U.S. Municipal Bond Market

While Public Finance Sleeps

Tom Kozlik
Head of Public Policy and Municipal Strategy
214.859.9439
tom.kozlik@hilltopsecurities.com

- **Imminent Threat:** This report highlights the imminent threat to the municipal bond tax-exemption, emphasizing that all potential pay-fors are being considered, including a possible zero-sum relationship between raising the SALT cap and maintaining the tax-exemption.
- **Different Threat than in the Past:** The current political and fiscal environment, characterized by public dissatisfaction that led to the "Red Wave," the weaker fiscal status of the U.S., and the greater potential for competing policy all pose a greater threat to the municipal bond tax-exemption than in past decades.
- **Potential Cost:** President Donald Trump's 2025 fiscal policy priorities could cost between $5 trillion and $11 trillion, as estimated by the Committee for a Responsible Federal Budget.
- **Public Finance Inaction:** Despite the significant threat to the municipal bond tax-exemption, the public finance sector remains largely inactive, failing to recognize and respond to the urgency of the situation. The tax-exemption needs to be understood by D.C. lawmakers to be preserved.

Everything is On the Table

The potential cost of President Donald Trump's 2025 fiscal policy tax priorities is estimated to be between $5 trillion and $11 trillion, according to a Committee for a Responsible Federal Budget analysis. D.C. lawmakers are currently assessing their priorities while debating whether the President's political and fiscal plans will necessitate "one big, beautiful bill" or two.

Despite the significant threat to the municipal bond tax-exemption, the public finance sector remains largely inactive, failing to recognize and respond to the urgency of the situation. The tax-exemption needs to be understood by D.C. lawmakers to be preserved.

This report aims to inform the market and public finance community about the imminent threat to the municipal bond tax-exemption following our meetings last week in Washington, D.C. Here are our key takeaways:

- All potential pay-fors are on the table.
- There could be a zero-sum relationship between raising the SALT cap and maintaining the municipal bond tax-exemption.
- The Government Finance Officers Association, the Bond Dealers of America and some of their members visited the Capitol already in 2025 to discuss the importance of the tax-exemption.

The Tax-Exemption Needs to Be Understood by D.C. Lawmakers to Be Preserved

Public entities, state and local governments, and much of their supporting public finance ecosystem remain inactive in efforts to save the municipal bond tax-exemption. It would be beneficial if the public finance industry could initiate messaging to raise awareness about this threat among their networks.

Many in the public finance industry have responded to the threat to the municipal bond tax-exemption by emphasizing its importance as an infrastructure financing tool. They generally believe that, in the end, the tax-exemption will be preserved.

However, the details and especially the benefits of the tax-exemption need to be more widely understood by lawmakers in D.C. to ensure its preservation.

However, the details and especially the benefits of the tax-exemption need to be more widely understood by lawmakers in D.C. to ensure its preservation.

While it is true that the municipal bond tax-exemption is a crucial and irreplaceable infrastructure financing tool, the current political landscape in D.C. is very different than in past years. The current administration and the 119th Congress are challenging the status quo. It is essential for the administration and all members of the 119th Congress to understand the importance of the tax-exemption for infrastructure finance. Without proper education and advocacy, there is a significant risk that the municipal bond tax-exemption could be sacrificed to raise the SALT cap or to fund another competing policy priority. In 2025, everything is on the table, and nothing should be taken for granted.

Everything is on the table, yet public finance still sleeps.

Answers to Common Questions We are Getting Related to the Tax-Exemption Threat

Question: What do you mean by "Public Finance Sleeps?"

Answer: The public finance sector is generally not recognizing how strong the threat to the municipal bond tax-exemption is right now.

For years the municipal bond tax-exemption faced mostly weak pressure. This pressure finally resulted in a policy change via the 2017 Tax Cuts and Jobs Act. One would think losing the ability to advance refund with tax-exempts would seem like a shot across the bow, and wake folks in the public finance sector up. However, they have generally not engaged.

One would think losing the ability to advance refund with tax-exempts would seem like a shot across the bow, and wake folks in the public finance sector up.

The strongest threat to the municipal bond tax-exemption we have ever seen has emerged since the November 2024 elections, driven by:

- Public dissatisfaction, resulting in November's "Red Wave"
- The deteriorating U.S. fiscal situation
- Competing policy priorities

All these elements are all converging, creating the most significant threat we have seen to date. We still estimate there is a 50% or greater chance D.C. lawmakers could eliminate or significantly curtail the tax-exemption during 2025 fiscal policy negotiations due to one or more of these factors.

