Muni Bonds Deserve a Tax Break: Obama's proposal to limit the municipal-bond tax exemption would raise the cost of public works.

President Obama’s budget, introduced in April, includes proposals to attract private investment in partnership with government for upgrading the nation’s infrastructure. As he said in his State of the Union address, “what our businesses need most [are] modern ports to move our goods, modern pipelines to withstand a storm, and modern schools worthy of our children.”

State and local governments are crucial for achieving the president’s goals. Three-quarters of all U.S. public infrastructure projects are built by state and local governments, and tax-exempt municipal bonds are the primary means to finance them. Unfortunately, the president’s budget includes a provision to limit the tax-exempt status of these bonds.

This would make it more costly for governments, and ultimately taxpayers, to improve America’s roads, ports, bridges, schools, hospitals, and even its water and wastewater systems.

The municipal bond market has functioned effectively for much of U.S. history, and one important reason was the agreement reached between states and the federal government a century ago that the interest on these bonds would never be subject to the income tax. Tax exemption was an integral part of the debate on the adoption of the 16th Amendment, which authorized the federal government to tax income.

Because municipal bonds have a strong repayment record—much higher than corporate bonds—they provide a safe and reliable investment income for U.S. citizens. More than 60% of municipal bonds are owned by individuals, directly or through mutual funds. The federal tax exemption makes them attractive to all investors, especially those whose income is taxed at high rates.

That would all change if the president’s proposal—which would cap the tax exemption at 28% for the top 2% of income earners. Consider someone in the 39.6% bracket earning $100,000 in municipal-bond interest; he currently pays no federal income taxes on that interest. After a 28% cap, he will pay $11,600 in federal income taxes—and demand a higher return to offset the tax burden.

Limiting the tax exemption would reduce investor demand for municipal bonds and raise the interest states and localities would have to offer to attract the investments they need. Had the tax-exemption limit been in place from 2003-2012, it would have cost state and local governments an additional $173 billion of interest on infrastructure investments, according to an analysis by the Securities Industry and Financial Markets Association. These added costs mean higher taxes.

Worse, the tax cap proposed by the president would apply to interest income on bonds that people have already purchased. That will disrupt the bond market, because the value of bonds held by all investors will decline. The change to 100 years of tax policy also would introduce an unwelcome uncertainty into an efficient public-private system. Investors would demand higher rates simply to protect them from future tax shocks.

One estimate by Citigroup Municipal Strategists puts the tax-risk premium alone at 30-40 basis points, and we've already had a demonstration of what could occur. Further analysis by Citigroup showed that the municipal bond market experienced dramatic rate increases of between 20 and 50 basis points depending on the quality of the bonds in December. The increase was directly related to proposals made during the fiscal-cliff debate to cap the municipal-bond tax exemption.

Washington's renewed focus on rebuilding and improving the nation's infrastructure is welcome, and so is the search for new ways to meet the challenge. However, any new tools must be in addition to—not instead of—the primary financing mechanism that state and local governments have used to meet the needs of their citizens. Let's not dismantle something that works.

Ms. Ganeriwala is treasurer of Virginia and president of the National Association of State Treasurers.