The Impact of Budget Proposals on Tax-Exempt Bonds

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Summary

Under current law, interest income from bonds issued by state and local governments is exempt from federal income taxes. In addition, interest on bonds issued by certain nonprofit entities and authorities is also exempt from federal income taxes. Together, these tax preferences are estimated to generate a federal revenue loss of $309.9 billion over the 2012 to 2016 budget window. Along with this direct "cost," economic theory holds that tax-exempt bonds distort investment decisions (leading to over-investment in this sector). As with many other tax preferences, the income exclusion is being examined as part of fundamental tax reform.

Generally, the tax preference directly benefits two groups: issuers and investors. Issuers, principally state and local governments (but also certain nonprofits and qualified private entities) benefit from a current lower cost of borrowing. Investors, particularly those in the top tax brackets, benefit from mostly tax-free income. In particular, the top 10% of all earners realize more than 77% of the total reported tax-exempt interest income.

This report first explains the tax preference and the distribution of the receipt of tax-exempt interest. An analysis of the impact of several different proposals then follows. Included in this analysis are proposals to (1) cap the benefit at a specific income tax rate (as offered in the FY2013 budget), (2) eliminate the tax preference and lower overall rates (as proposed in the Simpson-Bowles (SB) deficit reduction plan), and (3) change the current tax exclusion for investors to a tax credit (or subsidy) for issuers (as proposed in the Congressional Budget Office (CBO) Revenue Options report). The proposals differ in the relative impact on investors and issuers.

The proposal in the President's FY2013 budget would be felt relatively equally by issuers and investors and would not address the economic inefficiency of using tax-exempt bonds to encourage investment in public capital. The SB tax reform plan would eliminate the tax preference thereby eliminating the economic inefficiency generated by the current tax preference, but would also eliminate the relative benefit of tax-exempt bonds for both issuers and investors. The CBO proposal also eliminates the tax preference for investors, but would preserve the issuer preference albeit at a lower level. The economic inefficiency arising from the current tax preference would also be eliminated by the CBO proposal. The CBO proposal can be modified to yield a roughly equivalent subsidy to the current tax-exempt bond preference for issuers.

This report will be updated as significant new proposals or legislative events warrant.

Contents

Figures

Tables

Contacts

Introduction

The current budget situation has prompted Congress to examine a variety of revenue raising options.[1] Repealing or modifying some or all of the long list of so-called tax expenditures is often included as part of those options.[2] The exclusion from income of the interest paid on state and local government debt is one such tax expenditure.[3] There are three primary types of proposals that include changes to state and local government bonds—capping the preference, eliminating the preference, and changing the preference to a direct issuer subsidy. These three types can be seen in the following proposals. The President's FY2013 budget proposal would include partial elimination of the tax preference by capping the preference at the 28% marginal tax rate. The Simpson-Bowles (SB) deficit reduction plan proposes complete elimination of the tax preference.[4] The Congressional Budget Office (CBO) "Revenue Options" report proposes changing the tax exclusion for *investors* to a direct tax subsidy to *issuers*.[5]

One of the cited reasons for the elimination (or at least modification) of the tax exclusion for interest on state and local government bonds (tax-exempt bonds) is that the preference is a financially and economically inefficient tool for inducing public capital investment.[6] In short, the federal revenue loss is greater than the subsidy to state and local governments. Thus, modifying, eliminating, or reducing the tax preference could generate federal revenue and make the federal tax code more economically efficient.

Policymakers must weigh a variety of competing concerns when evaluating these proposals to modify tax-exempt bonds. Issuers, such as governments and certain private entities, benefit from lower cost of borrowing and relatively high-income investors benefit from the resulting tax-free income. With the proposals presented here, issuers would likely encounter higher borrowing costs and relative wealthy investors would lose a significant tax preference. In particular, the top 10% of all earners realize more than 77% of the total reported tax-exempt interest income. The reduced benefits accruing to issuers and these investors, however, should be weighed against the benefit of a potentially more efficient (and to some, equitable) federal income tax.

[1] For an overview of various approaches, see CRS Report R41970, *Addressing the Long-Run Budget Deficit: A Comparison of Approaches*, by (name redacted).

[2] The FY2013 budget identifies 173 separate tax expenditures. For more on tax expenditures, see CRS Report RL34622, *Tax Expenditures and the Federal Budget*, by (name redacted).

[3] For more on tax-exempt bonds, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by (name redacted).

[4] The White House, The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010, available at http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

[5] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, p. 163. Available at http://www.cbo.gov/doc.cfm?index=12085.

