

2012

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Recommended Citation

Arthur Flynn, *The Life and Premature Death of BABS: A Proposal to Reinstate the Subsidized Taxable Municipal Bond*, 6 Brook. J. Corp. Fin. & Com. L. (2012).

Available at: <https://brooklynworks.brooklaw.edu/bjcfcl/vol6/iss2/10>

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THE LIFE AND PREMATURE DEATH OF BABS: A PROPOSAL TO REINSTATE THE SUBSIDIZED TAXABLE MUNICIPAL BOND

INTRODUCTION

Amidst severe contraction in the credit markets following the subprime mortgage crisis, state and local governments had trouble raising capital needed to fund public services, payrolls, infrastructure demands, and other public projects.¹ Further exasperating their condition, state and local governments' access to the municipal bond market—often used to fund both long-term and short-term capital needs²—began to slip away as a confluence of factors stemming from the mortgage-backed security crisis³ and lack of direct federal aid eroded investors' confidence in the safety of municipal bonds.⁴ Thus, despite the appeal of municipal bonds to certain types of investors—an appeal largely created by federal tax exemptions for interest earned on most municipal bonds⁵—the municipal bond market failed to generate sufficient capital to meet state and local governments' needs.⁶ Recognizing that, among other things, widespread state and municipal defaults could have a potentially catastrophic impact on the U.S. economy,⁷ the federal government enacted the American Recovery and Reinvestment Act of 2009, which included the Build America Bonds program.⁸

Build America Bonds (BABs) helped assuage municipalities' mounting capital needs by increasing their access to the credit markets.⁹ Subject to federal income tax but federally subsidized in the amount of 35 percent of the issuer's interest costs, BABs¹⁰ broadened the municipal bond investor pool by appealing to tax-indifferent investors¹¹ while simultaneously

1. See Mary William Walsh, *Cities Are Cutting Back Projects*, N.Y. TIMES, Oct. 1, 2008, at A1; see also Philip Shishkin, *States Cut Services for Elderly, Disabled — As Budget Shortfalls Force Reductions in Home Care, Low-Income People May Face Nursing Homes, Advocates Say*, WALL ST. J., Nov. 20, 2008, at D1.

2. Randle Pollard, *Who's Going to Pick Up the Trash?-Using the Build America Bond Program to Help State and Local Governments' Cash Deficits*, 8 PITT. TAX REV. 171, 182–83 (2011).

3. See *id.* at 173, 191–92; see generally *infra* Part I.B.

4. See, e.g., Tara Bernard, *Reassessing Safety of Bonds*, N.Y. TIMES, Dec. 27, 2008, at B1; see generally THIERRY PAULAIS, LOCAL GOVERNMENTS AND THE FINANCIAL CRISIS: AN ANALYSIS 5–6 (2009).

5. See 26 U.S.C. § 103(a) (2010).

6. See Pollard, *supra* note 2, at 172–73.

7. See H.R. REP. NO. 111-16, at 2 (2009) (Conf. Rep.).

8. See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1531(a), 123 Stat. 115, 358 (codified at 26 U.S.C. § 54AA) [hereinafter ARRA of 2009].

9. See U.S. TREASURY DEP'T, TREASURY ANALYSIS OF BUILD AMERICA BONDS ISSUANCE AND SAVINGS 3 (2011) [hereinafter TREASURY ANALYSIS].

10. 26 U.S.C. § 54AA(b) (2009).

11. Lynn Hume, *Bond Lawyers: BABs May Have Permanent Effect on Tax-Exempts, Expert Says*, THE BOND BUYER, Oct. 1, 2009, at 5.

reducing borrowing costs for states¹² and providing attractive returns for investors.¹³ Widely considered a success,¹⁴ the BAB program helped state and local governments raise capital, create jobs, and save money, while benefitting a wider range of investors and strengthening the municipal bond market as a whole.¹⁵

Since the BAB program's expiration in December 2010, many commentators have advocated making BABs a permanent fixture of the federal tax code.¹⁶ One notable advocate is President Barak Obama, who championed the program's renewal in his budget proposals for fiscal years 2011, 2012, and 2013.¹⁷ President Obama's BAB proposals would expand the bonds' eligible uses and would set the subsidy rate at 28 percent.¹⁸ Yet, commentators on and off Capitol Hill have attacked the President's proposals, citing fears that BABs would be used to perpetuate unsustainable state spending,¹⁹ will unduly burden federal taxpayers,²⁰ or might completely replace traditional tax-exempt bonds.²¹ Others support the idea of taxable bonds, but would limit President Obama's proposal by changing the subsidy rate, placing caps on BAB issuance, limiting the types of activities that may be funded by BABs, and/or using taxable bonds to

12. By reducing issuers' debt servicing costs, the subsidy allows issuers to offer more competitive interest rates to investors. *See generally* Part II.

13. Jason Zweig, *The Intelligent Investor: How Long Will the Tax Break on Municipal Bonds Last?*, WALL ST. J., May 7, 2011, at B1, available at <http://online.wsj.com/article/SB10001424052748704810504576307233579693982.html>. *See also infra* Part II.B.

14. *See, e.g.*, David Wessel, *A Stimulus Plan Success Story*, WALL ST. J., Feb. 18, 2010, at A2; *see also* Steven Gandel, *A Stimulus Success: Build America Bonds Are Working*, TIME (Nov. 17, 2009), <http://www.time.com/time/business/article/0,8599,1939720,00.html>.

15. *See The Reviews Are In: States, Cities Hail Build America Bonds Program*, U.S. DEP'T OF THE TREASURY (June 2010), <http://www.treasury.gov/initiatives/recovery/Documents/Build%20America%20Bonds%20Reviews%20-%20FINAL,%2006-10-10.pdf> [hereinafter TREASURY NEWSLETTER]; *see also* TREASURY ANALYSIS, *supra* note 9, at 4.

16. *See generally infra* Part III.C.

17. For President Obama's budget proposal for fiscal year 2013, *see* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 11–12 (Feb. 2012) [hereinafter FY2013 EXPLANATIONS], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. For President Obama's budget proposal for fiscal year 2012, *see* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS 20–21 (Feb. 2011) [hereinafter FY2012 EXPLANATIONS], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf>.

18. *See* FY2013 EXPLANATIONS, *supra* note 17, at 11–12. *See also infra* Part III.C.

19. *See* Steven Malanga, Letter to the Editor, *The 'Build America' Debt Bomb*, WALL ST. J., Nov. 22, 2010, at A19; Eric Stewart, Letter to the Editor, *Can BABs Be a Real Growth-Producing Sweetheart?*, WALL ST. J., Nov. 30, 2010, at A18.

20. *See* Sen. Chuck Grassley, *Grassley: Build America Bonds Program Keeps Getting Richer for Wall Street, Harder on Taxpayers* (Mar. 16, 2010), http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=25758 (noting in his floor speech that BABs are a costly program that ultimately lines Wall Street pockets through underwriting fees).

21. *See* PETER G. KESSENIK, MUNICIPAL MARKET UPDATE 37–48 (2011), available at <http://aysps.gsu.edu/images/LTDebt1045PK.pptx> (suggesting that tax-credit bonds should not replace tax-exempt bonds).

completely replace tax-exempt municipal bonds.²² From this, one would be amiss to conclude that change is not in the air surrounding the municipal bond market. But while the path remains unclear, the goal seems crystal: creating an efficient, equitable, and stable municipal bond market for the benefit of state and local governments and their citizens.

To be efficient, federal tax expenditures should achieve their political or fiscal objectives directly, without spending money or forgoing taxes in ways that do not optimally further those goals.²³ Toward that end, subsidized taxable bonds go a long way. Subsidized taxable municipal bonds achieve greater efficiency by providing a direct subsidy to the municipal issuer, thereby eliminating the inefficient and inequitable “windfall” that investors in the upper tax brackets receive through investing in tax-exempt municipal bonds.²⁴ Furthermore, by broadening the investor base, taxable bonds reduce market volatility by relieving demand pressures in the municipal bond market.²⁵ Nevertheless, lawmakers must tread carefully when limiting municipal bonds’ tax-exempt status, because such limitations might upset constitutional principles of state sovereign immunity.²⁶ With these objectives in mind, it becomes clear that supplementing the traditional tax-exempt municipal bond market with subsidized taxable municipal bonds best provides the means for attaining these goals.

This note proposes that creating a subsidized taxable municipal bond program to supplement traditional tax-exempt bonds, much like President Obama’s proposal for fiscal year 2013, best provides for an efficient, equitable, and stable municipal bond market by broadening the investor pool, mitigating the windfall to investors in high tax brackets, expanding taxable municipal bonds’ uses, and respecting the integrity of state sovereignty.

Part I provides a brief overview of the municipal bond market, focusing on the traditional tax-exempt municipal bond and the problems it faced in the wake of the subprime mortgage crisis. Part II examines BABs, as enacted in the American Recovery and Reinvestment Act of 2009, by briefly describing how the program works—on paper and in practice—and the underlying policy rationales that contributed greatly to its success. Part III surveys private investment strategies, issuer conduct, and legislative proposals in the wake of the BAB program’s expiration in 2010. Part IV analyzes the various legislative proposals with an eye towards creating an efficient, equitable, stable, and constitutionally sound municipal bond market. Finally, I conclude that a program similar to President Obama’s

22. *See infra* Part III.C.

23. *See generally infra* Part IV.A.

24. *See infra* Parts IV.A and IV.B.

25. *See infra* Part IV.C.

26. *See infra* Part IV.D.

proposal for fiscal year 2013 would best facilitate optimal municipal bond market conditions, benefitting both federal fiscal policy and state and local economies.

I. THE MUNICIPAL BOND MARKET

So that the reader may better understand this note's proposal, this section provides a brief overview of the municipal bond market's objectives and structure, the basic types of securities offered by issuers, and the typical purchasers of those securities in order to give context to analysis in this note's subsequent sections. Additionally, to put the municipal bond system in today's perspective, this section will briefly examine the subprime mortgage crisis's impact on the municipal bond market.

A. THE IMPORTANCE, STRUCTURE AND TAX CONSEQUENCES OF THE MUNICIPAL BOND MARKET

State and local governments²⁷ provide essential services for their citizens, such as schools, hospitals, highways, parks, utilities, police, firefighters, judicial services, community development, and other projects related to the public welfare.²⁸ Municipal governments fund these expenditures²⁹ primarily through taxes,³⁰ though they also rely on government aid, insurance trust revenue, and other sources of revenue such as tolls and license fees.³¹ Yet, because municipal governments must create annual budgets in anticipation of isolated or erratic periods of tax revenue, the mismatch between projected periodic revenue and ongoing—and at times unexpected—expenses creates a systemic need for alternative sources of capital.³² To fill these gaps in revenue and expenditure requirements, municipal governments raise money in the capital markets by issuing municipal bonds.³³

A municipal bond is a type of interest-bearing debt instrument issued by state or local governments to fund certain types of financial needs.³⁴

27. State and local governments will be referred to collectively as “municipal governments” throughout the remainder of this note.

