Ohio cities warn plan to pay for Trump tax cuts will raise costs for roads, bridges

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COLUMBUS, Ohio -- Ohio cities warn that taxing the interest on municipal bonds to help extend President Donald Trump's tax cuts could drive up costs for roads, schools and even hospitals.

"Eliminating the income tax exemption for municipal bonds would have a devastating impact on local governments' ability to invest in critical infrastructure," Ohio Mayors Alliance spokesman Keary McCarthy said.

Bonds let government borrow money at lower interest rates because, at least in part, investors don't pay taxes on the interest (what they earn). It's a system that's saved Ohio about $2 billion since 2015, according to a University of Chicago's Harris School of Public Policy brief.

If Congress ends this tax exemption, communities might need to delay infrastructure repairs or scale back new projects.

Critics of the exemption say that might not be a bad thing.

They argue lower interest rates encourage excessive borrowing and the exemption primarily benefits wealthy investors.

This debate isn't new. Lawmakers have questioned the exemption for decades. But with Trump's 2017 tax cuts set to expire, the issue is gaining new urgency as Congressional Republicans and Trump's advisors search for ways to offset the $4.5 trillion cost of extending them.

In Ohio, the policy decision could have wide-ranging effects. Local communities issue millions of dollars in bonds every year to pay for capital projects. The state is asking voters in May for authority to issue $2.5 billion in bonds over the next 10 years. And the Cleveland Browns want $1.2 billion in state and local bonds to help pay for a new stadium in Brook Park.

Here's what you need to know:

What are municipal bonds?

Municipal bonds are loans governments use to fund public projects like new schools, road repairs and sewer upgrades.

Investors accept interest rates below market rate in part because they don't pay federal income tax on what they earn. The relative stability of the investment also is a factor -- governments can levy taxes to repay bonds if their existing revenue doesn't cover the bill.

Municipal Bonds for America, an industry lobbying group, estimates that 75% of U.S. infrastructure has been financed by municipal bonds. This includes:

- 4 million miles of roads
- 500,000 bridges
- 16,000 airports
- 900,000 miles of pipeline for water systems

Why is the interest tax free?

Congress has exempted municipal bond interest since it first began levying income taxes in 1913.

One reason why was lawmakers, quite simply, weren't sure they had legal authority to do it.

"The exemption for interest on state and local bonds arose, not from a well engineered subsidy program, but because of doubts about the constitutionality," said Calvin Johnson, a tax attorney and emeritus professor at the University of Texas School of Law.

That changed in 1988 when the U.S. Supreme Court ruled in South Carolina v. Baker that Congress could tax the interest in non-discriminatory ways.
And budget hawks have floated the idea ever since.

The Joint Committee on Taxation estimates that taxing municipal bond interest would bring in about $36 billion per year.

What could this cost Cleveland?

Cleveland borrows $60 million to $70 million each year through 30-year municipal bonds.

If the exemption were taken away, Cleveland's Finance Director Paul Barrett said the city's interest rate for borrowing money could jump one or two percentage points.

That difference would add $700,000 to $1.4 million in interest costs for a $70 million bond. And those costs would multiply as the city issues new bonds each year.

Right now, Cleveland borrows at about 4.1% while similar taxable bonds go for 5.3%.

Cleveland City Council President Blaine Griffin said this move, if Congress goes through with it, would make roads, bridges and other infrastructure projects more expensive.

Cleveland would essentially go from being able to repave one street for every five the city can afford today, he said.

Griffin, who chairs the National League of Cities' finance, administration and intergovernmental affairs committee, said this has been a top priority as he and the organization lobby federal lawmakers.

"It's one of those things that for whatever reason has not been on the top of everybody's radar," Griffin said. "People need to watch these subtle government moves that can cause a real problem."

The National League of Cities estimated city interest rates would rise by about 2 percentage points on average. While big cities like Cleveland might see increased costs, small rural cities may not be able to use bonds, said Dante Moreno, a legislative advocacy manager for the organization.

A municipality that borrows $5 million to $10 million a year can find a buyer for their bonds because of the tax-exempt status. Without that, investors would look for other avenues.