[6] The tax preference delivered through tax-exempt bonds is widely accepted as an economically inefficient tool for encouraging public sector capital investment. For more, see Fortune, Peter, "The Municipal Bond Market, Part II: Problems and Policies," New England Economic Review, May/June 1992, p. 50.

Overview and Background

The impact of changes to the tax treatment of the interest on state and local government debt can be assessed from three perspectives to analyze: the size of the tax expenditure, the distribution of the tax-exempt interest income, and the value of the tax-exemption to issuers.

Size of the Tax Expenditure

The size of the tax subsidy is significant. The Administration's 2013 budget includes a tax expenditure estimate of $227.5 billion for the 2013 to 2017 budget window for public purpose state and local government bonds (**Table 1**).[7] The 2013 budget also estimates that non-governmental tax-exempt bonds (so-called qualified private activity bonds) will generate an additional $78.7 billion in revenue losses over the same time frame.[8] The single largest non-governmental tax expenditure for tax-exempt bonds is for non-profit hospital bonds ($26.9 billion). The column identified "Rank" in **Table 1** is the position of the provision in the list of all 173 federal tax expenditures contained in the 2013 budget.

Table 1. Tax Expenditures for Tax-Exempt Bonds

Rank is Among All Tax Expenditures and Dollar Amounts Are in Millions

		2013		2013-2017	
Rank	**Provision**	**Amount**	**Share of Tax Receipts**	**Amount**	**Share of Tax Receipts**
Exclusion of interest on:					
10	Public purpose state and local bonds	$36,210	1.25%	$227,500	1.33%
35	Hospital construction bonds	4,280	0.15%	$26,890	0.16%
41	Bonds for private nonprofit educational facilities	2,900	0.10%	18,230	0.11%
56	Owner-occupied mortgage subsidy bonds	1,460	0.05%	9,170	0.05%
60	Rental housing bonds	1,240	0.04%	7,790	0.05%
67	Airport, dock, and similar bonds	970	0.03%	6,130	0.04%
76	Student-loan bonds	660	0.02%	4,130	0.02%
80	Water, sewage, and hazardous waste facilities	580	0.02%	3,640	0.02%
92	Small issue bonds	340	0.01%	2,110	0.01%
104	Bonds for highway projects and rail-truck transfer facilities	230	0.01%	1,000	0.01%
131	Energy facility bonds	30	0.00%	200	0.00%

[7] Office of Management and Budget, "Budget of the United States Government: Analytical Perspectives, Supplemental Materials Fiscal Year 2013," Table 17-1.

[8] For more, see CRS Report RL31457, *Private Activity Bonds: An Introduction*, by (name redacted).

Rank	Provision	2013 Amount	2013 Share of Tax Receipts	2013-2017 Amount	2013-2017 Share of Tax Receipts
138	Veterans housing bonds	20	0.00%	140	0.00%
	Subtotal for Qualified Private Activity Bonds	$12,710	0.44%	79,430	0.46%
Grand Total		**$48,920**	**1.69%**	**$306,930**	**1.79%**

Source: CRS presentation of data from Office of Management and Budget, "Budget of the United States Government: Analytical Perspectives, Supplemental Materials Fiscal Year 2013," Table 17-1.

How this tax subsidy is distributed across taxpayers underlies the analysis of the potential impact of tax reform proposals. The President's 2013 budget would cap the exclusion of interest income from tax-exempt bonds at 28%. The Simpson-Bowles (SB) plan would eliminate the income exclusion entirely and lower marginal tax rates. The CBO deficit reduction options report proposes to replace the interest exclusion for tax-exempt bonds with a direct payment to issuers.

Distribution of Tax-Exempt Interest Income

The distribution of tax-exempt interest is skewed to higher income taxpayers because the marginal income tax rates provide a higher after-tax rate of return for these taxpayers. Consequently, proposals that change the tax rules for tax-exempt bonds will have a greater impact on higher-income taxpayers.

The Internal Revenue Service, Statistics of Income Division (SOI), publishes annual summaries of the composition of income for all tax returns. Relatively few returns report earning tax-exempt interest income. In 2009, approximately 4.5% of all returns (6.3 million) reported tax-exempt interest income. As income increases, however, the percentage of returns reporting tax-exempt interest income rises significantly. Almost two-thirds (64.1%) of returns with adjusted gross income (AGI) over $1 million included tax-exempt interest income.[9]

Table 2 presents the distribution of interest income by AGI with a break at the $200,000 income threshold. The $200,000 income level roughly approximates the income threshold at which policymakers have discussed reducing preferences in the tax code—as in the FY2013 budget proposal. In 2009, 80.6% of returns reported AGI under $200,000. These returns with AGI of less than $200,000 accounted for just 50.5% ($37.2 billion) of tax-exempt interest income. The remaining 19.4% of returns with AGI above $200,000 reported 49.5% ($36.4 billion) of tax-exempt interest income.