28. See U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2008, at 3–4, 10–11 (2011) [hereinafter CENSUS FINANCE SUMMARY 2008], available at <http://www.census.gov/prod/2011pubs/g08-alfin.pdf>.

29. Such expenditures can be substantial in amount. According to the 2008 census, municipal governments spent \$826.1 billion on education alone. *Id.* at 1.

30. In 2008, taxes amounted to about one-half of municipal government revenue, with sales and property taxes constituting about 65 percent of all tax revenue. *Id.* at 2.

31. *Id.* at 3, 6.

32. See Pollard, *supra* note 2, at 171–72 (discussing state and local governments' systemic temporary cash flow deficits).

33. See *id.*

34. See BLACK'S LAW DICTIONARY 76 (3d pocket ed. 2006).

Traditionally understood as constitutionally exempt from federal taxation,³⁵ the Internal Revenue Code exempts interest on municipal bonds from federal income tax³⁶ as long as the bonds' revenue and debt servicing are sufficiently unrelated to nongovernmental private business.³⁷ While there are many types of municipal debt instruments, general obligation bonds and revenue bonds comprise the two most common tax-exempt municipal bonds.³⁸ For general obligation bonds, the issuer's full faith and credit secures its debt servicing obligations, while specific pools or sources of revenue secure the issuer's debt servicing obligations for revenue bonds.³⁹ The vast majority of outstanding municipal bonds are tax exempt.⁴⁰

By exempting interest on municipal bonds from federal income tax, Congress reduces municipalities' costs of raising money for governmental projects by increasing the bond's after-tax yield.⁴¹ Thus, if the municipal issuer sets the bond's interest rate so that its yield is comparable to the after-tax yield on a taxable bond of similar risk and qualities, the municipality can offer lower interest rates than a comparable taxable bond without reducing the bond's value to the investor because the bond purchaser will earn the same amount of interest on either bond.⁴² To illustrate, an investor with a marginal tax rate of 30 percent would be as willing to purchase a \$1,000 taxable bond carrying a 7 percent interest rate as he would a \$1,000 tax-exempt bond carrying a 4.9 percent interest rate.⁴³ Here, the investor would earn \$49 in interest by purchasing either bond at

35. See *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895) (invalidating federal tax on municipal bonds as repugnant to the Constitution because such a tax interferes with states' sovereign power to raise money).

36. Subject to certain exceptions discussed *infra* note 37, "gross income does not include interest on any State or local bond." I.R.C. § 103(a) (2012); *but see* U.S. CONST. amend. XVI ("The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."). Yet, ultimately persuaded by U.S. Supreme Court cases like *Pollock v. Farmer's Loan & Trust Co.*, Congress believed that interest on municipal bonds should be tax free and enacted § 103 of the Internal Revenue Code. See Patrick Manchester, Note, *Be Kind to Your Foreign Investor Friends*, 98 GEO. L.J. 1823, 1829 (2010).

37. Under I.R.C. § 103(b), the federal tax exemption provided in § 103(a) does not apply to: (1) private activity bonds that are not qualified; (2) arbitrage bonds; or (3) bonds in unregistered form. I.R.C. § 103(b). Unqualified private activity bonds, as defined in § 103(b), are municipal bonds where more than 10 percent of the issuer's proceeds are used for any nongovernmental private business use and more than 10 percent of either payment or security for debt services are derived from such private business or its property. *Id.* § 141(a)-(c).

38. See Pollard, *supra* note 2, at 178.

39. Because general obligation bonds are effectively secured by all revenue potentially attainable though the municipal government's taxing powers, while revenue bonds are secured only by specific pools of resources, investors typically demand higher interest rates for revenue bonds to account for those bonds' increased risk of default. See *id.* at 178-79.

40. See *id.* at 180.

41. See *id.*

42. See *id.*

43. See CONG. BUDGET OFFICE, TAX-CREDIT BONDS AND THE FEDERAL COST OF FINANCING PUBLIC EXPENDITURES 4 (2004) [hereinafter 2004 CBO REPORT].

par value because the investor's \$70 pre-tax earnings on the taxable bond will be reduced by \$21 (30 percent of \$70) by federal income tax, resulting in a \$49 after-tax yield.⁴⁴ In effect, Congress helps municipalities pay for the extra amount of interest needed to attract investors interested in comparable taxable bonds by forgoing income taxes it could have collected from the municipal bond purchaser.⁴⁵ By making municipal bonds less expensive for issuers, Congress encourages public projects, which benefits the general welfare in turn.⁴⁶

Excluding interest earnings on municipal bonds from gross income appeals to a specific category of investors—investors who would gain most from not paying taxes. Thus, tax-exempt municipal bonds attract investors with higher marginal tax rates as well as other investors that are interested in reducing their taxable income, such as banks, investment fund managers, and casualty insurance companies.⁴⁷

B. THE SUBPRIME MORTGAGE CRISIS AND ITS IMPACT ON THE MUNICIPAL BOND MARKET

In 2007, after the U.S. housing market enjoyed steadily increasing real estate values during the beginning half of the decade, real estate values dropped off severely.⁴⁸ Because many homes purchased during the housing boom were financed through subprime mortgages—mortgages targeting consumers with little assets and poor credit scores—the drop in home values caused real estate values to drop below mortgage values. This drop in value gave hundreds of thousands of mortgagors an incentive to enter into foreclosure and greatly reduced or eliminated the value of those mortgages.⁴⁹ As subprime mortgage brokers packaged prime and subprime mortgages into single pools of mortgage-backed securities for resale—making it difficult to separate subprime mortgages from prime mortgages—entire investment pools were severely reduced in value, collapsing the subprime mortgage industry and greatly harming investors that purchased

44. *See id.*

45. As we shall see, Congress pays *more* than the amount necessary to attract the marginal taxpayer to purchase municipal bonds without providing any extra benefit to the municipal issuer, resulting in an inefficient allocation of government resources. *See infra* Part II.B.

46. *See* Pollard, *supra* note 2, at 180.

47. *See id.* at 201.

48. AFP, *Housing Woes Take Bigger Toll on Economy than Expected, Says US Treasury Secretary*, THE DAILY STAR (Tues., Oct. 18, 2007), <http://www.thedailystar.net/newDesign/news-details.php?nid=7828>.

49. *See* Pollard, *supra* note 2, at 192.

those securities.⁵⁰ As a result, many large financial institutions either filed for bankruptcy or suffered severe reductions in capital.⁵¹

The subprime mortgage crisis increased municipal governments' cost of raising capital in the municipal bond market for a number of reasons. First, and probably most apparent, uncertainty in the strength of financial markets caused investors to retreat from the market, thereby reducing the demand for municipal bonds.⁵² For those investors that remained, municipal issuers had to pay higher interest rates on their bonds to compensate investors for the increased amount of perceived risk. Second, the collapse of major financial institutions⁵³ meant that fewer underwriters were available to underwrite municipal bonds, making underwriting fees more costly for municipal governments.⁵⁴ Third, municipal bond insurers, who also insured many subprime mortgages, suffered major losses when mortgage defaults increased dramatically after the housing bubble burst.⁵⁵ As a result, insurance rating agencies downgraded most municipal bond insurers, raising the cost of insurance, and thus, increasing the cost of raising capital through municipal bond offerings.⁵⁶ Finally, municipal governments themselves were experiencing financial hardship from reduced property and income tax revenues.⁵⁷ Consequently, as municipal governments entered a period where their own finances were stretched thin, municipalities' access to the municipal bond market became increasingly difficult.

II. BUILD AMERICA BONDS

Congress created the BAB program to help financially strapped municipal governments raise capital in the years following the subprime mortgage crisis. To better understand the BAB program, this section examines how BABs work within the federal tax code, Congress' reasons for enacting the program, and the program's reception in and impact on the municipal bond market.

50. Mara De Hovanesian & Matthew Goldstein, *The Mortgage Mess Spreads*, BLOOMBERG BUSINESSWEEK (Mar. 7, 2007, 5:11 PM), http://www.businessweek.com/investor/content/mar2007/pi20070307_505304.htm.

51. See, e.g., Dan Wilchins, *Merrill Sells Off Assets from Bear Hedge Funds*, REUTERS (June 21, 2007), <http://www.reuters.com/article/2007/06/21/us-bearstearns-merrilllynch-idUSN2024502520070621>; Daniel Pimlott, *H&R Block Feels Effects of Subprime Woes*, FINANCIALTIMES.COM (June 21, 2007, 7:36 PM), <http://www.ft.com/intl/cms/s/0/2485fd88-1ffa-11dc-9eb1-000b5df10621.html#axzz1oxVLRup>.

52. Ryan Barnes, *The Fuel That Fed the Subprime Meltdown*, INVESTOPEDIA.COM (Sept. 4, 2007), <http://www.investopedia.com/articles/07/subprime-overview.asp#axzz1bjRXywoG>.

53. In 2008, Bank of America acquired Merrill Lynch, Lehman Brothers filed for bankruptcy, and J.P. Morgan Chase acquired a failing Washington Mutual. See Pollard, *supra* note 2, at 192.

54. See *id.*

55. See *id.* at 193.

56. See *id.*

57. See *id.* at 192.

A. BUILD AMERICA BONDS' OPERATION IN THE INTERNAL REVENUE CODE

Section 1531 of the American Recovery and Reinvestment Act of 2009⁵⁸ amends Part IV of Subtitle A, Chapter 1, Subchapter A in the Internal Revenue Code by adding § 54AA.⁵⁹ Section 54AA authorizes state and local governments to issue two general types of BABs,⁶⁰ both subject to federal income tax on interest earned by the investor.⁶¹ A state or local government BAB issuer may choose to issue either “tax-credit” BABs⁶² or “direct payment” BABs,⁶³ depending on its financing needs.⁶⁴

Section 54AA(b) provides that the tax credit due the holder of a “tax-credit” BAB described above is equal to “35 percent of the amount of interest payable by the issuer with respect to such date,”⁶⁵ net of the tax credit.⁶⁶ Thus, in effect, the BAB issuer receives a federal tax subsidy of approximately 25 percent of the “tax-credit” BAB holder’s total return on the bond.⁶⁷ Here, the issuer’s borrowing costs are not reduced by the full 35 percent because the tax credit itself is taxed, causing the issuer to increase the pre-tax coupon to offset the investor’s reduced tax credit.

