
The Municipal Bond Industry Responds to Tax Foundation's Recent Paper.

Last week, the Tax Foundation released a paper titled, "Reexamining the Tax Exemption of Municipal Bond Interest," which argued that lawmakers should consider reforming the current tax treatment of municipal bond interest. Apparently, the municipal bond industry is less than thrilled with our report: yesterday, *The Bond Buyer* published an article titled, "Why the Tax Foundation Report on Munis is 'Woolly-Headed,' " which quotes several individuals who take issue with our analysis.

Here are a few selections from the article:

> Advocates for maintaining the tax-exempt status of municipal bonds are firing back after a Tax Foundation report last week concluded lawmakers should consider limiting, reforming or eliminating the muni exemption…
>
> "This is a classic woolly-headed, ivory tower analysis," said Chuck Samuels, a member of Mintz, Levin, Cohn, Ferris, Govsky and Popeo. "Tax exempts might cause state and local governments to over-invest in infrastructure? Does anyone feel like their pot holed, overcrowded roads, mass transit and airports are over-invested?"…
>
> John Vahey, director of federal policy for Bond Dealers of America, also disagreed with the opinion that municipalities may be prone to overinvesting in infrastructure. "We think the notion that there is an overinvestment in infrastructure in the U.S. generally right now is a fallacy," Vahey said. "You just need to point to the glaring need to rebuild roads and bridges as well as grades and reports by engineering organizations that analyze the condition of infrastructure."

Most of the negative reactions in the article seem to be directed at one specific argument in the paper: that the tax exemption of municipal bond interest could lead state and local governments to overinvest in infrastructure. To illustrate this concern: it would be socially wasteful for a state government to spend $10 million on a highway project that delivers only $9 million in economic benefits, but the state government might undertake such an investment if the federal government provided it with a $1.5 million subsidy, in the form of a tax exemption.

As an aside, I'll note that this is not an imaginary, theoretical concern. State and local governments have spent over $6 billion on pro football stadiums since 1995, despite questionable public benefits. There is an entire book about how states and localities spend far too much money building new convention centers.

But the individuals quoted in *The Bond Buyer* article seem entirely unconcerned with the possibility that states and localities might invest in infrastructure projects with high costs and low benefits. Instead, they are worried about the opposite scenario: that state and local governments are currently passing up urgent opportunities to invest in infrastructure projects with high benefits and low costs.

Here’s my question: if there’s a “glaring need” for more infrastructure investment, why aren’t state and local governments already filling that need? If there are urgent infrastructure projects with high potential benefits and low costs, why do state and local governments need a federal subsidy to invest in them?

I suspect that the reason why state and local governments aren’t investing as much in infrastructure as Chuck Samuels and John Vahey would like is because *state and local voters aren’t willing to foot the bill*. And there’s the rub.

Supporters of the federal tax exemption of municipal bond interest are essentially making the case that 1) state and local voters are missing a great opportunity to reap large economic benefits at minimal costs, and that 2) the federal government should step in to nudge their decision-making in the right direction, by continuing to subsidize their infrastructure spending.

This is an entirely valid argument, but it assumes that the federal government has a better understanding of what infrastructure should be built than state and local voters do. If this is the case, why have the federal government subsidize state and local infrastructure projects? Why not argue for the federal government to increase its own direct spending on infrastructure?

In other words, it is either the case that 1) the federal government has a better idea of what infrastructure should be built, and it should purchase the infrastructure itself, or 2) state and local governments have a better idea of what infrastructure should be built, and the federal government should not subsidize them. Either way, a federal tax exclusion for municipal bond interest seems like an unideal policy.

Notably, no one quoted in *The Bond Buyer* article yesterday took issue with the other central claim in the Tax Foundation’s report: that the current tax exemption of municipal bond interest is a poorly designed, inequitable, and inefficient tool for subsidizing state and local infrastructure.

The Tax Foundation

By Scott Greenberg

July 27, 2016