

## Debt and Taxes: Tax-Exempt vs. Taxable Bonds

When local governments want to invest in capital projects, they typically issue bonds to borrow funds from investors whom they agree to repay with interest. The cost of borrowing depends on how the debt service is structured, how confident investors are in the local government's ability to service the debt, and whether the federal government taxes investors' earnings. Issuing tax-exempt bonds can lower the cost of borrowing, but place limits on how bond proceeds can be used. Issuing taxable bonds, which generally carry slightly higher borrowing costs, can enable more flexible and direct investment into projects and properties that aren't publicly owned. The Government Finance Officers Association (GFOA) [recommends](#) that cities develop a thorough understanding of the differences between tax-exempt and taxable debt so they can determine the most appropriate financing option for each proposed project.

### Tax-Exempt Bonds

Tax-exempt bonds are the [primary tool](#) used by state and local governments to invest in public infrastructure in the United States. By exempting investors' interest earnings from federal taxation, the tax-exempt designation enables cities to lower their borrowing costs while still attracting investors. Recent [analysis by the GFOA](#) found that, on average, tax-exempt borrowing rates are 2.1 percentage points lower than taxable borrowing rates.

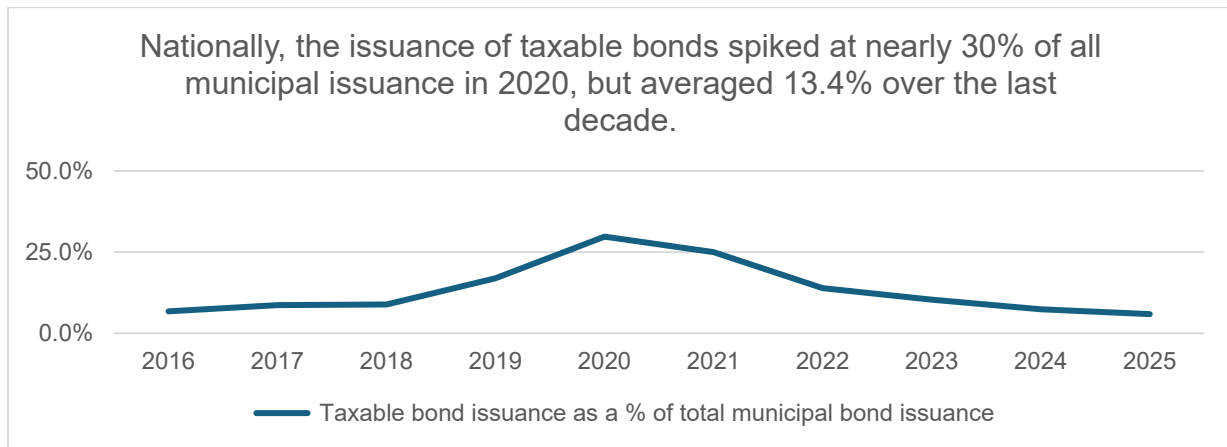
*Borrowing \$100 million at a **taxable** rate of 5.5%, could lead to repaying of \$167.4 million in principal and interest costs over a 20-year term.*

*Borrowing the same amount in **tax-exempt** bonds over the same term at a rate of 3.4% (2.10 percentage points lower) would result in \$139.5 million in debt service costs, **saving \$27.9 million.***

To qualify as tax-exempt, bond proceeds must be spent according to [IRS guidelines](#). Central to these guidelines is the requirement that at least 90 percent of tax-exempt bond proceeds are spent by the government, for public purposes, on publicly owned property. This requirement isn't an issue when bond funding is used by a city government to invest in publicly owned and publicly operated assets like a library or recreation center. The \$1.87 billion in tax-exempt General Obligation bonds and \$300.0 million the City of Philadelphia borrowed to fund the Rebuild Initiative are local examples of tax-exempt borrowing used to invest in City-owned assets.

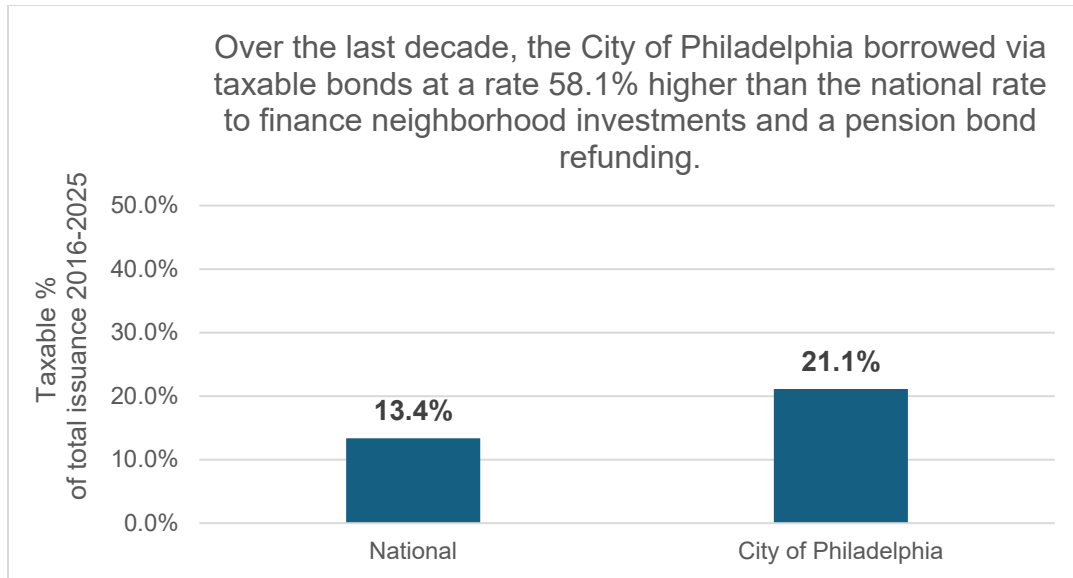
There are a number of IRS tax-exempt related provisions that issuers like the City must follow. These regulations may become an obstacle if bond proceeds are used to invest in properties or activities that are not publicly owned or operated, like affordable housing owned by various non-profit organizations or private developers. Tax-exempt bonds are also prohibited from engaging in arbitrage, meaning they cannot generate investment earnings that exceed the yield paid to bondholders.

