JOURNAL ARTICLE

Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds that are Secured by U.S. Treasury Obligations

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Abstract

Fama (1977) and Miller (1977) predict that one minus the corporate tax rate will equate after tax yields from comparable taxable and tax-exempt bonds. Empirical evidence shows that long-term tax-exempt yields are higher than theory predicts. Two popular explanations for this empirical puzzle are that, relative to taxable bonds, municipal bonds bear more default risk and include costly call options. I study U.S. government secured municipal bond yields which are effectively default-free and noncallable. These municipal yields display the same tendency to be too high. I conclude that differential default risk and call options do not explain the municipal bond puzzle.

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