Rather than placing blame for the public finance community's lack of mobilization, it is more important to find a way to rally the public finance ecosystem into action. The public finance sector needs to effectively communicate to public entities, state, and local governments that this crucial infrastructure financing tool must be preserved.

Rather than placing blame for the public finance community's lack of mobilization, it is more important to find a way to rally the public finance ecosystem into action.

Question: Do you know something others don't? Why is it that you have been warning about the potential and now imminent threat to the municipal bond tax-exemption?

Answer: We don't know, and no one knows exactly how the 2025 fiscal policy story will unfold. Most importantly, no one—not even Speaker of the House Mike Johnson or President Trump—knows what the result will be. There is a range of potential scenarios.

We have been tracking the rising threat to the tax-exemption for decades. Initially, we believed the greatest risk stemmed from potential deficit reduction measures. However, the 2017 TCJA demonstrated that competing policy initiatives pose an even stronger threat. Additionally, there appears to be very little political will to push for impactful infrastructure related legislation.

Question: Describe why you think there could be a zero-sum relationship between raising the SALT cap and maintaining the tax-exemption.

Answer: The municipal bond tax-exemption and SALT cap relief are perceived to benefit the same recipients, competing for limited federal resources, and potentially creating a zero-sum relationship. Lawmakers from high-tax states have prioritized raising the SALT cap, as it provides immediate tax relief to only some of their constituents. However, lifting the SALT cap reduces federal revenue, which may lead Congress to seek offsets elsewhere, potentially by limiting or eliminating the municipal bond tax-exemption. Congress may effectively be forced to choose between them either directly or indirectly. If raising the SALT cap takes precedence, the municipal bond tax-exemption could be at risk as a trade-off.

However, lifting the SALT cap reduces federal revenue, which may lead Congress to seek offsets elsewhere, potentially by limiting or eliminating the municipal bond tax-exemption.

Question: What is the cost of the municipal bond tax-exemption?

Answer: U.S. Treasury Department data places it a little over $50 billion annually; this includes general state and local government and private activity bond issuance.

Question: Given that this ($50 billion) is relatively such a small amount in the context of finding pay-fors to cover $5 trillion to $11 trillion, do you really think they would target such a minor line item?

Answer: The reason lawmakers might target the tax-exemption is rooted in that it is considered one of the $1.5 trillion of federal tax expenditures. Tax expenditures represent revenue losses for the federal government due to various exclusions, exemptions, deductions, credits, preferential rates, or deferrals in the tax code.

The reason lawmakers might target the tax-exemption is rooted in that it is considered one of the $1.5 trillion of federal tax expenditures.

These expenditures cover a wide range of areas, including healthcare, housing, retirement savings, and education. The costs for the largest tax expenditures are in the hundreds of billions of dollars per year, the tax-exemption is #10 on the next page.

Some lawmakers aim to reduce spending by cutting or eliminating tax-expenditures, which they view as inefficient ways to allocate federal resources. By targeting tax-exempt municipal bonds, and other tax expenditures they believe they can help pay for other policy priorities.

Some lawmakers aim to reduce spending by cutting or eliminating tax-expenditures, which they view as inefficient ways to allocate federal resources.

Income Tax Expenditures Ranked by Total Fiscal Year 2025-2024 Projected Revenue Effect

Rank	Provision	2024	2025	2025-34
1	Exclusion of employer contributions for medical insurance premiums and medical care	$247,300	$262,310	$3,908,910
2	Exclusion of net imputed rental income	164,730	172,300	2,173,940
3	Defined contribution employer plans	144,630	152,190	2,134,080
4	Capital gains (except agriculture, timber, iron ore, and coal)	133,350	149,680	1,772,980
5	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	6,540	6,250	974,450
6	Deductibility of mortgage interest on owner-occupied homes	29,060	29,600	903,680
7	Capital gains exclusion on home sales	59,070	61,740	801,870
8	Deductibility of charitable contributions, other than education and health	46,240	47,460	749,270
9	Defined benefit employer plans	68,430	68,710	739,560
10	Exclusion of interest on public purpose and private activity bonds	52,270	53,800	603,780
11	Treatment of qualified dividends	40,060	43,580	590,820
12	Self-Employed plans	39,350	41,410	580,680
13	Step-up basis of capital gains at death	33,560	37,830	570,050
14	Deductibility of State and local property tax on owner-occupied homes	6,360	6,210	539,770
15	Individual Retirement Accounts	33,550	35,110	530,050
	Total of Top 15	$1,104,680	$1,168,180	$17,573,890

Source: U.S. Department of the Treasury (Nov., 2024) and HilltopSecurities, (in millions of dollars).

