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Interest Costs Could Eat Into City, State Budgets If Tax Exemption Is Axed.

Cities like Chicago, Atlanta and Houston, which already spend a substantial chunk of revenue to cover interest on their bond debt, could face more budget strains if Congress moves to strip the tax exemption from municipal bonds.

That's according to the Tax Policy Center, which examined which large cities and states already face relatively high interest costs in a March 13 blog on the muni bond tax exemption.

TPC senior research associate Thomas Brosy, who wrote the piece, said it came about after he saw the exemption named in a list of potential revenue raisers floated by House Republicans in January.

"I felt it was worth exploring a little more what it would mean for specific states and cities – I was interested in doing a shallow dive into the variation in interest burdens," Brosy said, adding that he hopes the blog would "present some new facts for people interested in this issue."

The blog is part of a drumbeat of data and reports centered on the costs and benefits of the municipal bond tax exemption as Congress tackles a massive tax package. The municipal market lobby is relying on pro-exemption arguments, including first-of-its-kind data from the University of Chicago, that illustrate how borrowing costs would rise for various cities and states if the exemption is eliminated. In aggregate, elimination of the tax-exemption would raise borrowing costs $823.92 billion between 2026 and 2035, according to the Government Finance Officers Association.

Those larger borrowing costs could become a "significant chunk" of the budgets of large cities, some of which have interest costs that already account for a double-digit share of expenditures, the Tax Policy Center found.

Brosy examined cities with populations over 500,000, and found that as of 2022, they had an average share of interest expenditures – on general obligation and revenue bonds combined – of about 5.6%, but with significant variation.

Atlanta, Houston, and Chicago had shares over 10%, while New York had a 6% share. Those cities are followed by Phoenix, El Paso, Dallas and Portland, Ore.

"I was surprised by how large the share was in terms of expenditures for some cities and states," Brosy said.

New York, Illinois, Colorado, and Connecticut had the largest share of combined state and local interest. Connecticut by far had the largest share of interest on state debt, at more than 6% of its total expenditures, followed by Massachusetts, New York and Illinois.

Total interest expenditures in 2022, the latest year that U.S. Census Bureau numbers were available, averaged about 2.8% in the U.S., the blog said.

Interest on debt for state and local governments totaled $120 billion that year.

Brosy urged Congress to consider the pros and cons of the muni tax exemption. On the con side, it may not be the most efficient subsidy, as "the cost to the federal government is larger than the benefits received by state and localities," he said. And the wealthiest 0.5 percent of investors had a 42 percent holding share in 2013.

On the pro side, repealing the exemption could lead to an increase in state or local taxes or spending cuts to maintain infrastructure, and the move may lead to less infrastructure investment overall, he said.

By Caitlin Devitt

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