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Will a "Red Wave" Affect Municipal Bonds' Tax-Exempt Status? - AllianceBernstein

Wholesale elimination of tax exemption isn't likely, but certain types of muni bonds could be targets.

With the Tax Cuts and Jobs Act (TCJA) of 2017 slated to expire at year-end 2025, we expect tax policy to be high on Republicans' legislative agenda. But an extension or expansion of TCJA's provisions could grow the federal budget deficit—unless lawmakers can find revenue offsets. As in the past, this could put a target on municipal bonds' federal income tax exemption.

Tax-exempt municipal bonds are critical to America's infrastructure and to a functioning US economy. Muni bonds' tax exemption dates back to the earliest federal income tax in 1913 and has been a pillar of state and local project funding ever since. According to the National League of Cities, municipal bonds are a $4 trillion market and have financed approximately 75% of US infrastructure—with hospitals, schools, airports, water and sewer systems, public power facilities and toll roads among the many beneficiaries.

In our view, eliminating or limiting the exemption could hurt economic growth and throttle infrastructure investment nationwide. Both sides of the aisle seem to acknowledge America's need to improve and rebuild its infrastructure, which makes preserving tax exemption so important.

Ultimately, we believe tax exemption will be mostly preserved, given that its elimination would save Washington only about $40 billion in revenue annually, according to the Congressional Joint Committee on Taxation. That's a fraction of the $6.5 trillion federal budget. Considering approximately $500 billion in tax-exempt bonds were issued in 2024 alone, we think eliminating tax exemption would throw infrastructure financing and the economic freedom of local communities into disarray—with little help to the national deficit.

Wholesale Elimination Would Erase Vital Infrastructure Investment

We've observed three major benefits to the US economy from the tax exemption on municipal interest income:

Increased infrastructure spending, thanks to lower borrowing costs that boost demand for public projects. Many improvements in airports, schools, hospitals and other public facilities are financed through tax-exempt debt.

Lower prices and reduced local and state tax burdens. Cheaper access to capital allows municipal entities to charge their constituents less in the form of lower tolls, airport fees, taxes and rates for water, waste management and power. Based on recently observed trades, the interest rate for tax-exempt munis was about 1.5% lower than for comparable taxable bonds. That's the equivalent of $1.5 million less in annual interest on a $100 million bond. This would all but evaporate, with state and local taxpayers paying more for infrastructure improvements or seeing fewer of them altogether.

Increased autonomy and policy freedom for state and local governments. Tax exemption allows communities to chart their own paths, as they're not overly dependent on Washington for infrastructure dollars. Moreover, direct funding from the federal government strikes us as impossibly unwieldy, given the muni market's 50,000 issuers. It would certainly be less efficient than the current system, which encourages local capital allocation and sharper attention to smaller projects easily overlooked.

Removing the tax exemption on municipal bonds would, in our view, substantially reduce municipal bonds' investor base. With fewer investors seeking to invest in state and local infrastructure projects, local governments would need to rely more on states for financing, and states would need to rely more on the federal government.

Thus, the benefits we've cited—increased infrastructure spending, lower costs for constituents, and greater autonomy for state and local governments—would be substantially reduced. This would disproportionately affect rural areas, as smaller municipalities would likely struggle more to find capital for their projects.

Infrastructure Funding Alternatives Are Limited

The American Society of Civil Engineers estimates an existing underfunded infrastructure gap of more than $2 trillion, with 43% of US roads in disrepair and water-treatment plants losing six billion gallons daily to the environment. Outside of tax-exempt issuance, the primary public alternative for bridging this gap would be direct federal or state funding.

Other approaches to infrastructure financing include private investment and direct government subsidies. Certain public-private partnerships (PPPs), for example, use tax-exempt bonds to offset a project's other debt interest. Besides lower costs for end users, such as for a toll road, PPPs can encourage more corporate investment in infrastructure. We favor such partnerships, especially as an alternative to taxable debt.

Direct government subsidies are another approach to state and local funding, with Build America Bonds (BABs) as a prime example. Introduced during the 2008 financial crisis, BABs were intended to help municipalities finance capital spending during economic rough patches, but their interest isn't tax exempt. Instead, the federal government subsidizes bondholders a portion of their earned interest—35% originally. But the BAB subsidy level isn't guaranteed and has shrunk significantly, along with the bond's popularity.

One Potential Tax-Exemption Target: Private Activity Bonds

Considering how much is at stake in practically every constituency, legislators may prefer to just chip away at the exemption, targeting certain types of municipal bonds rather than the entire market. We saw this in the "red wave" of 2017, when Congress discussed many potential targets but settled on nixing the tax exemption on new pre-refunded bonds. This time around, we think the scope could similarly focus on private activity and not-for-profit tax-exempt muni bonds.

Most private activity bonds (PABs) finance projects that benefit the public, but they also involve a private entity. PABs play an important role in the US economy by helping to finance airports, shipping ports, roads and energy infrastructure, while benefiting everyone who uses such infrastructure.

PAB interest is also exempt from federal income tax, although individuals subject to the alternative minimum tax (AMT) generally do pay taxes on it.*

PABs have historically helped rebuild from tragedies. For example, Midwestern Disaster Area Bonds helped states recover from 2008's widespread storms and tornadoes, the Gulf Opportunity Zone Act of 2005 helped rebuild after Hurricane Katrina, and Liberty Bonds were used to help New York City recover from the September 11 terrorist attacks.

Another Potential Target: Not-for-Profit Tax-Exempt Bonds

Another critical supplier of infrastructure investment comes from not-for-profit, 501(c)(3) entities that assist Americans in multiple ways. The tax exemption on these bonds has encouraged steady investment in their efforts.

Not-for-profit issuers include nearly two-thirds of all US hospitals, charter schools in lower-income and middle-class communities, and senior living facilities that house hundreds of thousands of seniors.

Both PABs and not-for-profit munis help bring public and private entities together to grow the economy. Accordingly, we think there's a stronger argument to expand their use to enhance growth than to reduce infrastructure spending by eliminating their tax exemption.

In our view, tax exemption is much too important to lose. While imperfect, its lasting benefits outweigh the near-term loss in revenues, given how much US infrastructure is financed by muni debt. We think a wholesale elimination is unlikely and that any targeted elimination would affect future issues only, as was the case for pre-refunded bonds in 2017. Meanwhile, tax exemption is alive and well, though we think muni investors should stay tuned in to the conversation as lawmakers ponder its future.

*About 60% of airport and 40% of shipping port PABs are subject to AMT, representing more than $200 billion in outstanding municipal bond debt.

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