Question: Can or should the municipal tax-exemption be saved?

Answer: A compelling bipartisan argument can be made in support of the municipal bond tax-exemption. This exemption is a critical tool for financing a significant portion of U.S. infrastructure projects, including roads, bridges, schools, and hospitals. Eliminating the municipal bond tax-exemption would not only increase borrowing costs for state and local governments but also widen the infrastructure gap, hindering essential development and maintenance efforts. Preserving this tax-exemption is vital for sustaining and advancing the nation's infrastructure, ensuring that public entities can continue to meet the needs of their communities effectively. We absolutely believe that with education and advocacy in D.C., lawmakers will be able to understand the importance of the municipal bond tax-exemption and that it is a valuable tax-expenditure.

We absolutely believe that with education and advocacy in D.C., lawmakers will be able to understand the importance of the municipal bond tax-exemption and that it is a valuable tax-expenditure.

Question: Do you think there is a chance lawmakers will consider eliminating the tax-exemption for only private activity bonds, or select private activity and not all municipal bonds?

Answer: There is a chance this could occur. In 2017, lawmakers initially targeted private activity bonds, but ultimately decided to eliminate advance refundings with tax-exempts instead. There is much confusion surrounding private activity bonds in D.C. This confusion highlights the importance of educating lawmakers about the definition and importance of private activity bonds. It is crucial for lawmakers to understand that private activity bonds are issued for single and multi-family housing, which is a critical financial and political issue in most Congressional districts in 2025. Additionally, private activity bonds are used for transportation, education, healthcare, and other traditional infrastructure-related purposes. It's also worth noting that private activity bonds only account for about $10 billion of the total $50 billion cost.

Despite the passage of the Infrastructure Investment and Jobs Act of 2021 and the Inflation Reduction Act of 2022, which together offered only a very modest funding increase, the United States continues to grapple with persistent infrastructure challenges.

Question: What would the impact be if the municipal bond tax-exemption was eliminated?

Answer: There are various negative results we expect if the tax-exemption is not preserved.

- Elimination would raise borrowing costs by $824 billion (over the next 10 years), a cost that would be passed onto American residents and amount to a $6,555 tax and rate increase for every American household over the next decade, per the GFOA.
- The U.S. infrastructure gap would increase. We detailed that the U.S. infrastructure crisis has persisted in As the 2024 Elections Loom, America's Infrastructure Challenges Persist & Threaten to Deepen. Despite the passage of the Infrastructure Investment and Jobs Act of 2021 and the Inflation Reduction Act of 2022, which together offered only a very modest funding increase, the United States continues to grapple with persistent infrastructure challenges. The American Society of Civil Engineers has highlighted a substantial investment gap remains.
- The majority of municipal issuance is by small issuers (see page 2), and many of them could be frozen out of the taxable market, or access to investors could be too expensive.

Eliminating the tax-exempt status would negatively impact many retired fixed-income investors, potentially undermining investor trust and resulting in market instability.

Question: If the tax-exemption was eliminated, do you think existing tax-exempt bonds would keep their tax-exempt status?

Answer: We believe it is more likely that existing bonds will retain their tax-exempt status. We have not seen many reputable proposals suggesting the elimination of the tax-exempt status on existing bonds. Federal officials generally understand the importance of maintaining investor trust. Eliminating the tax-exempt status would negatively impact many retired fixed-income investors, potentially undermining investor trust and resulting in market instability.

However, as we witness how the current administration has targeted D.C. institutions, we are increasingly rethinking that this may not be the case. For now, our base case scenario is that existing bonds will keep their tax-exempt status if the tax-exemption is eliminated.

For now, our base case scenario is that existing bonds will keep their tax-exempt status if the tax-exemption is eliminated.

Question: Does the municipal bond tax-exemption incentivize state and local governments to sell too much debt?

Answer: The municipal bond tax-exemption does not incentivize state and local governments to overextend themselves with debt, despite some misinformed opinions to the contrary. Several factors help keep outstanding bonded debt and debt service relatively low.