"There is not another financing mechanism that can come in," Moreno said. "It is irreplaceable."

Across Ohio, state and local governments have invested $97.4 billion in these kinds of bonds over the last decade, according to the Harris School brief. And 73% come from municipalities that borrowed less than $30 million.

What about those state bonds we're voting on?

Ohio's State Capital Improvement Program expires next July, and Ohioans will vote May 6 on a constitutional amendment that would renew it.

The program, which Ohioans have renewed three different times, pays for local infrastructure projects.

This time lawmakers want permission to borrow $2.5 billion over 10 years.

State Rep. Dan Troy, a Willowick Democrat, brought the idea to lawmakers late last year.

"This is not for a lot of new infrastructure, new highway projects," Troy said in December. "This is to try and address some of those things that have happened, fall into deterioration and other things over the years."

The ability to do all those projects rests on the assumption that bond holders won't pay income taxes on the interest they earn.

Troy told Cleveland.com taxing the interest would "absolutely" decrease the number of projects Ohio could pay for.

Who holds municipal bonds?

Municipal Bonds for America data says 72% of municipal bonds are owned by individuals directly or through mutual funds, and the majority of those people are 65 or older.

And 40% of the interest paid goes to households earning less than $200,000 per year.

"Tax-exempt bonds have long played a role in helping Americans conservatively save for retirement and plan with greater tax certainty," said Brian Egan, chief policy officer for the National Association of Bond Lawyers.

If interest on municipal bonds becomes taxable, investors would need to include it as part of their gross income. That would increase their liabilities and could push some people into higher tax brackets.

Why we might want to tax bond interest

Even though individuals hold the majority of these bonds, Municipal Bonds for America says 25% "are owned by businesses, primarily property and casualty and life insurance companies, but also banks."

Stephen Moore, an informal economic adviser to Trump, told Bloomberg that targeting these bonds was "politically feasible" because it would raise revenue without creating new taxes and primarily impact high-income investors. "You want to impose taxes on the wealthy? This is an effective method," Moore said.

Lowering borrowing costs can also lead to overinvestment and funding projects that perhaps "should not be undertaken," Johnson said.

"If the general cost of borrowing is $100 in interest that has to be paid, then municipalities get to borrow for $72. People with good projects that can generate more than $100 will be perfectly happy to borrow," he said. "We allow municipalities to go forward with projects the rest of the world says aren't good enough."

He acknowledged that essential projects, like schools and bridges, have public value beyond profits. But he said cities have also used low borrowing costs to build questionable projects, like sports stadiums.

What about those bonds for the Cleveland Browns stadium?

The Ohio House budget would issue $600 million in bonds to help the Cleveland Browns pay for a new $2.4 billion football stadium in Brook Park. The team is seeking $600 million in local municipal bonds from Cuyahoga County.

"The reason I don't like this bond issue proposal by the state, I think its puts us in jeopardy with the budget writers in Washington," Troy said.

Stadiums, in Troy's opinion, are a nice to have but not a necessity.

"Directing bonds toward professional stadiums jeopardizes our arguments that they're for critical infrastructure," he said.

House Speaker Matt Huffman, a Lima Republican, told reporters the stadium is the second largest private investment in Ohio, coming in behind Intel's campus in Central Ohio. And the state routinely offers incentives for megaprojects.

What are the chances Congress does this?

Whether Congress ends the tax exemption for muni bonds depends on who you ask.

“There are still many ideas being considered to offset the cost of extending tax cuts,” Ohio Chamber of Commerce President Steve Stivers said. “However, taxing municipal bonds raises serious constitutional and legal concerns, so I don’t think that will be used as a major pay-for.”

Troy agreed for the most part, saying “this pops up every once in a while” and he used to be confident that it wouldn’t go anywhere.

What gives him pause today is President Trump.

“Getting rid of the tax exemption on municipal bonds is not going to cover the cost of trump’s tax cuts,” he said. But that doesn’t mean the Department of Government Efficiency won’t flag it. “I just don’t know with the mentality today.”

Cleveland.com reached out to U.S. Rep. Mike Carey, a Columbus Republican, who sits on the House Ways and Means Committee.