In contrast, at the issuer’s irrevocable option,⁶⁸ the municipal issuer may elect to issue “direct payment” BABs, which provide a subsidy directly to the BAB issuer equal to 35 percent of the total coupon interest payable to the BAB investor.⁶⁹ However, in contrast to the 35 percent subsidy provided by a “tax-credit” BAB, the 35 percent credit in a “direct payment” BAB is not taxed, which results in a deeper subsidy to the municipal issuer than the “tax-credit” BAB effectively provides.⁷⁰

The tax code restricts a municipal issuer’s uses of BABs. Section 54AA(d) provides that a BAB obligation may not be a “private activity

58. ARRA of 2009 § 1531, 123 Stat. 358 (codified at 26 U.S.C. § 54AA).

59. *Id.*

60. See I.R.C. § 54AA(a), (g) (2009).

61. See *id.* § 54AA(f)(1).

62. See, e.g., Notice 2009-26, INTERNAL REVENUE SERV., 2009-16 I.R.B. 801, 834 (Apr. 20, 2009) [hereinafter IRB REPORT]; Pollard, *supra* note 2, at 199–200. See also CONG. BUDGET OFFICE JOINT COMM. ON TAXATION, SUBSIDIZING INFRASTRUCTURE INVESTMENT WITH TAX-PREFERRED BONDS viii, 13 (Sherry Snyder ed., Oct. 2009) [hereinafter 2009 CBO/JCT STUDY] (describing “tax-credit” bonds generally).

63. See, e.g., IRB REPORT, 2009-16 I.R.B. 801, 834–35; Pollard, *supra* note 2, at 199–200. See also 2009 CBO/JCT STUDY, *supra* note 62, at 16 (describing “direct pay” bonds generally).

64. See generally IRB REPORT, 2009-16 I.R.B. at 833.

65. I.R.C. § 54AA(b).

66. See IRB REPORT, 2009-16 I.R.B. at 834.

67. *Id.* In other words, the issuer receives a subsidy equal to 25 percent of what an issuer’s interest obligations would have been had that issuer offered an unsubsidized taxable bond of similar risk and qualities.

68. See I.R.C. § 54AA(g)(2)(B), 54AA(d)(1)(C).

69. See *id.* § 54AA(g)(1), (g)(2)(B), (d)(1)(C); see also *id.* § 6431(a), (b).

70. See IRB REPORT, 2009-16 I.R.B. at 834 (noting that the “direct payment” BABs provide a “deeper” subsidy than the “tax-credit” BABs).

bond”⁷¹ and must be an obligation that “would (but for this section) be excludable from gross income under section 103 [of the I.R.C.]”⁷² (i.e., a “tax-exempt governmental bond”).⁷³ In essence, BABs may not be used to finance certain projects where more than 10 percent of the proceeds are used for nongovernmental matters and where more than 10 percent of the interest payments are secured by private assets.⁷⁴ Additionally, BABs cannot directly or indirectly finance loans to one or more nongovernmental persons exceeding \$5 million or 5 percent of the issue proceeds.⁷⁵ In general, “tax-credit” BABs are relatively restriction free and may be used to finance any project that a municipal issuer could finance through a traditional tax-exempt bond, including current refundings and advance refundings of capital and working capital expenditures.⁷⁶

In contrast to “tax-credit” BABs, “direct payment” BABs must be “qualified bonds” as defined in § 54AA(g) in order to receive the 35 percent subsidy, and hence, are more restricted in their uses. In principal part, § 54AA(g)(2) requires that 100 percent of the available project proceeds,⁷⁷ divided by the amount held in a reasonably required reserve fund,⁷⁸ be used for capital expenditures only.⁷⁹ As such, “direct payment” BABs cannot be used for working capital expenditures or to refinance capital expenditures, limiting the municipal issuer’s use of the “direct payment” BAB program.⁸⁰

Finally, the BAB program spanned from April 2009 through December 2010, when it was allowed to expire.⁸¹ During the course of its existence, no “tax-credit” BABs were issued, presumably due to the deeper subsidy offered through the “direct payment” BAB program.⁸²

71. I.R.C. § 54AA(d).

72. *Id.* § 54AA(d)(1). Section 54AA(d)(1) contains two more restrictions: (1) that the obligation is issued before January 1, 2011; and (2) that the issuer makes an irrevocable election to have § 54AA apply. *See id.* § 54AA(d)(1)(B), (d)(1)(C).

73. *See* IRB REPORT, 2009-16 I.R.B. at 834.

74. *See* 2009 CBO/JCT STUDY, *supra* note 62, at 11.

75. *See id.* at 12.

76. *See id.* at 11.

77. Available project proceeds means “the excess of— (i) the proceeds from the sale of an issue, over (ii) the issuance costs financed by the issuer (to the extent that such costs do not exceed 2 percent of such proceeds),” including any proceeds from investing that excess, if any. I.R.C. § 54A(e)(4).

78. “Reasonably required reserve fund” refers to I.R.C. § 148(d) (arbitrage funds) and I.R.C. § 150(a)(3) (net proceeds). *See* IRB REPORT, 2009-16 I.R.B. at 833, 835. Thus, if the reasonably required reserve fund exceeds 10 percent of the total sale proceeds from the issue, the bond is an “arbitrage bond” and does not qualify as a tax-exempt bond under § 103(b)(2), meaning that the bond would also not be a BAB under § 54AA. *See* I.R.C. § 54AA(d)(1)(A).

79. I.R.C. § 54AA(g)(2) (2009); *see also* IRB REPORT, 2009-16 I.R.B. 801, 835. The “qualified activity bond” must also be a BAB, I.R.C. § 54AA(g), and the issuer must irrevocably elect to have § 54AA(g) apply, I.R.C. § 54AA(g)(2)(B).

80. *See* FY2013 EXPLANATIONS, *supra* note 17, at 11–12.

81. *See* 2011 TREASURY ANALYSIS, *supra* note 9, at 3.

82. *See* Pollard, *supra* note 2, at 200; *see also* Patrick Temple-West, *Senator Wyden Touts Tax-Credit Bonds, Hits Tax Exemption for New Munis*, THE BOND BUYER, Apr. 13, 2011,

B. BAB FUNCTION AND POLICY

Congress' objectives in creating the BAB program reflect the underlying purposes of the American Recovery and Reinvestment Act of 2009—promoting economic recovery by creating jobs and increasing government spending.⁸³ To wit, the BAB program assists municipal governments finance capital projects by lowering the cost of borrowing, thereby helping to create jobs and stimulate the economy.⁸⁴ By focusing on its underlying economic rationales, however, the BAB program reveals a more optimal approach to federal tax incentives and highlights the reasons for its success. In particular, the BAB program more efficiently allocates the federal tax subsidy than traditional tax-exempt bonds and increases investor demand for municipal bonds by widening the investor pool.⁸⁵

1. Efficient Allocation of Federal Resources

“Direct payment” and “tax-credit” bonds more efficiently allocate federal tax incentives by greatly reducing the tax expenditure inefficiencies inherent in traditional tax-exempt bonds.⁸⁶ Thus, to better understand how the “direct payment” and “tax-credit” BAB programs are more efficient, it is necessary to understand why traditional tax-exempt municipal bonds inefficiently allocate federal resources.

By exempting the investor's interest earnings from federal taxes,⁸⁷ tax-exempt bonds reduce a municipal issuer's cost of borrowing by allowing the issuer to sell the bond at a lower coupon rate than a similarly risky taxable bond of comparable maturity.⁸⁸ To illustrate, an investor P with a marginal tax rate of 25 percent would be as willing to purchase a \$1,000 taxable corporate bond with a 6 percent interest rate as she would a \$1,000 tax-exempt municipal bond of comparable risk and maturity with a 4.5 percent interest rate because the investor's net after tax interest earnings on either bond would be same. The \$60 coupon on the taxable corporate bond will be reduced by \$15 (25 percent of \$60), resulting in net after-tax interest earnings of \$45, while the investor would similarly net \$45 on the tax-free municipal bond because its \$45 coupon is not reduced by federal income taxes. Thus, the federal tax expenditure⁸⁹ of \$11.25 (25 percent of \$45)

http://www.bondbuyer.com/issues/120_71/wyden_tax_credit-1025513-1.html (reporting that no issuer sold “tax-credit” BABs during the program's lifespan).

83. See Pollard, *supra* note 2, at 199.

84. See *id.*; see also *IRS Issues Guidance on New Build America Bonds*, I.R.S. News Release IR-2009-33 (Apr. 3, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=206037,00.html>.

85. See 2011 TREASURY ANALYSIS, *supra* note 9, at 3–4.

86. See generally 2009 CBO/JCT STUDY, *supra* note 62.

87. I.R.C. § 103(a) (2009).

88. See 2009 CBO/JCT STUDY, *supra* note 62, at 9.

89. “Tax expenditure” refers to money *forgone* by the federal government through exemptions, exclusions, or deductions. See JOINT COMM. ON TAXATION, BACKGROUND INFORMATION ON

allows a municipal issuer to sell bonds with lower interest rates, thereby reducing the municipality's costs of raising capital.

Yet, because the municipal issuer must set the bond's coupon rate at the marginal tax rate of the "market-clearing" buyer,⁹⁰ the federal tax expenditure exceeds the amount by which the municipal issuer's borrowing costs are reduced. This results in a windfall to the investors in higher tax brackets because the market-clearing buyer will probably be in a lower tax bracket than most other investors in that municipal bond.⁹¹ To illustrate, assume the same market conditions in the previous illustration and further assume that the market-clearing buyer has a 25 percent marginal tax rate, just as investor P above, which would cause the municipal issuer to set the interest rate at 4.5 percent for a \$1,000 bond. An investor R with a marginal tax rate of 33 percent who invests in that \$1,000 bond will realize a net interest earning of \$45 (4.5 percent of \$1,000, the same interest earned by the market-clearing investor above) but will save \$14.85 in income taxes (33 percent of \$45). Thus, the federal government provides an additional \$3.60 "windfall" in forgone taxes (\$14.85 for investor R minus \$11.25 for investor P) to investor R in the higher tax bracket without a corresponding reduction in the issuer's borrowing costs.⁹² In effect, the federal government pays \$1.32 in forgone taxes for each \$1.00 given to the municipal issuer when investor R purchases a tax-free municipal bond. This inefficient allocation of tax expenditures is projected to cost the federal government \$132 billion—or more than \$26 billion annually—between 2008 and 2012 for using tax-exempt municipal bonds to finance infrastructure projects alone.⁹³

"Direct payment" and, to a lesser degree, "tax-credit" taxable bonds, such as those authorized by the BAB program, eliminate the inefficient and seemingly inequitable⁹⁴ result of the tax-exempt municipal bond system. For "direct payment" BABs, each federal dollar spent to reduce the issuer's borrowing costs goes directly to the issuer, regardless of the market-clearing investor's marginal tax rate, without accumulating disproportionately in the higher tax brackets. This results in greater savings for issuers without compromising the competitiveness of the bond's

TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES 2 (Mar. 1, 2011) [hereinafter TAX EXPENDITURE ANALYSIS].

