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Banks, firms and the relative pricing of tax-exempt and taxable bonds

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Abstract

The traditional analysis of the relative pricing of tax-exempt and taxable debt is a habitat theory of the term structure of interest rates. In the traditional analysis the preferences of investors for particular maturities of debt lead to unique pricing relations at every point on the yield curve which are indicative of investor marginal tax brackets. Recent work by Fama (1977) suggests that banks are potential arbitrageurs across tax-exempt and taxable bond markets which force a particular equilibrium on the pricing of short-term bonds. Miller (1977) suggests that the choice of debt or equity financing by firms in the aggregate forces a similar equilibrium on the pricing of all tax-exempt and taxable bonds. This paper exploits the institution of Regulation Q and its effects on the banking system to bring evidence to bear on the predictions of these three models.

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