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Key Issues in Tax Reform: Federal Subsidies for Interest Income Generated from Municipal Bonds

Changes to tax expenditures have been a core component of several recent tax reform proposals. Tax expenditures are special provisions that move the tax code away from a "theoretically normal" tax system. In most cases, these special tax provisions result in a revenue loss for the federal government. Among the tax expenditures modified by tax reform proposals in the 115th Congress are the exclusions for interest income generated from certain state and local bonds. State and local (municipal) governments issue bonds to investors to finance investments in exchange for interest payments and the eventual repayment of the principal (amount borrowed).

Current Law

The federal government subsidizes state and local debt through three policies: (1) all interest income earned from public purpose bonds is excluded from federal income taxation; (2) a tax credit may be claimed on interest income in lieu of the exclusion in some cases; and (3) interest income earned from qualified private activity bonds (PABs) is excluded from federal regular income taxation.

Table 1. Estimated Combined Expenditures on Federal Bond Subsidies, FY2016-FY2020
(billions of dollars)

	Reduced Revenues	Increased Outlays	Total
Tax-Exempt Bonds	194.7	-	194.7
Tax Credit Bonds	1.8	24.0	25.8
Qualified PABs	60.8	-	60.8

Source: JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020,* December 2016.

Table 1 shows Joint Committee on Taxation (JCT) estimates of the budgetary effects of federal bond subsidies from FY2016-FY2020. The federal bond subsidies are projected to provide a total of $281.3 billion in benefits over five years. That annual subsidy represents roughly 2% of the current municipal debt stock: the Federal Reserve estimated that state and local governments had $3.05 trillion in debt issuances outstanding in the first quarter of 2017.

Tax-Exempt Bonds

Bonds are considered to be for a public purpose if they satisfy either of two criteria: (1) less than 10% of the proceeds are used directly or indirectly by a non-governmental entity; or (2) less than 10% of the bond proceeds are secured directly or indirectly by property used in a trade or business. Bonds that satisfy either test are termed "governmental" bonds and can be issued without federal restriction. The federal government subsidizes the cost of governmental bonds by excluding interest income earned by investors on those bonds from federal income taxation. The exclusion lowers the cost of debt for state and local governments by allowing them to borrow at lower interest rates than would otherwise apply if the interest income were taxable.

The lower cost of capital arises because in most cases investors will be indifferent between taxable and tax-exempt bonds of equivalent risk if their after-tax return is identical. For example, consider a taxpayer in the 35% tax bracket who is considering investing in a taxable bond with a 10% interest rate and a tax-exempt bond with a 6.5% interest rate. The taxability of the bond with the 10% interest rate makes the investor's after-tax income identical to that of the tax-exempt bond with a 6.5% interest rate. Thus, state and local governments could raise capital from investors at an interest cost 3.5 percentage points (350 basis points) lower than a borrower issuing taxable debt.

The direct cost to the federal government of tax-exempt bonds is the individual and corporate income tax revenue forgone. In the example above, the taxable bond with a 10% interest rate would have generated federal tax liability equal to 3.5% (or 35% x 10%) of the bond's principal value each year.

Tax Credit Bonds

Tax credit bonds (TCBs) are an alternative to tax-exempt bonds. TCBs provide a tax credit or direct payment proportional to the bond's face value in lieu of the tax exemption. Unlike tax-exempt bonds, the value of the credit (and subsequent cost to the federal government) is not dependent on the investor's marginal income tax rate.

Most TCBs are designated for a specific purpose. For example, TCBs have been used by issuers for financing public school construction and renovation, clean renewable energy projects, refinancing of outstanding government debt in regions affected by natural disasters, conservation of forest land, investment in energy conservation, and economic development purposes.

All of the TCBs currently in circulation were established as temporary tax provisions. Many recent TCBs are not eligible for new issuances, due either to the expiration of issuing authority or to full subscription of the TCB issuing limit. Bonds that are no longer issued may still be held by the public. The relative appeal of TCBs and tax-exempt bonds varies with bond interest rates, tax status of the investor, and underlying economic conditions.

Qualified Private Activity Bonds

Bonds that fail both public purpose tests are termed private-activity bonds (PABs) because they provide significant benefits to private individuals or businesses. These projects are generally ineligible for tax-exempt financing. Activities that fail each test but that Congress considers to provide both public and private benefits are categorized as *qualified* and can be financed with qualified PABs, which are tax exempt. Only qualified activities included in the federal code can be financed with tax-exempt PABs.