90. The marginal tax rate of the "market-clearing" investor is determined by asking at what interest rate the supply of tax-exempt bonds would equal demand. See 2009 CBO/JCT STUDY, *supra* note 62, at 31–32.

91. See *id.* at 34; 2004 CBO REPORT, *supra* note 43, at 4.

92. In effect, investor R in the higher tax bracket is receiving the value of a taxable corporate bond of similar risk and maturity carrying a coupon of \$67.16 (6.716 percent interest rate).

93. See 2009 CBO/JCT STUDY, *supra* note 62, at 31.

94. See STEVEN MAGUIRE, CONG. RESEARCH SERV., TAX CREDIT BONDS: OVERVIEW AND ANALYSIS 10 (April 16, 2009); Manchester, *supra* note 36, at 1825–27; see also *infra* Part IV.B.

coupon.⁹⁵ For example, a \$1,000 taxable “direct payment” BAB with a 6-percent interest rate (the same coupon as the comparable corporate bond described above) would produce \$60 in pre-tax interest income for both investors R and P above (6 percent of \$1,000). After taxes, investors R and P would net \$40.20 (\$60 reduced by 33 percent) and \$45.00 (\$60 reduced by 25 percent), respectively, which is exactly what each investor would earn if they had invested in taxable corporate bonds of comparable risk and maturity. The “direct payment” BAB program, however, directly provides the issuer \$21 (35 percent of \$60) for each of its payments to investors R and P, reducing the issuer’s interest payments to \$39 in both cases.⁹⁶ Thus, each federal dollar spent in the “direct payment” BAB program goes directly to the issuer to reduce its borrowing costs rather than accumulating in part in the upper tax brackets, shaving billions of dollars from the federal government’s estimated \$26 billion in forgone tax revenue through the use of tax-exempt bonds.⁹⁷

2. Widening the Investor Pool

Because they are taxable, BABs broaden the investor base in the municipal bond market by appealing to “tax-indifferent”⁹⁸ investors (i.e., investors without tax liability). Understanding why BABs broaden the investor pool by appealing to “tax-indifferent” investors requires an examination of the typical investors in tax-exempt municipal bonds and the reasons for their decision to invest.

Tax-exempt municipal bonds principally appeal to investors that would like to reduce their taxable income, such as high-income individuals and juridical persons, due to their ability to capture the windfall tax-exempt bonds provide investors in high tax brackets.⁹⁹ Thus, mutual funds, financial institutions, casualty insurers, investment portfolio managers, and other taxpayers in high tax brackets typically invest in these tax-free

95. See 2009 CBO/JCT STUDY, *supra* note 62, at 31–38.

96. In this example, the 35 percent subsidy rate is generous to the issuer because the issuer effectively pays a \$39 coupon (interest on a \$1,000 bond with a 3.9 percent interest rate) rather than the \$45 coupon it would pay under the tax-exempt regime (here, the 4.5 percent interest rate is set to net out the market-clearing investor’s income tax obligations). Because the market-clearing buyer in this example has a marginal tax rate of 25 percent, the 35 percent subsidy overcompensates the issuer in the sense that the issuer would not be able to sell its bonds at a 3.9 percent interest rate and remain competitive with comparable taxable bonds. This provides the issuer with a windfall. A “revenue neutral” subsidy rate would be set at the market-clearing buyer’s marginal tax rate—here, at 25 percent of the issuer’s borrowing costs—to approximate the issuer’s interest costs under a tax-exempt system. Most legislative proposals advocating reinstating direct payment BABs attempt to set the subsidy at a “revenue neutral” rate. See *infra* Part IV.

97. See 2009 CBO/JCT STUDY, *supra* note 62, at ix.

98. See Pollard, *supra* note 2, at 200; see also TREASURY ANALYSIS, *supra* note 9, at 3.

99. See Pollard, *supra* note 2, at 200; see also *supra* Part II.B.1.

municipal bonds,¹⁰⁰ with individuals and mutual funds owning about 70 percent of outstanding tax-exempt bonds.¹⁰¹ It is estimated that this traditional tax-exempt municipal bond market has a total size of about \$2.8 trillion.¹⁰²

In contrast, BABs appeal to a different type of investor: investors who do not have income tax liability or otherwise cannot take advantage of traditional municipal bonds' tax-exempt interest.¹⁰³ These "tax indifferent" investors include pension funds, university endowments, life insurance companies, 401(k) retirement accounts, and foreign investors.¹⁰⁴ Thus, taxable BABs give municipal issuers access to the much larger \$30 trillion conventional taxable bond market, which includes "tax-indifferent" investors.¹⁰⁵ This broadened investor base increases demand and relieves supply pressures for municipal bonds.¹⁰⁶ As a result, municipal issuers benefit from reduced market volatility¹⁰⁷ and access to a deeper source of funds, ultimately reducing the issuer's borrowing costs.

C. BAB ISSUANCE AND IMPACT

Market commentators have regarded the BAB program to be successful in many respects.¹⁰⁸ Aside from the theoretical justifications given for the BAB program,¹⁰⁹ a review of BAB issuance and the projected savings generated by such issuances provide further evidence of the program's success. I will discuss each consideration in turn.

100. See Pollard, *supra* note 2, at 200.

101. TREASURY ANALYSIS, *supra* note 9, at 3.

102. *Id.*

103. See Pollard, *supra* note 2, at 200.

104. *Id.* at 200; see also Manchester, *supra* note 36, at 1835–44 (describing federal taxation of foreign entities).

105. TREASURY ANALYSIS, *supra* note 9, at 3–4.

106. Relieving supply pressures through expanding the investor base also benefits supply pressure on tax-exempt bonds, reducing the issuer's borrowing costs on those bonds as well. See *id.* at 4.

107. See Manchester, *supra* note 36, at 1827; see also *infra* Part IV.C.

108. See Wessel, *supra* note 14 (noting that BABs helped revive the municipal bond market and kept local construction projects going, reducing municipal issuers borrowing costs and broadening the investor base in turn); Michael Decker, Letter to the Editor, *BABs Promote Jobs and Investment*, WALL ST. J., Apr. 3, 2010, at A12 (noting that issuers' interest savings generated by the BAB program is instrumental in creating and preserving jobs and promoting capital investment, both of which help ease municipal governments' important responsibilities to provide roads, bridges, and water systems that are critical to our national infrastructure); Daisy Maxey, *Build America Bonds Gain Advisers' Favor – Pension Funds, 401(k)s Are Buying In*, WALL ST. J., July 9, 2010, at C9 (noting that BABs are attractive to and are used by investment advisors for clients in lower tax brackets and tax-free institutional investors such as endowments and foundations); Dan Seymour, *Volume Cranked It Up in 2009 – BABs Boost Year to 2nd-Highest Ever*, THE BOND BUYER, Jan. 4, 2010, at 1, available at http://www.bondbuyer.com/issues/119_250/new-issue-volume-december-2009-1005601-1.html (noting the BAB program's large and beneficial impact on municipal finance).

109. See *supra* Part II.B.

First, municipalities issued a higher percentage of taxable bonds during the life of the BAB program, which was largely attributable to “direct payment” BAB issuances.¹¹⁰ In the ten years before the BAB program, taxable bonds constituted about 7 percent of total municipal bond issuance.¹¹¹ After the BAB program took effect in April 2009, “direct payment” BAB issuance rose to 24 percent of total municipal bond issuance, dropped to 16 percent in the summer of 2010, then rose to about 33 percent in the last three months prior to the program’s expiration in December 2010.¹¹² Municipalities in all fifty states issued BABs during the program’s lifetime, with the largest issuers being California (\$37.68 billion), New York (\$20.63 billion), and Illinois (\$11.23 billion).¹¹³ In total, \$181 billion of BABs were issued during the program’s lifetime.¹¹⁴ Municipal governments’ extensive use of “direct payment” BABs reflects the program’s economic utility and importance in the context of municipal finance.¹¹⁵

Second, apart from saving the federal government more money,¹¹⁶ “direct payment” BABs provided municipal issuers with deeper savings on interest obligations than traditional tax-exempt municipal bonds.¹¹⁷ By looking at their respective yields through a “fixed effects” regression model,¹¹⁸ the U.S. Treasury Department determined the present value of a “direct payment” BAB issuer’s net savings as compared to the net savings generated by comparable tax-exempt bonds.¹¹⁹ Specifically, to determine the net savings a municipal issuer of “direct payment” BABs receives as compared to an issuer of comparable tax-exempt bonds, one must: (1) determine the BAB’s yield; then (2) compute the predicted interest rate of a comparable tax-exempt bond (taking into account the “fixed effects” regression model); and then (3) apply the 35 percent direct subsidy to the

110. See Seymour, *supra* note 108. See also Pollard, *supra* note 2, at 200 (noting that no “tax-credit” BABs had been issued during the pendency of the program).

111. See Dan Seymour, *Munis See 3d Busiest November on Record*, THE BOND BUYER, Dec. 1, 2009, at 1, available at http://www.bondbuyer.com/issues/118_229/new-issue-volume-november-2009-1004416-1.html.

112. See TREASURY ANALYSIS, *supra* note 9, at 6.

113. See *id.* at 6–7.

114. See *id.* at 5.

115. See TREASURY NEWSLETTER, *supra* note 15.

116. For an explanation about how “direct payment” and “tax-credit” bonds provide more efficient federal subsidies to the municipal issuer than do tax-exempt bonds, see *supra* Part II.B.1.

117. See TREASURY ANALYSIS, *supra* note 9, at 2.

118. The “fixed-effects” regression model used by the Department of the Treasury controls for most issuer-specific and bond-specific characteristics on the date of issuance, including: (1) the riskiness of the issuer as perceived by the market; (2) the quality of the bond’s underwriting; (3) the market’s perception of economic factors influencing the outlook of the issuer; and (4) the maturity of the bond and its impact on the bond’s yield. U.S. TREASURY DEP’T, TREASURY ANALYSIS OF BUILD AMERICA BONDS AND ISSUER NET BORROWING COSTS 5 (April 2, 2010) [hereinafter TREASURY BORROWING REPORT].

