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IN FOCUS

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Federal Support for the Municipal Bond Markets

Introduction

Municipal bonds are debt securities issued by state, city, county, and other nonfederal government agencies to pay for capital projects, such as highways, airports, sewers, bridges, schools, hospitals, and other public goods for residents. The municipal bond market consists of more than an estimated 1.5 million types of bond issuances from more than an estimated 55,000 issuers. The U.S. market had a total of $3.2 trillion municipal bonds outstanding, at the end of June 2021, roughly 4.3% higher than the amount outstanding at the end of 2019 (the last quarter before the economic recession accompanying the COVID-19 crisis).

This In Focus summarizes the federal tax and regulatory treatments of municipal bonds, summarizes recent legislative proposals to modify certain treatments, and discusses possible impacts that current treatments may have on the demand and supply of municipal bonds.

Tax Preferences

Tax preferences for municipal bonds subsidize state and local government borrowing costs for capital projects. Preferential tax treatment may compensate state and local taxpayers for benefits provided to nonresidents. Debt issuances to fund long-term projects may also better align the financial burden with the timing of benefits, thus allowing for more predictable state and local financial planning.

The federal government subsidizes municipal debt issuances via three types of tax preferences: (1) a federal tax exemption on interest income for public purpose bonds, (2) the same tax exemption for selected bonds issued for private purposes, and (3) a federal tax credit offered in lieu of a tax exemption for bonds supporting certain activities. By increasing the investor's interest income net of taxes, these subsidies allow state and local governments to sell bonds at lower interest rates while remaining competitive with comparable bonds without a federal tax preference ("taxable" bonds).

Tax-Exempt Bonds

All interest income earned by an investor holding a bond issued for a public purpose, as defined in the federal tax code, is exempt from federal income taxation. Public purpose bonds generally meet either of the following criteria: (1) less than 10% of the proceeds are used directly or indirectly by a private (nongovernmental) entity, or (2) less than 10% of the bond proceeds are secured directly or indirectly by property used in a trade or business.

Qualified Private Activity Bonds (QPABs)

Private purpose bonds are any bonds that fail to meet either of the public purpose criteria and generally do not receive a federal tax preference. However, a federal income tax exemption is extended to certain bonds—*qualified private activity bonds* (QPABs)—issued for private purposes explicitly listed in federal statute (26 U.S.C. §141). QPABs are designed to support projects with a significant nongovernmental presence yet still serve a public benefit (e.g., a privately built toll road that eases highway congestion).

Tax Credit Bonds (TCBs)

The third preference is a tax credit attached to certain bonds that may be claimed in lieu of a federal tax exemption. For these tax credit bonds (TCBs), rather than a federal tax exemption on interest income earned, the investor receives a tax credit, a direct payment that is proportional to a TCB's face value. The value of the tax credit does not depend on the investor's marginal income tax rate, as is the case with tax-exempt bonds and QPABs. The authority to issue TCBs was repealed by P.L. 115-97, though previously issued TCBs still outstanding receive federal tax credits.

Legislative Proposals

Legislative proposals have been introduced every year that would change the tax treatment of municipal bonds. Stand-alone bills in recent Congresses would revive TCBs (e.g., S. 1308 and S. 1676), modify the list of activities eligible for QPABs (e.g., H.R. 1396 and S. 1499), and adjust the definition of public purpose activities eligible for tax-exempt bonds (e.g., H.R. 606 and S. 1242, 116th Cong.).

Modifications to the tax treatment of municipal bonds were also included in the large infrastructure proposals in 2021. H.R. 3684, the Infrastructure Investment and Jobs Act, includes language that would expand the activities eligible for QPAB financing and increase the total amount of funding available for certain purposes. Additionally, in September 2021, the House Ways and Means Committee marked up language for H.R. 5376—the Build Back Better Act—that would reinstate TCB issuance authority and establish a new TCB for infrastructure projects, allow for advance refunding of tax-exempt bonds, and make a number of modifications to QPAB activity. More recent versions of H.R. 5376 have not included bond preference modifications. For more on the bond proposals in H.R. 5376, see CRS Report R46923, *Tax Provisions in the "Build Back Better Act:" The House Ways and Means Committee's Legislative Recommendations*.

