

# Tax Advantages and Imperfect Competition in Auctions for Municipal Bonds\*

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## Abstract

We show that the effect of tax advantages of municipal bonds on the market structure of municipal bond auctions is a crucial determinant of state and local governments' borrowing costs. Reduced-form estimates show that increasing the tax advantage by 3-pp. lowers mean borrowing costs by 9-10%, consistent with a greater-than-unity passthrough elasticity. Non-parametric evidence shows that strategic participation and bidding in imperfectly-competitive auctions generates this greater-than-unity passthrough. Using a structural auction model to evaluate the efficiency of Obama and Trump administration proposals, we find that the reduction in municipal borrowing costs is 2.8-times the revenue cost of the tax advantage.

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