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Eliminate the Income Tax Exclusion for Municipal Bond Interest: Tax Foundation

The exemption for municipal bond interest has been a feature of the individual income tax since its inception in 1913. It provides an indirect tax subsidy to state and local governments by reducing their borrowing costs. The tax exemption incentivizes investors to accept lower interest rates on tax-exempt bonds than on taxable bonds. The lower interest rate offsets much of the tax benefit for investors, who tend to be high-income individuals and corporations, allowing state and local governments to capture the benefit.

This option eliminates the tax exclusion for municipal bond interest on a prospective basis. This would increase marginal tax rates on individual and corporate income, resulting in a small negative effect on total economic output. It would also increase borrowing costs for state and local governments.

On a conventional basis, this option would decrease the primary deficit by $157.8 billion over the budget window. Long-run GDP would fall by less than 0.05 percent, while long-run GNP would rise by less than 0.05 percent. On a dynamic basis, the primary deficit would decrease by $155.2 billion from 2027 through 2036, $2.6 billion less than the conventional estimate. Incorporating changes in interest costs, the publicly held debt-to-GDP ratio would be lower than baseline, reaching 174.2 percent by 2056.

On average, in 2036, taxpayers would see decreases in their after-tax incomes of 0.1 percent. The top quintile of taxpayers would experience a 0.1 percent decrease, and the bottom quintile would also experience a 0.1 percent decrease. On a long-run dynamic basis, taxpayers would see a 0.1 percent decrease on average.

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