119. See *id.* at 5–7.

BAB issuer's borrowing costs.¹²⁰ From here, calculate the present value of the BAB issuer's net savings by: (a) subtracting the predicted yield on the comparable tax-exempt bond from the BAB issuer's final borrowing costs;¹²¹ then (b) adjust that amount to present value.¹²² By way of a concrete example, if California issued \$3 billion in "direct payment" BABs in 2009 with thirty-year maturities paying 7.8 percent interest while the market interest rate for California's comparable tax-exempt municipal bond was 5.65 percent during the same period, California will have saved 0.85 percent,¹²³ or \$25.5 million, by using "direct payment" BABs.¹²⁴ Reduced to present value, California would save approximately \$13 million using "direct payment" BABs, assuming a 5 percent rate.¹²⁵ Using this analysis, the U.S. Treasury Department determined that municipal issuers saved approximately \$20 billion, on a present value basis, by using "direct payment" BABs than they would have spent on comparable tax-exempt bonds.¹²⁶

III. LIFE AFTER BABS: ISSUER CONDUCT, PRIVATE INVESTMENT STRATEGIES, AND LEGISLATIVE PROPOSALS

At the time of this writing, the eleven months following the BAB program's expiration on December 31, 2010 has seen a highly volatile municipal bond market.¹²⁷ In the first and second quarters of 2011, the municipal bond market saw steep outflows of cash¹²⁸ and municipal bond

120. See TREASURY ANALYSIS, *supra* note 9, at 11 n.6.

121. The BAB issuer's final borrowing cost is the difference between steps (1) and (3) above.

122. See *id.* In its analysis, the U.S. Treasury also took into account the impact of underwriting fees. For a more complete discussion of how underwriting fees affect the above calculus, see *id.* at 9–11; TREASURY BORROWING REPORT, *supra* note 118, at 8–10.

123. In this example, California's net borrowing costs for the BABs would be 4.8 percent, which is calculated by reducing 7.8 percent by 35 percent. Thus, California would have saved 0.85 percent in its borrowing costs by issuing "direct payment" BABs rather than comparable tax-exempt bonds carrying 5.65 percent interest, because 5.65 percent minus 4.8 percent equals 0.85 percent.

124. Tom Petrino, *U.S. Bond Plan Lowers Muni Yields; California's Treasurer Boosts the Size of a Debt Offering that Includes Subsidized Build America Bonds*, L.A. TIMES, Apr. 23, 2009, at B2.

125. Here, the present value factor for a 30 year annuity at 5 percent interest is 15.3725. See *Time Value of Money Tables*, STUDYFINANCE.COM, <http://www.studyfinance.com/common/TVMTable4.pdf>.

126. See TREASURY ANALYSIS, *supra* note 9, at 11.

127. See Carla Fried, *Gauging Those Tremors in Municipal Bonds*, N.Y. TIMES, Jan. 8, 2011, at BU13, available at <http://www.nytimes.com/2011/01/09/business/mutfund/09muni.html?pagewanted=all>; Steven Permut, *Understanding Recent Municipal Bond Market Volatility*, AMERICAN CENTURY INVESTMENTS (Jan. 4, 2011), http://www.advisorperspectives.com/commentaries/aci_10411.php.

128. The outflows began in November 2010, see Gregory White, *The Shocking Selloff in Muni Bonds That Has Investors Running Scared*, BUSINESS INSIDER, Dec. 8, 2010, http://articles.businessinsider.com/2010-12-08/wall_street/29965743_1_muni-bond-muni-market-

issuances at record lows.¹²⁹ Yet, the latter half of 2011 saw strong inflows into the municipal bond market¹³⁰ and low municipal default rates.¹³¹ This volatility in the municipal bond market has been attributed to fluctuations in the Treasury bond market,¹³² uncertainty about whether Congress will extend the BAB program and/or the Bush tax cuts,¹³³ and speculation about whether municipal governments would be able to meet their interest obligations to investors.¹³⁴ Amidst this market climate, municipal issuers, investors, and Congresspeople have reacted by engaging in questionable disclosure conduct, employing potentially unstable investment strategies, and proposing amendments to the Internal Revenue Code, respectively.

A. ISSUER CONDUCT

Municipal issuers' disclosure of relevant financial information enables investors to better analyze the issuer's credit risks and potential for default. As a result, investors place great value on timely and accurate disclosure of

bond-situation, remained steep through early 2011, *see* Dan Seymour, *Mutual Fund Cash Exodus Continues*, THE BOND BUYER, Jan. 10, 2011, at 1, available at http://www.bondbuyer.com/issues/120_6/-1021922-1.html, and continued through spring 2011, *see* Jeannette Neumann, *Misery Continues for Munis – After Dismal Quarter for Issuance, Signs Point to Weak Investor Demand*, WALL ST. J., Apr. 4, 2011, at C1. In total, investors withdrew an estimated \$45 billion from the municipal bond market during the record twenty-six consecutive weeks of withdrawals ending in early May 2011. *See* Ben Levisohn, *Five Reasons to Rethink the Muni Rally – Municipal Bonds Have Surged – but Investors Need to be Skeptical; Here's Why*, WALL ST. J., May 21, 2011, at B7.

129. *See* Neumann, *supra* note 128 (reporting that first week of April concluded the slowest quarter for municipal bond issuance in eleven years); *see also* Kelly Nolan, *A Deep Freeze Hits Muni Market*, WALL ST. J., Mar. 9, 2011 at C1.

130. *See* *Muni Bond Fund Inflows Best since August 2010—ICI*, REUTERS (Nov. 16, 2011, 3:15 PM), <http://www.reuters.com/article/2011/11/16/investing-fundflows-ici-idUSN1E7AF1IZ20111116>; Michelle Kaske, *Investment in Local Governments Hits One-Year High: Muni Credit*, BLOOMBERG BUSINESSWEEK (Oct. 4, 2011, 12:23 AM), <http://www.businessweek.com/news/2011-10-04/investment-in-local-governments-hits-one-year-high-muni-credit.html>. Nevertheless, it is worth observing that September and October 2011 inflows were still far short of total municipal bond inflows during the pendency of the BAB program in October 2010.

131. *See* Michael McDonald, *Meredith Whitney Loses Credibility as Muni Defaults Fall 60%*, BLOOMBERG (July 15, 2011), <http://www.bloomberg.com/news/2011-07-15/muni-default-plunge-belies-whitney-prediction-as-borrowers-shun-insolvency.html>.

132. The U.S. Treasury market volatility continued following Standard & Poor's downgrade of the Treasury in August 2011. *See* Jonnelle Marte, *The Ripple Effects of the Downgrade*, SMARTMONEY.COM (Aug. 8, 2011, 12:20 PM), <http://www.smartmoney.com/invest/bonds/what-does-the-downgrade-mean-for-bonds-1312664759999/>.

133. *See* Permut, *supra* note 127.

134. *See* Shah Gilani, *The Looming Muni-Bond Meltdown: Profit from the Collapse—and Then Again from the Rebound*, MONEY MORNING (Mar. 3, 2011), <http://moneymorning.com/2011/03/03/the-looming-muni-bond-meltdown-profit-from-the-collapse-and-then-again-from-the-rebound/> (commenting on Nouriel Roubini's prediction of municipal defaults in 2011); Dave Lindorff, *Despite Dire Prediction, Muni Default Pace Slows in First Half*, ONWALLSTREET.COM (July 8, 2011), <http://www.onwallstreet.com/news/meredith-whitney-muni-bonds-defaults-2674137-1.html> (commenting on Meredith Whitney's prediction of municipal defaults in 2011). Both Whitney's and Roubini's predictions have subsequently been discredited. *See* McDonald, *supra* note 131.

municipal issuers' financial reports.¹³⁵ Yet, municipal bond issuers' disclosure practices have historically been inconsistent, intermittent, and incomplete,¹³⁶ with some commentators observing that disclosure has become even worse since the sufferings following the subprime mortgage crisis.¹³⁷ Not surprisingly, investors have become increasingly more uneasy about the municipal bond market following the crisis and the BAB program's expiration.¹³⁸ Poor disclosure practices have prompted the Securities and Exchange Commission (SEC) to investigate cases where municipalities failed to warn their investors about fiscal problems, leading to SEC investigations of the State of New Jersey, the State of Illinois, and Harrisburg, Pennsylvania.¹³⁹ These poor disclosure practices decrease investor confidence in municipal bonds at a time when municipal governments still face difficulties in raising capital.¹⁴⁰

B. PRIVATE INVESTMENT STRATEGIES

In the volatile municipal bond market following the expiration of the BAB program, municipal bond investors have resorted to potentially risky investment strategies, including credit default swaps (CDSs) tied to municipal securities and private loans from the investor to the distressed issuer.¹⁴¹ With respect to CDSs, large derivatives dealers¹⁴² have developed

135. See FINRA, *Municipal Bonds—Staying on the Safe Side of the Street in Rough Times*, FINRA.COM, <http://www.finra.org/investors/protectyourself/investoralerts/bonds/p118923> (last visited Apr. 25, 2012); DCP DATA *Issues New Study on Transparency in the Municipal Bond Market*, DCP DATA (Feb. 3, 2011), <http://www.dpcdata.com/html/newsid45.html> [hereinafter DCP DATA].

136. For a look at state and local financial disclosures within the municipal bond market, see Tesia Nichole Stanley, Note, *Narrowing the Disclosure Gap: Is EMMA EDGAR for the Municipal Securities Market?*, 7 J.L. ECON & POL'Y 91 (Fall 2010) (noting that, for fear of running afoul of the 10th Amendment, the federal regulatory framework for municipal securities is weak and results in inconsistent and hard-to-find issuer disclosure documents).

137. See Ianthe Jeanne Dugan, *Bondholders Left in the Dark – Concern Grows Over Lack of Financial Disclosure by State, Local Governments*, WALL ST. J., Jan. 26, 2011, at C1 (noting that 40 percent of municipalities completely failed to file disclosure statements concerning their municipal bonds in three or more years between 2005 and 2009); DCP DATA, *supra* note 135 (finding that issuers' promised time for disclosure of financial documents grew to 228 days in 2010).

138. See Dugan, *supra* note 137.

139. See Press Release, SEC, *SEC Charges State of New Jersey for Fraudulent Municipal Bond Offerings*, U.S. Securities and Exchange Comm., Aug. 8, 2010 (SEC investigation of State of New Jersey); Dugan, *supra* note 137 (noting SEC investigation of Illinois State); Charles Thompson, *SEC Subpoenas Harrisburg Officials, Investigates Municipal Bond Issues*, PENNLIVE.COM (updated Feb. 2, 2011, 11:58 AM), http://www.pennlive.com/midstate/index.ssf/2011/02/post_175.html (discussing SEC probe into Harrisburg, Pennsylvania disclosure practices).