[9] Adjusted gross income or AGI is a broad measure of income but does not include exclusions such as tax-exempt interest and so-called above-the-line deductions like student loan interest and qualified moving expenses.

Table 2. Returns with Tax-Exempt Interest Income by AGI Class

Data Are for the 2009 Tax Year

	Returns		Tax-Exempt Interest Income	
Adjusted Gross Income	**Number**	**Percent of Total**	**Amount ($ 000's)**	**Percent of Interest Income**
Total	6,255,546	100.0%	73,574,105	100.0%
Returns with AGI Under $200,000				
No adjusted gross income	169,099	2.7%	3,295,942	4.5%
$1 under $5,000	184,782	3.0%	532,652	0.7%
$5,000 under $10,000	190,416	3.0%	654,513	0.9%
$10,000 under $15,000	183,334	2.9%	690,565	0.9%
$15,000 under $20,000	174,936	2.8%	742,563	1.0%
$20,000 under $25,000	173,481	2.8%	901,404	1.2%
$25,000 under $30,000	193,480	3.1%	1,317,972	1.8%
$30,000 under $40,000	348,900	5.6%	1,938,484	2.6%
$40,000 under $50,000	395,746	6.3%	2,301,166	3.1%
$50,000 under $75,000	861,906	13.8%	6,510,415	8.8%
$75,000 under $100,000	727,805	11.6%	5,494,705	7.5%
$100,000 under $200,000	1,436,541	23.0%	12,790,658	17.4%
Total under $200,000	5,040,426	80.6%	37,171,039	50.5%
Returns with AGI Over $200,000				
$200,000 under $250,000	291,534	4.7%	3,410,392	4.6%
$250,000 under $500,000	540,947	8.6%	9,707,487	13.2%
$500,000 under $1,000,000	230,906	3.7%	7,185,390	9.8%
$1,000,000 under $1,500,000	63,126	1.0%	3,315,316	4.5%
$1,500,000 under $2,000,000	28,264	0.5%	1,984,949	2.7%
$2,000,000 under $5,000,000	42,567	0.7%	4,663,281	6.3%
$5,000,000 under $10,000,000	10,900	0.2%	2,266,394	3.1%
$10,000,000 or more	6,876	0.1%	3,869,855	5.3%
Total over $200,000	1,215,120	19.4%	$36,403,064	49.5%

Source: Internal Revenue Service, Statistics of Income Division, Table 1.4, July 2011.

