

Tax-exempt bonds

Dennis Zimmerman

Congressional Research Service, Library of Congress

A bond, issued by a state or local government, the interest on which is exempt from taxation.

State and local governments issue debt (\$267 billion in 1997) in exchange for the use of the savings of individuals and corporations. This debt obligates state and local governments to make interest payments for the use of these savings and to repay, some time in the future, the amount borrowed (the bond proceeds).

The first income tax law in the United States, in 1913, excluded from taxable income the interest income earned by holders of the debt obligations of states and their political subdivisions. In 1988 the U.S. Supreme Court in *South Carolina v. Baker* (485 U.S. 505 [1988]) rejected the assertion that any federal taxation of interest income derived from this debt is unconstitutional because the exemption is protected by the Tenth Amendment and the doctrine of intergovernmental tax immunity. The Court denied the claim of constitutional protection and found tax exemption to be dependent upon statute and regulation. In short, Congress has the right to tax this interest income if it chooses—which it has not done.

Because the interest income on state and local debt is excluded from federal income taxation, the interest rate on this “tax-exempt” debt is lower than the interest rate on taxable debt. For this reason, tax-exempt debt has its own “market” and is an important factor in several economic policy issues.

Characteristics of tax-exempt bonds

Maturity

State and local governments must borrow money for long periods of time and for short periods of time. Long-term debt instruments are usually referred to as bonds and carry maturities in excess of one year (\$221 billion in 1997). Because public capital facilities provide services over a long period of time, it makes sense to pay for these facilities over a long period of time. Thus, long-term bonds are an effort to match the timing of the payments for the capital facilities (taxes raised to fund interest and principal payments) to the flow of services from the capital facilities. An attempt to pay for capital facilities “up front” is likely to result in a less-than-optimal rate of public capital formation, as current taxpayers vote against paying taxes now for benefits provided to future citizens.

Short-term debt instruments are usually referred to as notes and carry maturities of 12 months or less (\$46 billion in 1997). Notes usually are paid from specific taxes due in the near future or from anticipated intergovernmental revenue and are often referred to as tax and revenue anticipation notes (TRANS). These short-term notes are issued because governments are faced with the necessity of planning a budget for the year (or in some cases for two years). This requires a balancing of revenue forecasts (see Revenue forecasting, federal) against forecasts of the demand for services and spending. Not infrequently, the inevitable unforeseen circumstances that undermine any forecast cause a revenue shortfall that must be financed with short-term borrowing. In addition, even when the forecasts are met, the timing of expenditures may precede the arrival of revenues, creating the necessity to borrow within an otherwise balanced fiscal year. Finally, temporarily high interest rates that prevail at the time bonds are issued to finance a capital project may induce short-term borrowing in anticipation of a drop in rates.

Security

General obligation debt, which is the sum of short-plus long-term bonds, pledges the “full faith and credit” of the issuing government, an unconditional pledge of its powers of taxation to guarantee its liability for interest and principal repayment (\$106 billion in 1997). Revenue bonds, or nonguaranteed debt (\$161 billion in 1997), pledge only the earnings from revenue-producing activities, most often the earnings from the facilities being built with the revenue bond proceeds. Should these earnings prove to be inadequate to repay interest and principal, the issuing government is under no obligation to utilize its taxing powers to finance the shortfall.

New issue versus refunding

New-issue bonds (\$140 billion in 1997) finance new capital facilities. Refunding-issue bonds (\$60 billion in 1997) replace outstanding bond issues with bonds that carry more favorable terms, such as lower interest rates. The refunding issue usually does not add to the stock of outstanding bonds or the stock of capital facilities; its proceeds are used to pay off (retire) the remaining principal of the original bond issue. Advance refunding bonds are issued before the date on which the original bonds are refunded and add to the outstanding stock of bonds without adding to the stock of capital facilities.