140. See Dugan, *supra* note 137.

141. See Katy Burne, *Some Banks See Profit in Muni Woes*, WALL ST. J., Dec. 21, 2010, at C1 [hereinafter Burne1] (discussing "muni CDSs"); Jason Zweig, *Unwitting Angels: When Fund Investors Become Bankers*, WALL ST. J., July 30, 2011, at B1 (discussing privately negotiated loans between investors and municipal issuers). See also Jean Eaglesham, *Mutual Funds' Muni-*

CDSs tied to municipal bonds in hopes to attract more buyers into a municipal bond market plagued by massive investor selloffs.¹⁴³ Essentially, these CDSs obligate swap sellers (i.e., “protection sellers”) to compensate the swap buyers (i.e., “protection buyers”) when a municipal issuer defaults on its interest obligations to bondholders, effectively allowing swap buyers to speculate on and profit from municipal defaults.¹⁴⁴ Market commentators have observed that CDSs tied to municipal bond defaults encourage speculators to bet on financially weakened municipal issuers, thereby contributing to the issuer’s financial distress and, in turn, undermining the stability of municipal bonds.¹⁴⁵ Additionally, some mutual funds—which otherwise cannot “short” municipal bonds¹⁴⁶—that invest in municipal bonds have used other types of derivatives to achieve the functional equivalent of a CDS tied to municipal bonds.¹⁴⁷ In a market that has been criticized as being under regulated,¹⁴⁸ the use of CDSs and other derivatives to bet against municipal issuers negatively affects the municipal bond market without providing much benefit.¹⁴⁹

Another potentially risky private investment strategy involves privately negotiated loans from mutual fund investors to financially distressed

Debt Prices Are Questioned, WALL ST. J., Feb. 18, 2011, at C1 (mutual funds overstating value of thinly-traded municipal bonds).

142. Such dealers include UBS AG, Bank of America, Merrill Lynch, Citigroup Inc., Goldman Sachs Group Inc., J.P. Morgan Chase & Co., and Morgan Stanley. See Burne1, *supra* note 141.

143. See *id.*

144. See Richard R. Zabel, *Credit Default Swaps: From Protection to Speculation*, ROBINS, KAPLAN, MILLER & CIRESI L.L.P. (Sept. 2008), <http://www.rkmc.com/Credit-Default-Swaps-From-Protection-To-Speculation.htm>; Burne1, *supra* note 141; John E. Peterson, *Could Credit Default Swaps Undermine the Fiscal Stability of Municipal Bonds?*, GOVERNING.COM (Sept. 2010), <http://www.governing.com/columns/public-finance/could-credit-default-swaps-undermine-fiscal-stability-municipal-bonds.html>.

145. See Burne1, *supra* note 141; Peterson, *supra* note 144.

146. See Katy Burne, *Muni Bonds, with a Derivatives Twist*, WALL ST. J., Apr. 22, 2011, at C9 [hereinafter Burne2]. “Shorting,” or “short selling,” is an investment strategy where the short seller borrows securities from a securities holder and sells those securities at market price, with the intention of repurchasing those securities and returning them to the lender at a later date. The short seller profits from these transactions when the short seller repurchases the sold securities after the securities’ market value decreases. The short seller then pockets the difference between the sale and repurchase prices upon returning the securities to the lender. Pursuant to the Investment Company Act of 1940, the SEC regulates the extent to which mutual funds may engage in short selling. See generally Note, *Regulating Risk-Taking by Mutual Funds*, 82 YALE L.J. 1305 (1973).

147. See Burne2, *supra* note 146 (reporting that J.P. Morgan Asset Management started a mutual fund in May 2011 using derivatives to achieve an economically similar effect of betting against municipal bonds).

148. See Andrew Ackerman, *Reg Reform, SEC Top Agenda*, THE BOND BUYER (Dec. 30, 2009), http://www.bondbuyer.com/issues/118_248/regulatory-reform-1005502-1.html.

149. See Michael B. Marois, *California’s Lockyer Seeks Leverage Limits to Curb ‘Naked’ Muni Swap Trade*, BLOOMBERG (June 4, 2010, 4:54 PM), <http://www.bloomberg.com/news/2010-06-04/california-s-lockyer-seeks-leverage-limits-to-curb-naked-muni-swap-trade.html>; Burne1, *supra* note 141.

municipal issuers.¹⁵⁰ While these loans could help forestall losses from municipal defaults, they essentially throw “good money . . . after bad” and may lead to potentially treacherous consequences if the practice is left unchecked.¹⁵¹ These loans are currently far from prevalent, but, according to some experts, could become more common as municipal bond issuers become more financially distressed.¹⁵²

C. LEGISLATIVE PROPOSALS

In the years following the BAB program’s expiration, at least six legislative proposals to create some form of taxable bond—either in addition to or in lieu of traditional tax-exempt municipal bonds—have been introduced.¹⁵³ While politicians have proposed eliminating tax-exempt bonds or replacing tax-exempt bonds with some form of taxable bond since 1918,¹⁵⁴ many of the current legislative proposals have not faded away as their predecessors have done in the past.¹⁵⁵ In part, this resilience may be owing to the BAB program’s recent example of a well-functioning taxable municipal bond.¹⁵⁶ Even though each proposal is unique, it is possible to group them into three general types.

The first and second types of proposals would eliminate tax-exempt bonds and replace them with either “direct payment” bonds (where the federal subsidy goes to the issuer) or with “tax-credit” bonds (where the federal subsidy goes to the investor). Representative John Tierney’s Tax Equity and Middle Class Fairness Act exemplifies the first type of proposal and would replace tax-exempt bonds with “direct payment” taxable bonds with the subsidy set at 28 percent of the issuer’s interest payments on the bond.¹⁵⁷ The Bipartisan Tax Fairness and Simplification Act of 2011,

150. See Zweig, *supra* note 141.

151. *Id.*

152. See *id.*

153. See H.R. 992, 112th Cong. (2011) (Rep. Levin); H.R. 736, 112th Cong. (2011) (Rep. Richardson); H.R. 747, 112th Cong. (2011) (Rep. Schiff); H.R. 11, 112th Cong. (2011) (Rep. Connolly); H.R. 2495, 112th Cong. § 523 (2011) (Rep. Tierney); S. 727, 112th Cong. § 111 (2011) (Sens. Wyden & Coats); OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2013, at 235 (2012) (President Obama’s proposal).

154. See Jason Zweig, *The Intelligent Investor: How Long Will the Tax Break on Municipal Bonds Last?*, WALL ST. J., May 7, 2011, at B1; see also Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145, 166–68 n.110 (1998) (identifying 122 proposals between 1920 and 1943).

155. See Zweig, *supra* note 154.

156. See Daisy Maxey, *Extension of BABs Would Lift Demand – Funds Likely to Add to Scant Offerings*, WALL ST. J., Feb. 4, 2010, at C9; Martin Vaughan, *‘Build America’ Permanently? – Obama Will Seek to Continue the Temporary Municipal-Bond Program*, WALL ST. J., Jan. 30, 2010, at B7.

157. H.R. 2495. Additionally, the Congressional Budget Office issued a report in March 2011 recommending eliminating tax-exempt bonds and replacing them with taxable bonds carrying a 15 percent federal subsidy payable to the issuer. See Andrew Ackerman, *New Build America Bonds*

sponsored by Senators Ron Wyden and Dan Coats (collectively, Wyden-Coats), typifies the second type of proposal and would give the investor a tax credit in the amount of 25 percent of the issuer's interest payments on that bond.¹⁵⁸

The third type of proposal, which is best typified by President Obama's proposed budget for fiscal year 2013, would supplement traditional tax-exempt bonds with "direct payment" BABs, but would lower the federal subsidy to a "revenue neutral" rate.¹⁵⁹ In President Obama's proposal, the subsidy rate would be set at 28 percent of the issuer's interest obligations¹⁶⁰ and would expand BABs' uses to include current refundings,¹⁶¹ short-term governmental working capital financings for governmental operating expenses, and financing for § 501(c)(3) nonprofit entities.¹⁶² Also, President Obama's American Jobs Act would have capped the tax exemption available on tax-exempt bonds at 28 percent for individuals in upper income brackets,¹⁶³ which would limit tax savings on interest earned on tax-exempt bonds in a way that no other proposal in this group has done.

IV. WEIGHING OUR OPTIONS—AN ANALYSIS OF THE VARIOUS LEGISLATIVE PROPOSALS UNDER THE LENS OF EFFICIENCY, EQUITY, VOLATILITY, AND CONSTITUTIONALITY

Fundamental changes in the federal tax system ought to be assessed in light of a diverse set of criteria to best achieve an effective and principled decision. Thus, in analyzing the three types of legislative proposals outlined above, I will consider each in light of economic efficiency, equitable

Proposal on Tap, WALL ST. J. (Mar. 15, 2011, 6:30 PM), <http://online.wsj.com/article/SB10001424052748704662604576202722122800598.html>.

158. S. 727, 112th Cong. § 111 (2009); *see also* Michael Corkery & Andrew Ackerman, *Muni-Bond Tax Break Under Siege*, WALL ST. J., Apr. 8, 2011, at C2. The tax credit, however, is itself subject to income tax. S. 727 § 111(a). *See also infra* Part IV.B.

159. *See* FY2013 EXPLANATIONS, *supra* note 17, at 11–12 (describing President Obama's proposal to extend the BAB program). Representatives Sandy Levin's (Michigan), Gerry Connolly's (Virginia), and Adam Schiff's (California) proposals would also supplement tax-exempt municipal bonds with subsidized taxable bonds. *See* H.R. 992, 112th Cong. (2011) (Rep. Levin); H.R. 11, 112th Cong. (2011) (Rep. Connolly); H.R. 747, 112th Cong. (2011) (Rep. Schiff).

160. *Id.* Representatives Levin's and Connolly's proposals would only reduce the subsidy to 31 percent in 2012. H.R. 992; H.R. 11. Representative Schiff would use a 28 percent subsidy rate. H.R. 747.

161. Current refundings can be used to refinance prior public capital projects where the old bonds are repaid within ninety days of issuing the current refunding bonds. *See* FY2013 EXPLANATIONS, *supra* note 17, at 21.

