Bond Case Briefs

Municipal Finance Law Since 1971

Why Report Suggests Muni Tax Exclusion Be Limited or Eliminated.

WASHINGTON – Lawmakers should consider limiting, reforming or eliminating the tax exclusion for municipal bond interest, the Tax Foundation suggested in a report.

The report, called "Reexamining the Tax Exemption of Municipal Bond Interest" was authored by analyst Scott Greenberg.

The report argues that tax-exempt bonds: can encourage municipalities to over-invest in infrastructure; are inefficient when comparing foregone federal government revenue and state and local borrowing costs; and can unfairly benefit taxpayers in higher income brackets.

"The U.S. tax code is badly in need of reform, and any tax reform effort will need to limit or eliminate tax expenditures in order to broaden the federal tax base," the group said in the report. "As Congress moves forward with discussions about tax reform, it should keep every tax provision on the table, including the exclusion of municipal bond interest."

The report does not make any recommendations for lawmakers, but suggests they consider the "flaws and drawbacks" of the muni exemption in potential tax reform legislation.

It also asks lawmakers to consider three questions: should the federal government subsidize state and local borrowing; should the subsidy take the form of a tax exclusion; and is the current treatment of muni bond interest efficient and equitable.

Greenberg, who also published analyses on the GOP blueprint for tax reform released in June and the tax reform plan proposed by Rep. Jim Renacci, R-Ohio, earlier this month, said in the 12-page report released on Thursday that the muni exemption is an "unideal policy design" for subsidizing state and local debt because it provides larger benefits for taxpayers in higher income brackets and smaller benefits for those in smaller tax brackets. It also shuts some investors completely out of the muni market such as those who do not pay taxes, foreign investors and pension funds, he added.

Greenberg said that while tax-exempt munis encourage states and localities to invest in infrastructure, they also can cause these governments to over-invest, especially when the tax burdens are placed on nonresidents.

For example, he said if a state is considering spending $10 million on a new highway that will only provide $9 million in economic benefits it may decide not to move forward. But if the state receives a $1.5 million subsidy from the federal government, it may go forward with the project "even though the highway is a socially wasteful investment," he wrote.

The report also said the "most compelling case" that the tax-exempt standing of munis is inefficient, is that for every dollar of revenue the federal government forgoes because of the muni exemption, state and local governments receive less than a dollar in lower borrowing costs.

Citing a 2015 Treasury Department estimate, the report says the federal government will forgo as much as $617 billion in revenue over the next 10 years by excluding interest on munis. It is one of the largest tax expenditures in the individual income tax code, Greenberg said.

Not all munis are used for public purposes, the report pointed out. State and local governments issued $421 billion in tax-exempt bonds in 2013. Of that figure, $340 billion or 80.6% were governmental bonds and $81 billion of 19.4% were private activity bonds, which benefit private parties. This ratio is fairly typical," the report said. Between 1991 and 2013 governmental bonds accounted for 75.3% of all tax-exempt bonds issued and the other 24.7% were PABs, it said.

In addition, the report said, the majority of tax-exempt bonds are issued in a few states: California, New York, Texas, Pennsylvania, Illinois, Ohio and New Jersey.

Greenberg told The Bond Buyer that the report stems from the fact that the Tax Foundation researches parts of the tax code that "haven't been sufficiently researched or discussed," before compiling reports like this one.

"My personal opinion was that the conversation about the tax exemption of munis was an important one," he said.

The report was met with opposition from Bond Dealers of America, which warned that even just limiting the muni exemption could increase infrastructure costs by more than 10%. BDA and other muni groups contend munis are cost effective in helping to finance infrastructure projects.

Jessica Giroux, general counsel and managing director of federal regulatory policy for BDA, said that eliminating or limiting the muni exemption would pass increased infrastructure costs onto both those who invest in municipal bonds and taxpayers.

"Stripping the muni tax exemption would have a devastating fiscal impact on local governments and their ability to meet the needs of their citizens," she said. "When put in the context how to reform the federal tax code, this is not a change in the law that we believe many taxpayers would support."

Giroux said that munis are crucial to funding better roads, water systems, schools and "other vital components of daily life."

"There continues to be a tremendous need in every state to repair existing and build new infrastructure," Giroux said. "Municipal bonds continue to be the primary mechanism state and local governments turn to to finance those infrastructure needs."

The Tax Foundation report comes less than a week after BDA sent a letter to House Speaker Paul Ryan, R-Wis., and Rep. Kevin Brady, R-Tex., the House Ways and Means Committee chairman, that says any repeal of the tax exemption for munis would cost state and local governments an additional $495 billion in interest over a ten-year period.

The GOP plan does not mention munis directly, but it calls for limiting or eliminating unnamed deductions, exclusions and credits. Several muni groups, including BDA and the Government Finance Officers Association, have expressed concern that munis may be included as the plan is amended before Republicans hope to introduce formal tax legislation next year.

Renacci's plan, released on July 14, would replace the corporate income tax with a consumption tax but would maintain the muni exemption.

The Tax Foundation report's suggestions echo those of other reports released in recent years. The

Simpson-Bowles Commission on Fiscal Responsibility and Reform in 2010 also called for eliminating the tax-exempt status of all new municipal bonds. The Bipartisan Policy Center’s debt reduction task force had earlier called for eliminating the tax exemption for new private activity bonds.

The Bond Buyer

By Evan Fallor

July 22, 2016