Arbitrage

State and local governments do not pay federal income tax, and absent federal constraint they have

unlimited capacity to issue debt at low interest rates and reinvest the bond proceeds in higher-yielding taxable debt instruments, thereby earning arbitrage profits (see Tax arbitrage). Unchecked, state and local governments could substitute arbitrage earnings for a substantial portion of their own citizens' tax effort.

Such activity lies outside the purpose of tax exemption, and the federal tax law requires that tax-exempt bond proceeds be used as quickly as possible to pay contractors for the construction of capital facilities. Because it is impossible for bonds to be issued on the day every contractor must be paid for expenses incurred in building public capital facilities, a two-year period is granted to spend an increasing share of the bond proceeds. Bond issues that have unspent proceeds in excess of the allowed amounts during this two-year spend-down schedule must rebate any arbitrage earnings to the U.S. Treasury. Bond issues are considered to be taxable arbitrage bonds if a governmental unit, in violation of the arbitrage restriction in the tax code, purposely invests a substantial portion of the proceeds in assets that earn interest rates that exceed the tax-exempt interest rate by more than one-eighth of a percentage point.

Public purpose versus private purpose

Before the late 1960s, nothing in the tax law prevented state and local officials from issuing bonds and using the proceeds to finance investments for private individuals and businesses. This "conduit" financing became an increasingly larger share of the total volume of bonds, rising from 21 percent of total bond volume in 1975 to 73 percent of total bond volume in 1984. Unfortunately, these bonds generated no public capital facilities (the reason for having tax-exempt bonds).

Most of the legislation pertaining to tax-exempt bonds over the 30 years from 1968 to 1998 represents an effort to reduce this "conduit" financing. The legislation restricted tax exemption to bonds issued for activities that satisfy some broadly defined "public" purpose, that is, for which federal taxpayers are likely to receive substantial benefits. Bonds are considered to satisfy a public purpose if they meet either of two criteria: No more than 10 percent of the proceeds is used directly or indirectly by a nongovernmental entity; and no more than 10 percent of the proceeds is secured directly or indirectly by property used in a trade or business. Bonds that satisfy either of these tests are termed "governmental" bonds and can be issued without limit. Bonds that fail both of these tests are considered to primarily benefit private individuals or businesses, are termed "private-activity" bonds, and are ineligible for tax-exempt financing.

Some activities that fail the two tests are considered to provide some public benefits in addition to private benefits. These activities, termed qualified private activities, can be financed with tax-exempt bonds. The annual volume of bonds issued within a state for all qualified private activities is restricted to the greater of \$50 per state resident or \$150 million. The majority of bonds issued for these qualified private activities finance mortgages for owner-occupied housing, student loans for postsecondary education, and loans for private manufacturing facilities. By 1990, legislative changes had succeeded in reducing private-activity bonds to 20 percent of total bond volume.

Tax-exempt bonds and economic issues

The lower interest rate of tax-exempt bonds relative to taxable bonds makes these bonds an important factor in four economic policy issues.

Intergovernmental fiscal relations

In the context of the U.S. system of fiscal federalism (see Fiscal federalism), federal taxpayers have decided that it makes economic sense to subsidize (reduce the cost of) state and local services. The lower interest rate of tax-exempt bonds is one form of subsidy; two others are grants-in-aid (which increase the income of the governmental unit) and the deduction of state and local income and property taxes from federal taxable income (which reduces the tax price (see Tax price) of state and local government services). During the 1980s, the real value of intergovernmental aid provided via tax-exempt bonds grew dramatically, while the real value of grants-in-aid and tax deductibility declined. Providing aid via tax-exempt bonds rather than grants-in-aid allows state and local governments to determine the total cost to the federal government (bond issuance is unconstrained except for private-activity bonds); costs more than a dollar to provide a dollar of aid; allows state and local taxpayers to decide which goods and services should be subsidized; and keeps administrative costs relatively low.

