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The Rich Rush to Muni Bonds.

As Biden's tax hikes loom, cities and states see a tax-exempt boom.

The biggest winners of the 2020 election have turned out to be state and local governments, especially those run by Democrats. Democrats in Congress have showered them with federal largesse, and President Biden is now reducing their borrowing costs by driving a stampede of investors into tax-exempt municipal bonds.

Demand for muni debt has surged this year even from last year's high levels as well-to-do Americans seek protection from the expected income and capital gains tax increases. Investors have plowed a record $69 billion into muni-bond mutual and exchange traded funds during the first seven months of this year, driving yields to historic lows.

The yield on the S&P Municipal Bond Index this summer fell below 1% for the first time and is now about half of what it was two years ago. BlackRock's California and New York Muni Bond ETFs (which include bonds from municipalities and local public agencies) are yielding 0.83% and 0.86%, respectively, versus 1.29% on the 10-year Treasury.

Try to wrap your head around this: The U.S. government has been issuing hundreds of billions of dollars in debt to help states and localities that are rolling in record tax revenue and can borrow at negative real rates. Now Congress plans to borrow even more for public works that many states could finance more cheaply. Only in Washington does this make any sense.

Munis have become more attractive because their interest is exempt from federal income tax, unlike Treasurys and corporate bonds. Most states also exempt debt issued by their localities from income taxes. This makes muni ETF and mutual funds especially popular among wealthy Americans in states with high tax rates like California and New York.

Now Mr. Biden wants to raise the top income tax rate to 39.6% from 37%. After adding the 3.8% investment tax, couples making more than $509,000 would pay 43.4% on interest income and dividends. High earners currently pay 23.8% on long-term capital gains, but Democrats also want to tax their capital gains as ordinary income.

The tax bill for wealthy Americans in many states could soon exceed 50% on stock sales, dividends and interest income. Tax-exempt munis are a port in this tax storm. Despite the paltry yields on munis, Americans may still net more than they would buying corporate bonds or Treasurys.

The gusher of cash from Congress to the states has also reduced muni-bond risk. Illinois recently received its first credit rating upgrade in more than 20 years, though the state's spendthrift policies and public-union stranglehold on Springfield haven't changed. The difference is the federal bailout cash.

The biggest, if unseen, cost of this investment in munis is misallocation of capital. Muni bonds do finance some needed public works improvements. But today's extraordinary rush to munis means that many investors are looking for tax avoidance rather than investing for higher returns in new ventures or productive private enterprises.

All of this finances bigger government, not the wealth creation that is essential to long-term growth and higher living standards.

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