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What Happens When You Start Taxing Muni Bonds?

A new study offers the best data to date on how much the tax exemption on municipal bonds, which are often used to finance sports stadiums, saves state and local governments.

The $3.6 trillion municipal bond market is about as uniform as a crazy quilt. That's why it's hard to measure what one policy change — mainly, removing muni bonds' tax-exempt status — could mean for the market. But a new analysis offers the best glimpse yet of the impact that revisions might have on state and local governments.

The new study, commissioned by the International City/County Management Association and the Government Finance Officers Association, confirms one argument made in favor of the exemption: Since investors don't have to pay an income tax on their interest earnings from the bonds, governments can pay off their bonds at a lower interest rate than they would otherwise. The tax-free status of municipal bonds saved governments an estimated $714 billion in extra interest payments from 2000 to 2014, according to the report. That's the equivalent of building a state-of-the-art stadium, ballpark and arena for every professional sports city in the U.S. and Canada six times over.

Of course, this isn't the first study to back up the tax exemption's positive affect. What's different about this study is the level of data it provides policymakers. Previous reports merely offered a blanket comparison between the interest rates on a range of municipal bonds to the interest rate on U.S. treasuries, leading to the conclusion that interest rates for all muni bonds would have been between 2 and 3 points higher over the last decade without the tax exemption. But there's an old saying about the municipal market: If you've seen one muni bond, then you've seen one muni bond.

To get at a more accurate picture of how the exemption saves governments money, Justin Marlowe, author of the new report and a Governing columnist, looked at how the type of issuer affects interest rates. He found that depending on the issuer, savings can range from $80 to $210 in additional interest expenses per $1,000 of borrowed money.

"The effect of the exemption is much more stable or predictable for bigger issuers than other kinds," said Marlowe, a public finance professor at the University of Washington. "It's valuable, but the value doesn't vary as much as it does for smaller issuers." And, he adds, the value of the exemption is lower post-financial crisis.

Very small bond offerings — less than $3 million — see the lowest savings, little more $50 per $1,000 borrowed. Cities, counties and schools on average see slightly better savings of roughly $75 per $1,000 borrowed. Before the financial crisis, those groups saw average savings ranging between $120 and $150 per $1,000 borrowed.

Among the different types of issuers, hospitals see some of the biggest savings on interest payments. The average hospital today saves more than $100 per $1,000 borrowed — 1 percent less in interest — than it would if the bonds were taxable. Before the 2008 financial crisis, hospitals saved more than $150 per $1,000 borrowed. The big savings is because hospitals, which include nursing homes, tend to be among the riskiest investments in the municipal market. For hospitals, the default rate is still very low — less than a half percent, according to Municipal Market Analytics. But for retirement homes, a very small player in the market, the default rate is 5 percent.

Although talk about removing the muni bond tax exemption seems to have cooled on Capitol Hill until at least after next year's presidential election, tax reform is on the lips of just about every presidential candidate. While it would likely cost governments more to borrow if the exemption is eventually removed, the action would also trigger other changes to the market, said Marlowe. Many high-net-worth investors attracted to the tax-free feature of muni bonds would likely bow out. At the same time, foreign and corporate investors who don't currently benefit from the tax-free status could swoop in. It could create an increase in demand for muni bonds and thus keep interest rates low.

"There are lots of market dynamics that might change who buys munis," Marlowe said. "The question is, how many of those folks are out there?"

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