To illustrate that the debt levels of states, counties, and cities are manageable, we are citing a valuable median data point from Moody's Ratings: implied debt service as a percentage of revenue. Below is a summary by sub-sector for fiscal year 2023:

- U.S. State Government: Implied debt service is only 1.8% of revenues
- Counties: Implied debt service is only 2.9% of revenues.
- Cities: Implied debt service is only 5.0% of revenues.

The municipal bond tax exemption does not incentivize state and local governments to overextend themselves with debt, despite some misinformed opinions to the contrary

Question: What is the breakdown of municipal bond issuance by sector?

Answer: We summarized sector by sector issuance results for 2024 in Building America's Infrastructure with Municipal Bonds: A 2024 Overview. 28% of 2024's issuance was for general government purpose or state and local governments.

Question: Who and what kind of data is supporting the municipal bond tax-exemption?

Answer: There is traditional support and there is support from those who recognize the strongest threat we have ever seen. Support from those who recognize the threat is needed now.

The Center for Municipal Finance at the University of Chicago recently published a tool that shows Municipal Bonds in Congressional Districts.

- The Government Finance Officer's Association's and the GFOA's Public Finance Network has been very active in advocacy efforts in general and in D.C. specifically. Their Built by Bonds campaign seeks to explain what type of specific projects benefit from the tax-exemption. Also, their report, Protecting Bonds to Build Infrastructure and Create Jobs includes important key findings.
- The Center for Municipal Finance at the University of Chicago recently published a tool that shows Municipal Bonds in Congressional Districts. This first-of-its-kind tool creates multi-page tear sheets that summarize, by sector, the amount of issuance in every U.S. congressional district. We believe this data will help members in Congress and their staff better understand the impact of tax-exempt municipal bonds on communities in their districts.
- Organizations such as the America Society of Civil Engineers, the Bond Dealers of America and the American Securities Association are actively educating and advocating on the topic. The BDA promoted the importance of the tax-exemption with meetings on Capitol Hill during the first week of February.
- Chris Iacovella, CEO of the American Securities Association, recently highlighted a critical issue in his publication, "The $823 Billion Tax Bomb Threatening America's Communities" (Jan. 21, 2025). He warns that Washington policymakers might get lost in the numbers and overlook the real-world impact of their decisions.
- Moody's Ratings published a report titled, Losing tax exemption would increase borrowing costs, market access risk at the end of January 2025. Various media outlets, especially The Bond Buyer and Bloomberg have covered the topic in recent weeks.

We believe this data will help members in Congress and their staff better understand the impact of tax-exempt municipal bonds on communities in their districts

Question: What are some of the recent examples where you wrote about the rising threat?

Answer:

- We indicated, "Washington could target the tax exemption," in a collaboration titled The Next Big Risk we published back on Sept. 8, 2022. We summarized our warning by writing, "It is important that state and local government related organizations, public finance industry groups, and related parties increase the amount of education currently being done in Washington to inform lawmakers about the policy implications of different scenarios related to the municipal bond tax-exemption".

- We published a call to action for public entities and public finance back in August 2023, just after Fitch Ratings downgraded the U.S. sovereign rating. Please see Save the Tax-Exemption, A Call to Action for U.S. Public Finance (Aug. 17th, 2023).

- Just after the November 2024 elections we wrote, An Almost Imminent Threat to the Municipal Bond Tax-Exemption is Here: Act Now to Preserve This Vital Infrastructure Financing Tool (Nov. 13, 2024).

- We even included the potential elimination as part of the base case in our municipal bond issuance forecast for 2025, published on Nov. 25, 2024.

- Then at the beginning of January, as the political support for raising the SALT cap grew, we wrote Growing Support for SALT Cap Expansion, Backing for Tax-Exemption Needed (Jan. 9, 2025).

- At the end of January we noted, Threat Now Imminent, Advocacy for Infrastructure Financing Tool Falling Way Behind in Tempo (Jan. 23, 2025).

Recent HilltopSecurities Municipal Commentary

- Growing Support for SALT Cap Expansion, Backing for Tax-Exemption Needed, Jan. 9, 2025
- Building America's Infrastructure with Municipal Bonds: A 2024 Overview, Dec. 23, 2024
- Forecasting $745 Billion in Municipal Bond Issuance for 2025 Amid Potential Tax-Exemption Elimination, Nov. 24, 2024
- Crypto Abstinence: Safeguarding Public Entity Credit Quality, Taxpayer and Public Funds by Avoiding Digital Illusions, Nov. 20, 2024

Readers may view all of the HilltopSecurities Municipal Commentary here.