162. *See id.*

163. *See* Lynne Hume & Patrick Temple-West, *Obama Proposal Stuns Market*, THE BOND BUYER (Sept. 14, 2011), http://www.bondbuyer.com/issues/120_177/muni-reaction-obama-jobs-bill-1031028-1.html.

principles of federal tax law, influence on market volatility, and principles of constitutional law.

A. ECONOMIC EFFICIENCY

In the context of federal tax expenditures, the concept of efficiency is best stated by Professor Edward Zelinsky's "technical efficiency" taxonomy, where efficiency is measured by the degree to which the federal government's use of tax expenditures achieves those expenditures' underlying governmental objectives.¹⁶⁴ In the municipal bond market, federal tax exemptions and credits aim to reduce municipal governments' costs of raising capital needed for beneficial public projects.¹⁶⁵ Thus, whether tax exemptions, credits, or direct subsidies are efficient depends on the degree to which the money spent or taxes forgone by the federal government results in a reduction of municipal governments' borrowing costs.

As discussed in Part II, the amount of taxes forgone through exempting interest on municipal bonds from federal income tax does not reduce the municipal issuer's cost of borrowing by the same amount.¹⁶⁶ Because a municipal issuer will use the market-clearing taxpayer's marginal tax rate to set the interest rate on its municipal bonds, investors in higher tax brackets will receive a larger tax break than the issuer receives a reduction in interest costs.¹⁶⁷ As a result, the taxes forgone by the federal government do not equal the benefit received by the municipal issuer.¹⁶⁸ Therefore, this windfall received by taxpayers in the upper tax brackets, inherent in tax-exempt municipal bonds, results in an inefficient allocation federal resources.¹⁶⁹

The first and second types of legislative proposals would eliminate this inefficiency by abolishing tax-exempt treatment of interest generated on municipal bonds. Under the first type of proposal, tax-exempt bonds would be replaced by "direct payment" bonds, where the federal government pays the municipal issuer a fixed percentage of that issuer's interest obligations.¹⁷⁰ Under this system, the federal government directly achieves its goal of reducing municipal governments' borrowing costs by making payments directly to municipal issuers in amounts proportionate to the issuer's interest obligations. Therefore, by replacing tax-exempt bonds with

164. See Brian H. Jenn, *The Case for Tax Credits*, 61 TAX LAW. 549, 556 (2008).

165. See Manchester, *supra* note 36, at 1825; 2009 CBO/JCT STUDY, *supra* note 62, at 1, 31, 33. Another underlying reason for exempting interest on municipal bonds derives from constitutional issues of federalism, discussed *infra* Part IV.D.

166. See *supra* Part II.B.1.

167. See *id.*

168. See *id.*; see also Yamamoto, *supra* note 154, at 176–77.

169. See Yamamoto, *supra* note 154, at 176–77; Manchester, *supra* note 36, at 1829–33; 2009 CBO/JCT STUDY, *supra* note 62, at 33–34.

170. See *supra* Part III.C.

“direct payment” bonds, the first type of proposal would greatly enhance federal tax efficiency under Professor Zelinsky’s rubric.¹⁷¹

Under the second type of proposal, tax-exempt bonds would be replaced by “tax-credit” bonds, where the federal government provides the investor with a tax credit against the investor’s federal tax liabilities at a fixed percentage of the bond’s pre-tax coupon. While there are many types of tax-credit bonds currently available,¹⁷² the types proposed in the legislation discussed above set the tax-credit level at 25 percent of the issuer’s interest costs¹⁷³ and would include the credit amount in the investor’s gross income.¹⁷⁴ Because the tax credit itself is taxed, the municipal issuer must provide a slightly higher interest rate than it would if it were receiving a “direct payment” subsidy of the same rate as the tax credit.¹⁷⁵ As a result, because the investor’s net tax savings will be less than the amount of the tax credit, the tax credit does not reduce the issuer’s borrowing costs at the same rate as the subsidy,¹⁷⁶ resulting in a slightly less efficient federal tax expenditure system than the “direct payment” option, but a more efficient system than tax-exempt bonds.

Under the third type of proposal, “direct payment” bonds would be an alternative to, but would not replace, tax-exempt bonds.¹⁷⁷ Consequently, the inefficiencies of the tax-exempt system would remain, but would be diminished to the extent that the “direct payment” bonds displaced tax-exempt financing of public projects. Additionally, legislation similar to President Obama’s American Jobs Act might reduce the inefficiencies inherent in tax-exempt bonds by limiting the amount of income an investor may claim as tax exempt.¹⁷⁸

On balance, replacing tax-exempt bonds with “direct payment” or “tax-credit” bonds results in a more efficient federal tax expenditure, suggesting that the first two types of legislative proposals are more optimal than the

171. See Manchester, *supra* note 36, at 1833–34. Nonetheless, some argue that even the “direct payment” subsidy is not completely efficient because the federal government expends resources on implementing the subsidy. See Yamamoto, *supra* note 154, at 189.

172. See, e.g., MAGUIRE, *supra* note 94, at 1–2.

173. S. 727 112th Cong. § 111 (2011) (Wyden-Coats proposal).

174. See I.R.C. § 54A(f) (2012); see also MAGUIRE, *supra* note 36, at 4.

175. See generally MAGUIRE, *supra* note 36, at 4; see also IRB REPORT, 2009-16 I.R.B. 801, 835. In setting the interest higher on “tax-credit” bonds, the issuer makes the after-tax interest earnings competitive with unsubsidized taxable bonds of similar risk and maturity by compensating the investor for the portion of the tax credit the investor does not realize due to the income tax.

176. See MAGUIRE, *supra* note 36, at 4.

177. See *supra* Part III.C.

178. See *supra* Part III.C. Presumably, such a cap would function similarly to a tax-credit bond, but would avoid the double taxation in the tax-credit system (where the investor is taxed on the bond interest and the tax-credit amount). However, it is unclear whether these “limited tax-exempt” bonds proposed in the American Jobs Act would be sellable without also increasing the coupon payable to the investor to compensate for any decreased demand from investors in the upper tax brackets.

third type of proposal. However, it is possible that using a more limited form of tax-exempt bond, such as that proposed in President Obama's American Jobs Act, could also result in a more efficient federal tax expenditure system without eliminating the traditional tax-exempt bond.

B. VERTICAL AND HORIZONTAL EQUITY

Although theoretical notions of vertical and horizontal equity present a danger of exaggerating equities or inequities if viewed in isolation from the tax system as a whole,¹⁷⁹ vertical and horizontal equity nonetheless remain important criteria for evaluating discrete tax proposals, especially those that contemplate sweeping change.¹⁸⁰ Vertical equity exists "when persons in unequal situations are differentiated in an appropriate manner."¹⁸¹ Horizontal equity exists "when taxation on income is applied equally to those with equal incomes."¹⁸²

1. Vertical Equity

In the clearest sense, vertical equity is violated when the tax system treats two taxpayers in different tax brackets differently (e.g., when individuals in higher tax brackets pay a disproportionately small amount of tax, relative to their wealth, than do individuals in lower tax brackets).¹⁸³ The tax-exempt municipal bond system most vividly demonstrates this violation of vertical equity. Due to the windfall tax-exempt municipal bonds provide investors in tax brackets higher than the market-clearing investor, taxpayers in the highest tax brackets receive the greatest amount of tax benefit.¹⁸⁴ "Direct payment" municipal bonds, such as those proposed in the first type of legislative proposals, reduce the vertical inequities inherent in the tax-exempt system because investors in different tax brackets pay income taxes according to their individual levels of income, comparable to what they would pay on any other unsubsidized taxable corporate bond. Thus, "direct payment" bonds remove the windfall to the upper tax brackets that make tax-exempt bonds vertically inequitable.¹⁸⁵

Nevertheless, while "tax-credit" municipal bonds do not pose the same degree of vertical inequity posed by tax-exempt bonds, "tax-credit" bonds may still violate principles of vertical equity. For example, a "tax-credit" bond would violate vertical equity if and to the extent that: (1) the tax credit

179. See Jenn, *supra* note 164, at 555–56, 558.

180. See *id.* at 554.

181. Yamamoto, *supra* note 154, at 179.

182. *Id.* at 178–79.

183. See Jenn, *supra* note 164, at 555.

184. See Yamamoto, *supra* note 154, at 179–80. See also *supra* Part II.B.1.

185. See Yamamoto, *supra* note 154, at 189.

exceeds the taxpayer's tax liability;¹⁸⁶ or (2) the tax credit is itself exempt from taxes and investors are permitted to deduct the tax credit's value from their taxable income.¹⁸⁷ Yet, the first problem may be remedied by giving the investor in the lower tax bracket the ability to refund the tax credit for cash or other value because each investor would be able to take the same amount of tax credit regardless of their tax brackets.¹⁸⁸ Likewise, the second problem would not be vertically inequitable if the tax credits were themselves taxable because the amount of the deduction would be proportional to each investor's tax rate. For example, legislation similar to the Wyden-Coats proposal does not suffer from the second problem because the tax credits are themselves taxable under I.R.C. § 54A(f).¹⁸⁹ Therefore, even if the "tax-credit" bonds found in the second type of legislative proposals suffer from one or both of these two problems, such problems may be fixed, and, if remedied, would result in a more vertically equitable system of federal tax expenditures.¹⁹⁰

Finally, even though tax-exempt municipal bonds clearly violate principles of vertical equity, President Obama's American Jobs Act would at least mitigate such inequity by capping the amount of interest income otherwise excludable from taxes.¹⁹¹ Capping the tax-exemption on traditional bonds eliminates the "windfall" generated by an unregulated tax-exempt municipal bond system and creates a more vertically equitable tax expenditure because all investors would be subject to the same cap regardless of their respective tax brackets. Thus, all three types of legislative proposals would increase vertical equity above the current tax-exempt system, though the second and third types must satisfy certain contingencies to ensure the same level of vertical equity available in a pure "direct payment" system.¹⁹²

186. An investor in a lower tax bracket might not be able to take advantage of the full value of the tax credit if that investor's tax liabilities are less than the tax credit. *See Jenn, supra* note 164, at 557.

187. Here, the value to an investor in a higher tax bracket (investor R) of excluding a taxable tax credit from income taxes is greater than the value an investor in a lower tax bracket (investor P) would obtain from taking the same deduction because investor R is taxed at a higher rate, allowing investor R to avoid a greater amount of tax liability than would investor P. *See id.* at 557.

188. *See id.*

189. S. 727, 112th Cong. § 111(a) (2009).

190. *See id.*

191. *See Hume, supra* note 163.