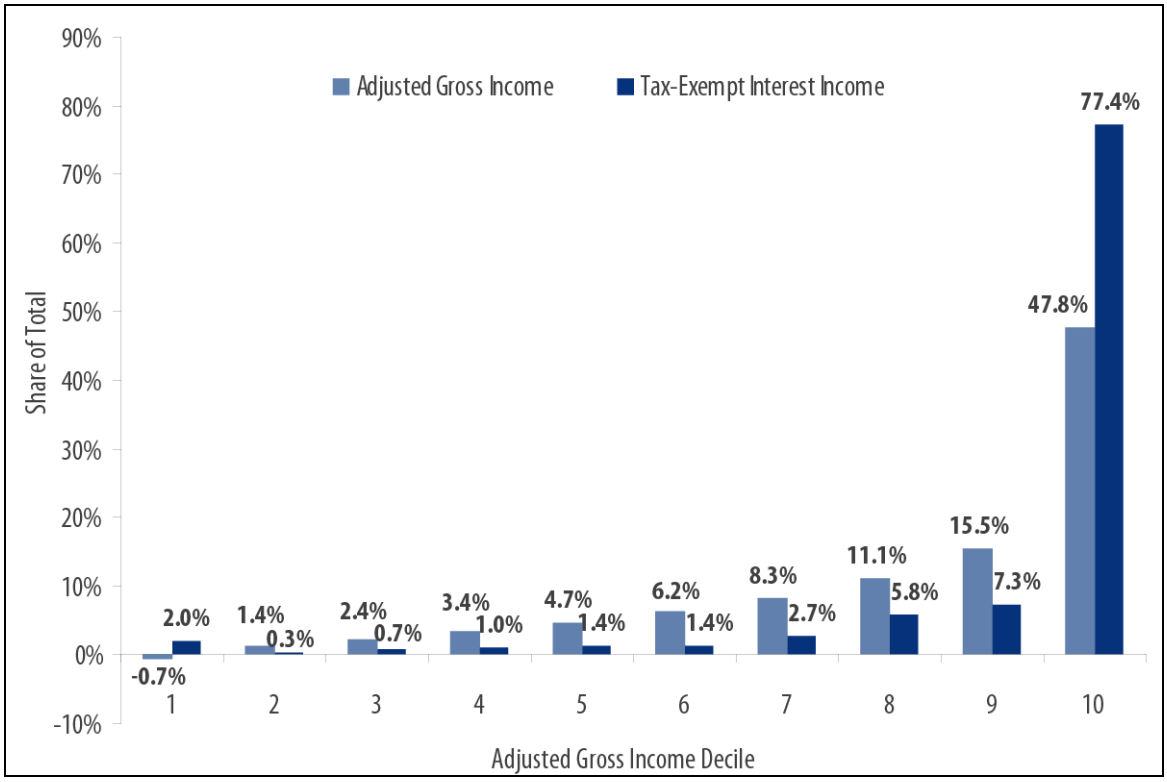
The data by broad AGI groups presented in IRS published reports provides a reasonable assessment of the distribution of tax-exempt interest income. The IRS also releases data for public use that can be organized to address different policy questions. For example, **Figure 1** reports the portion of tax-exempt interest reported by tax return decile for the 2007 tax year. The deciles for the figure are created by sorting all returns by AGI from lowest to highest. The first decile is the first 10% of returns and includes many returns with "negative" income. Each successive decile represents the next 10%. The deciles provide a smoother climb up through the range of AGI. The tenth or highest decile, returns with AGI above $113,400, reported over 77%

of all tax-exempt interest income and exceeded total AGI for the cohort. Interestingly, the bottom decile, with negative aggregate AGI, actually claimed 2.0% of the interest income and was the only other cohort with tax-exempt interest income that exceeded aggregate AGI. This income cohort likely includes filers that in previous years had been in higher income cohorts and are temporarily in this lowest cohort. This cohort also includes retired taxpayers that do not earn wage and salary income.

Within the top decile, tax-exempt interest income is even further concentrated in the top one percent of AGI. In 2007, the top one percent of returns all reported AGI over $407,500 and earned 49.0% of all tax-exempt interest income.[10] Clearly, the benefit of the tax exclusion is concentrated in the upper income groups. Thus, modification of the tax preference will impact this income cohort the most.

Figure 1. Share of AGI and Tax-Exempt Interest Income by AGI Decile

2007 Tax Year



Source: CRS calculations based on data from the SOI Public Use File for 2007.

The Value of the Tax-Exemption to Issuers

Generally, the interest rate on tax-exempt bonds is considered the "cost of capital" for the issuing entity. If the interest rate on state and local government bonds is lower than the comparable taxable interest rate for private borrowers, then the issuing government is receiving a federal

[10] CRS calculation based on data from the SOI Public Use File for 2007.

subsidy, reducing the cost of capital. [11] Thus, the relative difference between taxable bonds and tax-exempt bonds (or spread) is a straightforward way to evaluate or quantify the value of the interest exclusion to issuers.

The next section reviews selected proposals that would modify the tax preferences for tax-exempt bonds. The 2013 budget proposal, the Simpson-Bowles deficit reduction proposal, and the Congressional Budget Revenue Option, would all impact tax-exempt bonds directly if enacted.

Proposals for Changing Tax Preference

As discussed above, three types of proposals are examined here. The first, capping the benefit of the tax-exemption to the 28% marginal tax rate, was included in the President's 2013 budget. The second, eliminating the tax-exemption while broadening the income tax base and lowering rates, was included in the Simpson-Bowles Deficit Commission Report. The third, replacing the tax-exemption for investors with a direct payment to the issuer, was proposed in the Congressional Budget Office publication, "Revenue Options." Variants of this last proposal include so-called tax credit bonds where the issuer or investor receives a tax credit rather than a tax exclusion.[12] For example, the President's FY2013 budget includes reinstating one type of tax credit bond, the Build America Bond (BAB), which expired December 31, 2010.

