Bond Case Briefs

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Municipal Debt: What Does It Buy and Who Benefits?

This paper examines the incidence of the federal income tax exemption of interest on state and local bonds, applying a fixed-savings, simplified general equilibrium approach to estimate incidence effects on both the sources and uses of income. In contrast to traditional empirical work that allocates the benefit of tax exemption only to current holders of tax-exempt bonds based on current interest rates, we incorporate the fact that the existence of tax exemption causes the taxable interest rate to rise and the tax-exempt rate to fall. As a consequence, on the sources side, tax exemption can increase after-tax income for holders of both taxable and tax exempt bonds. On the uses side, consumers of both private and public goods are affected by the higher cost of funds to private and federal government borrowers, the lower cost of funds to state and local borrowers, and the lower cost of funds to private-sector entities with access to the proceeds of tax-exempt borrowing. Overall, higher income individuals remain the primary beneficiaries of tax exemption on the sources side with this new approach, but less so than under the traditional approach. On the uses side, households who consume a relatively large share of state and local public services, such as those with several school-age children, receive significant net benefits.

Read the full paper.

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