192. The second type of proposal would have to make tax credits refundable in the event that a taxpayer's tax liability was less than the amount of the tax credit, and would have to make the tax credit taxable. *See supra* notes 186–89 and accompanying text. The third type of proposal must reduce or eliminate the windfall to the upper tax bracket generated by tax-exempt bonds, much like the American Jobs Act would. *See supra* note 191 and accompanying text.

2. Horizontal Equity

Horizontal equity is violated when taxpayers with identical incomes incur unequal tax liabilities, as would happen when one investor invests in a tax-exempt bond and another investor with an identical income invests in a taxable bond.¹⁹³ Thus, the current municipal bond system violates horizontal equity because two taxpayers in the same tax bracket would incur different tax liabilities depending on whether they bought taxable or tax-exempt bonds. In contrast, the first and second types of legislative proposals—which would replace tax-exempt municipal bonds with “direct payment” or “tax-credit” bonds, respectively—would eliminate horizontal inequity because all investors who pay taxes would be taxed proportionately to their income.¹⁹⁴ Likewise, even though the third type of legislative proposal would maintain both taxable and tax-exempt bonds, President Obama’s cap on tax-exempt income on traditional tax-exempt municipal bonds might reduce the horizontal inequity normally present in the current municipal bond tax system because all investors with tax liability would be subject to the same ceiling on the tax exemption. Thus, on balance, the first two types of legislative proposals would go the furthest in eliminating horizontal inequity, while the third type of proposal would reduce horizontal inequity to the extent it included a cap on tax-exempt interest on municipal bonds.

C. MARKET VOLATILITY

As we have observed in the years following the subprime mortgage crisis, market volatility can have a negative impact on municipal issuers.¹⁹⁵ Issuers’ uncertainty about future funding increases the amount of interest demanded by investors to account for this risk, making it more expensive for municipal governments to raise capital.¹⁹⁶ Market volatility may be reduced by increasing demand for municipal bonds, which may be achieved by increasing the number of potential investors.¹⁹⁷ Increased demand lessens municipal issuers’ financial uncertainty, which reduces interest demanded by investors, and hence, lowers the cost of borrowing for municipal governments.¹⁹⁸ As seen in Part II, “direct payment” BABs increased and diversified the investor pool by appealing to “tax-indifferent” investors,¹⁹⁹ which gave municipal governments access to the much larger

193. See Yamamoto, *supra* note 154, at 179.

194. See *id.* at 189.

195. See *supra* Parts I.B. and III.

196. See Pollard, *supra* note 2, at 192–93.

197. See Manchester, *supra* note 36, at 1827.

198. See *id.*

199. See *supra* Part II.B.2.

taxable bond market.²⁰⁰ Additionally, “tax-credit” municipal bonds—which otherwise would not appeal to “tax-indifferent” investors—could also widen the investor pool if such “tax-indifferent” investors could “strip” the tax credit from the “tax-credit” municipal bond for resale to investors with tax liability.²⁰¹ As such, “direct payment” and “tax-credit” tax expenditure systems benefit the municipal bond market by helping reduce market volatility by increasing demand in a way that the traditional tax-exempt market could not do on its own.

Yet, the first and second types of legislative proposals give with one hand while taking away with the other: while both types expand the investor base by making municipal bonds taxable, they also constrict the investor base by eliminating the traditional tax-exempt market.²⁰² In so doing, these proposals could decrease demand, which would contribute to increasing market volatility and, with it, municipal governments’ cost of raising capital. Additionally, to the extent that the first two types of proposals extend the BAB program without a corresponding expansion of BABs’ uses, municipal issuers would be denied access to the municipal bond market for a number of important capital needs,²⁰³ further restricting their access to the capital markets. Therefore, while all three types of proposals would reduce market volatility by giving municipal governments access to the taxable bond market, this reduction would be limited to the extent that the first proposal would displace “tax adverse” investors and to the extent that both the first and the second proposals would restrict the uses to which municipal governments could put the taxable bonds to work.

D. CONSTITUTIONALITY

In 1895, the U.S. Supreme Court in *Pollock v. Farmer’s Loan & Trust Co.* invalidated on constitutional grounds a federal tax imposed on interest on state bonds.²⁰⁴ Commentators have reasoned that the Court used the doctrine of “reciprocal intergovernmental tax immunity”²⁰⁵ to uphold the federalist principle, beginning in *McCulloch v. Maryland* and later expanded upon in *Collector v. Day*, that both state and federal governments are each immune from taxes levied by the other due to their separate and

200. The taxable bond market is approximately \$30 trillion, whereas the traditional tax-exempt municipal market is approximately \$2.8 trillion. See TREASURY ANALYSIS, *supra* note 9, at 3–4.

201. See MAGUIRE, *supra* note 94, at 5.

202. See *supra* Part III.C. However, “tax adverse” investors would not be completely shunned in a “tax-credit” system. In order to take advantage of the tax credits, an investor would have to have tax liability.

203. For a description of restrictions placed on BABs within the Internal Revenue Code, see *supra* Part II.A.

204. *Pollock v. Farmer’s Loan & Trust Co.*, 157 U.S. 429, 583, 586 (1895).

205. See Yamamoto, *supra* note 154, at 163 n.86.

inviolable sovereign powers.²⁰⁶ Although the Sixteenth Amendment later permitted the federal government to tax “all income from whatever source derived,”²⁰⁷ Congress nevertheless was hesitant to tax interest on state and local bonds for fear of violating the federalist principles of the Constitution and passed the first federal income tax exemption for interest on state bonds.²⁰⁸

Commentators now suggest that the principal constitutional concern implicated by a federal tax on municipal bond interest is not that the federal government is without the power to do so, but rather that taxing municipal bonds would undermine federalist principles inherent in the Constitution and could lead to a gradual erosion of state sovereignty.²⁰⁹ Framed in this way, a federal income tax on municipal bonds would be problematic because the federal government would start down a path of controlling the states’ power of the purse, a power that should not be exercised by the federal government except for compelling reasons.²¹⁰

Starting with the premise that a federal tax on municipal bonds should be avoided if possible, the first and second legislative proposals—eliminating tax-exempt bonds altogether—seem at odds with the federalist teachings of *Day* and *McCulloch*. Indeed, commentators cite the fear that the federal government gains too much control over state and local spending through “tax-credit” or “direct payment” municipal bonds because investors and issuers rely on the federal government to set a fair subsidy rate and run the risk of retroactively losing their subsidies through tax setoffs or noncompliance with arbitrage rules.²¹¹ The third type of legislative proposal, however, would avoid treading on state sovereignty by retaining tax-exempt municipal bonds and offering “direct payment” municipal bonds to supplement the existing tax-exempt market. Finally, a proposal similar to President Obama’s American Jobs Act would fall

206. See *id.* at 162–65. In *Collector v. Day*, the Court struck down a federal tax on a state judge’s salary, reasoning that the states and the federal government may not be taxed by each other. *Collector v. Day*, 78 U.S. 113, 124 (1870).

207. “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and with regard to any census or enumeration.” U.S. CONST. amend. XVI.

208. See Yamamoto, *supra* note 154, at 165–66.

209. See *id.* at 191.

210. See *id.* at 191–93 (“[A]lthough Congress may create laws that upset the balance of power between the states and federal government, it should not create laws that impede federalism principles unless it has no better choice.”).

211. See Nicole C. O’Neal, *Build America Bonds: A Catalyst for the US Bond Market*, 29 BANKING & FIN. SERVICES POL’Y REP. 19, 20–21 (2010); Elana Schor, *Behind Build America Bonds’ Popularity, Some Lurking Concerns*, THE WASH. INDEP. (Mar. 29, 2010, 6:00 AM), <http://washingtonindependent.com/80724/behind-build-america-bonds-popularity-some-lurkingconcerns> (noting concern that the federal government might reduce subsidy levels in times of fiscal stress); Michael McDonald, *Build America with Obama Bonds Signals Munis’ Fall (Update1)*, BLOOMBERG (June 25, 2009, 10:55 AM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQqI3SKPm.t4>.

somewhere between the first two proposals and the third type of proposal because investors would not have to completely rely on the federal government to provide fair federal subsidies (by retaining tax-exempt bonds), but would begin eroding state sovereignty by limiting the amount of income on municipal bonds that may be exempted from taxes.

CONCLUSION

The years following the subprime mortgage crisis placed tremendous strain on municipal governments' abilities to raise capital in the municipal bond market.²¹² Through the BAB program, the federal government provided municipal issuers with the option of a subsidized taxable bond to supplement existing tax-exempt municipal bonds. This gave issuers a powerful new method of raising capital²¹³ while saving the federal government substantial tax revenue by delivering a more efficient federal subsidy to municipal issuers.²¹⁴ While a number of politicians would create a subsidized taxable municipal bond system similar to that in the BAB program, not all proposals are created equally. Wholesale replacement of the tax-exempt market with taxable bonds may have the virtue of eliminating a tax-exempt system widely criticized as being inefficient and inequitable, but runs the risk of displacing investors from the municipal bond market.²¹⁵ Furthermore, such proposals create the possibility of increasing market volatility and eroding principles of state sovereign immunity under the U.S. Constitution.²¹⁶ To date, only President Obama's proposals embrace the virtues of the BAB program—greater efficiency, equity, and market access—but avoid the problems associated with a wholesale elimination of the tax-exempt municipal bond.

The tax exemption given to interest earned on municipal bonds is one of the last remaining bulwarks guarding against the gradual erosion of states' sovereign power to raise capital. Thus, despite its flaws, the tax-exemption system should be retained, albeit in a limited form, and supplemented with a subsidized taxable bond. As the American Jobs Act suggests, the inefficiencies and inequities that persist in the traditional tax-exempt municipal bond system might be offset by limiting the windfall to investors in the upper tax brackets by capping the amount of income exempt from federal taxes. Overall, in creating a more workable tax expenditure system for municipal bonds, I believe that supplementing the traditional tax-exempt municipal bond market with subsidized taxable bonds, much like President Obama's proposals, best walks the line between

212. *See supra* Part I.B.

213. *See supra* Part II.B.

214. *See supra* Parts II.B.1 and IV.A.

215. *See supra* Part IV.

216. *See supra* Parts IV.C and IV.D.

upholding principles of state sovereignty and creating a more efficient, equitable, and stable municipal bond market.

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* B.S. University of California, Irvine, 2006; J.D. candidate, Brooklyn Law School, 2013. I would like to thank Amy Craiger, Janine Stanisz, and Nidhi Geevarghese for their patience and guidance throughout the note-writing process. Additionally, I thank the entire staff of the Brooklyn Journal of Corporate, Financial & Commercial Law, whose hard work made this issue possible. Finally, I give special thanks to my family for their ongoing and unconditional love and support.