PERSPECTIVE

Recycling the Muni Exemption Debate

BY JUSTIN MARLOWE

With a bit of late summer, pre-midterm election legislative maneuvering, Congress passed the Inflation Reduction Act of 2022 (IRA). Critics and defenders of the law both seem to agree that its name doesn't describe its main objective. In fact, the IRA is really a climate bill. It calls for $737 billion in new spending over the next decade, most of it for climate-focused investments like energy security, climate adaptation, and drought resiliency.

As is often the case with major pieces of federal legislation, IRA's unintended consequences could far outweigh its intentions. That's especially true for state and local finance. If IRA works as intended, we'll see a lot more wind farms, solar panels, recycling facilities, and electric vehicles. But this legislation might also inadvertently reopen a longstanding and acrimonious debate about the federal government's role in the municipal bond market.

IRA doubles down on many of the Biden Administration's core principles around climate adaptation. One of those principles is "carrots before sticks." President Biden and many Congressional leaders have said they'd much prefer to encourage businesses and individuals to invest in clean energy than to discourage fossil fuel use through a carbon tax or other "sticks." The challenge with this approach is that the federal government's main tool—in many ways its only tool—to that end is tax subsidies that encourage investment by reducing an individual's or business's federal tax liability. We know from decades of research that tax preferences of that sort are a decidedly imperfect way to encourage investment. But despite those imperfections, IRA includes more than $200 billion for energy-related tax subsidies over the next decade.

Tucked into IRA's arcane details are two subtle but enormous shifts that chart a new course for these types of energy tax subsidies. One is that IRA allows a business that's received many of these credits to sell or transfer those credits to "unrelated parties." This is similar to affordable housing tax credits, where developers that seek to build or rehabilitate affordable housing receive the credits and sell them to investors. That upfront capital from investors is often what makes a project profitable. Before IRA, most energy-related tax credits were not transferable. Now they are.

But IRA doesn't stop there on transferability. It goes a monumental extra step by defining "unrelated parties" for some credits to include tax-exempt organizations. Broadly speaking; that could include state and local governments, public pension funds, nonprofits, and philanthropies, among others.

That begs an obvious question: Why would a local government that doesn't pay federal income taxes buy federal income tax credits?

The answer is IRA's other big change. It allows tax-exempt entities to convert certain climate-focused subsidies into "direct pay" credits. A direct pay tax credit allows the holder to redeem that credit for a direct payment from the federal government. No need to file income taxes. Just request a check directly from Uncle Sam.

Direct pay is not new to municipal finance generally, and definitely not to the municipal bond market. Muni veterans will remember Build America Bonds, a brief experiment with direct pay brought about by President Obama's 2009 stimulus. In that program, states and localities issued taxable bonds, and then received a payment from the federal government roughly equivalent to the foregone income taxes that would have been claimed by investors if the bonds had been tax-exempt. Federal law has also allowed forms of tax credit bonds where investors in taxable munis receive a tax credit rather than tax-exempt interest. Programs like the Qualified Zone Activity Bonds for schools and the Qualified Energy Conservation Bonds for economic development projects made use of this tax credit structure.

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If we take this combination of transferability and direct pay to its logical end, we can concoct a few hypothetical—but likely—scenarios. Imagine, for instance, that a developer receives tax credits to build a solar farm. It builds that farm and then sells it to a public employee pension fund. That pension fund converts those credits to direct pay credits, and in turn leases the farm back to the developer. The developer then sells the power generated by that farm to a utility and realizes additional credits for power production. The pension fund converts a small financial investment into a reliable revenue stream and new clean energy. The developer makes money on an otherwise risky project.

One can imagine similar scenarios with wind farms, electric vehicle charging stations, and other infrastructure investments, with many types of tax-exempt entities as the counterparty. Imagine a wind farm owned by a rural county government and used to power an Amazon data center. Or high-capacity battery production in a rehabilitated factory, heavily subsidized by a major local foundation, in a city in the old industrial Midwest. And so forth.

Whether governments and nonprofits ought to make these types of investments is an important policy question. State and local policymakers around the country will now inevitably take up that debate.

The more immediate question for municipal finance is what will happen if IRA normalizes the large-scale state/local government use of direct pay credits? Critics of traditional tax-exempt municipal bonds have hoped for precisely that for decades. They've long argued that we ought to replace most municipal bonds with a taxable, direct subsidy structure, which they consider much more efficient than the status quo.

Proponents of traditional tax-exempt munis have pushed back, pointing out that many small and infrequent muni issuers would flounder in a taxable bond-direct pay market. They also point out that uncertainty about the federal government's long-term commitment to making those direct payments is a major deterrent for many government issuers. The BABs experience, where the federal subsidy payments routinely become ensnared in federal deficit reduction plans, only underscores that concern.

So, the stage is set. State and local governments have new tools that will allow them to play a much greater role in clean energy production. That's a top priority for many governors, mayors, and other state/local policymakers, so it seems inevitable that many will use those tools to the greatest extent possible. But using those tools could upend municipal finance as we know it.

For details about the IRS, see Galen McDonald's article on page 11 of this issue.

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