Federal budget deficit

The desire to control the deficit was an important factor in legislative efforts in the 1980s to restrict state and local use of private-activity bonds. The exclusion of interest income from federal income taxation imposes a revenue loss on the federal government and contributes to the federal deficit; in fact, this revenue loss is among the largest of all preferential tax provisions listed in the federal government's tax expenditure budget. The revenue loss is calculated as the taxes that would have been collected if tax-exempt bond purchasers had instead

purchased taxable debt and received taxable interest income. The revenue loss from the outstanding stock of tax-exempt debt in 1997 is estimated to be \$24.9 billion.

Resource allocation

The exclusion of interest income lowers the cost of capital for facilities that can be financed with tax-exempt bonds, thereby raising their after-tax rate of return and reallocating resources (savings) away from noneligible facilities. This absence of neutral taxation occurs in three areas. First, because almost all public investment is eligible for tax-exempt financing and most private investment is not eligible, it increases public investment relative to private investment. Second, it increases private investment in the subset of private activities that are eligible for tax-exempt financing and decreases investment in non-qualifying private activities. And third, it changes state and local production processes toward more use of capital, which is subsidized, and away from labor, which is not subsidized.

All of these changes impose losses of national income on society, because the pretax rate of return on most of these subsidized investments is lower than the pretax rate of return on the unsubsidized investments that are displaced. The welfare of federal taxpayers is enhanced only if taxpayers value the social benefits produced by the subsidized investments more than the lost national income.

Tax equity

Tax-exempt bonds present an opportunity for individuals and corporations to shelter their income from federal income taxation. Because the bonds are most valuable to taxpayers with relatively high marginal tax rates, the reduced tax liability tends to reduce the progressivity of the distribution of the tax burden by income class and raises concerns about high-income taxpayers' use of tax-exempt bonds to escape their social duty as taxpayers.

If one ignores or dismisses as of little value the social objectives of the interest income exclusion that is used to justify resource reallocation, one is

left with the conclusion that tax-exempt bonds are, from the federal perspective, little more than a vehicle for investors to shelter a portion of their income from federal taxation. This is not, however, a balanced view. It is true that one can use tax-exempt bonds to reduce one's marginal tax rate to zero, but this is accompanied by an implicit tax in the form of a lower pretax rate of return that generates a positive marginal effective tax rate. Furthermore, society's vertical equity objectives are not expressed by the statutory rate structure, but by the effective rate structure that results from each income class's access to the numerous exemptions, deductions, exclusions, credits, deferrals, and so forth. This suggests that any effort to alter tax-exempt bonds on equity grounds is likely to be countered by adjustments in other tax preferences that leave the overall pattern of marginal effective tax rates by income class relatively unchanged.

Additional readings

Fortune, Peter. "The Municipal Bond Market, Part I: Politics, Taxes and Yields." *New England Economic Review* (September/October 1991): 13–36.

Fortune, Peter. "The Municipal Bond Market, Part II: Problems and Policies." *New England Economic Review* (May/June 1992): 47–64.

Hilhouse, Albert M. *Municipal Bonds: A Century of Experience*. New York: Prentice Hall, 1936.

Ott, David J., and Allan H. Meltzer. *Federal Tax Treatment of State and Local Securities*. Washington, D.C.: The Brookings Institution, 1963.

Petersen, John E., and Ronald Forbes. *Innovative Capital Financing*. Chicago: American Planning Association, 1985.

Public Securities Association. *Fundamentals of Municipal Bonds*. New York, 1989.

Zimmerman, Dennis. *The Private Use of Tax-Exempt Bonds: Controlling Public Subsidy of Private Activity*. Washington, D.C.: The Urban Institute Press, 1991.

Cross references: [cost of capital](#); [fairness in taxation](#); [implicit taxes](#); [marginal effective tax rate](#); [progressivity](#); [measures of](#); [tax arbitrage](#); [tax expenditures](#); [vertical equity](#).