Capping the Income Tax Benefit of the Tax-Exempt Interest

One proposal is to cap the benefit of tax-exempt interest at the 28% marginal tax rate.[13] The plan would allow taxpayers over $200,000 ($250,000 for joint filers) an exclusion only up to the equivalent of a 28% marginal income tax rate.[14] The impact on investors will be greater the higher the marginal tax rate. Generally, the taxpayers in tax brackets at or above the 33% rate will encounter the largest effect as more of their tax-exempt earnings would be subject to some tax under this proposal.

Impact on Investors

Investors evaluate the attractiveness of a tax-exempt bond investment through comparison to a taxable alternative. More generally, the market interest rate where the after-tax rate of return on a taxable bond matches the tax-exempt rate is commonly called the "market clearing rate." If some of the interest on a tax-exempt bond becomes taxable, then the market clearing rate will increase.

[11] For a detailed graphical presentation of the subsidy, see Peter Fortune, "Tax-exempt Bonds Really do Subsidize Municipal Capital," *National Tax Journal*, vol. 51, no. 1, March 1998. There are alternative arguments that suggest that using the spread between taxable rates and tax-exempt rates on debt is too simplistic. One theory posits that the tax-exemption is unrelated to the interest rate on municipal debt and therefore does not represent the true cost of capital. This view, however, relies on assumptions that when relaxed, do not support that conclusion.

[12] For more on tax credit bonds, see CRS Report R40523, *Tax Credit Bonds: Overview and Analysis*, by (name r edacted).

[13] The President's FY2013 budget and The American Jobs Act, S. 1549, for example.

[14] Note that analysts estimating the impact of these threshold triggered tax changes assume that the dollar amounts are taxable income and not gross income (adjusted gross income or AGI). Translating those estimates into AGI would necessarily add back itemized or standard deductions and personal exemptions. Thus, the adjusted gross income amounts would be significantly higher to account for exemptions and deductions.

The change in the market clearing rate is a rough gauge of the relative impact of the proposed modification to the tax treatment of interest paid on tax-exempt bonds. In **Table 3**, the column labeled "Hypothetical Taxable Bond Rate" is a taxable investment that serves as an investment alternative to tax-exempt bonds. Under current law (the third column), higher income investors would be willing to accept ever lower tax-exempt bond returns because the after-tax return to taxable bonds, the alternative, declines with the marginal tax rate. For example, a taxpayer in the 35.0% marginal tax bracket would earn a 3.90% after-tax rate of return on a taxable bond with a hypothetical 6% pre-tax rate of return. Thus, any tax-exempt bond that pays interest that is greater than 3.90% would provide a higher after-tax rate of return.

Table 3. Market Clearing Tax-Exempt Bond Rates Under Current Law and Under a 28% Income Tax Rate Benefit Cap

Calculated with a Hypothetical 6% Taxable Bond Market Rate

		Market Clearing After-Tax Yield for Tax-Exempt Bonds		
Investor Marginal Tax Rate	**Hypothetical Taxable Bond Rate**	**Current Law**	**With 28% Tax Rate Cap**	**Tax Rate Cap Premium**
10.0%	6.00%	5.40%	5.40%	0.00%
15.0%	6.00%	5.10%	5.10%	0.00%
25.0%	6.00%	4.50%	4.50%	0.00%
28.0%	6.00%	4.32%	4.32%	0.00%
33.0%	6.00%	4.02%	4.23%	0.21%
35.0%	6.00%	3.90%	4.19%	0.29%
36.0%	6.00%	3.84%	4.17%	0.33%
39.6%	6.00%	3.62%	4.10%	0.48%

Source: CRS calculations.

Notes: The tax rate cap premium would increase with higher taxable bond interest rates and decrease with lower rates.

Under the proposed cap the tax benefit is capped at the 28% marginal tax bracket. As a result, previously tax-exempt interest would be taxed for those in tax brackets above 28%. The higher required yield for the tax-exempt bond under this policy reflects the higher marginal tax rate which exceeds the proposed cap. The after-tax rate of return for partially tax-exempt bonds under the proposal for taxpayers in the 35.0% marginal tax bracket would rise to 4.19%, a 0.29% "premium" when compared to current law for a taxable investment with a 6% pre-tax return. The size of the premium would move with prevailing market interest rates. The higher the market interest rate, the larger the value of the premium. The market clearing rate for a tax-exempt security is the following if the taxpayer's marginal tax rate exceeds the cap:

$$r^{tax-exempt} = \frac{r^{taxable}\left(1-t^{i}\right)}{\left(1-\left(t^{i}-t^{cap}\right)\right)}$$

where the t^i is the individuals tax rate and the policy tax rate cap is t^{cap}. If the tax rate were less than the cap, then the clearing rate is simply:

$$r^{tax-exempt} = r^{taxable}(1-t^i)$$

The link between a taxpayers marginal tax rate and the value of investing in tax-exempt bonds complicates the investment decision for taxpayers. Generally, the tax cap would reduce the attractiveness of tax-exempt bonds for taxpayers in tax brackets above the 28% threshold. The decrease in demand would likely increase the borrowing costs for state and local governments.

