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IN FOCUS

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Selected Issues in Tax Reform: Federal Subsidies for Municipal Bond Interest

The federal tax code includes subsidies for interest income earned on state and local (municipal) bonds. Municipal governments issue bonds to investors to finance investments in exchange for interest payments and the eventual repayment of principal (the amount borrowed). Federal bond subsidies have been subject to sustained legislative interest, including changes enacted by P.L. 115-97 (often referred to as the Tax Cuts and Jobs Act, or TCJA) and the Infrastructure Investment and Jobs Act of 2021 (IIJA; P.L. 117-58). This In Focus summarizes the subsidies provided under current federal law, discusses changes enacted in recent Congresses, and briefly examines relevant policy issues.

Summary and Legislative Background

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) interest income earned from qualified private activity bonds (PABs) is excluded from federal regular income taxation; and (3) a tax credit may be claimed on interest income in lieu of the exclusion in some cases, though authority to issue new tax credit bonds has expired.

Table 1. Projected Tax Expenditures on Federal Bond Subsidies, FY2024-FY2028

Billions of dollars

	Reduced Revenues	Increased Outlays	Total
Tax-Exempt Bonds	131.0	—	131.0
Qualified PABs	49.9	—	49.9
Tax Credit Bonds	1.5	13.3	14.8

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2024-2028,* JCX-48-24, December 2024.

Table 1 shows Joint Committee on Taxation (JCT) estimates of the budgetary effects of federal bond subsidies from FY2024 to FY2028. The federal bond subsidies are projected to provide a total of $196 billion in benefits over five years. That annual subsidy represents about 1% of the current municipal debt stock: the Federal Reserve estimated that state and local governments had $3.3 trillion in debt issuances outstanding in the last quarter of 2024.

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 nongovernmental 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 called "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 interest rates arise 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 37% tax bracket who seeks to invest in a taxable bond with a 10% interest rate or a tax-exempt bond with a 6.3% 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 6.3% interest rate. Thus, state and local governments could raise capital from investors at an interest cost 3.7 percentage 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, a taxable bond with a 10% interest rate would have generated federal tax revenue equal to 3.7% (37% x 10%) of the bond's principal value annually.

Some bonds, called *refunding bonds*, are issued to replace outstanding bonds with less favorable terms. There are two types of refunding bonds: *current refunding bonds*, which are redeemed within 90 days of the refunding bond issue date, and *advance refunding bonds*, which are issued in such a way that both the original and refunding bonds are outstanding longer than 90 days. Only current refunding bonds are eligible for a federal tax subsidy, as P.L. 115-97 repealed the ability to issue tax-exempt advance refunding bonds. Refunding bonds may be issued for public or private purposes.

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. However, 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. About 30 types of issuances are eligible for the qualified PAB subsidy. The IIJA created two new qualified PAB categories (for certain broadband projects and carbon capture facilities) and increased an overall limitation on the issuances available for certain highway and surface transfer facility bonds.

Some qualified PABs are also subject to an annual, state-specific issuance cap intended to limit the benefits provided through the subsidy. The value of bonds issued for these activities by all governmental units in a state is limited to the greater of $130 per resident or $388.8 million in 2025.

Tax Credit Bonds

Tax credit bonds (TCBs) were created as 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 is not dependent on the investor's marginal income tax rate. The relative appeal of TCBs and tax-exempt bonds varies with bond interest rates, tax status of the investor, and underlying economic conditions.

All authority to issue tax credit bonds was repealed by P.L. 115-97, though most TCBs in the tax code were not eligible for new issuances prior to the law's enactment. Outstanding TCBs are still held by the public and thus still receive the federal subsidy. Most TCBs were designated for a specific purpose, including public school construction and renovation, clean renewable energy projects, and refinancing outstanding government debt in regions affected by natural disasters.

Policy Considerations

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, such spillover effects could justify some federal financing for state and local projects.

Subsidizing debt issuance specifically has the benefit of harmonizing the timing of the subsidy with the period over which bond-financed facilities provide services. State and local taxpayers lay claim to the benefits from these facilities through residency and relinquish benefit claim when they move. State or local officials may therefore prefer to spread the timing of the payments more evenly with the provision of services, precisely the function served by long-term bond financing.

State and local governments typically must plan their budgets 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. Timing issues may also 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, as 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 from them than do lower-income taxpayers. Higher-income taxpayers also tend to have more disposable capital to loan to municipal governments, making them more likely to receive such benefits.

Recent Reform Proposals

The Congressional Budget Office published an option in its December 2024 *Options for Reducing the Deficit* report that would eliminate the tax exemption for new qualified PABs. The JCT estimated that proposal would increase revenues by about $43 billion over the FY2025-FY2034 period.

An early version of P.L. 115-97 considered in the House prior to its enactment included language that would have (1) repealed all new issuance authority of qualified PABs; and (2) amended the definition of tax-exempt bonds so that issuances for the construction of professional sports stadiums did not qualify for the exemption. P.L. 115-97 as enacted did not include that language.

Recently introduced legislation that would modify federal bond subsidies has included, but is not limited to

- legislation that would create new qualified PAB categories, including for spaceports (S. 3823 and H.R. 7470 in the 118th Congress) and for replacement of lead service lines in public water systems (S. 726 and H.R. 6985 in the 118th);
- legislation that would expand bond subsidies, including expanded use for tribal governments (S. 5048 in the 117th), reinstatement of advance refunding bonds (S. 1453 in the 118th), and reinstatement of TCBs for certain infrastructure projects (S. 1403 in the 117th); and
- legislation that would restrict bond subsidies, including repealing bond subsidies for sports stadiums (S. 392 and H.R. 993 in the 118th), and denial of bond issuances for certain governments (H.R. 1879 in the 119th).

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