Market Liquidity and Disclosure Issues

Municipal bonds tend to be most actively traded in the primary market, the market where they are newly issued. According to the Securities and Exchange Commission (SEC), one-third of municipal bonds trade once after initial issuance; the remaining bonds trade two or three times

during their lifetimes, and 5% of all municipal bonds may trade once every 12 years. Bond trading after initial issuance, referred to as secondary market trading, occurs between two parties via broker-dealers. (Brokers conduct securities transactions for others and are generally paid a commission on securities sales. Dealers conduct securities transactions for their own accounts. Broker-dealers conduct securities transactions for other investors and for their own accounts.) Because retail (i.e., individual) investors largely buy and hold these assets, secondary market trading of municipal bonds is *thin*, meaning they trade in low volumes on an irregular basis (as opposed to trading more frequently in large volumes). Consequently, municipals are not considered *liquid*, meaning they cannot quickly be bought or sold in exchange for cash.

Additionally, dealer markups, the commission paid to broker-dealers to facilitate municipal trades, may be excessive if retail investors have information disadvantages. Unlike broker-dealers, retail investors are less likely to have access to electronic pricing information about past transactions. Efforts to increase market transparency, therefore, may enhance liquidity and increase the overall willingness to hold (and trade) municipal bonds.

Disclosure Requirements for Market Transactions

Although federal securities financial disclosure laws do not apply to state and local governments, the Municipal Securities Rulemaking Board (MSRB), was created by the Securities Act Amendments of 1975 (P.L. 94-29, 89 Stat. 97) to promote fairness and transparency in the municipal securities markets. The MSRB is a self-regulatory organization that establishes trading rules in the municipal bond market for its members, who are required to register with the MSRB. MSRB members consist of all municipal broker-dealers as well as municipal advisors who earn fees for advisory services. Because the MSRB does not have enforcement authority, its rules are approved by the SEC and enforced primarily by the Financial Industry Regulatory Authority, which is another self-regulatory organization.

The MSRB Rule G-14 requires dealers to submit transaction data 15 minutes after execution of a municipal securities trade, with limited exceptions. Municipal bond prices are frequently determined by observing past trades of municipal securities that arguably share similar characteristics, which has become easier for retail investors since launch of the MSRB's Electronic Municipal Market Access website. Also, the MSRB Rule G-15 prescribes certain uniform transaction settlement procedures and requires dealers to provide customers with written confirmations of transactions, which contain information about dealer markups and mark-downs.

Furthermore, the SEC's Rule 15c2-12 requires municipal bond underwriters to obtain official documentation to confirm that issuers are providing the MSRB and other regulatory repositories timely financial information and disclosures of certain events relevant to their bond issuances. Underwriters must also obtain official documentation to confirm that issuers have in place continuing disclosure agreements.

Disclosure Requirements for Private Placements

In 2012, the SEC noticed a rise in the *private placement* of municipal debt to investors. Rather than issue municipals in public offerings, some municipal borrowers were able to place debt securities with private market lenders (e.g., banks), thus avoiding underwriting and disclosure compliance costs. In response, the SEC adopted a final rule in August 2018 revising the list of events that require dealers to notify the MSRB of a private placement transaction with an aggregate principal amount of $1 million or more. Because (1) private lenders can subsequently sell recently acquired debt, and (2) some municipalities may have existing bond issuances outstanding, the disclosure of privately placed municipal debt obligations allows prospective investors to better evaluate financial risks linked to the issuers.

Cumulative Impact of Federal Efforts

Economic analysis of federal efforts to support the municipal bond markets would consider improvements in information dissemination, liquidity, and competitiveness. Such improvements may depend on whether these efforts generate reinforcing or offsetting incentive effects.

- Federal tax preferences may increase the appeal of municipal bond investments with lower returns relative to other comparable (bond) investments. Also, if investors anticipate paying higher markups to purchase municipals or selling at deep discounts due to market liquidity issues, the tax preferences may also be seen as abating these transactions costs. Hence, tax preferences may complement efforts to improve market liquidity.

- Alternatively, the need for municipal bond tax preferences to attract funds to the market may decrease if enhanced disclosures can reduce market transactions costs. Furthermore, some municipal investments may be attractive investments even in the absence of federal tax preferences because of their historically infrequent default experiences. The MSRB reports a 0.10% 10-year (2010-2019) cumulative default rate for municipals compared to 2.25% for investment grade corporate bonds over the same period. Hence, whether federal tax preferences encourage greater investments in municipal bonds or reward investors who already favor these investments is unclear.

- Knowledge of dealer markup pricing does not provide information about the likely performance of issuers' cash flows during unanticipated events (e.g., a severe recession), which arguably may be a better indicator of municipal investment risks. Hence, greater disclosure requirements may reduce markups and result in price improvements for some transactions, but compliance may increase issuance costs—particularly for small issuers—possibly reducing bonds supplied to market.

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