Impact by Marginal Tax Rate

The concentration of tax-exempt interest income in the higher income ranges implies that a significant share of taxpayers receiving tax-exempt interest will be affected by such a policy shift. The response to the changing tax status of tax-exempt bonds by investors as proposed by the cap, however, may be muted. Most tax-exempt bonds would still provide a greater after-tax return than comparable taxable investments. The array of marginal tax rates in the first column of **Table 3** are a mix of current law rates and rates as proposed in the President's FY2013 budget. Specifically, the top two rates, 36.0% and 39.6%, would apply to taxpayers filing joint returns with taxable income over $250,000 and single taxpayers with taxable income over $200,000 in 2013 if current law is not extended.

For example, a taxpayer in the 33% tax bracket who holds a $100,000 taxable bond with a 6% coupon payment would receive $6,000 each year.[15] Investors then determine tax implications to arrive at the after-tax return of investments. Under current law, the taxes would amount to 33% of that amount or $1,980. After paying this tax, the investor would have $4,020. Thus, a tax-exempt bond investment would need to offer at least 4.02% to lure this investor under current law. In contrast, under the proposal, the investor would need a 4.23% return on a tax-exempt bond because some of the interest would be taxed. The last column of **Table 3** provides a relative measure for "tax premium" on tax-exempt bonds for the selected tax rates given a 6% market interest rate on taxable bonds. Note that for the highest rate investors, the premium approaches 50 basis points or almost one-half a percent.

The number of taxpayers in the top two brackets comprise just 1.9% of all returns in 2007, but 35.2% of all tax-exempt interest or $25.6 billion (see **Table 4**). If the 28% proposal were in effect, these taxpayers would pay some tax on these earnings. Assuming the hypothetical 6% market rate and no change in taxpayer behavior, then the additional revenue would be $70.3 million for this cohort. As discussed earlier, for the 33.0% marginal tax rate investors, taxes would be owed at the 5% rate difference between the cap amount and marginal tax rate (7% for the 35% marginal tax bracket). Even with the premium imposed by this proposal, there is still a significant subsidy for these taxpayers. The reduced after tax rate of return would still likely be greater than the taxable investment alternative for most taxpayers, particularly for those in the 35% bracket.

[15] This example reflects the behavior of a single "representative" rational investor. In reality, some individual investors do not exhibit rational behavior and some may not know in advance their marginal tax rate at the end of the tax year.

Table 4. Tax-Exempt Interest Income by Marginal Tax Rate in 2007

Marginal Tax Rate	Share of Returns	Share of AGI	Tax-Exempt Interest Income	Share of Tax-Exempt Interest Income
0.0%	22.3%	2.4%	$4,377,334,421	5.7%
5.0%	0.8%	0.4%	1,236,153,669	1.6%
10.0%	19.3%	6.6%	2,223,206,842	2.9%
15.0%	36.1%	31.6%	20,893,392,286	27.1%
25.0%	16.6%	26.6%	11,431,999,990	14.9%
28.0%	3.0%	9.0%	7,036,898,377	9.1%
33.0%	1.2%	6.5%	6,962,142,883	9.0%
35.0%	0.7%	16.9%	22,804,839,307	29.6%
Total	**100.0%**	**100.0%**	**76,965,967,775**	**100.0%**

Source: CRS calculations based on Internal Revenue Service, Statistics of Income (SOI), Public Use File for 2007.

Impact on Issuers

The impact on issuers is difficult to predict because the response of investors is uncertain and is a critical element in evaluating issuer impact. And, as noted above, the magnitude of investor response is unclear. Some have suggested that the retroactive application of the proposed tax cap could introduce a tax-risk premium to all tax-exempt bonds. The tax-risk premium would be passed on to issuers through higher interest costs. The impact on issuers will depend on the extent to which a premium exists and how much is passed on to the issuer.

