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What Is a Dedicated Tax-Backed Municipal Debt?

A string of municipal bankruptcies following the 2008 financial crisis forced many investors to question the utility of municipal bonds in their portfolio. Whether warranted or not, these concerns have given rise to dedicated tax bonds.

A dedicated tax bond, as far as municipal debt is concerned, refers to a variety of bond issues whose primary repayment method is secured by government tax or fee revenues. So long as a municipality generates tax and other forms of revenue, bondholders can feel certain that they will be repaid. The majority of debt issuers are supported by income tax, sales tax or gas tax, among others. The projects usually financed by this type of debt include economic growth initiatives.

To be sure, most general obligation (GO) bonds have an unlimited tax pledge. However, municipalities must use a portion of their tax revenues to cover frequent operating costs. Dedicated tax bonds, on the other hand, have revenue streams specially assigned to servicing debt. As such, they differ from traditional GO bonds and limited-tax GO bonds, which are backed by a limited amount of taxes.

Although dedicated tax-backed municipal bonds are more secure during economic downturns, there's little recourse for bondholders to access other funds from the issuer. However, since these bonds are backed by state revenues, the prospect of default is extremely slim.

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