PLYMOUTH INSTITUTE FOR FREE ENTERPRISE

END THE MUNICIPAL BOND EXCLUSION

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TOPLINE: Congress should phase out the federal tax exclusion for interest income from state and local bonds.

BACKGROUND: Taxpayers can exclude interest income received from state and local bonds (referred to as municipal bonds) from their taxable income. In contrast, interest income from *private* sources such as corporate bonds is taxed as ordinary income, *plus* it may be subject to the net investment income tax, meaning it may face a federal tax rate of up to 40.8%. After factoring in state and local taxes, half or more of the gross interest received on private bonds may be taxed away, while municipal bond interest generally goes untaxed. This wide gap in tax treatment leads investors to demand higher interest rates from private borrowers than from state and local borrowers. This drives up borrowing costs for individuals and businesses and discourages private investment. At the same time, the municipal bond exclusion encourages more public spending and debt by acting as an implicit subsidy for state and local borrowing.

States are also allocated a limited amount of "private activity bonds" that they can issue on behalf of private or nonprofit entities for financing specified project types.

Action Items (Congress):

- **Repeal the tax exclusion for interest on newly issued municipal bonds**.
- **Repeal the tax exclusion for interest on private activity bonds** (but not before repealing the exclusion for public bonds).
- To avoid a net tax increase from the change to municipal bond treatment, Congress should **pair the change with offsetting income tax reductions** (ideally with reduced taxes on private investments, such as permanent full and immediate expensing for factories and other structures).

How It Would Make Life More Affordable:

- Ending the municipal bond exclusion would help ease borrowing costs for individuals and businesses who need financing.
- By equalizing the tax treatment of different investments, it would lead to more capital flowing into sound and promising private investments, which, in turn, would support productivity gains and higher wages.

Related Legislation: No Tax Subsidies for Stadiums Act of 2023 (S. 392 [118th Congr.], H.R. 993).

BOTTOMLINE: The federal tax code shouldn't be used to influence capital markets to give preferences to state and local government borrowers over individuals and businesses.