Simpson-Bowles Deficit Reduction Committee Plan

The Simpson-Bowles (SB) deficit reduction committee plan recommended eliminating the exclusion of interest on state and local government debt paired with a reduction in marginal tax rates. Specifically, the SB plan would repeal the tax-exemption for all newly issued state and local government bonds. The tax rate on these bonds would be the proposed individual income tax brackets contained in the proposal (**Table 5**). Thus, under the SB plan, interest payments from new bonds issued by state and local governments would be treated like all other income.

Impact on Investors

Investment in tax-exempt bonds would no longer receive a tax preference if SB were to become law. Current high-income investors would no longer prefer tax-exempt bonds to taxable alternatives and would likely adjust their portfolios accordingly. The reduction in demand from this segment of the bond market, however, may be partly mitigated by an increase in demand from entities that previously did not invest in tax-exempt bonds. This group would include international investors and U.S. pension funds. These new investors, who do not pay U.S. taxes, place no value on the tax exclusion. The increased demand of these two types of investors combined would have positive impact on the tax-exempt bond market and a generally negative impact on the taxable bond (or similar taxable asset) market. This effect, however, will likely be minimal.

Table 5. Proposed Tax Rates Under the Simpson-Bowles Co-Chairmen's Proposal

Joint and Single Filer Taxable Income Bracket Amounts

2012 IRC Rates	SB Plan Rates	2012 IRC Joint Filer	2012 IRC Single Filer
10%	12%	$0 to $17,400	$0 to $8,700
15%		$17,400 to $70,700	$8,700 to $35,350
25%	22%	$70,700 to $142,700	$35,350 to $85,650
28%		$142,700 to $217,450	$85,650 to $178,650
33%	28%	$217,450 to $388,350	$178,650 to $388,350
35%		$388,350 and over	$388,350 and over

Source: The Internal Revenue Code and the White House, The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010.

As with the income tax cap, the impact of the SB proposal would be concentrated in the top two current marginal tax rates. For the top two rate brackets, tax-exempt interest would shift from generating a tax savings of 33% or 35% to a tax liability of 28%. **Table 4** shows that almost 40% of tax-exempt interest ($29.8 billion) was earned by taxpayers in these two marginal rate brackets in 2007.

An additional impact would be on the secondary market for outstanding tax-exempt debt. Assuming the tax treatment of outstanding tax-exempt bonds would not change, the supply of these bonds would shrink, increasing the price offered to current holders. The windfall gain to current tax-exempt bond holders may be significant.

Impact on Issuers

The cost of tax-exempt bond-financed investment would likely increase under the SB plan absent the federal tax preference. Proponents of preserving tax-exempt bonds claim that

> If eliminated, the interest rates on what would now amount to taxable bonds would rise dramatically, almost certainly resulting in a period of stagnation within state and local governments. Important infrastructure, education, health care, and community amenity projects would be delayed, scaled back, or altogether eliminated.[16]

This claim, though likely overstated, is the primary reason cited for preserving the tax exemption.

Eliminating the tax-exempt bond market for new issues as under SB would also eliminate the tilt of the federal preference to riskier projects. Under current law, the tax preference applies to all projects regardless of relative risk. Thus, the absolute value of the tax preference (and federal revenue loss) is greater for projects with a greater risk profile. This arises because the interest rate premium on those projects is greater (i.e., the interest rate is higher). Returning to **Table 3**, the hypothetical comparative taxable bond was assumed to be 6.0% and an investor in the 35% bracket needed a tax-exempt return of at least 3.9% to invest in the tax-exempt bond. If the project were deemed riskier, then the rate on a taxable bond of like risk could be as high as 8.0%

[16] Council of Development Finance Agencies, "Built by Bonds," available at the following: http://www.cdfa.net/cdfa/cdfaweb.nsf/ord/builtbybonds.html/$file/CDFA-Built-by-Bonds.pdf.

(the higher rate is the so-called "risk premium"). This implies the tax-exempt interest rate would need to be at least 5.2% to justify investment in the riskier project. Under SB, issuers of riskier bonds would not receive more federal assistance as the risk premium increases.

The elimination of the exclusion of interest on state and local government debt would also have a differential impact across states. States that rely more on debt will realize a greater increase in the cost of debt than states less reliant on debt. And, within states, relatively debt reliant local governments would also be relatively worse off. In FY2009, state and local governments in Massachusetts, New York, and Kentucky all had debt outstanding exceeding 25% of state gross domestic product (GDP).[17] In contrast, governments in Iowa, Idaho, and Wyoming had debt to GDP ratios of less than 12%. From this, one could conclude that elimination of the tax-exemption would have roughly twice the impact in the most debt reliant states compared to the least debt reliant states.

