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Hundreds of Local Officials Defend Municipal-Bond Tax Exemption.

WASHINGTON — The prospects for a tax overhaul this year are nil, yet hundreds of state treasurers, mayors and other officials are mobilizing to protect a cornerstone of the $3.9 trillion market for municipal debt: the tax breaks the bonds offer investors.

Some 600 state and local officials are calling on Congress to stay away from taxing the interest paid to municipal-bond investors, warning the municipal market is a vital mechanism for financing schools, roads, transit systems and other infrastructure projects that create jobs. They fear Congress may try to do just that in 2017.

“Proposals to change this commitment to tax-free municipal bonds would not only be costly for state and local taxpayers, but also result in fewer projects, fewer jobs and further deterioration of our infrastructure,” the officials wrote in a letter they plan to send Wednesday to top lawmakers on the tax-writing committees of the House and Senate.

The letter, organized by the National Association of State Treasurers, reflects a heightened state of anxiety among officials in states and localities that Washington policy makers will move to limit or kill the exemption, after years of trying—and failing—to do so.

While no broad tax-code overhaul is expected this year, state and local officials are taking pre-emptive steps to protect their bonds’ tax exemption from any deal that might materialize down the road.

President Barack Obama has repeatedly advanced the idea of capping the tax exemption on the grounds that too much of the roughly $30 billion a year in forgone federal tax payments from a century-old interest exemption goes to higher-income households. Top lawmakers in both parties have said they, too, are willing to consider curbing the bonds’ tax-exempt status.

Investors are willing to accept lower yields for municipal bonds than corporate debt because their interest income is exempt from federal income taxes as well as taxes in the state in which the bonds were issued. In some high-tax areas, such as California, the bonds are also exempt from local income taxes.

By exempting municipal bond interest from federal taxes, the government creates an incentive for investors to buy them, which helps hold down the borrowing costs of the states, cities and other entities that issue them. Curbing the exemption would likely reduce demand for the bonds, pushing those borrowing costs higher, critics say.

Mr. Obama’s proposal, floated several times since 2011 including in a budget he released last month, would place a 28% cap on the tax exemption for interest earned on municipal bonds. That means a wealthy household—in a top tax bracket of 35%—with $100,000 in previously tax-free municipal-bond interest income would have to pay 7% in taxes, reducing their income from the bonds to $93,000.

Capping or eliminating the tax-exemption would hurt taxpayers in every state, the officials wrote, because “municipalities will have to either curtail infrastructure projects or raise taxes on sales, property or income” to attract investors.

State officials said the harm is more than theoretical: In December 2012, the municipal market experienced a spike in rates as investors recognized a cap on exemption was under consideration, they said.

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