Qualified PABs are subject to restrictions that do not apply to governmental bonds, such as being required to include subsequent interest income in the alternative minimum income tax (AMT) base. Some qualified PABs are also subjected to an annual, state-specific issuance cap intended to limit the benefits provided through the subsidy. The value of bonds issued for some of these activities by all governmental units within a state was limited to the greater of $100 per resident or $305.3 million in 2017. Qualified PABs issued for several activities are not subject to the cap, including for all bonds issued for government-owned facilities.

Recent Reform Proposals

Tax reform proposals in the 115th Congress have included several modifications to the exclusion for bond interest income. H.R. 1, as reported by the Committee on Ways and Means, would eliminate the ability to issue TCBs and qualified PABs beginning in 2018. H.R. 1 would also repeal the exclusion of interest income earned on advance refunding bonds from federal income taxation. Refunding bonds are bonds that are typically issued to replace outstanding bonds with bonds that carry more favorable terms; advance refunding bonds are refunding bonds that are issued in such a way that both the original and refunding bonds are outstanding for a period of time. Finally, H.R. 1 would amend the definition of *tax-exempt bonds* so that issuances for the construction of professional sports stadiums do not qualify for the exemption. The JCT estimated that those proposals would increase revenues by a combined $56.9 billion over the FY2018-FY2027 window.

The Senate Finance Committee chairman's mark to the "Tax Cuts and Jobs Act" as scheduled for markup the week of November 13, 2017, would repeal the income exclusion for advance refunding bonds but would make no other changes to federal bond subsidies, including to TCBs and qualified PABs. The JCT estimated that the proposal would increase revenues by $16.8 billion over the FY2018-FY2027 period.

The Congressional Budget Office published an option modifying the bond exclusion in its December 2016 *Options for Reducing the Deficit* report. That option restricts the tax exemption for future municipal debt issuances to governmental bonds only. The JCT estimated that proposal would increase revenues by $27.5 billion over the FY2017-FY2026 period.

Policy Issues

Certain goods and services provided by state or local governments benefit both residents, who pay municipal taxes, and nonresidents, who pay minimal if any municipal taxes. State and local taxpayers may be unwilling to provide these services to nonresidents without compensation, which could cause the services to be underprovided relative to their public benefits. In theory, the cost reduction provided by the exemption of interest income compensates state and local taxpayers for benefits provided to nonresidents.

It may be appealing to finance public capital facilities over a long period of time to match the period over which those facilities provide services. This is particularly true for state and local governments, whose taxpayers lay claim to the benefits from these facilities through residency and relinquish benefit claim when they move. State or local officials may therefore elect to match the timing of the payments to the flow of services, precisely the function served by long-term bond financing. Federal subsidies for municipal debt encourage state and local governments to engage in more debt financing.

State and local governments are also faced with the necessity of planning their budget one to two years in advance, and often are required to balance some or all of their incoming and outgoing payments. Unforeseen circumstances can undermine such plans and cause a revenue shortfall, which must be financed with short-term borrowing. Even when forecasts are met, timing issues may create the necessity to borrow within an otherwise balanced fiscal year. Finally, temporarily high interest rates that prevail at the time bonds are issued may induce short-term borrowing in anticipation of a drop in rates. Federal subsidies reduce the costs of these activities, though the economic rationale behind the transfer of such costs from municipal taxpayers to federal taxpayers is less clear.

Critics of the subsidies for municipal debt believe that they represent a suboptimal allocation of federal resources. Spending incurred for one program directly reduces amounts available for others, and some observers believe that the subsidies for municipal debt could be better used on some combination of direct federal investment in municipal infrastructure, other federal programs, or deficit reduction. Moreover, since the amount of capital investors are willing to loan is limited, offering subsidies for municipal debt may increase the interest costs for other types of debt issuances, including for federal borrowing and private financing.

The bond subsidies also affect the distribution of the federal tax system. Benefits from tax-exempt bonds and qualified PABs are directly proportional to the investor's marginal tax rate, meaning that higher-income taxpayers benefit more than lower-income taxpayers using the program. Higher-income taxpayers also tend to have more disposable capital to loan to municipal governments, making them more likely to receive such benefits even without the incremental marginal tax benefits described above.

Grant A. Driessen, Analyst in Public Finance

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