Congressional Budget Office Revenue Option

The Congressional Budget Office (CBO) provided several options to reduce the deficit and one was to replace the "tax exclusion for interest income on state and local government bonds with a direct subsidy to the issuer."[18] This option is estimated to increase revenues $142.7 billion over the 2012 to 2021 budget window. In addition to raising revenue, the proposal would also increase the economic efficiency of the tax preference for non-federal government borrowing. Under current law, the tax exclusion provides a disproportionately greater benefit to high-income taxpayers. This proposal would replace the tax bracket dependent preference (see the column labeled "Current Law" in **Table 3**) with a subsidy payment to the issuer. The proposed payment amount, 15% of the issuer coupon payment, is lower than the estimated rate that would equate a direct pay bond to traditional tax-exempt bonds. This option is similar to the now expired Build America Bond (BAB), though the subsidy payment was significantly higher, 35%.

Similar to the CBO proposal, the President's 2013 budget proposes making permanent an expanded version of the BAB financing tool for state and local governments issuers as well as non-profit issuers (hospitals and universities).[19] The new BAB program would carry a subsidy rate of 30% for 2013, dropping to 28% thereafter. The subsidy rates in the President's budget are intended to be revenue neutral though are still estimated to reduce revenues $1.1 billion over the 2013 to 2022 budget window.

Impact on Investors

There are three types of investors to consider when assessing the impact of the CBO proposal: (1) high marginal tax bracket investors, (2) current holders of bonds, and (3) potential new investors in taxable state and local government debt. If the CBO proposal were to become law, high marginal tax rate tax-exempt bond investors would lose a tax preference. In 2009, $73.6 billion in

[17] State GDP Data are from the U.S. Census Bureau, Bureau of Economic Analysis, and the government budget data are from U.S. Census Bureau, Governments Division, State and Local Government Finances, 2008-2009.

[18] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, p. 163. Available at http://www.cbo.gov/doc.cfm?index=12085.

[19] U.S. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," February 2012, p. 11-12.

tax-exempt interest income was reported (see **Table 2**). Current holders of tax-exempt bonds would likely see a windfall gain with the now limited stock of tax favored bonds (if the tax status of existing bonds were grandfathered). There would likely be a negative impact on the market for existing taxable bonds. If potential investors rebalanced portfolios by reducing their holdings of other taxable bonds, then prices for those securities would decline. New investors that are not subject to federal income taxes, such as pension funds and international investors, would likely buy state and local government bonds. The additional investment option for these investors would likely be a welcome change from current law and could be viewed as a positive impact for investors.

Impact on Issuers

The issuers would have a higher interest cost because the 15% subsidy rate would not match the savings with tax-exempt bonds. Nevertheless, the subsidy would flow directly to the issuer and still provide a federal tax benefit. The subsidy would also be more economically efficient than the current subsidy delivered with the tax exclusion as investors in higher marginal tax brackets would not receive the previously explained windfall gain.

Conclusion

Under current law, there is a significant transfer of federal tax revenue to tax-exempt bond issuers and investors. Investors benefit from the exclusion of interest on the bonds from taxable income and the above market rate of return offered by most tax-exempt bonds. State and local governments, non-profit hospitals, educational institutions, and a variety of other entities all benefit from lower interest rates than otherwise would be the case. Importantly, the federal revenue loss to the federal government exceeds the benefit received by the issuer.

The three proposals reviewed here would all reduce the benefit received by issuers and investors while increasing revenues for the federal government. As a result, under these proposals, issuers will face higher borrowing costs and investors will lose one option for earning tax-free income. The proposals do differ in the relative impact on investors and issuers. The FY2013 budget proposal to cap the benefit to the 28% tax bracket would be felt relatively equally between issuers and investors and would not address the inefficiency of using tax-exempt bonds to encourage investment in public capital. The SB tax reform plan would eliminate the tax preference thereby eliminating the economic inefficiency generated by the current tax preference, but would also eliminate the relative benefit of tax-exempt bonds for both issuers and investors. The CBO proposal also eliminates the tax preference for investors, but would preserve the issuer preference albeit at a lower level. The economic inefficiency arising from the current tax preference would also be eliminated by the CBO proposal. The CBO proposal can be modified to yield a roughly equivalent subsidy to the current tax-exempt bond preference for issuers.

Balancing the loss of tax preferences for issuers and investors against the benefit of a more economically efficient tax code and a smaller deficit is the critical challenge for Congress.

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