### Taxable Bonds



Source: Refinitiv and LSEG via [The Bond Buyer](#)

Cities may use taxable bonds for projects where the end user isn't the local government. Without a tax-exempt status to subsidize investor returns, the cost of borrowing tends to be higher for taxable bonds. After careful evaluation, the benefits of capital investment that doesn't qualify for tax-exemption can outweigh the increased borrowing costs, especially when compared to the potential impact of financing such projects using pay-as-you-go funds pulled from a limited operating budget.



Sources: Refinitiv & LSEG via The Bond Buyer, City of Philadelphia non-enterprise issuances

Nationally, a spike in taxable bond issuance around 2020 was [driven by a change in federal tax policy](#) that removed the ability for cities to use tax-exempt bonds to conduct advanced refundings of prior bond issuances and low taxable bond rates that reduced the difference in cost between taxable and tax-exempt bonds. This change caused the City of Philadelphia to issue [\\$118.0 million in taxable bonds](#) in 2020 that could have been tax-exempt prior to the policy change. Otherwise, the City’s taxable borrowing was directed toward [securing better rates](#) on its Pension Obligation Bonds, and making direct investments in projects not owned or operated by the City. Nearly \$300 million in taxable bonds have been issued to fund the [Neighborhood Preservation Initiative](#), which provides essential home repairs, downpayment assistance, and development subsidies for affordable homeownership, among other investments. Because these investments are being made in properties not owned by the City, the majority of bonds used to fund the investments do not qualify for federal tax exemption.

### Looking Ahead

In March 2026, the City issued its first bonds under the H.O.M.E. Initiative. Because the Initiative is intended to fund affordable homeownership development and support for renters, much of the issuance will be federally taxable. The City can continue to take a responsible approach to selecting the most appropriate financing options by carefully considering how the differences in costs and use apply to proposed projects.

**Appendix: City of Philadelphia Bond Issuances 2016-2025**

Year	Issuance	Tax-Exempt		Taxable		Total
		Original Issue	Refunding	Original Issue	Refunding	
2025	<a href="#">General Obligation</a>	301.3	470.8	100.5	-	872.6
2025	<a href="#">PAID Rebuild / Cultural and Commercial Corridor Refunding</a>	128.8	41.1	-	-	169.9
2024/ 2025	<a href="#">PRA Neighborhood Preservation Initiative / Neighborhood Transformation Initiative Refunding</a>	21.3	68.8	127.8	-	217.9
2024	<a href="#">PAID Rebuild</a>	91.8	-	-	-	91.8
2023	<a href="#">PEA Street Lighting Project</a>	72.7	-	10.8	-	83.5
2023	<a href="#">PRA Neighborhood Preservation Initiative / Neighborhood Transformation Initiative Refunding</a>	20.0	24.6	79.5	-	124.1
2021	<a href="#">General Obligation</a>	294.7	-	-	132.1	426.8
2021	<a href="#">PRA Neighborhood Preservation Initiative</a>	8.9	-	89.7	-	98.6
2021	<a href="#">PAID Pension Refunding</a>	-	-	-	137.0	137.0
2020	<a href="#">General Obligation Refunding</a>	-	-	-	118.0	118.0
2019	<a href="#">General Obligation</a>	293.4	-	-	-	293.4
2019	<a href="#">General Obligation Refunding</a>	-	188.7	-	-	188.7
2019	<a href="#">PAID Lease Revenue Refunding</a>	-	147.6	-	-	147.6
2018	<a href="#">PAID Rebuild</a>	79.5	-	-	-	79.5
2018	<a href="#">PRA Home Repair</a>	-	-	40.0	-	40.0
2018	<a href="#">PAID Philadelphia Museum of Art Energy Savings / Parkway Refunding</a>	10.3	27.6	-	-	37.9
2017	<a href="#">PMA Juvenile Justice Services Center Refunding</a>	-	83.2	-	-	83.2
2017	<a href="#">PAID Affordable Housing Preservation</a>	52.9	-	-	-	52.9
2017	<a href="#">General Obligation Refunding</a>	-	262.9	-	-	262.9
2017	<a href="#">General Obligation</a>	331.6	-	-	-	331.6
2016	<a href="#">PAID Cultural and Commercial Corridors and Central Library Project Refunding</a>	-	95.4	-	-	95.4
<b>2016-2025 Total</b>		<b>1,707.1</b>	<b>1,410.6</b>	<b>448.2</b>	<b>387.1</b>	<b>3,953.1</b>
		<b>3,117.8</b>		<b>835.3</b>		

Source: [City of Philadelphia non-enterprise bond issuance official statements 2016-2025](#)