sometimes we do that because we don't have the tools to do more. But it is important to recognize the limitations of that exercise.

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