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02 April 2025

Rethinking the tax-exempt status of municipal bonds

Changing the municipal bond interest tax exemption has been discussed as a potential source to help pay for the extension of the Tax Cuts and Jobs Act (TCJA). Municipal bonds have long been a critical funding mechanism for infrastructure and community projects and removing their tax advantages would have broad effects over these essential services. Nuveen believes it should be fully preserved.

Update from the
Nuveen Municipal Credit Research Team

WILL THE MUNICIPAL TAX EXEMPTION BE DIMINISHED?

The municipal bond tax exemption has been critical in generating cost-effective financing for vital facilities and functions across the U.S. These include state and local governments, K-12 schools, colleges and universities, roads and airports, hospitals, water and sewer utilities, housing and much more. Because the exemption is essential to financing U.S. infrastructure in rural and urban communities alike, we believe it should be fully preserved.

IS THE MUNICIPAL TAX EXEMPTION A PARTISAN ISSUE?

No. Republican and Democratic states alike benefit from lower financing costs of infrastructure through the municipal market. Red states and blue states each have $1-2 trillion of outstanding municipal bonds.

Favorably, two members of the Republican Party within the House Ways and Means Committee recently proposed legislation to return advance refunding deals to the tax-exempt market – a financing tool that municipalities lost during the original version of the TCJA. This legislative proposal, while unlikely to become law, nevertheless sends a clear signal to Congress that the powerful House Ways and Means Committee views tax-exempt financing for local governments as a critically important issue.

HOW MUCH DOES THE EXEMPTION COST THE FEDERAL GOVERNMENT?

Tax-exemption is estimated to cost the federal government approximately $40 billion annually, compared to the more than $4 trillion needed to pay for extension of the TCJA.

HOW MUCH ADDITIONAL COST WOULD CITIES AND STATES INCUR?

The Public Finance Network estimated that eliminating the tax exemption would cost cities and states $824 billion in higher borrowing costs over 10 years (approximately $82 billion annually) or about 2.1% more when borrowing in the taxable market compared to the tax-exempt market. Higher borrowing costs could pressure local revenues supporting debt service, forcing issuers to weigh increasing taxes for debt service – often property or sales taxes – against scaling back capital investment or the scope of specific capital projects.

HOW WOULD LOSING TAX-EXEMPT STATUS IMPACT ISSUERS' MARKET ACCESS?

Issuers, especially smaller issuers, could lose their autonomy and market access. Without the exemption, many small issuers would no longer have affordable market access – if they could issue bonds at all – straining their ability to finance critical infrastructure projects.

Such lack of access would have several implications, including an increase in pooled financings or state authorities issuing on behalf of underlying entities. This would take away local autonomy over capital infrastructure, and local voters would lose decision making power over which projects their towns and villages pursue. Local projects could also take longer, delaying needed infrastructure upgrades.

There is also uncertainty about what demand for taxable municipal bonds would look like from retail investors. If there are significant declines in demand, market access could be further impeded and become more costly, particularly for small, local municipal issuers.

WHAT ABOUT CAPPING THE EXEMPTION RATHER THAN A FULL REPEAL?

As the TCJA was being negotiated in 2016, a proposal to place a 28% cap on the municipal bond interest exemption was discussed and ultimately rejected. Such a cap would mean a taxpayer in the 37% bracket would not receive tax-exempt income on the entire municipal bond coupon. Rather, the taxpayer would forfeit the exemption on the difference between their tax rate of 37% plus the 3.8% Medicare surtax and the 28% cap, or 12.8%.

Using current market rates, a 28% cap on the interest exemption could increase municipal rates anywhere from 0.4% to 1.0%, depending on the maturity of the bond.

Municipal borrowing rates could experience additional upward pressure if the potential cap were to reduce the buyer base for the asset class, as not all current municipal investors will likely want to take the extra step of calculating their tax-exempt income under the cap.

ARE CERTAIN SECTORS OR ISSUE TYPES MORE EXPOSED TO A POSSIBLE CHANGE?

Nuveen believes that private activity bonds – those issued by entities such as private colleges and universities, not-for-profit hospitals, stadiums and airports – are more likely to lose exempt status than other sectors such as state and local governments, water and sewer systems, or K-12 schools. While it is difficult to pinpoint an exact number, Nuveen estimates that private activity bonds comprise 25% of the overall market, or roughly $1 trillion of outstanding municipal paper.

HOW CAN INVESTORS TAKE ADVANTAGE OF TAX CODE UNCERTAINTY?

Nuveen believes any change to tax-exempt status would not be retroactive. In other words, already outstanding bonds issued by these entities are likely to keep their existing tax-exempt status – i.e., grandfathered exemptive status.

This dynamic could lead to an attractive investment opportunity, as outstanding tax-exempt bonds would likely see higher demand as scarcity of new issuance in these sectors takes hold. In addition, the market could experience a decrease in aggregate new issue supply going forward, which could have a positive technical impact.

Investors may want to consider increasing their exposures to both private activity bonds and the overall municipal market to capitalize on this potential future market opportunity.

For more information, please visit us at nuveen.com.

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