Revenue Bonds – What They are and How They Work

David Waring

Revenue Bonds are municipal bonds which are issued to fund a specific revenue generating project. In contrast to general obligation bonds which are backed by a taxing power, investors in revenue bonds are paid from the revenues generated from the projects they are issued to fund. A wide variety of public projects are funded using revenue bonds, ranging from toll roads and bridges, to water and sewage plants, to hospitals and public universities.

Here is a video overview of revenue bonds, the text for which you can find below the video.

If the project that a revenue bond is issued to fund cannot afford to pay bondholders, then the government to which the municipal bonds are tied does not have the obligation to pay the debt. It is for this reason revenue bonds as a category are considered riskier than general obligation bonds. While this can be looked at as a negative, revenue bonds also pay a higher rate of return on average, so this can be a positive as well.

Are Revenue Bonds Always Riskier than General Obligation Bonds?

No. As we discuss in our article on general obligation bonds, governments can run into issues and general obligation bonds have defaulted in the past. Two of the primary factors investors will look at when evaluating how risky a potential revenue bond is are:

1. What are the historical (if any) and expected revenues generated by the project that revenue bonds are being issued to fund, and how do these compare to the money needed to pay bondholders? When evaluating this factor investors will look at something which is known as the "debt coverage ratio".

2. What is the necessity of the project the revenue bonds were issued to fund? All else being equal, revenue bonds issued to fund a baseball stadium, are likely to be considered riskier than bonds issued to fund the same town's electric plant. In an economic downturn residents may cut back on their baseball game attendance, but they are unlikely to stop paying their electric bills.

What Types of Revenue Bonds Should You Avoid?

As we discuss in our article on municipal bond default rates, bond relating to housing and healthcare have the highest default rates and therefore should be looked at carefully or avoided all together. 75% of municipal bond defaults from 1970 to 2011 were from these two categories.

This lesson is part of our Free Guide to the Basics of Investing in Municipal Bonds. Continue to the next lesson here.