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Are Muni Bonds an Income Equalizer?

A surprising look at who owns and who benefits the most from tax-exempt debt.

Income inequality has reemerged as the central issue in American politics. States and localities across the country are considering a variety of responses, including raising the minimum wage, enacting rent control and expanding affordable housing. But how will we pay for these responses?

Advocates for the “99 percent” have built a simple and compelling story: They blame their situation on taxes, the super-fortunate “1 percent” and a broken promise. For decades, the story goes, the lower and middle classes permitted the rich to pay less than their fair share of federal taxes. More money in the private economy was supposed to mean stronger economic growth, more jobs and better opportunities for everyone else. But instead of reinvesting in America, the 1 percenters took the money and ran. Now the 99 percent want to put an end to tax exemptions, credits and other “tax preferences” that have done little to help them.

Among these taxes are the “muni exemption” that excuses investors from paying federal income taxes on the interest they collect on investments in state and local government bonds. That interest rate is, of course, lower than it would be for a corporate bond. The exemption has been part of the federal tax code for as long as we’ve had a federal income tax. It’s a natural target because conventional wisdom says municipal bonds mostly benefit rich folks who can afford to buy them. President Obama seems sympathetic to this argument and has floated his own plans to reform the exemption.

As it turns out, some new academic research sheds light on this issue. In a new paper, researchers Dan Bergstresser of Brandeis University and Randy Cohen of Massachusetts Institute of Technology ask a simple but often overlooked question: Who actually owns municipal bonds? To get at the answer, they analyzed 25 years of detailed data on individual households’ finances. They found that municipal bond ownership has in fact become more concentrated with the wealthy. The top 1 percent of households by total wealth owned about one-quarter of all municipal bonds in 1989. By 2013 they had upped that edge to around 42 percent.

Ironically enough, this concentration of investment has a lot to do with our past attempts to reduce inequality. From 1989 to 2013, tax-deferred retirement accounts like 401(k)s and IRAs became the savings vehicle of choice for the middle class. Before those tools were available, regular folks often bought municipal bonds as a tax-free way to save for retirement or for college. Today they can buy stocks and other taxable assets through a tax-free retirement account and realize a much better return on investment. Municipal bonds with their tax-free but lower interest rates make a lot of sense for rich people, but now the middle class have better options.

So if the 99 percent don’t benefit from the muni tax exemption, what else is in it for them? That’s the focus of a paper published in 2014 by a team of researchers from the Urban-Brookings Tax Policy Center. They looked at data from individuals’ tax returns to see the muni exemption’s direct and, more important, indirect effects. They too found the wealthy realize most of the tax benefits. However, their results also show that low-income taxpayers gain substantial indirect benefits, equal to as much as 15 percent of their total income.

How do these indirect benefits work? Simply put, the muni exemption reduces a government's cost to deliver basic public services more than it reduces the taxes paid by the rich. It allows public school districts to finance new school buildings at lower interest rates, so they do. Same for roads, transit systems, bridges and many other basic public services that the 99 percent use every day. It also shifts some of the 1 percent's attention away from corporate bonds and stocks, and that makes those investments even better: Through their 401(k)s and IRAs, lower- and middle-class folks can own them tax-free.

Tax reform can and perhaps should be a part of our policy response to income inequality. But that reform should follow from a compelling story that takes account of all the facts. This is especially true of the muni exemption's story.

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